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The first edition of Corporate Insolvency Law proposed a fundamentally revised concept of insolvency law – one intended to serve to corporate as well as broader social ends. This second edition takes on board a host of changes that have subsequently reshaped insolvency law and practice, such as the consolidation of the rescue culture in the UK, the arrival of the ‘pre-packaged’ administration and the broad replacement of administrative receivership with administration. It also considers the implications of recent and dramatic changes in the provision (and trading) of credit, the movement of an increasing amount of ‘insolvency work’ towards the pre-formal insolvency stage of corporate affairs and the explosion, on the insolvency scene, of a new cadre of specialists in corporate turnaround. Looking to the future, Vanessa Finch argues that changes of approach are needed if insolvency law is to develop with coherence and purpose and she offers a framework for such an approach.

Vanessa Finch is a Professor of Law at the London School of Economics and Political Science, where she teaches Corporate Insolvency Law and Corporate Accountability at undergraduate and master’s levels.
To Rob
and in memory of D.F.G. and M.A.G.
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ABBREVIATIONS

ABFA Asset Based Finance Association
ABS asset-backed security
ACCA Association of Chartered Certified Accountants
AR administrative receiver
ARA Assets Recovery Agency
BAPCPA Bankruptcy Abuse Prevention and Consumer Protection Act 2005
BBAA British Business Angels Association
BCCI Bank of Credit and Commerce International
BERR Department of Business Enterprise and Regulatory Reform
BVCA British Venture Capital Association
CA Companies Act 2006
CBI Confederation of British Industry
CDDA Company Directors’ Disqualification Act 1986
CDO collateralised debt obligation
CDS credit default swap
CFA conditional fee arrangement
CIB Companies Investigation Branch
CLRSG Company Law Review Steering Group
CVA Company Voluntary Arrangement
CVL Creditors’ Voluntary Liquidation
DIP debtor in possession
DTI Department of Trade and Industry
EA Enterprise Act 2002
EAT Employment Appeal Tribunal
ECHCR European Court of Human Rights
ECJ European Court of Justice
EEC European Economic Community
EHYA European High Yield Association
EIB European Investment Bank

xlviii
ERA Employment Rights Act 1996
ESRC Economic and Social Research Council
ETO economic, technical or organisational
FIRS Forensic Insolvency Recovery Service
FSA Financial Services Authority
FSB Federation of Small Businesses
FSMA Financial Services and Markets Act 2000
HMRC Her Majesty’s Revenue and Customs
HP hire purchase
HRA Human Rights Act 1998
IA Insolvency Act 1986
IBR independent business review
ICAEW Institute of Chartered Accountants of England and Wales
ICAI Institute of Chartered Accountants in Ireland
ICAS Institute of Chartered Accountants in Scotland
IFT Institute for Turnaround
ILA Insolvency Lawyers’ Association
IOD Institute of Directors
IP insolvency practitioner
IPA Insolvency Practitioners’ Association
IPC Insolvency Practices Council
IR Inland Revenue; Insolvency Rules
IRWP Insolvency Review Working Party
IS Insolvency Service
ISA Insolvency Services Account
IVA Individual Voluntary Arrangement
JIC Joint Insolvency Committee
JIEB Joint Insolvency Examining Board
JIMU Joint Insolvency Monitoring Unit
LPA Law of Property Act 1925
LS Law Society
LSS Law Society of Scotland
MBO management buyout
NAO National Audit Office
NBAN National Business Angel Network
NI national insurance
NIF National Insurance Fund
OFT Office of Fair Trading
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<tr>
<th>Abbreviation</th>
<th>Full Form</th>
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<tr>
<td>OR</td>
<td>Official Receiver</td>
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<tr>
<td>PAYE</td>
<td>pay as you earn</td>
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<tr>
<td>PCA</td>
<td>Parliamentary Commissioner for Administration</td>
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<td>PIK</td>
<td>payment in kind note</td>
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<td>PIL</td>
<td>public interest liquidation</td>
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<td>PIP</td>
<td>practitioner in possession</td>
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<td>PIU</td>
<td>Public Interest Unit</td>
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<td>PMSI</td>
<td>purchase money security interest</td>
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<td>PPF</td>
<td>Pension Protection Fund</td>
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<tr>
<td>QFC</td>
<td>qualifying floating charge</td>
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<td>QFCH</td>
<td>qualifying floating charge holder</td>
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<tr>
<td>R3</td>
<td>Association of Business Recovery Professionals</td>
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<td>RBS</td>
<td>Royal Bank of Scotland</td>
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<td>ROT</td>
<td>retention of title</td>
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<td>RPB</td>
<td>recognised professional body</td>
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<td>SBS</td>
<td>Small Business Service</td>
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<td>SFLGS</td>
<td>Small Firms Loan Guarantee Scheme</td>
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<td>SIP</td>
<td>Statement of Insolvency Practice</td>
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<td>SMEs</td>
<td>small and medium enterprises</td>
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<td>SPI</td>
<td>Society of Practitioners in Insolvency</td>
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<td>SPV</td>
<td>special purpose vehicle</td>
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<td>SSP</td>
<td>statutory super-priority</td>
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<td>STP</td>
<td>Society of Turnaround Professionals</td>
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<tr>
<td>TMA</td>
<td>Turnaround Management Association</td>
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<td>TP</td>
<td>turnaround professional</td>
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<td>TQM</td>
<td>total quality management</td>
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<td>TUPE</td>
<td>Transfer of Undertakings (Protection of Employment)</td>
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<td>UCC</td>
<td>Uniform Commercial Code</td>
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<tr>
<td>UNCITRAL</td>
<td>United Nations Commission on International Trade Law</td>
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<td>VAS</td>
<td>Voluntary Arrangements Service</td>
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Introduction to the second edition

This book sets out to offer a critical appraisal of modern corporate insolvency law rather than a description of existing statutory rules and case law on the subject. It will nevertheless attempt to set out rules and procedures of corporate insolvency law in sufficient detail to facilitate understanding of the framework and operation of this area of law.

A critical approach is seen as essential here on the grounds that it is impossible to evaluate areas of the law, suggest reforms or develop the law with a sense of purpose unless there is clarity concerning the objectives and values sought to be furthered, the feasibility of operating certain procedures and the efficiency with which given rules or processes can be applied on the ground.

Insolvency is an area of law of increasing importance not merely in its own right but because it impinges on a host of other sectors such as company, employment, tort, environmental, pension and banking law. It is essential, therefore, that the development of insolvency law proceeds with a sense of purpose. If this is lacking, this area of law is liable to be marked by inconsistencies of reasoning and failures of policy, with the result that related legal sectors will also be adversely affected.

The book’s aims are threefold. The first is to outline the law on corporate insolvency (as at 31 May 2008) and the procedures and enforcement mechanisms used in giving effect to that law. Corporate insolvency law will be seen as raising important social, political and moral issues rather than viewed merely as a device for maximising returns for creditors. Questions of stakeholding, community interests and the concerns of employees and the public as well as creditors will thus be discussed.

The second aim is to set out a theoretical framework for corporate insolvency law that will establish benchmarks for evaluating that law and any proposed reforms. Those benchmarks will be applied throughout the volume. It will be consistently asked whether the laws and processes under discussion will serve the variety of values and ends suggested at the start of the book.

A third objective is to move beyond an appraisal of current laws and processes and to consider whether new approaches to insolvency
institutions and rules are called for: in other words, to see whether improvements have to be sought by adopting new perspectives; by changing approaches in response to developments in commercial and credit markets; and by challenging the assumptions that underpin present corporate insolvency regimes. The focus here is on domestic corporate insolvency law. Space does not allow an appraisal of the European Council Regulation on Insolvency Proceedings\(^1\) or of international and cross-border issues\(^2\) as individual topics (these are areas that have been dealt with specifically by others, though mention will be made of non-UK or international insolvency laws and processes that are of relevance to questions under discussion).\(^3\)

Since the first edition of this book was published in 2002, a number of important changes have taken place both within corporate insolvency

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law and in the business and credit worlds. As will be detailed further in chapter 1, the rescue culture has become further embedded within the UK insolvency culture so that an increased stress is placed on dealing with insolvency risks at the earliest stages of corporate difficulties. Part of this process involves the greater use of ‘pre-packaged’ arrangements that deal with problems well in advance of entry into any formal insolvency procedure. New types of specialist adviser now play a role in such negotiations and they supplement the work done by the insolvency practitioners who formerly dominated this area of activity.

Legal procedures have also changed markedly, with the Enterprise Act 2002 largely replacing administrative receivership with a revised administration process; offering greater protection for unsecured creditors (by means of a ‘prescribed part’ fund); and removing the Crown’s status as a preferential creditor. For their part, the courts have contributed to change by deciding such landmark cases as Spectrum Plus and Leyland DAF, which have impacted significantly on financing possibilities.

As will also be discussed in more detail below, the credit crisis of 2007–8 has highlighted the extent to which debt arrangements have shifted remarkably in recent years – and in ways that present dramatic new challenges for those involved with insolvency processes and with corporate rescue. Borrower-to-lender relationships have become vastly more complex and less transparent than was traditionally the case and creditors’ incentives to intervene in, or monitor, management were reduced (most markedly in the lead up to the credit crisis) as it became ever easier to deal with insolvency risks by trading in packages of debt rather than by instigating reforms within the corporation. Such changes in the debt markets have involved significant adjustments in the roles played by different parties and organisations. The major banks, for instance, can no longer be assumed to lie at the heart of the credit supply or managerial discipline processes and greater attention has to be paid to the implications of financing by means of such sources as the bond markets and hedge funds.

These and further changes both bring insolvency law into increasingly close contact with other areas of law and make the study of insolvency laws and processes more interesting than at any time before. It is clearer than ever that insolvency law and procedure is of relevance not merely to insolvent and distressed companies but also to those companies that are concerned to manage their financial risks according to best practice.

The framing structure of this volume remains as found in the first edition except that a new chapter 10 has been added in order to discuss
the advent of the ‘pre-packaged’ administration. Many additions and revisions have, however, been included in this new edition. It is hoped that these will assist in both updating the discussion and in reorienting it towards the many new challenges that insolvency law now confronts.

Part I of the book deals with agendas and objectives. Chapter 1 discusses the principal concerns of corporate insolvency law and considers the set of major issues that confront corporate insolvency law. Chapter 2 examines the values and aims sought to be furthered in this area. It is this chapter that identifies the benchmarks already referred to.

Part II is concerned with the financial and institutional context within which corporate insolvency laws and processes play a role. The problems with which corporate insolvency law has to come to grips cannot be fully understood without an appreciation of the legal regimes that govern corporate structures and borrowing. Chapter 3, accordingly, examines corporate borrowing, its continuing development and the rapid movement towards more complex and fragmented credit structures and markets. Other matters dealt with are the nature of security interests, fixed and floating charges, and different types of creditor. Chapter 4 looks at the nature and causes of corporate failure and the ways in which the law decides that a company is ‘insolvent’, and Chapter 5 moves to the administrative framework and the role of insolvency practitioners, the Insolvency Service and turnaround professionals.

Corporate insolvency law is not merely concerned with the death and burial of companies. Important issues are whether corporate difficulties should be treated as terminal and whether it is feasible to mount rescue operations. Part III reviews processes for attempting to avert corporate death and liquidation. Chapter 6 considers the challenge of corporate rescue, the reasons for attempting rescue, the development of the UK’s focus on rescue and rescue proceedings and approaches in other jurisdictions (including the US Chapter 11 strategy). It discusses the nature and implications of the recent shift towards seeing corporate troubles as matters to be anticipated rather than reacted to. Chapter 7 deals with rescue mechanisms (such as negotiated settlements) that avoid resort to formal insolvency procedures as provided under insolvency legislation. Chapters 8, 9, 10 and 11 consider different aspects of the formal rescue procedures: administrative receivership; administration; and company voluntary arrangements (including schemes of arrangement). Chapter 9 has been substantially rewritten since the first edition in order to take account of the Enterprise Act 2002 and its establishment of a new administration procedure. Chapter 10 is new to this edition and develops
the discussion of administration by examining the emergence of the ‘pre-packaging’ process and the use of negotiations and agreements that anticipate resort to this procedure. Chapter 12 offers an overview and evaluation of rescue procedures and reviews proposed improvements.

Part IV is concerned with the process of liquidating companies. Chapter 13 deals with gathering in the assets of an insolvent company, the nature and scope of the winding-up process, the liquidator’s role, the special issues raised by corporate groups and the parts played by the courts, directors and creditors in liquidation. Chapter 14 focuses on the \textit{pari passu} principle and its place in the process of distributing assets. Chapter 15 discusses devices that are intended to gain, or have the effect of gaining, priority and bypass the \textit{pari passu} principle.

When a corporate failure occurs, this may have a dramatic impact on the lives, interests and employment prospects of a number of parties. It is important to understand the nature of these potential effects in considering how corporate insolvency law should be developed. Part V thus looks at the repercussions of insolvency. Chapter 16 reviews the implications of a corporate collapse for company directors, considers the incentives under which directors operate in times of crisis and also assesses rationales underpinning the law’s treatment of directors in this context. Chapter 17 looks to employees and asks how and why their interests should be considered when companies are in mortal peril. Further issues are whether employees should be seen as having interests other than financial ones and the extent to which efficiency considerations should be tempered with reference to other objectives, such as security of employment.

Finally, chapter 18, the Conclusion, offers more general observations.
PART I

Agendas and objectives
The roots of corporate insolvency law

In a society that facilitates the use of credit by companies\(^1\) there is a degree of risk that those who are owed money by a firm will suffer because the firm has become unable to pay its debts on the due date. If a number of creditors were owed money and all pursued the rights and remedies available to them (for example, contractual rights; rights to enforce security interests; rights to set off the debt against other obligations; proceedings for delivery, foreclosure or sale) a chaotic race to protect interests would take place and this might produce inefficiencies and unfairness. Huge costs would be incurred in pursuing individual creditors’ claims competitively\(^2\) and (since in an insolvency there are insufficient assets to go round) those creditors who enforced their claim with most vigour and expertise would be paid but naïve latecomers would not.

A main aim of insolvency law is to replace this free-for-all with a legal regime in which creditors’ rights and remedies are suspended and a process established for the orderly collection and realisation of the debtors’ assets and the fair distribution of these according to creditors’ claims. Part of the drama of insolvency law flows, accordingly, from its potentially having to unpack and reassemble what were seemingly concrete and clear legal rights.

Corporate insolvency law, with which this book is concerned, is now a quite separate body of law from personal bankruptcy law although these have shared historical roots. Those roots should be noted, since the shape of modern corporate insolvency law is as much a product of past history and accidents of development as of design.

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\(^1\) See Cork Report: *Report of the Review Committee on Insolvency Law and Practice* (Cmnd 8558, 1982) ch. 1; see ch. 3 below.

Development and structure

The earliest insolvency laws in England and Wales were concerned with individual insolvency (bankruptcy) and date back to medieval times. Early common law offered no collective procedure for administering an insolvent’s estate but a creditor could seize either the body of a debtor or his effects – but not both. Creditors, moreover, had to act individually, there being no machinery for sharing expenses. When the person of the debtor was seized, detention in person at the creditor’s pleasure was provided for. Insolvency was thus seen as an offence little less criminal than a felony. From Tudor times onwards, insolvency has been driven by three distinct forces: impulsons to punish bankrupts; wishes to organise administration of their assets so that competing creditors are treated fairly and efficiently; and the hope that the bankrupt would be allowed to rehabilitate himself. Early insolvency law was dominated by punitive approaches and it was not until the early eighteenth century that notions of rehabilitation gained force. The idea that creditors might act collectively was recognised in 1542 with the enactment of the first English Bankruptcy Act which dealt with absconding debtors and empowered any aggrieved party to procure seizure of the debtor’s property, its sale and distribution to creditors ‘according to the quantity of their debts’. This statute did not, however, provide for rehabilitation in so far as it did not discharge the bankrupt’s liability for claims that were not fully paid.

Elizabethan legislation of 1570 then drew an important distinction between traders and others, including within the definition of a bankrupt only traders and merchants: those who earned their living by ‘buying and selling’. Non-traders could thus not be declared bankrupt. As for

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4 See Cornish and Clark, Law and Society, p. 231.


distribution, this statute again provided for equal distribution of assets among creditors.

Discharge of a bankrupt’s existing liabilities came into the law in the early eighteenth century when a 1705 statute relieved traders of liability for existing debts. This restriction of discharge to traders prompted a good deal of litigation throughout the eighteenth and early nineteenth centuries and an expansion of the definition of a trader. On why bankruptcy should have been restricted to the trader, contemporary and modern commentators\(^7\) have followed Blackstone\(^8\) in referring to the risks that traders run of becoming unable to pay debts without any fault of their own and to the trading necessity of allowing merchants to discharge debts. It can be pointed out that long before a general law of incorporation arrived (in the mid-nineteenth century), bankruptcy served as almost a surrogate form of limited liability which needed to be restricted to those undertaking mercantile endeavours and risks. The bankruptcy legislation, moreover, provided the only means by which eighteenth- and early-nineteenth-century traders might limit their liabilities.

The state of the law was, however, deficient in many respects. Non-traders were still subject to the severities of common law enforcement procedures by means of seizures and impoundings of property and persons. These processes were non-collective and debtors might be imprisoned at the behest of single creditors without regard to the interests of others. An important difference between the bankruptcy laws available to traders and the insolvency schemes for non-traders was that whereas the bankrupt’s liabilities to creditors could be discharged on surrender of assets (even if these assets were insufficient to satisfy his entire debt), the insolvent non-trader was still obliged to repay the remainder of his judgment debt even though he had suffered seizure of his goods or served his term of imprisonment. Even traders could not apply of their own accord to be made bankrupt and, although discharge was possible after 1705, the law criminalised bankrupt traders and punished them severely, with the death penalty available in cases of

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fraud. The bankruptcy system, moreover, was liable to manipulation by creditors and laid open to the ‘eighteenth century penchant for malign administration’. Nor was it the case that all traders were in practice brought within bankruptcy proceedings. The Erskine Commission of 1840 noted that the common law insolvency processes were frequently being used for small traders whose creditors were owed too little to justify bankruptcy proceedings (two-thirds of those before the Insolvent Debtors Court in 1839 were traders).

Pressure for reform grew alongside dissatisfaction with the confinement of bankruptcy to traders. During the nineteenth century, attitudes towards trade credit and risk of default changed. A depersonalisation of business and credit was encouraged by Parliament’s enactment of the Joint Stock Companies Act 1844 together with notions that credit might be raised on an institutional basis and capital through stocks rather than both of these dealt with as matters of individual standing. Such changed attitudes rendered increasingly questionable Blackstone’s view that it was not justifiable for any person other than a trader to ‘encumber himself with debts of any considerable value’. The distinction between traders and non-traders was finally abolished in 1861 when bankruptcy proceedings became available for non-traders. Soon afterwards the Debtors Act 1869 abolished imprisonment for debt.

The origins of corporate insolvency law are to be found in the nineteenth-century development of the company. The key statute was the Joint Stock Companies Act 1844 which established the company as a distinct legal entity, although it retained unlimited liability for the shareholders. From 1844 onwards corporate insolvency was dealt with by means of special statutory provisions and the modern limited liability company emerged in 1855, to be followed seven years later by the first modern company law statute containing detailed winding-up provisions. Only from 1855 onwards, therefore, was the concept of the limited liability of members for the debts incurred by the company established in law. Members of incorporated companies could limit

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9 See Cork Report, paras. 37–8; Fletcher, Law of Insolvency, pp. 8–9.
10 Cornish and Clark, Law and Society, p. 232.
11 Ibid., p. 234.
12 On depersonalisation of business and credit in the USA see Rubin and Sugarman, Law, Economy and Society, pp. 43–4.
14 See e.g. Companies Winding Up Act 1844; Joint Stock Companies Act 1856; Companies Act 1862; Companies (Consolidation) Act 1908; Companies Acts of 1929, 1948 and 1985.
15 Limited Liability Act 1855; Companies Act 1862.
their personal liability, thus creating a distinction between corporate and individual insolvency. The House of Lords in *Salomon v. A. Salomon & Co. Ltd* [1897] AC 22 confirmed that a duly formed company was a separate legal person from its members and that consequently even a one-man company’s debts were self-contained and distinct. The growth of a specialised corpus of law and procedures dealing with corporate insolvency was manifest in the dedicated statutes already noted but it was also encouraged when issues relating to such matters became the exclusive jurisdiction of the Chancery Court in 1862.17

Thus the law dealing with company insolvencies developed independently from the law on the bankruptcy of individuals. By the late nineteenth century two separate bodies of law governed individual and corporate insolvency matters and these were dealt with by different courts, under different procedural rules18 and offering different substantive remedies. A degree of cross-influence between personal bankruptcy and corporate insolvency is discernible, however, and a number of principles and provisions of personal bankruptcy have been made applicable to company liquidation.19

Such a bifurcation of approaches produced, during the first half of the twentieth century, a confused tangle of insolvency laws that was both difficult to operate and prone to manipulation by the unscrupulous. Various committees were set up to look at particular aspects of the law dealing with credit, security and debt20 but it was the mid-1970s before the deficiencies in insolvency law were attended to at the governmental level. In 1975, Justice issued a report21 pointing to a number of serious deficiencies in the law of bankruptcy and making a number of reform proposals, some of which were adopted in the Insolvency Act of 1976, a short piece of legislation that was passed to remedy a number of the most serious defects pending broader review. Further pressure to reassess insolvency law flowed from the UK’s accession to membership of the EEC. This demanded that the UK negotiate with other Member States concerning a draft EEC Bankruptcy Convention. In order to secure advice for the Department of Trade, an advisory committee was

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16 *Salomon v. A. Salomon & Co. Ltd* [1897] AC 22.
17 Companies Act 1862 s. 81. 18 See Fletcher, *Law of Insolvency*, p. 12.
20 See the Crowther Committee (Cmnd 4596, 1968–71) and the Payne Committee (Cmnd 3909, 1965–9).
appointed in 1973 under the chairmanship of Mr Kenneth Cork, as he then was. The resultant report stressed that a comprehensive review of insolvency was required, not only in order to participate in negotiations with other EEC Member States, but also because the state of the law demanded this. Thus prompted, Edmund Dell MP, the Labour Government’s Secretary of State for Trade, appointed a Review Committee on Insolvency Law and Practice in January 1977, with Kenneth Cork again serving as chairman. The Committee was asked to review, examine and make recommendations on: the law and practice relating to ‘insolvency, bankruptcy, liquidation and receiverships’; the possibility of formulating a comprehensive insolvency system; the extent to which existing procedures should be harmonised and integrated; and less formal procedures as alternatives to bankruptcy and company winding-up proceedings. The Cork Committee was not, however, asked to conduct a review of credit and security laws or remedies for debt enforcement, nor was provision made for the Committee to undertake an extended programme of research into the causes of company failure.

The Cork Report in final form was published in June 1982 at a time when the rate of business failures was at a record level. The 460-page document provided a sustained critique of contemporary law and practice and a set of recommendations constituting the foundations of modern insolvency law. The report argued for fundamental reforms, and central recommendations were, inter alia: that a unified insolvency code replace the array of statutes that made up two distinct branches of the law; that a unified system of insolvency courts be created to administer the law; and that a range of new procedures be introduced as alternatives to outright bankruptcy or winding up, which would deal

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23 Cork Report, p. 3. On the background to, and implementation of, Cork see Carruthers and Halliday, Rescuing Business, pp. 112–23.
with individual cases on their merits. On particular matters of substance concerning corporate insolvency, the Cork Committee’s key recommendations included steps to deal with abusive practices. These involved recommendations that private insolvency practitioners should be professionally regulated to ensure adequate standards of competence and integrity; that creditors be given a greater voice in the choice of the liquidator; and that new penalties and constraints be placed on errant directors. Cork also proposed reforms designed to increase the survival chances of firms in difficulties. He had informed the press, on the establishment of his committee, that many more companies could be saved if outside administrators could be brought into companies before the time when a bank would formally appoint a receiver and in circumstances when the company lacked a loan structure allowing the appointment of receivers.27 The Cork Report, in due course, introduced the concept of the ‘administrator’ into corporate insolvency procedures with the function of managing a company’s business during a period of grace in the hope of reorganising the company and restoring it to profitability. The report, furthermore, favoured a movement towards greater creditor participation with an increased role for creditor committees and strengthened access to information for such committees.

A special concern of Cork was the plight of the unsecured creditor, who generally received nothing at the end of the day. This concern was reflected in the recommendations that virtually all preferential claims28 be abolished and that funding representing 10 per cent of all net realisations of assets subject to a floating charge be made available for distribution among ordinary unsecured creditors.29 This fund was also designed to be utilised to provide liquidators with the financial resources to investigate company affairs and to take the actions that Cork proposed should be taken against delinquent directors.

The broad philosophy of Cork – as far as it related to corporate insolvency – represented a movement towards stricter control of errant directors but also in favour of an increasing emphasis on rehabilitation of the company. Cork might have thought that existing law dealt with individual bankrupts (perhaps sole traders) in an excessively punitive

28 See pp. 604–14 below.
29 On the Enterprise Act 2002 reform implementing a similar ‘prescribed part’ see ch. 3 below.
and stigmatic manner, but the Committee was determined to remedy the law’s perceived leniency in dealing with directors who abused the privilege of limited liability. In doing so, Cork aimed to bolster standards of commercial morality and to encourage the fulfilment of financial obligations.

As for rehabilitation, the Cork Committee aimed to devise an insolvency regime that would facilitate rescues rather than just process failures. Sir Kenneth Cork was to reflect on this philosophy in the autobiography he published six years after his seminal report. He wrote:

> through publication of the Cork Report, I have … put forward our principle that business is a national asset and, that being so, all insolvency schemes must be aimed at saving businesses. I have been at pains to stress that when a business becomes insolvent it provides an occasion for a change of ownership from incompetent hands to people who not only have the wherewithal but also hopefully the competence, the imagination and the energy to save the business. Before the 1985 Act every insolvent business went into liquidation or receivership automatically. It was the kiss of death for them and the creator of unemployment … With the concept of the administrator and voluntary arrangements taking its place in Britain’s insolvency law, the chances look bright for more and more businesses being saved in the years that lie ahead …

The Cork Report thus not merely provided the most comprehensive and rational review of English company insolvency rules ever undertaken but also flagged a historic movement away from punitive towards rehabilitative objectives.

The Report was not, however, to be instantly transposed into legislative form. It was not even made the subject of a formal debate in either House of Parliament. Four years passed before legislation delivered the unified code of insolvency law that Cork had advocated. This came with the Insolvency Act 1986. That statute was preceded by a 1984 White Paper and the Insolvency Act 1985, which together dealt with a variety of important aspects of insolvency but neither implemented the main body of Cork nor brought together in one Act all the statutory provisions relating to bankruptcy and those dealing with corporate insolvency. The Insolvency Act 1986 offered such an aggregation of measures dealing with the bankruptcy

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34 *A Revised Framework for Insolvency Law* (Cmnd 9175, 1984).
of individuals and the insolvency of companies. It consolidated the Insolvency Act 1985 and the insolvency provisions of the Companies Act 1985 (except in relation to the disqualification of directors).35

The Cork Report recommendations produced a sea change in English corporate insolvency and, as noted, can be seen as the foundations of modern corporate insolvency regimes. The Cork Committee had been established by a Labour Government but its recommendations were given legislative effect by Margaret Thatcher’s Conservative administration. The membership of the committee was, however, characterised by strong professional and practitioner rather than political representation.36 The Cork Report set out to be systematic, pragmatic and balanced: as seen in its efforts to recognise the interests of secured creditors (especially banks) and those of unsecured, trade creditors. The Cork approach to floating charges, for instance, was to acknowledge their effect in prejudicing weaker creditors’ interests but to stop short of alienating the banks by proposing abolition of such charges.37 As for the Insolvency Act 1986, this can be seen as strongly shaped by both professional and political factors. As Carruthers and Halliday put it:

[I]t is inconceivable that the [1986 Act] can be understood without comprehension of the powerful ideological undercurrents that variously sought to champion reorganisation, privatise bankruptcy administration, professionalise insolvency practice and discipline company directors. While professionals and their technical interests were persuasive in the English reforms, the particular cost of the insolvency reforms, and the very fact of the parliamentary passage, testified to the affinity between professional agendas and wider party ideology.38

As will be seen in subsequent chapters, however, the Cork Report was not implemented to the letter by the 1986 Act and, although the different branches of insolvency law were harmonised to a degree, the long-established distinction between corporate insolvency and personal bankruptcy law and procedures survived the passing of the Act. Sir Kenneth, moreover, was to be deeply concerned that the Government was selective in its approach to his recommendations, saying in his autobiography: ‘They

ended up by doing the very thing we asked them not to. They picked bits and pieces out of it so that they finished with a mish-mash of old and new.\(^\text{39}\)

What was reflected in the 1986 Act, however, was the (already noted) aim of Cork to produce a set of rules capable of practical implementation. Thus, in the Act there can be seen two strong threads of concern: to establish formal legal procedures for business rescue and the orderly realisation and distribution of assets and to erect a regulatory framework that would prevent commercial malpractice and abuse of the insolvency procedures themselves.

The operation of the Insolvency Act 1986 is a central concern of the chapters that follow. This piece of legislation has been through the fire of the 1989–93 economic recession and has been subject to review in a number of respects.\(^\text{40}\) The Enterprise Act 2002 effected a number of highly significant changes – most notably in largely replacing administrative receivership with the more inclusive arrangements of a revised administration process; in providing a ‘prescribed part’ fund for unsecured creditors; and in ending the Crown’s status as preferential creditor. The courts have also played their role in effecting change – with cases such as Spectrum Plus and Leyland DAF that have served either to change incentives to use different financing arrangements or to prompt the Government to make a legislative response on an issue.

In recent years, moreover, a number of dramatic changes have altered the landscape of corporate insolvency law and have transformed the assumptions that underpin the law and key processes of insolvency beyond those obtaining during the passing of the 1986 Act. Commercially and politically, there has, for instance, been a consolidation of the rescue culture within the UK and a new emphasis on managing insolvency risks proactively rather than after troubles have become crises. In comparison with the seventies and eighties, much more work on corporate problems is now carried out before any insolvency procedure is entered into. The ‘pre-packaged’


administration, for instance, is rapidly growing in popularity and involves agreements that are drawn up in advance of entry into administration. The insolvency practitioners who carried out most of the insolvency work in the wake of Cork have now been joined by new ranks of specialist advisers, ‘turnaround professionals’ and others who are concerned to assist in reconstruction and rescue operations. The banks themselves are equipped as never before with departments that are dedicated to the provision of ‘intensive care’ for troubled companies. Procedures have also become more collective in nature – notably since the Enterprise Act 2002 reforms.

The world of credit has, however, also changed dramatically in the last decade or so and this has created challenges for companies and their insolvency advisers that could hardly have been envisaged by the Cork Committee or the drafters of the Insolvency Act 1986. In the global world of the ‘new capitalism’, credit has become a commodity that is traded across the world in ever more complex packages of debt. This emergence of the credit derivative markets impacts on insolvency processes and corporate rescues in a number of ways – notably by rendering relationships between lenders and borrowers more distant and less transparent than formerly and by making it much easier for creditors to handle insolvency risks by resort to credit or loan default swaps rather than by exerting influence over the relevant corporate managers. Thus, on the one hand, the banks have become better equipped than ever before to monitor managerial performance and to assist companies with rescue efforts, but, on the other, they have embraced new market opportunities and incentives to shed their debt problems by trading in debt products. In the world of Cork and the 1986 Act, the major banks were assumed to play roles in relation to the provision of credit and managerial discipline that cannot be taken for granted in a world where they have often become facilitators of credit rather than main creditors and where corporations that seek finance will as readily look to bond markets and hedge funds as to banks.

Such developments have left the corporate insolvency stage occupied by a number of actors operating a variety of procedures in carrying out certain key tasks. To provide a basis for further discussion it may be helpful to outline these procedures and players.

**Corporate insolvency procedures**

There are five main statutory procedures that may come into play when a company is in trouble. Four of these are provided for in the Insolvency Act 1986, the fifth by the Companies Act 1985.
Administrative receivership

Before the coming into operation of the Enterprise Act 2002, a creditor who had lent money to a company and secured this by means of a floating charge over the whole or substantially the whole of the company’s assets could appoint an administrative receiver (AR). This individual had to be an insolvency practitioner (IP) and could take control of all assets subject to the security, so that he would effectively control the company. His primary duty was to his appointor and to realise the security and, after deducting his remuneration and expenses and paying prior-ranking creditors, he would pay the proceeds to his appointor up to the amount of the secured debt and pay any balance to subsequent ranking creditors, the company or its liquidator, if one had been appointed.

The Enterprise Act 2002 largely replaced receivership with administration and prohibited (subject to certain exceptions) the use of administrative receivership by the holders of floating charges. The general enforcement of floating charges thus falls to be carried out through the administration process – in which the administrator differs from the traditional receiver in having a duty to act, not in the interests of the appointor, but in the interests of the creditors as a whole. Receivership is not, however, wholly dead. Creditors with qualifying floating charges created before the Enterprise Act 2002, or those with charges that fall within the exceptions now set out in the Insolvency Act 1986, may still appoint administrative receivers and ‘ordinary’ receivers can still be appointed by debenture holders and by the courts.

Although ‘ordinary’ receivers may be appointed by the court, these appointments are comparatively rare. Where the option is available to them, lenders (normally banks) prefer to appoint receivers in pursuance of express powers contained in their security. Indeed, receivership historically is a creation of equity and is merely a method by which a secured

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41 See Insolvency Act 1986 s. 29(2); see also ch. 8 below.
42 See Insolvency Act 1986 s. 230(2); see also ch. 5 below.
43 On security and methods of borrowing generally, see ch. 3 below.
44 See Enterprise Act 2002 s. 250 inserting s. 72A–72G into the Insolvency Act 1986 and Sch. 2A. See further ch. 8 below.
45 The AR must be distinguished from other types of receiver appointed over a specific part of the company’s assets, for example Law of Property Act 1925 receivers. Such a receiver can be removed or replaced with little formality (the AR can only be removed by the court), he has no management powers and his task is to collect an income and apply it to keep down outgoings and mortgage interest.
creditor enforces his security. ‘Ordinary’ receivership is a private contractual remedy requiring no recourse to the court. Administrative receivership, however, has more of the appearance of a collective insolvency proceeding.\textsuperscript{46}

\textit{Administration}

This was a court-based procedure, first introduced by the Insolvency Act 1985 following the Cork Committee’s recommendations and emphasis on the benefits that could flow from having a corporate insolvency procedure that was designed specifically for corporate rescue rather than asset realisation; one, moreover, that focused on the interests of unsecured creditors and of the company itself rather than those of a specific secured creditor.\textsuperscript{47}

Revisions to the administration procedure (as now detailed in the Insolvency Act 1986, Schedule B1) were introduced by the Enterprise Act 2002 so as to provide a more streamlined process. Since the 2002 Act, a company can be put into administration by the court (on application by the company, its directors or one or more creditors); out of court on the application of a holder of a qualifying floating charge; or out of court on application by the company or its directors. The court must be satisfied that the company is, or is likely to be, unable to pay its debts before making an order appointing an administrator – except if the application is from the holder of a qualifying floating charge. After the changes of the 2002 Act, the administrator (in brief terms)\textsuperscript{48} is obliged to act with the objective of (a) rescuing the company as a going concern or (b) achieving a better than winding-up outcome for creditors as a whole or (c) realising property to distribute to one or more secured or preferential creditors. Objective (a) must be pursued unless this is not reasonably practicable or if (b) would offer a better result for creditors as a whole. Aim (c) is only to be pursued if (a) and (b) are impracticable. This appointee has the power on behalf of the company to do all things necessary for the management of the affairs, business and property of the company.

\textsuperscript{46} The Insolvency Act 1986 tends to treat it as such: see Insolvency Act 1986 ss. 388(1)(a), 230–7 (office holder), 42–3 and Sch. 1, paras. 44–5; but see F. Oditah, ‘ Assets and the Treatment of Claims in Insolvency’ (1992) 108 LQR 459 at 460–1.

\textsuperscript{47} See Cork Report, ch. 6, paras. 29–33, and ch. 9. Cork’s view was that the potential benefit of rescue via a receiver/manager should also be available to cases where there was no floating charge.

\textsuperscript{48} See ch. 9 below for details.
The most significant feature of administration is that it imposes a freeze (moratorium) on all legal proceedings and creditor actions against the company, including the enforcement of security, while the administrator seeks to achieve the purpose(s) for which the administration order was granted. The position of secured creditors is thus less protected than in receivership or liquidation as the freeze includes (unless the administrator or court consents) a prohibition on any action to enforce any security or any rights under hire purchase (HP), chattel leasing, conditional sale and retention of title agreements. In addition, the administrator can sell property free of security constituted by floating charges and (with the court’s consent) fixed charges and free of any rights of third parties under HP agreements or other agreements mentioned above. An administrative receiver cannot be appointed when the company is in administration and an AR in office must vacate. No winding up can take place while the administrator is in control, but administration is often followed by liquidation. As soon as reasonably practicable after appointment, and after a maximum of eight weeks (or such longer period as the court allows), the administrator must produce a statement of proposals for achieving the objectives of the administration and send this to all creditors of whose addresses he is aware. Proposals must then be submitted for approval to a creditors’ meeting. Once approved, the administrator must manage the company in accordance with those proposals unless he, or any interested party, applies to the court for variation or discharge of the administration order. Administration is, at least initially, a temporary measure and an administrator will automatically vacate office one year from the commencement of the administration unless this period is extended by the court or with the consent of creditors.

Winding up/liquidation

Liquidation is a procedure of last resort. It involves a liquidator being appointed to take control of the company and to collect, realise and distribute its assets to creditors according to their legal priority. Once the

49 An interim moratorium applies pending the disposal of an administration order application or the coming into effect of an out-of-court appointment of an administrator: Insolvency Act 1986 Sch. B1, para. 44.
50 In each case the security will attach to the proceeds of sale and the administrator, when dealing with fixed charges, must account for any shortfall between those proceeds and the market value at the time of sale.
51 Sch. B1, paras. 43(6A), 41(1). 52 See Sch. B1, para. 42(2)(3) and ch. 13 below.
process has been completed, the company is dissolved: liquidators have no powers to carry on the company’s business except for the purpose of winding up. There are two routes to liquidating an insolvent company: a creditors’ voluntary liquidation and a compulsory liquidation. The former process involves a resolution of the shareholders to put the company into voluntary liquidation, followed by a creditors’ meeting to appoint a liquidator and establish a liquidation committee whose members are principally creditors’ representatives. The liquidation committee has a supervisory role over the liquidator, while he collects in and realises the company’s assets, ascertains claims, distributes dividends to creditors and investigates the causes of the company’s failure. The creditors’ voluntary liquidation is the most frequently used of the insolvency procedures.

Compulsory liquidation is liquidation by order of the court and is the only method by which a creditor can initiate winding up. A winding-up petition can be presented by a creditor, the directors, the company shareholders and, in certain circumstances, the Department of Trade and Industry (DTI). The petition to the court has to be based on one or more specific grounds stated in section 122 of the Insolvency Act 1986, including the inability of the company to pay its debts. If a winding-up order is made, the Official Receiver becomes liquidator, unless and until the creditors’ meeting appoints an insolvency practitioner in his place (i.e. if the company’s assets are sufficient to pay the liquidator’s remuneration and expenses). Generally compulsory liquidation is subjected to a greater degree of court control than a creditors’ voluntary liquidation, but in both methods interested parties can apply to the court to determine questions arising in the winding up or to confirm, reverse or nullify the liquidator’s decisions.

Formal arrangements with creditors

Companies in distress may be able to negotiate settlements on a variety of terms and such agreements may operate within a statutory format or informally and contractually between the company, its lenders and possibly even general creditors. These agreements may defer payments

55 Insolvency Act 1986 Sch. 4, para. 5.
56 Companies may also be wound up by the BERR or FSA in the public interest, e.g. to stop enterprises trading where they engage in practices that defraud customers and swindle the vulnerable: see ch. 13 below.
57 The Official Receiver is not to be confused with a receiver or administrative receiver appointed by a secured creditor.
58 See ch. 7 below.
or postpone collection (a moratorium); they may agree to pay sums less than those due (a composition); or to pay a designated sum where there is doubt about the quantum or enforceability of a claim (a compromise).

Formal, statutory arrangements or compromises may be made principally under section 895 of the Companies Act 2006 and ‘compositions in satisfaction of [the company’s] debts or a scheme of arrangement of its affairs’, termed ‘company voluntary arrangements’ (CVAs), can be made under section 2 of the Insolvency Act 1986. (Arrangements by way of reconstruction can be undertaken by liquidators in a voluntary winding up under section 110 of the Insolvency Act 1986, while sections 165–7 and Schedule 4 of the Insolvency Act 1986 allow liquidators with the appropriate sanction to make compromises or arrangements with creditors but only according to creditors’ strict legal rights.)

Small and medium-sized companies may find a CVA useful, since it is generally less complex, time-consuming and costly than alternative procedures. CVAs under section 1 of the Insolvency Act 1986 cannot, however, be undertaken when the company is in winding up and, indeed, do not even require a company to be insolvent. The use of this option will depend on the company’s precise position and the attitude of its creditors. Using a CVA allows a company to reach an arrangement with its creditors under the supervision of an insolvency practitioner. The CVA must, however, be approved by requisite majorities at shareholder (50 per cent by value) and creditors’ (75 per cent by value) meetings and it does not bind creditors without notice of the meetings nor those with unliquidated/unascertained claims nor secured or preferential creditors without their agreement. The Insolvency Act 2000 introduced a moratorium of twenty-eight days into a CVA procedure for small companies.59 The effect of the moratorium is inter alia to offer a company protection against petitions for winding up or administration orders, winding-up resolutions, appointments of receivers and other steps to enforce security or repossess goods – though a moratorium cannot be filed for if an administration order is already in force, the company is being wound up or a receiver has been appointed.

Schemes of arrangement under the Companies Act 2006 s. 895 are an alternative formal method. Here the court sanctions a scheme duly approved by the requisite majority of creditors of each class at separately convened meetings, and once the scheme has been so approved, all the creditors are

59 See now Insolvency Act 1986 Sch. 1A and ch. 11 below.
bound. The section 895 scheme is, however, more cumbersome than a CVA and the latter process is, therefore, likely to be used in preference.

The players

The insolvency procedures described above involve a number of institutions or actors and (leaving aside the turnaround specialists and other specialists who usually come into play before the operation of the above procedures) these can be outlined as follows:

Administrators

Administrators carry out administration orders under the Insolvency Act 1986 and must be qualified insolvency practitioners. An administrator possesses a wide range of powers, including the power to sell company property, is an officer of the court and can apply to the court for directions.

Administrative receivers

Administrative receivers are usually appointed out of court by debenture holders under an express power contained in the debenture. Such a receiver is defined by section 29(2) of the Insolvency Act 1986 as ‘a receiver or manager of the whole (or substantially the whole) of a company’s property appointed by and on behalf of the holders of any debentures of the company, secured by a charge, which, as created, was a floating charge, or by such charge and one or more other securities’. As noted above, the holder of a qualifying floating charge can, after the coming into effect of the Enterprise Act 2002, only appoint an administrative receiver if the charge predated the Act or falls within an exception to the Act’s prohibition on the appointment of administrative receivers by floating charge holders. The administrative receiver is the company’s agent and must be a qualified insolvency practitioner; he is an office holder; he has broader statutory powers than an ordinary receiver; and he enjoys the protection of section 44 of the Insolvency Act 1986 (as amended by the Insolvency Act 1994) concerning liability in respect of new contracts and contracts of employment which he adopts.

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60 Insolvency Act 1986 Sch. B1. 61 See ch. 9 below.
64 Ibid., ss. 42, 43 and Sch. 1. 65 See ch. 8 below.
Receivers

Receivers are appointed by creditors with a charge over particular assets or assets given in security pursuant to powers in a debenture and the Law of Property Act 1925. They may also (more rarely) be appointed by the court and, as such, are officers of the court and accountable to it rather than subject to the directions of the creditor in whose interest they have been appointed. Receivers are always in practice made agents of the company. A number of provisions of the Insolvency Act 1986 apply to receivership generally: for example, prohibiting the appointment of bodies corporate or undischarged bankrupts as receivers.66

Liquidators

Liquidators differ from receivers in so far as they act primarily in the interest of unsecured creditors and members whereas receivers look to the interests of the secured creditor who appointed them.67 Liquidators are statutory creatures and are appointed by the company or by the court, usually on an unsecured creditor’s petition. Like administrative receivers and administrators, liquidators must be qualified insolvency practitioners.

Company voluntary arrangement (CVA) supervisors

As previously noted, Part I of the Insolvency Act 1986 and Part I of the Insolvency Rules 1986 provide a statutory framework for voluntary arrangements between companies and their creditors. Central to the CVA is the issuing of a directors’ written proposal to creditors. This should identify the insolvency practitioner68 who has agreed to take responsibility for the CVA (‘the nominee’). The nominee will obtain statements of affairs from the directors, require further information from company officers and report to the court. The nominee will summon a meeting of the company and all known creditors to gain approval of the scheme. If obtained, it is the responsibility of the nominee, who becomes now ‘the supervisor’, to see that the CVA is put into effect. The

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66 Insolvency Act 1986 ss. 30, 32.
67 See Hoffmann J in Re Potters Oils Ltd (No. 2) [1986] 1 WLR 201; and ch. 12 below.
68 In the CVA procedure for small companies introduced by the Insolvency Act 2000 there is no requirement that a nominee/supervisor be an IP: see Insolvency Act 2000 s. 4(4) introducing a new s. 389A to the Insolvency Act 1986 to allow persons to act if authorised by a body recognised by the Secretary of State.
supervisor can apply to the court for directions; petition for a winding up; or ask for administration of the company. On completing the CVA the supervisor must make a final report within twenty-eight days to creditors and members.

The tasks of corporate insolvency law

Corporate insolvency law has a number of key tasks to perform (for example, to distribute the assets). In outlining these we should distinguish between descriptions of core jobs and statements of the broader objectives or values that a set of insolvency laws and procedures might seek to further (for example, fairness and efficiency). To list tasks provides very limited assistance in deciding what corporate insolvency laws should seek to achieve through carrying them out, just as composing a list of garden tasks for the autumn tells us little about why we are gardening. Selecting ‘key’ tasks does, moreover, make certain assumptions about the appropriate purposes of corporate insolvency law. It is useful, nevertheless, to note the key tasks that are frequently referred to in practice and in commentaries so that an image of the corporate insolvency law agenda can be conveyed. Chapter 2 will return to the theme of objectives and values to be furthered in carrying out (and in rethinking) such tasks.

The tasks can be set out thus:

- To lay down rules governing the distribution of the assets of an insolvent company, including rules protecting the pool of assets available to creditors.
- To provide for management of companies in times of crisis.
- To facilitate the recovery of companies in times of financial crisis and to stimulate the rehabilitation of insolvent companies and businesses as going concerns.
- To balance the interests of different groupings and to protect the interests of the public and of employees in the face of financial failures or management malpractices.
- To encourage good management of companies by imposing sanctions on directors who are responsible for financial collapses where there has been malpractice and by providing for the investigation of the causes of corporate failure.
- To dissolve companies when necessary.

69 Insolvency Act 1986 s. 7(4).
Conclusions

Corporate insolvency law has developed enormously during the last century and the Cork Report is a conspicuous highlight in that development. Cork and its statutory aftermath, however, have not supplied complete answers. In one sense this is inevitable since laws have to develop and adapt to social and economic changes. In another sense, however, current approaches to corporate insolvency law have yet to come fully to grips with certain challenges that have to be faced if corporate insolvency law is to develop in a manner that contributes appropriately to the (business) life of the nation. Three challenges are of central importance. The first is to see corporate insolvency law as a complete process: not merely as a set of rules but as a system of institutions, rules, procedures, implementation processes and practical effects. This demands that, in developing corporate insolvency law, there is an awareness of implications on the ground and of impacts on the resilience of enterprises as well as on credit and employment relationships. The second challenge is to develop clarity in setting out the general purposes of corporate insolvency law and in effecting balances between different competing interests. The third is to develop an insolvency law that is attuned to the changing realities of the business environment and, in particular, to the dynamics of credit markets.

Cork, in many ways, did not provide a fully satisfactory basis for meeting these challenges directly in so far as the Committee collected limited research and evidence on the effects of different insolvency procedures and because Cork offered a start but not a finish in outlining the objectives of insolvency law. On the particular challenges of the new markets Cork cannot be blamed for failing to anticipate the nature and implications of the global credit derivatives markets and there is work to be done by the current generation. This book seeks to take matters further in relation to these three different challenges: by taking on board the available research evidence on the workings of insolvency procedures; by looking to objectives and values; and by continuing to examine how corporate insolvency processes, seen as a whole, can meet those objectives within the context of new commercial and credit conditions.
Aims, objectives and benchmarks

Openness concerning the aims and objectives of corporate insolvency law is necessary if evaluations of proposals, or even existing regimes, are to be made. Without such transparency it is possible only to describe legal states of affairs or to make prescriptions on the basis of unstated premises. As will be argued in this chapter, however, it may not be possible to set down in convincing fashion a single rationale or end for corporate insolvency law. A number of objectives can be identified and these may have to be traded off against each other. It is, nevertheless, feasible to view legal developments with these objectives in mind and to argue about trade-offs once the natures of these objectives have been stipulated.

This chapter will suggest an approach that allows and explains such trade-offs but it begins by reviewing a number of competing visions of the insolvency process that are to be found in the legal literature. A starting point in looking for the objectives of modern English corporate insolvency law is the statement of aims contained in the Cork Committee Report of 1982.¹

Cork on principles

The Cork Committee produced a set of ‘aims of a good modern insolvency law’.² It is necessary, however, to draw from a number of areas of the Cork Report in order to produce a combined statement of objectives relevant to corporate insolvency.³ Drawing thus, and paraphrasing, produces the following exposition of aims:

(a) to underpin the credit system and cope with its casualties;
(b) to diagnose and treat an imminent insolvency at an early, rather than a late, stage;

² Para. 198.
(c) to prevent conflicts between individual creditors;
(d) to realise the assets of the insolvent which should properly be taken to satisfy debts with the minimum of delay and expense;
(e) to distribute the proceeds of realisations amongst creditors fairly and equitably, returning any surplus to the debtor;\textsuperscript{4}
(f) to ensure that the processes of realisation and distribution are administered honestly and competently;
(g) to ascertain the causes of the insolvent’s failure and, if conduct merits criticism or punishment, to decide what measures, if any, require to be taken; to establish an investigative process sufficiently full and competent to discourage undesirable conduct by creditors and debtors; to encourage settlement of debts; to uphold business standards and commercial morality; and to sustain confidence in insolvency law by effectively uncovering assets concealed from creditors, ascertaining the validity of creditors’ claims and exposing the circumstances attending failure;\textsuperscript{5}
(h) to recognise and safeguard the interests not merely of insolvents and their creditors but of society and other groups in society who are affected by the insolvency, for instance not only the interests of directors, shareholders and employees but also those of suppliers, those whose livelihoods depend on the enterprise and the community;\textsuperscript{6}
(i) to preserve viable commercial enterprises capable of contributing usefully to national economic life;\textsuperscript{7}
(j) to offer a framework of insolvency law commanding respect and observance, yet sufficiently flexible to cope with change, and which is also:
   (i) seen to produce practical solutions to commercial and financial problems,
   (ii) simple and easily understood,
   (iii) free from anomalies and inconsistencies,
   (iv) capable of being administered efficiently and economically;
(k) to ensure due recognition and respect abroad for English insolvency proceedings.

\textsuperscript{4} On the importance of fairness to creditors given the mandatory, collective nature of proceedings, see also para. 232.
\textsuperscript{5} See para. 198(h) and amplification in paras. 235 and 238.
\textsuperscript{6} See para. 198(i) and amplification in paras. 203–4.
\textsuperscript{7} See para. 198(j) and amplification in para. 204.
Cork’s statement of aims was largely endorsed in the subsequent 1984 Government White Paper.\textsuperscript{8} It is noteworthy, however, that the DTI objectives for insolvency legislation, as stated in the White Paper, expanded on Cork by stressing the need to provide a statutory framework to encourage companies to pay careful attention to their financial circumstances so as to recognise difficulties at an early stage and before the prejudicing of creditor interests. The White Paper, moreover, differed in emphasis from Cork in so far as its statement of objectives focused on the interests of creditors and express mention was not made of broader, non-creditor concerns.\textsuperscript{9}

Subsequent legislation\textsuperscript{10} gave substantial but not complete effect to Cork’s recommendations and, notably, reflected two major strands of Cork’s corporate insolvency law reform policy: namely those of providing a regulatory framework to prevent commercial malpractice or the abuse of insolvency procedures themselves,\textsuperscript{11} and of providing a formal legal procedure for business rescue.\textsuperscript{12} What that legislation (and subsequent legislation) did not do, however, was to lay down a formal statement of the purposes of insolvency law or a set of objectives.\textsuperscript{13}

\textsuperscript{8} A Revised Framework for Insolvency Law (Cmnd 9175, 1984). The 2005 United Nations Commission on International Trade Law (UNCITRAL), Legislative Guide on Insolvency Law (United Nations, New York, 2005) p. 14 suggests that an effective insolvency law should: (a) provide certainty in the market; (b) maximise value of assets; (c) balance liquidation and reorganisation; (d) ensure equitable treatment of similarly situated creditors; (e) provide for timely, efficient and impartial resolution of insolvency; (f) preserve the insolvency estate for distribution to creditors; (g) ensure transparency, predictability and good information flows; and (h) recognise existing creditors’ rights and establish clear rules on the ranking of claims.

\textsuperscript{9} Revised Framework, para. 2. Contrast the UNCITRAL Legislative Guide on Insolvency Law, the advice of which aims at ‘achieving a balance between the need to address the debtor’s financial difficulty as quickly and efficiently as possible and the interests of the various parties concerned with that financial difficulty, principally creditors and other parties with a stake in the debtor’s business, as well as public policy concerns’.\textsuperscript{10}


\textsuperscript{11} See e.g. Company Directors’ Disqualification Act 1986 ss. 2–12; Insolvency Act 1986 ss. 214, 238–41, 230(2), 390–2; Insolvency Practitioners (Recognised Professional Bodies) Order 1986 (SI 1986/1764).


\textsuperscript{13} Insolvency legislation thus differs materially from typical regulatory statutes which tend to lay down objectives: see e.g. the Communications Act 2003; Utilities Act 2000; Water Act 2003; Environment Act 1995.
Does Cork’s expression of aims offer a sustainable and useful statement of objectives for a modern insolvency law? It has not been beyond criticism. The Justice Report of 1994\textsuperscript{14} noted that Cork had failed to formulate a limited number of core principles to which others might be treated as subservient and that, as a result, no sense of direction could be discerned.\textsuperscript{15}

Some notable attempts have been made to provide single or dominant rationales for corporate insolvency processes and a variety of visions will now be reviewed before an alternative approach is suggested.\textsuperscript{16}

**Visions of corporate insolvency law**

*Creditors' wealth maximisation and the creditors' bargain*

A number of US commentators, inspired by the law and economics movement,\textsuperscript{17} have argued that the proper function of insolvency law can be seen in terms of a single objective: to maximise the collective return to creditors.\textsuperscript{18} Thus, according to Jackson,\textsuperscript{19} insolvency law is best seen as a ‘collectivized debt collection device’ and as a response to the ‘common pool’ problem created when diverse ‘co-owners’ assert rights against a common pool of assets. Jackson, moreover, has stated that insolvency law should be seen as a system designed to mirror the agreements one would expect creditors to arrive at were they able to negotiate

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\textsuperscript{15} Ibid., paras. 3.7–3.8.
\textsuperscript{16} On distinguishing ‘traditionalist’ insolvency scholars (who see insolvency law as unrelated to ‘healthy-state’ corporate behaviour) from ‘proceduralists’ (who ‘worry intensely about how rules in bankruptcy affect behaviour elsewhere’) see D. Baird, ‘Bankruptcy’s Uncontested Axioms’ (1998) 108 Yale LJ 573.
\textsuperscript{19} See Jackson, *Logic and Limits of Bankruptcy Law*, chs. 1 and 2.
such agreements *ex ante* from behind a Rawlsian ‘veil of ignorance’.\(^{20}\)

This ‘creditors’ bargain’ theory is argued to justify the compulsory, collectivist regime of insolvency law on the grounds that were company creditors free to agree forms of enforcement of their claims on insolvency they would agree to collectivist arrangements rather than procedures of individual action or partial collectivism. Jackson sees the collectivist, compulsory system as attractive to creditors in reducing strategic costs, increasing the aggregate pool of assets, and as administratively efficient. It follows from the above argument that the protection of the non-creditor interests of other victims of corporate decline, such as employees, managers and members of the community, is not the role of insolvency law.\(^{21}\)

Keeping firms in operation is thus not seen as an independent goal of insolvency law.

In the creditor wealth maximisation approach all policies and rules are designed to ensure that the return to creditors as a group is maximised. Insolvency law is thus concerned with maximising the value of a given pool of assets, not with how the law should allocate entitlements to the pool. Accordingly effect should only be given to existing pre-insolvency rights, and new rights should not be created. Variation of existing rights is only justified when those rights interfere with group advantages associated with creditors acting in concert.

The creditor wealth maximisation vision has been highly influential and has been put into legislative effect in some jurisdictions. Thus the German Bankruptcy Code of 1999 (*Insolvenzordnung*) aims to establish a system that will enhance market exchange processes and rationalise debt collection rather than supersede market processes.\(^{22}\) It is a vision, however, that has been subject to extensive criticism, some of which has been phrased in the strongest terms.\(^{23}\)

Major concerns have focused, firstly, on insolvency being seen as a debt collection process for the


\(^{21}\) See Jackson, *Logic and Limits of Bankruptcy Law*, p. 25.

\(^{22}\) See C. Schiller and E. Braun, ‘The New Insolvency Code’ in J. Reuvid and R. Millar (eds.), *Doing Business with Germany* (Kogan Page, London, 1999). (At the time of writing, a bill to amend the insolvency code has been passed by the German Parliament.)

benefit of creditors. This, it has been said, fails to recognise the legitimate interests of many who are not defined as contract creditors: for instance, managers, suppliers, employees, their dependants and the community at large. Creditor wealth maximisation, moreover, fails to focus on the non-efficiency objectives that are often recognised in legislation.

To see insolvency as in essence a sale of assets for creditors (what might be termed a ‘fire sale’ image), moreover, fails both to treat insolvency as a problem of business failure and to place value on assisting firms to stay in business. Thus, it has been argued that to explain why the law might give firms breathing space or reorganise them in order to preserve jobs requires resort to other values in addition to economic ones. The economic approach, as exemplified by Jackson, is alleged to demonstrate only that its own economic value is incapable of recognising non-economic values, such as moral, political, social and personal considerations.

The idea, moreover, that a troubled company constitutes a mere pool of assets can also be criticised. Such a firm can be seen not purely as a lost cause but as an organic enterprise with a degree of residual potential: ‘Unlike mere property, a corporation, whether in or out of bankruptcy, has potential. A corporation can continue as an enterprise: as an enterprise, it can change its personality and, perhaps more importantly, whether the corporation continues and how it changes its personality

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affects people in ways that are not only economic.\textsuperscript{28} Insolvency law, indeed, has for some time on both sides of the Atlantic recognised that the rehabilitation of the firm is a legitimate factor to take on board in insolvency decision-making.\textsuperscript{29}

Does it make sense, in any event, to point to a common pool of assets to which creditors have a claim before insolvency? Unless credit is secured, it is arguably extended on the basis that repayments will be made from income and not from a sale of fixed assets. Income, moreover, cannot be said normally to be produced by the assets themselves but, in the case of an enterprise, from ‘an organisational set-up consisting of owners, management, employees plus a functioning network of relations with the outside world, particularly with customers, suppliers and, under modern conditions, with various government agencies’.\textsuperscript{30} It is, indeed, insolvency law itself that creates an estate or pool of assets and this undermines any assertion that insolvency processes should maximise the value of a pre-existing pool of assets and should not disturb pre-insolvency entitlements.

The idea that insolvency law can be justified in a contractarian fashion with reference to a creditors’ bargain has also come under heavy fire.\textsuperscript{31} The creditors’ bargain restricts participation to contract creditors. In this sense the veil of ignorance used by Jackson is transparent since the agreeing parties know their status in insolvency. It is not surprising that in an \textit{ex ante} position such creditors would agree to maximise the value of assets available for distribution to themselves.\textsuperscript{32} Jackson, moreover, focuses exclusively on voluntary and bargaining creditors, while assuming a perfect market, and leaves out of account other types of creditor, for whom there is no market at all.

\textsuperscript{28} Korobkin, ‘Rehabilitating Values’, p. 745. See also Warren, ‘Bankruptcy Policy’, p. 798.
\textsuperscript{31} See Carlson, ‘Philosophy in Bankruptcy’, p. 1355: ‘even less than a hollow tautology’.
\textsuperscript{32} See Korobkin, ‘Contractarianism and the Normative Foundations’, p. 555. See also Gross, ‘Community Interests’, p. 1044.
The circular nature of the bargain has been exposed by critics. Creditors in the bargain are assumed to be de-historicised and equal. The creditors’ bargain model explains the rule of creditor equality only by presupposing what it sets out to prove.\textsuperscript{33} In real life, in contrast, creditors differ in their knowledge, skill, leverage and costs of litigating. The assumption that powerful creditors (e.g. secured creditors) would agree to collectivise their claims to the pool alongside their weaker brethren is highly questionable. It is more likely that what parties will agree to will inevitably mirror those disparities in rights, authority and practical leverage that shape their perspectives.\textsuperscript{34} Jackson’s solution to this problem is to suggest that secured creditors should receive from the pool no less than what they would be entitled to outside insolvency. This is the equality of Animal Farm, though, and is inconsistent with the homogeneity of creditors originally posited. To assume, moreover, that all creditors have purely economic interests is also questionable. Thus, for instance, employee creditors who face displacement costs that are separate from their claims for back wages might not agree to creditor equality because they could well consider that such costs should be reflected in a higher priority for their back-wages claims. They might, additionally, consider that their claims on assets morally outrank those of secured creditors and for this reason also insist on priority for wage claims.\textsuperscript{35}

A further major weakness of the creditor wealth maximisation vision is its alleged lack of honesty on distributional issues.\textsuperscript{36} The collectivism advocated by Jackson is treated as neutral but it begs distributional questions. By purporting merely to enforce pre-insolvency rights Jackson presupposes the defensibility of the state-determined collection scheme without further argument; by this process distributive elements are worked into his theory via the back door. The inappropriateness of transplanting the system of state allocation of rights becomes clearer on noting the very different functions of

\begin{itemize}
  \item \textsuperscript{34} See Korobkin, ‘Contractarianism and the Normative Foundations’, p. 552.
  \item \textsuperscript{36} See Warren, ‘Bankruptcy Policy’, esp. pp. 790, 802, 808.
\end{itemize}
the respective bodies of law. Whereas pre-insolvency state entitlements are designed with an eye to ongoing contractual relationships, it is arguably the very purpose of a (federal) insolvency system to apportion the losses of a debtor’s default in a new and different situation when a variety of factors impinge on decisions as to where losses should fall.

If, indeed, it is proper for insolvency law to look beyond pre-insolvency rights, this again strikes at the heart of the creditors’ bargain thesis. It can be said, in the first instance, that insolvency does and should recognise the interests of parties who lack formal legal rights in the pre-insolvency scenario, not least because parties with formal legal rights never bear the complete costs of a business failure. Thus, creditors may suffer in an insolvency but those without formal legal rights may also be prejudiced: not only, as already noted, employees who will lose jobs and suppliers who will lose customers, but also tax authorities whose prospective entitlements may be diminished and neighbouring traders whose business environments may be devalued. A danger of the creditor wealth maximisation vision is that it fails adequately to value the continuation of business relationships that have not been formalised in contracts and may, indeed, omit from consideration those who suffer the greatest hardships in the context of financial distress.

A second point concerns those parties with various pre-insolvency legal rights. The argument that insolvency law should only give effect to these pre-insolvency rights can be countered by asserting that a core and proper function of insolvency law is to pursue different distributional objectives than are implied in the body of pre-insolvency rights; that insolvency law does so by adopting a base-line rule on equality – *pari passu* – and by then making considered exceptions to that rule. It is insolvency law’s application to the turbulence of financial crisis, as distinct from the calm waters that mark pre-insolvency contracts, that can be said to justify the intrusion of a number of value judgements concerning relative priorities of various liabilities and the order in which groups of liabilities should be discharged.

A broad-based contractarian approach

A vision of insolvency law that attempts to overcome the restrictions of creditor wealth maximisation is a broader contractarianism. The version discussed here is the Rawlsian scheme of Donald Korobkin.\(^{40}\) Whereas Jackson seeks to justify insolvency law with reference to the rules that contract creditors would agree to from behind the veil of ignorance, Korobkin places behind the veil not merely contract creditors but representatives of all those persons who are potentially affected by a company’s decline, including employees, managers, owners, tort claimants, members of the community, etc. These people choose the principles of insolvency law from behind a strict veil, ignorant of their legal status, position within the company or other factors that might lead them to advance personal interests. They would, however, foresee that the financial distress of companies would affect a wide variety of individuals and groups occupying various positions and differing in their ability to affect the actions and decisions of the companies in distress.

Korobkin argues that the parties in such a position of choice would opt for two principles to govern insolvencies.\(^{41}\) First, a ‘principle of inclusion’ would provide that all parties affected by financial distress would be eligible to press their demands. Second, a principle of ‘rational planning’ would determine whether and to what extent persons would be able to enforce legal rights and exert leverage. It would seek to promote the greatest part of the most important aims (the ‘maximisation of aims’) and would involve formulating the most rational, long-term plan as a means of realising the ‘good’ for the business enterprise. It would require an outcome that would ‘maximumly satisfy the aims’ but, in reflection of Rawls’ difference principle, would mandate that persons in the worst-off positions in the context of financial distress should be protected over those occupying better-off positions. For such purposes persons in worst-off positions would be those relatively powerless to promote their aims, yet with the most to lose on the frustration of those aims.

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\(^{41}\) Korobkin, ‘Contractarianism and the Normative Foundations’, pp. 575–89.
Korobkin argues that application of his contractarian approach would produce laws corresponding in fundamental ways to the kind of insolvency system encountered in the USA.42 His approach, like that of Rawls,43 however, is open to question on a number of fronts. First, the particular choices of principle made from behind the veil of ignorance depend on a particular concept of the person: it is not possible to strip the individual completely yet conclude that he or she would choose, for instance, the difference principle.44 Risk-averse and risk-neutral individuals might produce very different principles of justice. It is not clear why an individual behind the veil might not prefer a regime marked by low-cost credit and low protection for vulnerable parties to one with high costs of credit and high levels of protection.

This introduces a second difficulty as encountered in Rawls: the extent to which diminutions in justice may be traded off against gains on other fronts, such as in wealth. Advocates of creditor wealth maximisation might object to Korobkin’s scheme on the grounds that principles of insolvency law designed by a veiled and highly inclusive group are liable to be so protective of so many interests, and as a result so uncertain, that the effects on the cost of credit would be catastrophic. Korobkin’s answer would be that such effects would be anticipated by those behind the veil.45 The device of the veil, however, does not in itself explain, in a convincing fashion, important distributional issues, such as how to judge

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42 In this, the approach differs markedly from other proposed regime designs that have been called ‘contractualist’ and which suggest that businesses might elect ex ante for a system in which they are free to bargain in advance for a set of rules to govern their rights in the event of bankruptcy and in which such bargains would override the federal rules of bankruptcy: see e.g. B. E. Adler, ‘Financial and Political Theories of American Corporate Bankruptcy’ (1993) 45 Stanford L Rev. 311; L. A. Bebchuk, ‘A New Approach to Corporate Reorganisations’ (1988) 101 Harv. L Rev. 775; R. Rasmussen, ‘Debtor’s Choice: A Menu Approach to Corporate Bankruptcy’ (1992) 71 Texas L Rev. 51; and for a critique of these (questioning their economic efficiency contentions) see E. Warren and J. Westbrook, ‘Contracting Out of Bankruptcy: An Empirical Intervention’ (2005) 118 Harv. L Rev 1197.


45 Korobkin (‘Contractarianism and the Normative Foundations’, pp. 583–4) notes that parties in a bankruptcy choice situation (behind the veil) are aware of the ‘difficulty of
trade-offs between fairness or justice and wealth creation. Such matters are governed by the concept of human nature built into the system rather than the veil.\footnote{Notably the concept of human nature that is assumed to attract parties behind the veil of ignorance to Rawls’ difference principle rather than to more high-risk principles that are less protective of the most vulnerable.} If such trade-offs are ruled out it can be objected that the protection offered by a just rule is of very limited value if individuals lack the resources required to take advantage of that rule. The distinction, moreover, between principles of fairness or justice and principles governing the allocation of other goods such as wealth is also problematic.\footnote{See P. P. Craig, \textit{Public Law and Democracy in the United Kingdom and the United States of America} (Clarendon Press, Oxford, 1990) pp. 262–3.}

It might be further objected that the contractarian approach fails to explain how agreements can be reached behind the veil as to who in a potential insolvency is most vulnerable and thus should enjoy priority of protection over those occupying less threatened positions. Korobkin acknowledges the difficulties of comparing positions in terms of vulnerability, and these are indeed real.\footnote{Korobkin, ‘Contractarianism and the Normative Foundations’, p. 584 and his n. 198.} He suggests that vulnerability be measured in terms of the product of the potential loss to, and the degree of influence exercised by, an individual. There is no reason, however, why such an approach would be accepted by all parties behind the veil. Many may think that such benchmarking distorts the system in favour of those who already possess advantages and so have much to lose. A final difficulty is whether agreement could be expected on the relative valuations of, say, rights to secure or continued employment, as opposed to particular sums of money owed by parties to others. As a guide to the practical development of insolvency law contractarianism may indeed be considerably flawed by its indeterminacy.

\textit{The communitarian vision}

In contrast with the emphasis on private rights contained within the creditor wealth maximisation approach, the communitarian counter-vision sees insolvency processes as weighing the interests of a broad range of different constituents. It accordingly countenances the redistribution of values so that, on insolvency, high-priority claimants may to some extent give way to others, including the community at large, in actual decision-making’ and would be attracted to a rational plan based on Rawls’ difference principle for this reason.
sharing the value of an insolvent firm. A concern to protect community interests may, furthermore, militate in favour of insolvency laws that compel companies and their creditors to bear the costs of financial failure (for example, environmental cleaning costs) rather than shift those to third parties or taxpayers.

Communitarianism thus challenges the premise that serves as the basis for the traditional economic model, namely that individuals should be seen as selfish, rational calculators. An important aspect of communitarianism is the centrality that is given to distributional concerns. Redistributions are seen, not as an aberration from the protection of creditors’ rights, but as a core and unavoidable function of insolvency law: ‘bankruptcy is simply a … scheme designed to distribute the costs amongst those at risk’.

It follows from the concerns of communitarianism that insolvency law should look to the survival of organisations as well as to their orderly liquidation. In this respect, the Cork Committee’s statement of aims incorporates aspects of communitarianism in stressing not merely that insolvency affects interests in society beyond insolvents and their creditors, but that the insolvency process should provide means to preserve viable commercial enterprises capable of contributing to the economic life of the country. To creditor wealth maximisers the communitarian vision is objectionable in so far as it clouds insolvency law by departing from creditor right enforcement and taking on issues – for example,


54 Cork Report, para. 198(i) and (j).
protections for workers – which more properly should be dealt with by allocating pre-insolvency rights – for example, rights to employment security, fair dismissal and compensation on redundancy. In response, communitarians might urge, first, that there is no reason why issues arising in insolvency should be governed by rules or agreements formulated without regard to insolvency and, second, that it is perfectly proper to advert to communitarian issues in both pre-insolvency and insolvency law.

The breadth of concerns encompassed within communitarianism gives rise in itself to problems of indeterminacy. It may be objected that corporatist visions of the company have difficulty in defining the public good and offer ‘simply a mask behind which corporate managers exercise unrestrained social and economic power.’ Similarly, communitarianism can be said to lack the degree of focus necessary for the design of insolvency law because of the breadth of interests to which it refers. As Schermer has argued, ‘it is impossible to delineate the community … There are an infinite number of community interests at stake in each bankruptcy and their boundaries are limitless…[A]lmost anyone, from local employee to a distant supplier, can claim some remote loss to the failure of a once viable local business.’

The problem is not so much that community interests cannot be identified but that there are so many potential interests in every insolvency and that selection of interests worthy of legal protection is liable to give rise to considerable contention. How, moreover, can selected interests be weighed? How might a court balance the community’s interest in maintaining employment against potential environmental damage? Doubts, furthermore, have been expressed about the feasibility of redistributing funds in an insolvency. Insolvency law might be designed in

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56 To argue that it is proper for insolvency law in some circumstances to look to communitarian issues and, if necessary, to adjust some prior rights is not, of course, to declare open season on adjusting any laws or rights that happen to arise in an insolvency, however tangentially.


58 B. S. Schermer, ‘Response to Professor Gross: Taking the Interests of the Community into Account in Bankruptcy’ (1994) 72 Wash. ULQ 1049 at 1051.

order to dilute the legal rights of secured creditors and redistribute the associated wealth to other parties, but (transaction costs permitting) prospective secured lenders may well alter the terms and tariffs of their respective deals so as to contract around the legal alterations. There is some evidence from US studies that such circumvention has been encountered.  

A final objection to communitarianism urges that insolvency judges are not necessarily well placed to decide what should, or should not, be deemed a community problem, or what should be in the community’s best interest, and that this involves judges in politically fraught decision-making and encourages policy ad hocery. In defence, however, communitarians might respond that judges inevitably and in all sectors of the law advert to public and community interests, that an insolvency law solely for creditor protection is objectionably narrow and that if community interests impinge on judicial decisions they should be dealt with openly and fully.

The forum vision

Rather than seeing the insolvency process in terms of substantive objectives it may be conceptualised in procedural terms, its essence being to establish a forum within which all interests affected by business failure, whether directly monetary or not, can be voiced. The enterprise is seen as comprising not merely the physical assets and stock of business but the focus of interests and concerns of all participants in the company’s financial distress. The law’s function, in turn, is seen as establishing space. It ‘creates conditions for an ongoing debate in which, by expressing … conflicting and incommensurable values, participants work towards defining and re-defining the fundamental aims of the enterprise. Through the medium of bankruptcy discourse, the enterprise realises its potential as a fully dimensional personality.’ Not only interested parties can engage in this discourse. To some it, most significantly, allows extra-legal resources and expertise to be brought into play so as to construct the domain to be legally regulated. Thus accountants play an important part in defining the onset of insolvency and in advising on responses: ‘Before corporate failure can be internalised within the legal system, it has first to

60 See citation in ibid., p. 959.  61 Schermers, ‘Response to Professor Gross’, p. 1051.  
63 Korobkin, ‘Rehabilitating Values’, p. 772.
be represented and calculated as an economic event by means of the 
calculative technologies of accountancy.  

Such a vision may throw light on an important role to be played by 
insolvency law but it necessarily falls short of offering guidance on 
matters of substance. As, moreover, with other theories of legitimization 
through providing means of representation, difficult issues remain 
concerning the amount of representation to be offered to different 
parties; the ‘right’ balance between provisions for representation and 
efficiency in decision- and policy-making; and the extent to which 
representation should be reinforced with legal rights.

The ethical vision

According to Philip Shuchman, insolvency laws fail to rest on an ade-
quate philosophical foundation in so far as the formal rules of insolvency 
disregard issues of greatest moral concern. He argues that the situation 
of the debtor, the moral worthiness of the debt and the size, situation and 
intent of the creditor should be taken into account in laying the founda-
tions for insolvency law. Judgements in such matters would not be based 
upon intuitions but on utilitarian principles. Thus the criteria to be 
employed would be ‘present and prospective need, desert and the 
moral and philanthropic worth, and the importance of the underlying 
transaction … [I]n the context of bankruptcy it is assumed that inter-
personal comparisons of utility are significant and that social states can 
be ordered according to the sum of utilities of individuals; further, that 
the choice of any given arrangement ordinarily ought to be some sort of 
aggregation of individual preferences.

Shuchman, therefore, argues that a distinction should be drawn 
between debts that have arisen out of contracts that personally benefit 
the creditor and debts flowing from involuntary acts or loans between 
friends. He would, accordingly, have judges or administrators base

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64 P. Miller and M. Power, ‘Calculating Corporate Failure’ in Y. Dezalay and D. Sugarman 
(eds.), Professional Competition and Professional Power: Lawyers, Accountants and the 
L Rev. 1667 and, generally, C. Pateman, Participation and Democratic Theory 
decisions on such matters as priorities on ethically relevant realities. He would resist blind acceptance of pre-petition creditors being equal.

Whether it is realistic to expect to find ethical principles to underpin all insolvency law can be questioned, as indeed might the possibility of any group of individuals or judges coming to agree on the substance of such principles. The boundaries, moreover, of relevant ethical principles (and the border between ethical principle and prejudice, distaste or disgust) cannot be established uncontentiously. To rely upon the judiciary to evaluate the moral needs and deserts of creditors and the moral worthiness of debts, and to incorporate such evaluations within insolvency law, places a large degree of faith in their own moral judgement (not to say the existence of an identifiable and agreed set of moral predicates) and their determination and ability to develop a consistent and coherent body of law on this basis. Such a system might also have considerable and detrimental effects on the availability and cost of credit in so far as creditors’ bargains would be placed in the shadow of legal uncertainty. Creditor wealth maximisers might, finally, add that questions of consistency between bodies of law arise, and argue that if non-insolvency law generally declines to take on board the virtuous (or disreputable) motives of those involved in legal transactions then insolvency law should do likewise.

The multiple values/eclectic approach

In stark contrast to approaches offering a single, economic rationale, as exemplified by the creditor wealth maximisation vision, is the notion that insolvency law serves a series of values that cannot be organised into neat priorities. Thus Warren offers what she calls a ‘dirty, complex, elastic, inter-connected’ view of insolvency law from which neither outcomes can be predicted nor all the factors relevant to a policy decision can necessarily be fully articulated. Whereas the economic account can explain insolvency law only as a device to maximise creditor wealth, not distribute fairly, a value-based account is said to understand

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71 See Jackson, Logic and Limits of Bankruptcy Law, ch. 1.
insolvency law’s ‘economic and non-economic dimensions and the principle of fairness as a moral, political, personal and social value’.73

Multiple values/eclectic approaches as exemplified by Warren and Korobkin see insolvency processes as attempting to achieve such ends as distributing the consequences of financial failure among a wide range of actors; establishing priorities between creditors; protecting the interests of future claimants; offering opportunities for continuation, reorganisation, rehabilitation; providing time for adjustments; serving the interests of those who are not technically creditors but who have an interest in continuation of the business (e.g. employees with scant prospect of re-employment, customers, suppliers, neighbouring property owners and state tax authorities); and protecting the investing public, jobs, the public and community interests. Such approaches incorporate communitarian philosophies and take on board distributive rationales, placing value, for instance, on relative ability to bear costs; the incentive effect on pre-insolvency transactions; the need to treat like creditors alike; and the aim of compelling shareholders to bear the lion’s share of the costs of failure.

Further goals can be added by making reference to the Cork Committee’s own statement of aims – a clear example of the multiple values approach.74 Thus, as already noted, Cork emphasised the role of insolvency law in reinforcing the demands of commercial morality and encouraging debt settlement,75 and also stressed deterrent and distributive ends in urging that insolvency should seek to ascertain the causes of failure and consider whether conduct merited punishment.

The multiple values approach, moreover, is broad enough to encompass the forum vision. Thus, in putting forward his own value-based approach, Korobkin posits the worth, inter alia, of insolvency law’s providing a forum for the representation of views: ‘under the value-based account, bankruptcy law has the distinct function of creating conditions for a discourse in which values of participants may be

73 Korobkin, ‘Rehabilitating Values’, p. 781.
75 See also G. Triantis, ‘Mitigating the Collective Action Problem of Debt Enforcement through Bankruptcy Law: Bill C-22 and its Shadow’ (1992) 20 Canadian Bus. LJ 242, who argues that while bankruptcy law may be valuable to resolve the collective action problem and to secure efficiency, an additional objective should be to promote efficient ‘private workouts’ in the shadow of bankruptcy law. (See also Baird’s reply, pp. 261–8.)
rehabilitated into an informed and coherent vision of what the estate as enterprise shall exist to do.\footnote{Korobkin, ‘Rehabilitating Values’, p. 781.}  

What is the case for a multiple values approach? Warren argues that a policy focusing on the values to be protected in an insolvency distribution and on the effective implementation of those values assists decision-makers even if it does not dictate specific answers. It illuminates the critical, normative and empirical questions and involves inquiries into the range of relevant issues such as who may be hurt by a business failure; how they may be hurt; whether the hurt can be avoided and at what cost; who is helped by the failure; whether aid to those helped offsets the injury to those hurt; who can effectively evaluate the risks of failure; who may have contributed to the failure and how; whether the contribution to failure serves useful goals; and who can best bear the costs of failure and who expected to bear those costs.\footnote{Warren, ‘Bankruptcy Policy’, p. 796.}

Such an approach is thus said to highlight the empirical assumptions underlying insolvency decisions to ask tough and specific questions by coming to grips with the ‘difficult and complex tapestry’ of empirical presumptions and normative concerns.\footnote{Ibid., p. 797.} It honestly acknowledges that judgements are made in balancing numbers of values in insolvency decision-making. Answers may not be complete but are said to be more fully reasoned than those resulting from single rationale approaches.\footnote{Korobkin, ‘Rehabilitating Values’, p. 787.}

Eclecticism, nevertheless, gives rise to not inconsiderable problems. In the first instance, little assistance is offered to decision-makers on the management of tensions and contradictions between different values or on the way that trade-offs between various ends should be effected. Questions, moreover, are easily begged in choosing which values to invoke or emphasise.\footnote{See G. E. Frug, ‘The Ideology of Bureaucracy in American Law’ (1984) 97 Harv. L Rev. 1277 at 1379.} Nor do core principles emerge to guide decisions on such trade-offs or to establish weightings: this, as noted, was a concern that the 1994 Justice Report expressed with regard to the Cork statement of aims.\footnote{Insolvency Law: An Agenda for Reform, paras. 3.7–3.8.}

The open-textured nature of eclecticism can be a problem in some multi-value schemes. Unless particular values are identified with
precision, appeals can be made to an open-ended menu\textsuperscript{82} of purposes and it is difficult to decide when to rule out appeals on the basis that they invoke irrelevant values or aims. (Cork, it should be conceded, does offer a list, as we have seen.) Eclecticism runs the danger of seeing all arguments as valid and, as a result, guidance for practical decision-making is lacking and confusion results. If an identification of the objectives of insolvency law is desired so as to provide a framework within which judges and legislators can act, then the multi-value/eclectic, even more than the communitarian, approach is guilty of settling untrammelled discretions on such individuals and allowing them freely to choose from and combine an indeterminately long list of vaguely stated ingredients.

The nature of measuring

The above visions or approaches to insolvency emphasise different facets of corporate insolvency law’s role. What fails to emerge from the review undertaken, however, is any complete view of the appropriate measures of insolvency law. Creditor wealth maximisation was narrow in its exclusive concerns with creditors’ interests and pre-insolvency rights and in its conception of the insolvent company as a pool of assets. The broad-based contractarian approach begged questions concerning the nature of persons behind the veil of ignorance and failed to explain trade-offs of fairness or justice versus efficiency or between different kinds of interests worthy of protection. The communitarian vision escaped the narrowness of creditor wealth maximisation but encountered problems of indeterminacy. The forum vision made much of procedural concerns but shed little light on the substantive ends to be pursued by insolvency law or processes. The ethical vision gave rise to difficulties concerning the possibility of locating agreement as to ethical content and to establishing the boundaries of relevant ethical concerns. How ethical aspects of decisions on insolvency interacted with other, say legal, principles remained in doubt. Finally, the eclectic approach, again, gave rise to problems of indeterminacy and of contradictions and tensions between different ends.

\textsuperscript{82} For a view that insolvency law should offer a ‘menu of options’ and allow firms to choose the optimal rules for their own, perhaps idiosyncratic, requirements, see Rasmussen, ‘Debtor’s Choice’ and Rasmussen, ‘The Ex Ante Effects of Bankruptcy Reform on Investment Incentives’ (1994) 72 Wash. ULQ 1159.
To advance the search for measures in the light of such competing, yet contestable, visions, it is necessary to examine further the purpose of a quest for benchmarks and in doing so to answer two questions. What precisely is being measured? Is it possible to justify insolvency law or processes given present approaches? A response to these issues can be made by examining a well-known treatment of justification in company law and by suggesting that it can be built upon to develop an approach that has relevance for the insolvency arena.

A framework for analysing the fundamental rules of company law has been offered by focusing on the question of how corporate managerial power is legitimated. This issue is said to be a ‘unifying theme of company law’. Mary Stokes’ argument, in brief, is as follows. If economic power, derived from private property, is to be legitimated within the framework of a liberal society, it is necessary to show that there are restraints preventing it from becoming a threat to liberty or a challenge to state power. Two strategies are contained within the fabric of the law to attempt this demonstration: first, it is posited that the economic power at issue is not sufficiently concentrated to be a threat; second, such economic power is seen as subject to constraints imposed by the competitive market. Unfortunately both strands of argument are afflicted with deficiencies. The growth of the corporate enterprise has allowed concentrations of economic power; and the separation of ownership from control has produced managers’ powers that are unrestrained by the market (much economic power indeed has come to be exercised not within markets but within corporate bureaucracies).

Company law can be said to have offered a response to the problem of corporate managerial power by explaining why discretion was conferred on corporate managers and by demonstrating that such discretionary power was subject to checks and controls. The justification for discretion was based by some on a contractual view of the company. Thus, the owners might legitimately contract with managers to establish the latter

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as agents. As companies grew, though, the artificiality of a contractarian analysis became apparent. A ‘natural entity’ view of the corporation was seen by others to be more appropriate. This saw the company as a living organism with the managers as the brain and the shareholders as passive suppliers of capital. The natural entity view gave rise to a further way of justifying the vesting of discretionary power in managers: it was the expertise and competence of managers that legitimated their discretion. The boundaries of such expertise and appropriate deference to it were nevertheless difficult to delineate.

As for legitimation through checks on arbitrariness, the traditional legal model offered two mechanisms: accountability to shareholders through internal company controls and directorial duties to act in the best interest of shareholders. (The latter duties legitimated discretions by compelling directors to aim at profit maximisation.) Both mechanisms proved flawed and the law’s quest to legitimate the power of corporate management failed.

In response to this failure two strategies might be advocated within the traditional approach: either managers could be made more responsible to the market or new legal steps could be taken to ensure management in the interest of shareholders. Both of these strategies would constitute tinkering. It would be better, argued Stokes, to recognise the misguided nature of attempts to control through markets or the ordering of power in the company and to adopt a new perspective on legitimating managerial power. This new approach would accept the separation of ownership and control and break free from the contractual conception of the company. It might build on a corporatist model of the company and see

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85 See Stokes, ‘Company Law and Legal Theory’, p. 164. See also further discussion in S. W. Mayson, D. French and C. L. Ryan, *Mayson, French and Ryan on Company Law* (24th edn, Oxford University Press, Oxford, 2007) ch. 5. Another problem of using a contractual conception to legitimate managerial power was that this view conflicted with the case-law theory of the company as a body distinct and separate from its shareholders. Notably because in large public companies the dispersion of shareholding undermined shareholder control and managers, in reality, wielded power free from either shareholder constraint or the courts, who displayed deference to managerial expertise. (Dispersed shareholding produced a lack of control over managers because of low information levels and low incentives to enforce duties against directors: see V. Finch, ‘Company Directors: Who Cares About Skill and Care?’ (1992) 55 MLR 179.)

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its interests not merely as those of shareholders but as involving both public and private dimensions; see directors as expert public servants balancing a variety of claims by various groups in the community and doing so with reference to public policy not private cupidity; and see the company as an organic body unifying the interests of participants in harmonious purpose. Managerial power would be legitimated as giving expression to the common purposes of shareholders, creditors, employees and the community.

Stokes’ argument, in short, is thus that current strategies for legitimating managerial power should be seen as unnecessarily tied to traditional contractarian views of the company and as inadequate; and that the values involved in the corporatist and democratic ideals of the company should be embraced in rethinking rationales for legitimation.

The importance of the argument outlined lies in its critique of the assumptions that underpin traditionalist approaches to the legitimation of managerial power and in its stressing that the public dimension of corporate power demands measures reflecting community and democratic rather than simply private values. Against Stokes it can be countered, however, that reservations about narrow contractarianism and endorsement of the communitarian/democratic approach do not necessarily mean that arguments for legitimation based on contractarian assumptions lack all validity. Here the question is whether traditionalist arguments for legitimation are ‘fundamentally misguided’ in the sense that they are positive deceptions or whether they are criticisable as telling only part of the story. The communitarian/democratic vision may be completely at odds with the contractarian vision but it may be that legitimating arguments from both camps may cumulate: that adding a communitarian perspective means that corporate managerial power is capable of legitimation to some degree with reference both to controls exercised over managers by the market and to controls operating through representative arrangements corresponding to the democratic ideal. Legitimating arguments such as those based on expertise and accountability can thus be seen as having cumulative force in spite of being flawed in various ways. Indeed, arguments derived from the communitarian/democratic vision are themselves not problem free. (How much representation of which interests is appropriate? How should such representation best be achieved?)

88 Ibid., p. 174.
To consider a series of legitimating arguments and point serially to the limitations of each one, and to conclude that legitimation cannot result, may be to misportray legitimation as a chain of arguments as strong as its weakest link rather than as a cable able to bear strain according to the collective power of its (albeit imperfect) strands.  

A further problem may arise if legitimation is seen exclusively as restraint, as all about the limitation of discretionary powers. Subjection to control and accountability may be necessary for legitimation but these factors may themselves be insufficient to guarantee it. Those attributing legitimacy may also demand that the system enables and encourages the protection of substantive outcomes effectively and they may also recognise the legitimacy of genuinely expert management.

An ‘explicit values’ approach to insolvency law

What lessons does the above discussion provide for those seeking measures and benchmarks for insolvency law? Indeed, whereabouts in the insolvency sphere is the power requiring legitimation? Company law was said to be about the legitimation of corporate managerial power in the hands of directors. Insolvency is more complex because it is the tendency of English insolvency law to take power out of the hands of management and place it, according to various circumstances, with different parties such as creditors, insolvency practitioners and the courts themselves. It

89 It might be argued that the strands analogy breaks down where individual strands oppose rather than lie parallel (e.g. employee versus creditor interests). The point, however, is that values may be placed on items in spite of such tensions. Employee and creditor interests are thus valued in spite of the trade-offs which often have to be made between them.


is thus the broad insolvency process in all its dimensions and with its variety of actors that requires legitimation.

A second issue concerns the basis for requiring legitimation. It cannot be assumed that since corporate managerial power in a going concern requires legitimation, insolvency regimes and powers automatically require legitimation. Insolvency processes do, however, impinge strongly upon the public interest in so far as decisions are made about the lives or deaths of enterprises and those decisions affect livelihoods and communities. Insolvency processes also have dramatic import for private rights in so far as, for instance, pre-insolvency property rights and securities can be frozen and individual efforts to enforce other legal rights constrained. On both public and private interest grounds, accordingly, the powers involved in insolvency processes can be seen as calling for strong justification. This, in turn, militates in favour of justifications that have aspects which can be democratically secured (as is appropriate in so far as the public interest is involved) and which involve respect for individual rights (since private interests are at issue).\(^\text{92}\) The attribution of legitimacy can accordingly be seen against a vision of the insolvency process that is broad enough to encompass legitimating arguments that are based on communitarian approaches as well as expressive of concerns that creditors’ interests be protected. How tensions and trade-offs between different legitimating rationales can be resolved remains, of course, an issue to which we shall return below.

To argue thus, it may be responded, is all very well where insolvency processes have both public and private dimensions, but in relation to some aspects of insolvency there are real disputes as to whether arrangements should be seen as an integral part of the insolvency process and not just as a matter of private debt collection or contracting. (Administrative receivership and types of ‘contractual’ arrangements such as \textit{ipso facto} clauses in contracts give rise to such issues.)\(^\text{93}\) Private

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\(^{92}\) Actors in insolvency processes may, of course, carry out some functions that are oriented towards private interests and some that look to public considerations: thus liquidators both collect and realise assets for distribution to creditors and report directorial ‘unfitness’ to the Disqualification Unit of the Insolvency Service as part of the disqualification process. See further S. Wheeler, ‘Directors’ Disqualification: Insolvency Practitioners and the Decision-making Process’ (1995) 15 \textit{Legal Studies} 283.

\(^{93}\) E.g. hire purchase agreements made to terminate on the insolvency of the hirer: see further D. Prentice, ‘Contracts and Corporate Insolvency Proceedings’, paper given at SPTL Seminar on Insolvency Proceedings, Oxford, September 1995. For US treatment of agreements designed to operate only on bankruptcy see Bankruptcy Code 1978 (as amended) s. 365(a)(1) and (b)(1).
contracting, indeed, can be seen as shading into the province of insolvency law so that clear boundaries do not exist.

Such a lack of clear boundaries should not, however, be seen as fatal to the enterprise of measuring insolvency processes. Persons of different political persuasions might be expected to disagree as to the aspects of insolvency processes that require legitimation by democratically secured rather than private rights based arguments. The point is that if legitimation is seen in terms of rationales that reflect both democratic (public) and private rights roots, clarity will be given to evaluations and the extent to which, for example, present arrangements in an area depend on contractarian justifications will be manifest. To explore modes of measuring or legitimating insolvency law is not to suppose homogeneity of political philosophies.

As for the array of rationales that can be used to legitimate powers impinging upon public interests and private rights, these have been identified by Stokes, Frug and others\(^94\) and, moreover, are limited in number. As Frug has commented: ‘we have adopted only a limited number of ways to reassure ourselves\(^95\) about the exercise of powers. The rationales can be described as: firstly, formalist, which justifies with reference to the efficient implementation of a statutory or shareholders’ mandate; secondly, expertise-based, which sees managers as worthy of trust due to their expertise and professionalism; thirdly, control-based, which looks to the restrictions imposed on discretions by courts, markets and others; and, fourthly, pluralist, which adverts to the degree of amenability of processes to representations from the public about how corporate affairs should be conducted.\(^96\)

The justifications of insolvency processes can similarly be seen as dependent not merely on the efficient pursuit of mandates but also on the degree of expertise exercised by relevant actors, the adequacy of control and accountability schemes and the procedural fairness that is shown in dealing with affected parties’ interests.

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\(^95\) Frug, ‘Ideology of Bureaucracy’, p. 1281. The description of rationales that follows in the text paraphrases and reorganises Frug in so far as judicial review is joined with market and other forms of control.

\(^96\) See also Baldwin and McCrudden, \textit{Regulation and Public Law}, ch. 3, who, in the public law context, employ the headings: legislative mandate; accountability; due process; expertise; and efficiency.
A final message to be drawn from a discussion of corporate power and its legitimation is that individual justificatory arguments may prove contentious and possess limitations (for example, the proper boundaries for expertise cannot be set without argument) but they may nevertheless possess force and may be combined with other arguments. To argue thus, it should be clear, is at odds with Frug’s well-known attack on the traditional bases for legitimating corporate or bureaucratic power. Frug identifies the four models of legitimation already noted but argues that these fail to legitimate corporate power and stresses that combining them together ‘only shifts the problem of making a subjective/objective distinction away from any particular model and locates it, instead, in the boundaries between different models’. For Frug each model fails to provide an objective justification for corporate/bureaucratic power, one free from contention. Linking the different models ‘allows people to believe that although the device they are considering at any particular moment is empty, one of the others surely is better [and] helps theorists convince themselves (and us) that the internal difficulties of each particular story of bureaucratic legitimation are unimportant’.

The limitation of Frug’s argument, however, lies in his fundamental idea of justification: in the notion that, without a basis in some objectivity, legitimating arguments lack force. If, as I have already contended, legitimation can be argued for cumulatively so that the justificatory cable is strong in spite of its flawed strands, there is far less of a problem in combining rationales of legitimation. The exercise of power can thus be seen as capable of being rendered acceptable not on the grounds that it is ‘objective in some way’ but because it is supportable by a thread of different arguments based on a limited number of identifiable rationales that are invoked on a collective basis.

Measuring the legitimacy of an insolvency process, decision or law, it should be made clear, differs from merely expressing a political opinion on the topic. Persons of opposing political persuasions – with divergent views on the just society – might differ radically in their views on dealing with a troubled enterprise. One individual might favour immediate closure, payment of creditors and reliance on reinvestment to create

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98 Ibid., p. 1379.
99 Ibid., p. 1380.

As Korobkin has argued, there are no ‘clear winners’ in arguments based on competing values, but: ‘much of the purpose of a full debate is to compare the relative strengths and weaknesses of plausible arguments, not to find a clear winner’: see Korobkin, ‘Role of Normative Theory’, pp. 108–9.
jobs. Another might stress the importance of allowing time for reorganisation because of the high premium he or she places on continuity of employment and avoidance of the external costs that closure might occasion. An exchange of such political views would not, however, amount to a discussion of the legitimacy of the proposed move. To debate legitimacy, as conceived here, involves a stepping back and reference, not to personal preferences or visions, but to values enjoying broad acceptance as consistent with the underpinnings of democratic liberalism. The four key values referred to build on Frug: thus ‘efficiency’ looks to the securing of democratically mandated ends at lowest cost; ‘expertise’ refers to the allocation of decision and policy functions to properly competent persons; ‘accountability’ looks to the control of insolvency participants by democratic bodies or courts or through the openness of processes and their amenability to representations; and ‘fairness’ considers issues of justice and propensities to respect the interests of affected parties by allowing such parties access to, and respect within, decision and policy processes.

To be clear, these are, accordingly, not offered as values plucked from the sky but as values that would be endorsed by parties of differing political persuasions – provided that those parties endorse democratic liberalism – albeit in their own precise terms. Such a ‘values’ argument thus proceeds to normativity from the factual assumption that certain values are broadly accepted and by asserting that it is, therefore, right that insolvency regimes should be designed and operated to serve those values. Such an approach does not offer the certainty or the authority that flows from a single theoretical vision of the just insolvency system but it is on much safer practical ground. It is inconceivable that all persons can be persuaded to share the same single theoretical vision (we will never all be Rawlsians or Jacksonians) but it is far safer to assert that we all share an acceptance of certain values: for instance, those served by pursuing democratically mandated ends without waste or by operating procedures that are accountable, open and fair to affected

101 See L. J. Rusch, ‘Bankruptcy Reorganisation Jurisprudence: Matters of Belief, Faith and Hope’ (1994) 55 Montana L Rev. 16, arguing that competing theories of bankruptcy law reduce to competing ‘beliefs and values’ which cannot be shown to be true or false (discussed in Korobkin, ‘Role of Normative Theory’).

102 Such a notion of justice, accordingly, has procedural and substantive aspects – whether a process accords respect to an interest can be seen as a procedural issue but defining who constitutes an ‘interested party’ raises substantive issues.

103 On ‘values’ approaches see Korobkin, ‘Role of Normative Theory’ pp. 104–11.
parties. As Korobkin has pointed out, such ‘value’ arguments are not completely authoritative—they do not attempt to set out an authoritative basis upon which to justify or act—but: ‘they have a certain kind of normative force, in that they identify what we value and cite coherent reasons to adopt a particular critical claim’. In essence they allow the proposer of a course of action to say: ‘We should do X because this course will serve the values we all acknowledge’ rather than: ‘We should do X because this course will serve my vision of the just society, which you should all accept.’

What, though, of the difficulty, noted above, of tensions and trade-offs between different legitimating values or rationales? Surely some such rationales will pull in opposite directions? How, moreover, will the above justificatory principles influence the concrete decisions to be confronted by insolvency law, for example whether English insolvency law might introduce some variant of debtor in possession?

The answer to these questions is that clarity concerning the measures of insolvency law can be seen as clarity concerning the values that can be served by such laws. Such clarity, however, does not produce cut and dried answers on whether particular trade-offs between, for instance, protections for secured creditors and for employees are desirable or not. The rightness or wrongness of particular trade-offs can only be argued for by giving weightings or priorities to the protection of different values or interests. Such weightings and priorities presuppose substantive visions of the just society and, accordingly, persons of different political persuasions might be expected to differ on the ‘right’ balancing of different interests in insolvency.

The approach to evaluation offered here may produce no fine-tuned answers on either procedural or substantive issues (to demand such answers would be to ask for conversion to a particular ethical or political vision). The approach, nevertheless, does have force in identifying the values and rationales that can be accorded currency in debates on insolvency law. It can, accordingly, be termed an ‘explicit values’ rather than a multiple value vision of insolvency processes. The explicit values perspective brings the advantage of making clear the need for and nature of trade-offs. Thus, in discussing whether a variant of debtor in possession ought to be introduced into English insolvency law, an assessment

104 We can thus all agree that processes should be fair (procedurally and substantively) even though we might, at the end of the day, disagree on the details, e.g. concerning the parties whose interests entitle them to participation in a process.
would be made of the support that such a measure would merit under the various legitimating headings made explicit above. Relevant questions would be: is this a process that allows Parliament’s will to be effected without waste of resources? Can appropriate expertise be applied in such processes? Are levels of accountability acceptable? Can the proposed processes be deemed fair as giving due access to and respect for the interests of affected parties? The issue of trade-offs would, nevertheless, remain, but final political judgements would be made with a transparency that would be lacking were reference not made to the array of values or rationales described here.

That transparency, it must be conceded, cannot be complete. Such a state of affairs could only be achieved by persuading all parties to agree to a single vision of the just insolvency regime as derived from a single vision of the just society.105 This sort of agreed vision would form a basis for clarity on, for example, the level of expertise that is appropriate in a process or how, precisely, we can delineate acceptable standards of access or qualifying interests. It is not, however, an agreed vision liable to be encountered in the real world. What the ‘explicit values’ approach offers, accordingly, is something more realistic but less neat. It offers no ideal vision aimed at universal subscription but a means of bringing a degree of clarity to evaluative discussions while accepting that we may all differ in our conceptions of the just society or the just distribution of rights in insolvency. It explains how, with such differing conceptions, and in the

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105 LoPucki has spoken of a debate between bankruptcy scholars as involving the ‘Paradigm Dominance Game’ which aims not to solve problems but ‘to get everyone thinking about the problem in one’s own frame of reference and talking about it in one’s own language’: see L. M. LoPucki, ‘Reorganisation Realities, Methodological Realities, and the Paradigm Dominance Game’ (1994) 72 Wash. ULQ 1307, 1310; and Korobkin, ‘Role of Normative Theory’. For an essay in promulgating a single vision see Mokal’s ‘Authentic Consent Model’ (in Corporate Insolvency Law ch. 3) which adapts Rawlsian principles for ‘analysing and justifying’ the body of corporate insolvency law. Sceptics are liable, however, to ask why any non-Rawlsian should be expected to buy into such a vision and are liable to object that Mokal’s use of a Dramatic Ignorance device is question-begging because the Rawlsian consent position is set up on the basis of prior and key assumptions of a contentious nature – notably regarding the political conception of the person (an ‘ideal of the individual’) and the ‘legal and political culture of society’. For further concerns regarding this approach see Duggan, ‘Contractarianism and the Law of Corporate Insolvency’, pp. 463–81 and Goode, Principles of Corporate Insolvency Law, p. 48, who criticises those who espouse variants of the creditors’ bargain theory on the grounds that: ‘most of them assume an original position in which the various players and the bargain they make act in an economically rational manner according to a single set of criteria. This may be an elegant model but has no necessary connection with fact.’
face of mandates that are less than certain, we can still have meaningful debates on insolvency processes or reforms – and can do so in examining how different values are collectively served. It accepts that there are no knock-down arguments in such debates, only those of greater or lesser persuasive power.

Assessing the legitimacy of insolvency processes or decisions is not, however, the same thing as assessing the formal legitimacy of an insolvency law or statute. As noted, one benchmark for processes or decisions is the extent to which a statutory mandate is efficiently implemented. Where a clear mandate exists this, indeed, provides a very compelling yardstick for measuring an insolvency decision or process, and some aspects of insolvency processes do involve agents in implementing quite clear, almost mechanical, tasks as set down in statutes: for example, the liquidator’s statutory duty in voluntary winding up to distribute pari passu.106 To the extent that such clear mandates are lacking – and it is not always possible to produce a clear prescription as opposed to a conferring of discretions, or a listing of factors to be taken into account or a stipulation of proper purposes for action107 – there is all the more need to legitimate with reference to the expertise, accountability and fairness justifications. Put another way, it is because mandates are often unclear that justifications based on expertise, accountability and fairness come into play. In such circumstances, these procedural rationales have a value that is freestanding and possessing of legitimating force within a democracy – and this is why they are not merely aspects of the mandate. To take the examples of accountability and fairness, it can be argued that if a procedure is appropriately open, controlled, amenable to access and respectful of affected interests, this allows the public and affected parties a degree of representation that, in a democracy, compensates for vagueness in the mandate by allowing them to shape the mandate in its application.

It might, of course, be objected that, without a single agreed notion of the just society, it is as impossible to say what procedural fairness amounts to as it is to give content to the notion of substantive fairness. The real world challenge is, however, not to sell a concept of justice to the

general population but to find what coherence we can in a world of
different visions and preferences – to explain how we can debate insolvency (or other) processes when we hold divergent views concerning justice, fairness, accountability and so on.\footnote{See also Korobkin’s argument that different kinds of insolvency theory can be thought of as doing different jobs – for example explaining events, offering predictions or providing normative prescriptions. (Korobkin, ‘Role of Normative Theory’ at p. 96.)} The contention here is that we can engage in such debates, and find a level of coherence in these, by using common benchmarks or reference points. In the case of procedural fairness, for instance, parties can – necessarily in a broad church manner – agree that this demands that persons or firms with affected interests should be allowed an access to processes that implies a respect for their interests. The fact that people with different visions of justice will disagree at the end of the day on the weighting of various interests is not, on such a view, fatal to a debate that makes reference to a series of democratically valued (but elastic) yardsticks.

Would it not be circular, however, to evaluate an insolvency law by asking (\textit{inter alia}) whether it implements a statutory mandate? If a judicial application of a statute is at issue then circularity is avoided since it makes sense to ask if, in a particular instance, a judge’s ruling derives legitimacy from its clear implementation of Parliament’s will as expressed in a statute (again there may or may not be a clear expression of the mandate available). What of an actual or proposed statutory provision? Does reference to the implementation of a statutory mandate involve circularity? This may not necessarily be the case. Where there is a clear policy or practice laid down then it may be claimed that Parliament’s will is being effected and there is a high degree of legitimacy involved, though it will still be possible to consider whether a reform of the provision would be supportable on grounds other than mandate implementation. If, however, the provision at issue merely confers discretion (while, perhaps, laying down factors for consideration) it can be contended that there is not so much an expression of Parliament’s voice as a delegation on the substantive issue. The legitimacy of any decision or act taken in implementation of such a provision would accordingly fall to be judged with reference to a series of rationales since the mandate justification only renders the others irrelevant where there is absolute clarity of the mandate.

Does this mean that an insolvency law is worthy of support provided that it has proper statutory form? Again this is not necessarily the case.
means that a very high level of democratic legitimacy is assured to a statutory insolvency provision provided that the statutory mandate is absolutely clear (a rare event). Where it is not possible to lay down a statutory provision that dictates a result with clarity, the other benchmarks come into play and reference can be made to expertise, accountability and fairness considerations in evaluating the provision and its anticipated effects.

The implication of this argument, it might be contended, is that if Parliament decrees something (anything) on insolvency with a clear voice then this is hardly challengeable. The response is that it is difficult to deny the democratic authority of our democracy’s most authoritative voice but that evaluation by the hypothetical or proposed reform method noted above is still possible. In the vast majority of instances, where Parliament does not dictate a result but leaves issues and discretions open (or indeed in debating proposed legislation), evaluations may be made with reference to the array of legitimating rationales: asking, for example, of a proposed insolvency provision, whether it will produce results that are supportable according to expertise, accountability and fairness as well as the mandate rationales. Such evaluations may be made of and by the various actors involved in the insolvency processes: for example, judges, administrators, nominees under voluntary arrangements and liquidators. 109

Where, though, does this leave economic efficiency in the wealth maximisation sense as a benchmark for insolvency regimes? 110 The

109 Liquidators may implement statutory mandates mechanically in distributing assets pari passu, but discretion is involved in their ‘policing’ functions (e.g. whether to initiate proceedings under inter alia the Insolvency Act 1986 ss. 214, 238 or 239) and in their reporting ‘unfit’ directorial conduct to the Disqualification Unit: see Wheeler, 'Directors’ Disqualification’, pp. 300–1.

110 Economists use ‘efficiency’ in a number of senses and it is as well to be clear about these. The notion of allocative efficiency is commonly used in two ways. A situation is Pareto efficient if the welfare of one individual cannot be improved without reducing the welfare of any other member of society. In contrast, a situation is Kaldor–Hicks efficient if those who gain could in principle compensate those who have been harmed by a position and still be better off. (This efficiency can also be referred to as cost–benefit analysis, wealth maximisation, allocative efficiency or simply efficiency.) Technical efficiency (or transaction cost efficiency) is concerned with achieving desired results with the minimum use of resources and costs and the minimum wastage of effort. Dynamic efficiency refers to the capacity of a given system to innovate and survive in a changing and uncertain environment. In this book the word ‘efficiency’ will be used to denote technical efficiency, and ‘economic efficiency’ will refer to efficiency in the Kaldor–Hicks/wealth maximisation/cost–benefit sense. On efficiency concepts and
wealth maximisation argument was criticised above as offering little assistance on distributional matters.\textsuperscript{111} We have seen that clear mandates are rare in the insolvency field and it is not advisable, in the absence of clear mandates, to leap to wealth maximisation itself as the next best statement of substantive objectives. Wealth maximisation, accordingly, will be treated, in this volume, as having no freestanding value as an objective of insolvency processes. Note will, nevertheless, be taken of influential debates concerning the economic efficiency/wealth maximising (hereafter ‘economic efficiency’) effects of certain processes – since, on a given issue, elective bodies may – or may not – be inclined to pursue such economic efficiency objectives.\textsuperscript{112}


\textsuperscript{111} See note 36 above, accompanying text, and, notably, Dworkin, ‘Is Wealth a Value?’ A key reason why principles of wealth maximisation offer no basis for guiding distributional decisions is that this would involve circularity – judgements regarding the actions that would maximise total wealth can only be made by making prior assumptions about the distributions of wealth in society. See e.g. R. Coase, ‘The Problem of Social Cost’ (1960) 3 J Law and Econ. 1; A. Kronman, ‘Wealth Maximisation as a Normative Principle’ (1980) 9 \textit{Journal of Legal Studies} 227.

\textsuperscript{112} The economic efficiency or otherwise of a process or institution is thus seen as contingently relevant – when, for instance, statutory objectives aim for such economic efficiency. In the absence of a link to a mandate, economic efficiency is not treated here as a factor of independent value. This treatment of economic efficiency contrasts with that accorded to, say, accountability which is seen as having a value independent of the mandate – indeed as a counterbalance to any lack of clarity in the mandate. On the value of considering economic efficiency as one of a number of evaluative criteria see A. Keay, ‘Directors’ Duties to Creditors: Contractarian Concerns Relating to Efficiency and Over-Protection of Creditors’ (2003) 66 MLR 665, 678.
accordingly, be that, given the objectives being pursued by Parliament (as derived from a reading of the Bill as a whole), the clause in question would set up a mode of achieving those objectives that is not lowest cost. To criticise on this basis is not so much to set one’s own objectives above those of Parliament as to assume that Parliament wishes its aims to be achieved without waste of resources. Arguments might similarly be mounted that a certain interpretation of a statutory provision is undesirable because it is not consistent with lowest-cost ways of achieving Parliament’s overall objectives as expressed in the given statute as a whole.

Conclusions

In looking for the measures of insolvency law, a series of different visions of insolvency is encountered and, although these visions may be flawed, they can be seen as incorporating a number of important legitimating rationales for insolvency processes. There is more to measuring such processes, it has been noted, than stipulating a series of substantive outcomes (e.g. preserving viable enterprises). Procedural concerns are relevant also. Measuring, as put forward here, thus looks to the whole breadth of insolvency processes and the cumulative force of arguments deriving from a variety of visions: making reference to technical efficiency in producing appropriate outcomes; expertise; accountability; and fairness.

How does this advance matters beyond the substantive and procedural aims set down, for instance, by Cork?\footnote{113 Cork Report, paras. 191–8, 203–4, 232, 238–9.} First, the approach arrived at here offers an explanation of what is involved in assessing insolvency processes and, in addition, throws light on the different kinds of legitimating argument that are contained within such lists of aims as Cork offers. Second, it might be complained that the present approach is as lacking in precise benchmarks as the eclectic or communitarian visions, but it has been possible to identify and make explicit a number of different rationales for justifying insolvency processes: namely efficiency, expertise, accountability and fairness. Trade-offs between different rationales do remain a problem but, unless a single vision of the just society is assumed, the absence of easy answers has to be accepted when dealing with processes whose essence is the balancing of multiple objectives.
What has been offered here has been an approach to measuring that takes on board the public and private, the procedural and substantive, and the contractarian and democratic dimensions of insolvency. As already noted, acceptance that both the public and private dimensions of insolvency law are to be reflected in legitimation involves an acceptance, in turn, that legitimation may be derived from both the propensity of insolvency laws and decisions to further communitarian interests and the potential of such laws and decisions to protect pre-existing rights. The approach offered in this book – the explicit values approach – holds that an identifiable list of justifications has relevance in assessing the legitimacy of insolvency processes. The list is limited rather than open-ended (as was a problem with eclectic and communitarian visions) in so far as relevant legitimating arguments are organised under the four headings noted and arguments not falling under such headings are accordingly not to be treated as relevant for purposes of legitimation.

Such an approach, in turn, implies a particular approach to insolvency procedures. Dealing with explicit values in the above manner exposes the trade-offs between different values that have to be made in designing and applying insolvency processes. A variety of interests will accordingly have to enter consideration in a host of procedures. Such processes must respect the interests of, and the roles to be played in, insolvency by a range of parties affected by insolvency: not merely creditors (secured and unsecured) but employees, company directors, shareholders, suppliers, customers and other ‘commercial dependants’ of the company. The broad public interest must also enter deliberations as a valid concern and procedural inclusivity should be seen in access to information, broad inputs into key decisions and in holding parties to account. This is not to argue that customers, for instance, should have the same access to information and processes as creditors; it is to suggest that reasonable access for customers should not be denied in insolvency procedures on the grounds that customers have no recognisable interest in insolvency. The interests of affected or potentially affected parties should be procedurally recognised where the costs of doing so are reasonable. In some particular contexts, of course, rights of reasonable access may involve excessive costs through creating legal uncertainties that cannot be resolved and in those contexts restrictions will be appropriate. Such matters will be considered in the chapters that follow.

Does an explicit values approach supply the ‘fundamental or core principles’ that the 1994 Justice Report advocated as guides to the ‘true essence of the insolvency process’? It does not offer a cut-and-dried series
of primary principles to which others can be seen as subservient. The list of values set out here does, however, provide a core in the sense of a framework offering guidance in the development of insolvency rules and arrangements. It adds, for instance, to the arrangements of objectives set down by the Cork Committee by placing those objectives within a frame of concerns established according to the four particular rationales serving to justify insolvency rules. Those rationales provide a context for Cork’s objectives rather than leaving them as aims apparently plucked from the sky. The linking or cumulation of rationales also reminds us that objectives, such as are set out by Cork, do have to be weighed and traded against each other.

An explicit list of rationales, furthermore, offers a checklist to be dealt with by judges and decision-makers when dealing with insolvency issues. These actors may thus be invited not to reason with reference to a single or dominant vision of insolvency but to deal with points relevant to each of the four kinds of justificatory argument noted. Trade-offs between different ends and justifications are thus to be argued for in particular contexts and cannot be preordained according to set rules. Such argumentation should, however, be carried out explicitly and it is this structured transparency that will be the best guarantee of insolvency laws and processes that display a sense of direction.

For the purposes of this book, the rationales of efficiency, expertise, accountability and fairness provide benchmarks with which to evaluate both current and proposed arrangements. Such benchmarks can be applied not merely to substantive laws and informal rules but also to institutional structures and to those processes that are used to apply insolvency laws and rules on the ground. Throughout the chapters that follow, these benchmarks will be applied and, in particular contexts, attempts will be made to explain the balances and trade-offs that are involved between particular values or rationales. This book, however, sets out not merely to evaluate laws, processes and reforms. As indicated in the Introduction, it also aims to rethink perspectives. The ensuing chapters will, accordingly, apply the above benchmarks but will also consider whether improvements in corporate insolvency laws and processes have to come through new approaches and by adopting perspectives that challenge the underpinning assumptions of current corporate insolvency systems.
PART II

The context of corporate insolvency law: financial and institutional
Insolvency and corporate borrowing

The issues attending corporate insolvency law are closely linked to those surrounding corporate borrowing. It is the creation of credit that gives rise to the debtor–creditor relationship and makes insolvency possible in the first place. Credit can be obtained by companies in a variety of ways, as we will see in this chapter, and the various modes of obtaining debt bring with them different arrangements for dealing with repayments. These arrangements will be relevant when dealing with companies that can no longer repay all their creditors.

To ask whether the legal framework of corporate insolvency law is acceptable demands, accordingly, some examination of the arrangements that the law recognises for obtaining credit in order to raise corporate capital. If corporations or creditors in an insolvency face problems that arise from the multiplicity and complexity of arrangements for obtaining credit and the ensuing difficulty of resolving the respective claims of different types of creditor, the best way to reform insolvency arrangements might well be to rationalise the legal methods available for raising capital and obtaining credit rather than to tinker with the insolvency rules that apply to the various credit devices.

Insolvency arrangements can be assessed with reference to the factors outlined in chapter 2 but the link with credit should always be borne in mind and companies should be seen in both their healthy and their troubled contexts. It would be undesirable, for instance, to reform and improve insolvency arrangements if the result was to prejudice mechanisms for providing healthy companies with the credit arrangements that they need for effective action in the marketplace. The arrangements that best meet the needs of healthy, trading companies, it should be recognised, are not those that necessarily produce the smoothest-operating insolvency regimes and,

1 See Report of the Review Committee on Insolvency Law and Practice (Cmd 8558, 1982) (‘Cork Report’) ch. 1, especially para. 10, on credit as the ‘lifeblood of the modern industrialised economy’ and ‘the cornerstone of the trading community’.

2 See Cork Report, para. 1628 for acknowledgement of this connection.
in designing credit arrangements (with their attendant insolvency implications), the objective should be to maximise the sum of benefits to those involved with both healthy and troubled companies. (Here 'benefits' refers to procedural and democratic as well as financial advantages.) It may be the case that companies need a wide range of flexible credit arrangements and insolvency law has to cope accordingly.

This chapter will consider the main methods by which companies can borrow money and will explore the insolvency law implications of different credit arrangements. The emphasis of the chapter will rest on the benchmark of economic efficiency since it is necessary to respond to a considerable body of debate on credit arrangements which has focused heavily on that yardstick. As was noted in chapter 2, however, it is essential to place economic efficiency debates in their proper, limited, context by considering questions of expertise, accountability and fairness. These matters, accordingly, will be returned to in parts III and IV of the book. The discussion here asks how the legal structure of each mode of obtaining credit contributes to the supply of funds for a healthy company and whether that structure fosters economic efficiency by allowing insolvencies to be dealt with at lowest cost. (The needs of healthy, trading companies will be dealt with briefly since this is not a book dealing centrally with corporate financing.) At this stage, it should be noted, it is the formal legal structure of financing arrangements that is the primary object of attention. Later chapters will broaden the discussion to consider in more detail how such arrangements are put into effect.

Arrangements for obtaining credit will be examined individually in this chapter but it will then be necessary to consider whether, as a package, the available legal arrangements perform well in relation to both healthy and troubled companies. It is conceivable, after all, that each device may perform adequately in its own right but that collectively they may prove economically inefficient because they give rise to legal confusions and uncertainties. We begin by looking at the parties involved in, and the incidence of, borrowing before considering in more detail the particular routes available for the financing of corporate activity.

**Creditors, borrowing and debtors**

Companies in England can raise capital through issuing equity – by selling shares\(^3\) – but they are also able to borrow from a wide variety of

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\(^3\) Space here does not allow a discussion of strategies for raising equity capital, on which see G. Arnold, *The Handbook of Corporate Finance* (Pearson Education, London, 2005)
individuals and institutions. A first kind of creditor is the institutional lender. This is exemplified by the high street clearing bank that plays an important role in offering companies not merely loans but flexible finance in the form of overdrafts. Other types of institution are the accepting houses: a number of merchant banks which usually offer term loans for periods of five years or more. The merchant banks have traditionally been associated with the supply of venture capital: money used in relation to high-risk activities, for example to start up ventures or to effect rescues and, in reflection of higher than average risks, tending to be accompanied by demands for higher than average returns or shares in the enterprise, or both.

A second kind of commonly encountered lender is the trade creditor, the individual or firm who supplies goods or services to the company but who does not require immediate payment. Such creditors will often transfer goods to a company and await payment at a later date but they may also offer goods in return for a bill of exchange (in the form, for example, of a post-dated cheque) or in accordance with leasing or hire purchase terms. These latter arrangements allow companies to spread the costs of purchasing an item (for example, a new piece of machinery) over a proportion, or all, of the asset’s lifetime.

A third type of creditor is the wealthy individual who may be persuaded to put money into a venture. The term ‘business angel’ has developed to refer to individuals who perform venture capital roles, usually offering loans and, in return for these, combining repayment...
conditions with the taking of an equity stake in the debtor company. There is now a trade association for business angels: the British Business Angels Association (BBAA), which aims to promote business angel finance subject to its own code of conduct for members.

Governmental agencies comprise a fourth group of creditors. Thus the Government has deployed three main types of fund in order to stimulate the growth of private capital. These are Regional Venture Capital Funds (which by 2006 had committed over £250 million); the UK High Technology Fund (supporting 216 small high technology businesses by the end of 2005) and Early Growth Funds (distributing early growth funding on a regional basis).

In 2000 the Government set up the Small Business Service (SBS) which, in 2007, was renamed the ‘Enterprise Directorate’. This is a unit within the Department for Business Enterprise and Regulatory Reform (BERR) and is given policy responsibility for the Government’s investments in a range of business support tools – including Business Link, Enterprise Insight and access to finance funds. Such funds can be used to stimulate private sector funding as is the case with the Small Firms Loan Guarantee Scheme (SFLGS). This is a joint venture between BERR and a number of participating lenders and, under this scheme, government guarantees against default can be used to encourage lenders to fund small firms that lack the assets to cover a security.

At the European level, the European Investment Bank (EIB) operates as a non-profit-making body and is a source of venture capital as well as medium- and long-term loans to companies of all sizes. The Inland Revenue also constitutes a creditor (often an involuntary one) in so far

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8 See further p. 82 below.
11 The European Commission decided to adopt a Fourth Multinational Programme for SMEs for the five years from January 2001 with a budget of €450 million: see EU Commission, Enterprise and Industry, Multinational Programme for SMEs 2001–6 (europa website). For an overview of funding opportunities available to European SMEs see European Commission, Enterprise Directorate-General, EU Support Programmes for SMEs, 2005.
12 See Cork Report, paras. 1409–50. The Crown’s preferential status for moneys owed on PAYE or NI has now been abolished: see Enterprise Act 2002 s. 251.
as companies may owe tax payments, though in some cases they may have negotiated schedules for such payments.\textsuperscript{13} A further type of creditor is the holder of a document issued by the company which acknowledges indebtedness and which usually (but not necessarily) involves a charge on the assets of the company. Under the Companies Act 2006 a ‘debenture’ includes debenture stock and bonds\textsuperscript{14} and company debentures can also be referred to as ‘loan stock’. A debenture is a document given in exchange for money lent to the company and debentures and debenture stock can be offered for sale to the public.\textsuperscript{15} The debenture holder is a creditor of the company and the latter agrees to repay the holder the principal sum by a future date and to pay, each year, a stated rate of interest in return for use of the funds. The use of loan stock, particularly by larger companies, will be returned to below.\textsuperscript{16}

Another major category of corporate creditor is the employee. In so far as employees have carried out work and are entitled contractually to wages and other benefits as yet unpaid, they constitute creditors of the firm. Shareholders, moreover, may also be creditors in that they may be owed money in their capacity as shareholders (such as dividends). Similarly, consumers of the company’s products and other corporate customers may provide credit to the company where they pay in advance for goods or services – practices common in the mail order, travel, furniture retail and building sectors.\textsuperscript{17} Those who prepay are almost invariably unsecured creditors where the supplying company becomes insolvent before delivery. They are, however, important creditors for many firms.\textsuperscript{18} Cork noted that ‘In many cases, advance payments are an essential part of the trader’s working capital.’\textsuperscript{19}

\textsuperscript{13} Local authorities can also be (unsecured) creditors for rate arrears and council taxes: see further D. Milman and C. Durrant, \textit{Corporate Insolvency: Law and Practice} (3rd edn, Sweet & Maxwell, London, 1999) ch. 10.

\textsuperscript{14} Companies Act 2006 s. 738; see further Fuller, \textit{Corporate Borrowing}, ch. 17.


\textsuperscript{16} See pp. 91–3 below.

\textsuperscript{17} See Office of Fair Trading (OFT), \textit{The Protection of Consumer Prepayments: A Discussion Paper} (1984); Cork Report, para. 1052: ‘the customer who pays in advance for goods or services to be supplied later extends credit just as surely as the trader who supplies in advance goods or services to be paid for later. There is no essential difference.’ See chs. 14 and 15 below.

\textsuperscript{18} The OFT has estimated there to be at least 15 million prepayment transactions each year (OFT, \textit{Protection of Consumer Prepayments}, para. 2.12).

\textsuperscript{19} Cork Report, para. 1050.
Finally, there is a class of involuntary creditor that should not be forgotten. This is the individual or firm who is owed money because they are entitled to payment from the company in accordance with a court order. Thus victims of corporate torts may be treated as corporate creditors and will have participatory rights in an insolvency.

How to borrow

Credit arrangements are complex and, as will be discussed below, are exploding in complexity. It is, therefore, useful before proceeding further to map out the main legal methods – or building blocks – of borrowing. This will give a picture of the array of options that are open to companies seeking funds. It should be repeated first, however, that not all ways of raising money involve credit. As we will see below, companies can raise finance through the sale of equity shares – a process in which money is put into the company in return for dividends and a hoped-for increase in share value. These shareholders are not creditors of the company, who have rights against the company, but owners of the company with rights in it.20

Credit can be obtained in four main ways: by offering security; by seeking an unsecured loan; by using a sale as a de facto security arrangement; and by resort to a third-party guarantee.

Security

When borrowing companies offer security to lenders this may prove attractive to the latter because, inter alia, it reduces their loan risks by giving them privileged claims to repayment in the event of the borrowing company’s insolvency.21 The normal rule in a corporate insolvency is...

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20 Capital in modern company law is used to cover not only share capital provided by the proprietors but also the loan capital provided by the creditors. On shareholders viewed as owners of the company see, for example, H. Butler, 'The Contractual Theory of the Corporation' (1989) 11 Geo. Mason UL Rev. 99. On different characterisations of the nature of a shareholder’s interest see E. Ferran, Company Law and Corporate Finance (Oxford University Press, Oxford, 1999) pp. 131–3.

supposedly that all unsecured creditors are treated on an equal footing – *pari passu* – and share in insolvency assets *pro rata* according to their pre-insolvency entitlements or sums they are owed. Security avoids the effect of *pari passu* distribution by creating rights that have priority over the claims of unsecured creditors.

Security can arise either consensually or through operation of the law. There are four forms of consensual security in English law: the pledge; the contractual lien; the mortgage; and the equitable charge. Pledges involve the creditor taking possession of the debtor’s assets (goods or documents of title to goods) and retaining these as security until payment of the debt. The early common law demanded actual transfer of possession to the creditor but the development of the doctrine of constructive possession obviated the need for this. Where a contractual lien is used to obtain credit, the borrower gives the creditor, by contract, a power to detain goods already in the creditor’s possession for non-security reasons and to use these as security for payment. This position might arise, for instance, where the creditor possesses an item of machinery in order to carry out maintenance work. A lien differs from a pledge in conveying a power to detain the goods rather than sell them on default by the borrower.

A mortgage of chattels transfers ownership to the creditor as security on a condition (express or implied) that there shall be reconveyance to the debtor once the secured sum has been repaid. In the case of land, however, a mortgage interest can be hived off from a fee simple so that land mortgages do not involve complete transfers of ownership and both mortgagor and mortgagee have concurrent legal estates (fee simple possession) and they can be applied to all classes of asset, tangible and intangible. They are, accordingly, of enormous utility to borrowers.

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25 See Goode, *Commercial Law*, p. 585; but see *Re Hamlet International plc* [1998] 2 BCLC 164, where a contractual possessory lien over goods, granted by a customer to a company, coupled with a contractual right entitling the company to sell such goods to pay sums owed to it by the customer, did *not* constitute a charge registrable under the Companies Act 1985 s. 395 (see now Companies Act 2006 s. 860). On registration of company charges generally see H. Beale, M. Bridge, L. Gullifer and E. Lomnicka, *The Law of Personal Property Security* (Oxford University Press, Oxford, 2007).
The use of an equitable charge allows debtors to agree that certain specific items of their property will be available as security for loans. Such a charge does not involve a transfer of ownership or possession; instead it gives the creditor a right to have the designated asset sold to discharge the debt. The equitable charge may be fixed on a particular asset or may be floating. With fixed charges the debtor may dispose of the asset only with the creditor’s consent (or by repaying the debt). The floating charge hovers over a stipulated class of assets in which the debtor has present or future interest. The debtor is, however, free to deal with particular assets within the class while the charge remains floating, that is until the point when the charge crystallises and fixes on all the assets then in the fund.26

As for security arising through operation of the law (‘non-consensual security’), this may be anticipated by the potential corporate debtor and used as a way of establishing a credit arrangement. The main forms of security thus arising are the lien, the statutory charge, the non-contractual right of set-off, the equitable right to trace and procedural securities.27

Liens, as noted, give persons in possession of the property of others for the purposes of work a right of retention until the work at issue has been paid for. Liens may arise through the operation of the common law,28 equity29 or statute.30 A statutory charge gives the chargee a right to apply to the court for an order of sale where a debt has not been paid.31 Both law and equity allow mutual debts between parties to be set off.32 Equitable tracing allows a person whose asset has been wrongfully

26 Or on assets of the specified description subsequently acquired by the debtor: see Goode, Commercial Law, p. 587. Crystallisation arises on the occurrence of a number of events, e.g. the commencement of the winding up of the company, the chargee appointing a receiver under the terms of the charging document or the chargee taking possession of the assets. Crystallisation will also occur where an administrator is appointed by a qualifying floating charge holder under the Insolvency Act 1986 Sch. B1, paras. 2(b), 14.
27 See generally Snaith, Law of Corporate Insolvency, ch. 6; Goode, Commercial Law, pp. 619–23.
28 Some general liens may extend to all goods in the lienee’s possession whether the sum payable relates to work done on those goods or other work. Thus solicitors, bankers and others enjoy these liens: see Goode, Commercial Law, p. 619.
29 Which does not require possession, as with the vendor of the land’s lien to secure the purchase price.
31 E.g. the Legal Aid Act 1988 s. 16(6) gave the Law Society a charge on money and property recovered in proceedings by a legally aided litigant to secure payment of Law Society costs.
32 See ch. 14 below.
disposed of by another to assert a claim to the proceeds received in exchange for it. Finally, procedural securities may operate at law so that a company making a claim through the legal process can apply to have certain of its opponent’s assets taken into the custody of the court as security for satisfaction of the claim at issue or, *inter alia*, an order for costs.33

Unsecured loans
A company can seek a loan without offering security but in such an arrangement the lender bears the risk that if the debtor company becomes insolvent its own debt will be satisfied after the secured creditors have been paid. The unsecured creditor, moreover, has no enforceable interest in the debtor’s property prior to bankruptcy or winding up, only a right to sue for money owed and to enforce a court judgment against the debtor.

Like a secured loan, an unsecured loan may constitute ‘loan credit’ – the loan of money – or it may be ‘sale credit’ – where goods or services are supplied to the debtor but payment of the price for these is allowed to be delayed. In practice, however, sale credit in the normal course of trade is more likely to be unsecured than secured. Companies, moreover, may seek either fixed-sum or revolving credit.34 With the former the debtor takes a fixed amount for a stated period but with revolving credit there is an ongoing facility to draw varying sums within agreed limits.

Quasi-security
Companies can enter into a number of legal relationships that, on their face, appear to be sale arrangements but which operate in practice as security devices.35 These arrangements may merit the close attention of insolvency lawyers since they can be seen as having roles both in supplementing and in circumventing legal rules and principles covering corporate insolvency. They may, for example, not require registration and the assets involved may not be caught in the insolvency net. The main

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devices are reservations of title;\textsuperscript{36} hire purchase agreements; sale and lease back; sale and repurchase; and discounting of receivables.\textsuperscript{37} The key aspect of these agreements is that the debtor company is able to raise funds by allowing ownership to rest with the ‘creditor’ rather than offering security, and the ‘creditor’ avoids having to compete for insolvency assets with other creditors because he or she holds title or has not passed title in the assets at issue to the insolvent company.

With reservations of title, for instance, the goods will be sent to the ‘debtor’ company by the seller, ‘creditor’ A, but ownership, it will be stipulated, will not pass until the full price has been paid. If the debtor company becomes insolvent, the goods, whose title remained with A, do not form part of the insolvency assets.\textsuperscript{38} In a sale and lease back a similar effect is achieved by the debtor selling an asset to the creditor in return for a sum of money and continuing to use the asset (for example, a warehouse) by leasing it back under a hire or hire purchase agreement.\textsuperscript{39} The creditor retains the title throughout and the warehouse does not form part of the insolvency assets or estate. Sale and repurchase offers another variation in which the company sells goods to the debtor company for a price to be paid in instalments. The agreement states that where the debtor defaults, A may repurchase the goods after deducting the amount outstanding from the purchase price. Finally, discounting of receivables (or factoring) involves the purchase of invoiced receivables (sums due under outstanding invoices) at less than their face value. The

\textsuperscript{36} Surveys reveal that the majority of suppliers employ retention of title clauses in their conditions of sale. J. Spencer, ‘The Commercial Realities of Reservation of Title Clauses’ [1989] JBL 220, 221 surveyed fifty suppliers and found that 59 per cent of respondents said they used such clauses. Wheeler examined fifteen receiverships and liquidations and found that 92 per cent of suppliers of goods had ‘some sort of reservation of title provision’: see S. Wheeler, Reservation of Title Clauses (Oxford University Press, Oxford, 1991) p. 5.


\textsuperscript{38} See generally Wheeler, Reservation of Title Clauses; I. Davies, Effective Retention of Title (Fourmat, London, 1991); G. McCormack, Reservation of Title (2nd edn, Sweet & Maxwell, London, 1995). See also ch. 15 below.

assignor whose receivables are so discounted receives immediate cash to the extent of the purchase price. The financier deducts an administration charge in addition to the ‘discount’, which, by being calculated on a daily yield basis, produces a sum equivalent to interest on the amount advanced to the assignor. The company thus receives a cash sum earlier than would have been the case had it waited for its debtors to settle their accounts.

As will be discussed below, however, it is not easy to characterise many quasi-security arrangements and the courts may face difficulties in deciding whether a transaction is, for legal and insolvency purposes, a loan secured by a mortgage or charge, a sale or an outright assignment.

Third-party guarantees

Often a loan from a creditor such as a bank will be ‘guaranteed’ by a third party – which may be an individual director of the debtor company but could also be a parent or subsidiary company within a group. The Government itself may also act as a guarantor and the UK offers a good deal of credit insurance to exporters through the Export Credits Guarantee Department, which, _inter alia_, guarantees bills of exchange purchased by banks. Guarantees may relate to specific transactions or operate on a continuing basis and relate to a flow of transactions.

The guarantor undertakes to answer for the default of the principal but guarantors can only be sued after the principal debtor’s default. Usually the undertaking of the guarantor is to meet the monetary liability arising out of the default, but a guarantor may also assume a secondary liability for performance as stipulated in the contract agreed by the principal. The guarantor is not liable for any amount in excess of that recoverable from the principal debtor and, if the guarantee is given at the request of the debtor, the guarantor has an implied contractual right to be indemnified by the debtor against all liabilities incurred.

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40 See Oditah, _Legal Aspects_, p. 34. 41 Ibid., pp. 35–40.
42 If A owes B a financial obligation, then instead of, or in addition to, taking a charge on A’s property, B may take a contract with a third party, C, under which C promises to meet A’s obligation to B if A fails to do so (C being the ‘guarantor’). See further R. M. Goode, _Legal Problems of Credit and Security_ (3rd edn, Sweet & Maxwell, London, 2003).
43 See Fuller, _Corporate Borrowing_, ch. 11.
44 In an insurance arrangement, in contrast, the insurer protects the covered party and there is no right of indemnity against the defaulter: see R. M. Goode, ‘Surety and On-Demand Performance Bonds’ [1988] JBL 87, 88–9.
Debtors and patterns of borrowing

The above discussion gives an idea of the main sources and credit devices available to borrowers but not of the patterns of borrowing that tend to be encountered in companies. Such patterns are liable to vary according to a number of factors such as the company’s needs, size, commercial sector and plans but, bearing this in mind, some generalisations can be made. In doing so it is helpful to distinguish the practices of small and medium enterprises (SMEs) from those of larger companies.

Certain research on SMEs reveals that small businesses tend to rely heavily on internal funds for both operating and investment purposes. Internal sources of finance thus seem to be more attractive than external borrowing. Around 38 per cent of SMEs would appear to seek external finance in a given two-year period, however, with a greater proportion of borrowing by firms of above-average growth rate. Of the SMEs surveyed by Cosh and Hughes for 2002–4, 81 per cent of those who had sought finance externally went to their bank; 38 per cent had sought credit from hire purchase or leasing businesses; 19 per cent went to partners or shareholders; 15 per cent approached factoring businesses; 14 per cent went to venture capitalists; 6 per cent looked to trade customers and around 20 per cent had sought to raise funds by other routes (namely through private individuals or other sources). As for the amount of finance raised by SMEs, the same survey revealed that banks provided 56.9 per cent of this;

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46 See Cosh and Hughes 2007, p. 50; figures for 2004 indicate that the total of external funds sought in 2004 was £1.4 billion.
47 Ibid. (years 2002–4); Cosh and Hughes 2000 (for years 1997–9). See, however, Fraser 2004 and the survey indicating that 80 per cent of SMEs had used one or more sources of external finance in the previous three years.
48 See Cosh and Hughes 2007, p. 51. In recent years SMEs have become less reliant on external finance: the 38 per cent figure for SMEs seeking external finance in 2002–4 is down from 65 per cent in 1987–90.
50 Cosh and Hughes 2007, pp. 51–3, noting that, compared to the 1997–9 survey, there had been a slight increase in resort to banks and a significant increase in approaches to venture capital firms.
hire purchase/leasing firms, 15.9 per cent; partners and shareholders, 6.5 per cent; factoring businesses, 5.5 per cent; other sources, 7.3 per cent; other private individuals, 2.6 per cent; venture capitalists, 4.4 per cent and trade customers, 0.9 per cent. These figures show a decline in bank finance compared to a similar 1997–9 analysis (from 61.2 per cent to 56.9 per cent), a doubling of factoring (from 2.6 to 5.5 per cent); a more than tripling of venture capital funding (from 1.3 to 4.4 per cent); and a drop in hire purchase/leasing sources (from 22.7 per cent to 15.9 per cent).

Banks thus remain the main providers of credit for SMEs, with more borrowing by term lending than through overdrafts. In the early 1990s the Bank of England expressed concern at the dependence of small businesses on overdraft facilities for purposes other than working capital: for example, to finance long-term business expansion.51 There has been, since that time, a drift away from overdraft borrowing in favour of term loans. Term lending in 2003 amounted to over £38.9 billion and borrowing on overdrafts was around £9.1 billion. By the end of 2003, overdrafts made up only 23 per cent of small firms’ borrowings compared to 25 per cent at the end of 2002.52 The Bank of England has, nevertheless, acknowledged that the overdraft will ‘always be important to small businessmen as a flexible source of working capital’.53

Certain kinds of borrowing seem, additionally, to be size dependent. Findings reported in 2007 suggested that micro-companies use venture capital, HP/leasing and factoring significantly less frequently than larger firms and resort to banks more often.54

A significant source of SME working capital has been factoring and invoice discounting and, as noted, financing through factoring more than doubled between 1997–9 and 2002–4.55 An area of modest uptake

54 See Cosh and Hughes 2007, p. 55.
55 Ibid., pp. 53–5. Factoring, as noted above, is the purchase by the factor and the sale by a company of book debts on a continuing basis, usually for immediate cash. The sales accounting functions are then provided by the factor who manages the sales ledger and the collection of accounts under the terms agreed by the seller. The factor may assume the credit risk for accounts within agreed limits (non-recourse) or this risk may be retained by the seller. Invoice discounting is the purchase by the discounter and the sale by the company of book debts for immediate cash. The sales accounting functions are retained by the seller and the facility is usually provided on a confidential basis. See Hewitt, ‘Asset Finance’. Fraser (2004) suggests that more than half of SMEs use invoice
from SMEs, however, is equity financing, where the evidence is that around 6 per cent of external financing to small businesses in the 2002–4 period involved equity and earlier work suggested that only a third of businesses were even prepared to consider equity financing. There are reasons why smaller enterprises face constraints in using equity to raise finance. First, markets may be reluctant to supply funds in return for equity because they see a willingness to give up equity as a sign of either the equity seller’s low confidence in levels of anticipated returns or their having exhausted their ability to raise debt finance. Second, raising equity may be expensive for smaller firms, compared to their larger brethren, because the transaction costs will be relatively high for small investments. Third, investors will want to research the risks involved but, for smaller investments, the costs of such research will be proportionately higher than with larger deals and this may prove off-putting – as may the higher risks posed by smaller companies.

Funding in the UK by the venture capital/private equity industry grew by 28 per cent in 2005 to £6.8 billion (from £5.3 billion in 2004) though figures for 2002–4 suggest that venture capital supplied only 4.4 per cent of total SME finance from external sources. Of total informal venture capital investment, business angel activity, on official figures, makes up only a small proportion. Raising funds through the provision of venture capital often involves investments in high-risk ventures (typically with new companies) and the investor will usually demand a significant equity stake in the enterprise. The expected return is accordingly of capital gain rather than merely income from dividends. Venture capital is frequently used as a

discounting and two in five use factoring. In 2008, £16.4 billion was advanced against invoices in the UK: see n. 244 below.

56 Cosh and Hughes 2007, p. 56.
58 See Cosh and Hughes 2007, p. 48.
60 See Cosh and Hughes 2007.
61 In 1998–9 around £20 million was invested by business angels in UK companies: Bank of England 2001, p. 5. In 2005 about £29 million was invested in 180 businesses by participating members of the trade association: see BVCA Annual Report 2006. The amount of informal lending by business angels is, however, difficult to quantify since most such angels act anonymously. One estimate is that the UK has 18,000 business angels investing around £500 million annually: see C. Mason and R. Harrison, ‘Public Policy and the Development of the Informal Venture Capital Market’ in K. Cowling (ed.), Industrial Policy in Europe: Theoretical Perspectives and Practical Proposals (Routledge, London, 1999). See also A. Belcher, Corporate Rescue (Sweet & Maxwell, London, 1997) pp. 133–4.
source of finance for management buyouts (MBOs) and may well involve the supply of business skills as well as funds.\textsuperscript{62}

Credit arrangements such as overdrafts, bank loans, trade credit, leasing and hire purchase can be resorted to by firms of all sizes. Large companies, however, are able, in addition, to secure credit by making use of the capital markets and trading in a huge variety of financial instruments and forms of debt.\textsuperscript{63} Thus, use can be made, \textit{inter alia}, of bonds, loan stock, syndicated loans, mezzanine finance, notes and securitisation. A bond\textsuperscript{64} involves a contract in which the bondholder lends money to a company and the company agrees to make a series of interest payments (‘coupons’) until the bond matures – commonly in between seven and thirty years’ time. They are usually secured by either fixed or floating charges against the firm’s assets. Bonds are tradeable in secondary markets in a variety of arrangements and larger, creditworthy companies are able to use not only domestic bond markets but the foreign bond and the Eurobond markets. Foreign bonds are bonds that are denominated in the country of issue where the issuer is non-resident\textsuperscript{65} and Eurobonds (or ‘international bonds’) are bonds that are traded outside the country of the denominated currency. ‘Syndicated loans’ are bank loans that spread credit provision across a number of banks, with the originating bank usually managing that syndicate. These loans are normally tradeable in a secondary market. ‘Mezzanine’ debt offers a high risk / high return mix and may be either secured or unsecured but it will rank below senior loans. It constitutes hybrid financing when it offers lenders a mix of debt and equity and is described as subordinated, intermediate or low grade because it ranks for payment below straight debt but above equity.\textsuperscript{66} It is a device that is useful to companies when bank borrowing limits are reached and the firm cannot, or is unwilling to, issue further equity. The term ‘mezzanine finance’ has, in recent years, tended to be used to refer to high yield / high risk debt that is private rather than gained through a publicly traded bond. Such privately based financing has grown rapidly over the last twenty years and has proved especially attractive to fast-growing companies in the communications and media sectors.\textsuperscript{67}

\textsuperscript{63} For a concise outline see Arnold, \textit{Handbook of Corporate Finance}.
\textsuperscript{64} The terms ‘bond’ and ‘loan stock’ are often used interchangeably.
\textsuperscript{65} So that in Japan, bonds issued by non-Japanese companies and denominated in yen (for example, for interest and capital payments) are foreign bonds: see Arnold, \textit{Handbook of Corporate Finance}, p. 430.
\textsuperscript{66} \textit{Ibid.}, p. 415.  \textsuperscript{67} \textit{Ibid.}, p. 416.
Mezzanine financing also has a role in corporate rescues when the creditors of a troubled company may be persuaded to raise leveraging and to effect recapitalisation by accepting a mixture of shares and mezzanine finance – where the high returns attaching to the latter reflect the high risks involved in advancing credit to the firm. ‘Junk bonds’ involve high risk / high return characteristics and their use has grown dramatically in the USA since the 1980s. The high-yield bond market is, however, yet to develop to the same extent in Europe.

Turning to notes, a medium-term note undertakes to pay the holder a specified sum on the maturity date and interest in the meantime. Such notes are unsecured and may vary widely in terms. A medium-term note programme may provide for the issuing of further bonds under the same documentation (though with a variety of terms and conditions) and this avoids the costs of producing new papers for each stand-alone note (or bond). Finally, note should be taken of securitisation. This involves the marketing of repackaged debt – as where a mortgage lender bundles together its claims to repayment and sells these ‘asset-backed securities’ to participants in the credit market. This increases liquidity (by replacing long-term assets with cash) but it places a new distance between the borrower and the lender and this may have implications for the monitoring of management and for potential rescues in times of trouble. These matters will be returned to below in discussing the significance of those developments that can be called ‘the new capitalism’ and in the examination (in part III) of rescue strategies and processes.

**Equity and security**

Bearing in mind the above fundamentals of borrowing, it is time to consider in more detail how corporate activities can be financed by either equity or credit means and to explore the ways in which different devices serve the needs of healthy and of troubled companies.

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68 Where over $100 billion of new issues are now introduced annually. Ibid., p. 415.
69 Ibid., p. 441. ‘Commercial paper’ involves shorter terms than the usual medium-term note and promises to the holder that a sum will be paid in a few days and the consideration for the loan is set out by giving the amount paid on redemption a higher value than that of the money advanced for the paper. A high credit rating on the borrower’s part is usually required as there is routinely no security involved.
70 On securitisation see further Fuller, *Corporate Borrowing*, pp. 124–8. See also pp. 133–5 below.
71 See pp. 133–40 below.
Equity shares

Companies, as noted, can raise funds through the sale of shares either on a flotation or by a subsequent issue. The purchasers of shares have interests in the company and the money they put into the company can be used to buy assets with which to earn profits. If shareholders wish to take their money out of the company, they must sell their shares or force the company into liquidation. The former course of action is more common and relatively easy when the shares are quoted on a stock exchange. If the company is liquidated, the assets of the company are sold, liabilities and insolvency claims are met and the remaining funds are paid out to equity shareholders. These shareholders, as a group, are the last to have their claims met (all other interested parties, be they debenture holders, unsecured creditors or employees, have priority). The ordinary shareholders in a company thus take the greatest risks but they benefit from profits when the firm is successful and if, as is usual, the company is a limited liability company, in times of trouble they are liable only to the amount unpaid on their shares.

The rationale for financing through share capital is that this provides a financial basis for corporate activity: one that, on establishing the company, provides a platform for both commencing operations and seeking funds through non-equity routes such as loans. Whether a going concern raises funds through equity capital or, say, bank borrowing depends on the relative costs. In the case of equity capital, the company management must offer investors at least the annual rate of return that those investors would expect to earn in the market on a share bearing the equivalent level of risk. If a company cannot earn this rate of return it will find it difficult to attract new funds because potential investors will look elsewhere in the marketplace.

If it is assumed that markets are competitive and that a company is able to offer a competitive rate of return to investors, there should be no difficulty in raising equity capital through share sales. This, however, demands such conditions as frictionless exchanges (without transaction costs, taxes or entry/exit constraints); rational behaviour by all players in the market; many buyers and sellers; and a free flow of full, costless information to all parties.

It has been asserted that some institutions, such as the Bank of England, view the equity route as an effective way to raise finance.\textsuperscript{72} This may be true in the case of large, established companies, but, as noted

\textsuperscript{72} W. Hutton, \textit{The State We’re In} (Vintage, London, 1996) p. 145.
above, smaller firms may find it much more difficult to finance through equity due to the relatively high transaction and risk appraisal costs in their small-scale offerings. When firms are new, moreover, the market may prefer to look to those with a known record and reputation.

Taxation regimes may also make financing through equity shares less attractive than through loans.\(^{73}\) If funds are raised through borrowing, the interest paid on a loan can be deducted before payable corporation tax is calculated. Such a deduction will not apply in the case of the rate of return that has to be earned in order to satisfy investors. Loan capital may, as a result, prove cheaper than equity financing and there may accordingly be a bias towards borrowing rather than equity financing. In regard to small businesses it may be the case that investors are reluctant to purchase equity (for reasons discussed above) but, in addition, businesses may be slow to seek financing through equity. Three reasons mooted for such low uptake are the lack of understanding of equity finance among small businesses, the desire of many UK entrepreneurs to avoid sacrificing any degree of ownership, independence or control, even if this could produce higher profits,\(^{74}\) and a set of cultural factors found in the UK. On the last point, the Bank of England has suggested that a ‘fear of failure’ may deter business owners from seeking venture capital.\(^{75}\) To these reasons may be added a fourth: the failure of banks to offer competitively priced equity financing. The Cruickshank review\(^{76}\) of March 2000 highlighted a number of key barriers to entry in the SME equity markets (including asymmetric information), confirmed the existence of an equity gap for firms which aim to raise between £100,000 and £500,000, and criticised the Small Firms Loan Guarantee Scheme for not


\(^{75}\) Bank of England 2001, p. 44.

addressing these market imperfections. The evidence nevertheless indicates that small businesses will only consider equity finance after internal sources and debt finance have been exhausted. Equity finance, in any event, is seldom used for raising sums of less than £30,000.77

From the above there emerge two messages for insolvency lawyers: first, that how shareholders are dealt with in an insolvency will depend very much on the efficiency with which creditors’ interests are processed within an insolvency and, second, that there are scant grounds for assuming that corporate financing through the equity route does or will ever do away with a system of credit that can deal efficiently with the needs of both going concerns and companies in trouble.

Secured loan financing

Companies can borrow funds by offering security or by seeking an unsecured loan. The essence of a security interest is that it gives the holder a proprietary claim over assets in order to secure payment of a debt. In contrast, the unsecured creditor will have lent funds to the debtor but will have a personal claim to sue for payment of the debt and the power to use legal processes to enforce any judgment against the debtor. A security interest may, as noted above, be consensual – where it results from the agreement of the parties – or non-consensual – where it arises through the operation of law. Consensual securities include pledges, mortgages, charges and contractual liens. Non-consensual securities can be divided into liens, statutory charges, equitable rights of set-off, equitable rights to trace and procedural securities.78 It should be emphasised that charges can be equitable or legal. Equitable charges do not involve the transfer of possession or ownership that gives creditors the right to have a designated asset appropriated to discharge their debt. An equitable charge is thus a mere encumbrance and does not involve any conveyance or assignment at law: it can exist only in equity or by statute.

Security may involve establishing real rights over one, some or all of the debtor’s assets (a real security) or rights of recourse from a third party who has guaranteed payment to the lender in the event of the debtor’s

77 There may, however, be substantial barriers to entry into the public equity markets in the form of fees charged by investment bankers, securities buyers and accountants, and these costs may not be justified where financing needs are modest: see Scott, ‘Relational Theory’, p. 916.
78 See further Ferran, Company Law and Corporate Finance, ch. 15.
default (a personal security).

In this section we consider why security is asked for by creditors and the extent to which the existing legal framework for security serves the needs of healthy and of troubled companies. Creditors are interested in security as a means of reducing the default risks they face. Before taking security or other protective measures they will be concerned about their position in insolvency and more particularly about the ways in which the shareholders and managers of the company may transfer wealth away from lenders and dilute their potential claims. A number of fears may loom large in their minds. A first worry is that excessive dividend payments may be made, thereby reducing the value of the firm. Second, excessive borrowing may occur when new debt is raised – which may affect the claims of prior debt or, if subordinate, may increase the insolvency risk of all creditors by changing the level of gearing and thus the risks associated with capital structure. Third, assets may be taken outside the company and out of the reach of creditors in an insolvency. Fourth, asset substitutions may occur in a way that alters the risk profile of the firm and disadvantages the creditor (for example, where a move from tangible fixed assets to

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79 See further Snaith, *Law of Corporate Insolvency*, chs. 2–6. Since 1981 the UK Government has, as noted, operated a government-guaranteed loan scheme designed to encourage bankers to lend to small and medium-sized companies that have exhausted normal financing channels. The Government guarantees the banker that, in the event of a default, the Government will repay 75 per cent of outstanding sums. Personal security from the borrower will not be taken but business assets will be expected to be offered as security. The guarantor may or may not go beyond guaranteeing payments and undertake liability for performance of non-monetary obligations. See generally Goode, *Commercial Law*, ch. 30.


81 I.e. if cash flows are directed to dividends rather than investment or the repayment of debt or if assets are sold (for example, by sale and lease-back arrangements) and the proceeds paid in dividends thereby reduce the value of assets available to creditors on break up: see Day and Taylor, ‘Role of Debt Contracts’, p. 176.

82 Ibid., pp. 176–7.

intangibles takes place). Fifth, underinvestment may occur where managers forgo investments that would benefit lenders (they may, alternatively, engage in inefficient strategies because their central aim is to preserve managerial jobs). Finally, managers may engage in excessive risk-taking. They may borrow money for stated purposes but divert those funds towards use on projects presenting higher financial risks – projects the creditor would not have funded at the given interest rates or perhaps at all.

In responding to these potential problems, creditors can seek security; obtain price protection by trading debts, where possible; spread risks by diversifying; shorten repayment periods; and use covenants in debt contracts. The clauses of the latter can, for instance, be used to restrict levels of dividends or asset disposals or levels of debt.

A major reason for taking security, in this risk-laden context, is thus to establish claims that, on distribution of the insolvent company’s assets, will rank above the claims of unsecured creditors. Creditors may also take security in order to gain access to information. This can be achieved by using the threat of realising the security to obtain access to company decision-making. The creditor can thus become privy to managerial decisions, may even be represented on the board and may engage in informed monitoring in order to protect their security. Security may, in addition, give the creditor a right of pursuit so that where the debtor disposes of property that is subject to a charge, a claim may be advanced.

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88 See Day and Taylor, ‘Role of Debt Contracts’.

89 See R. M. Goode, ‘Is the Law Too Favourable to Secured Creditors?’ (1983–4) 8 Canadian Bus. LJ 53. See also Diamond Report (1989). Security may also be attractive to creditors because it gives powers of enforcement (fear of which often leads debtors to give priority of performance to secured creditors); it allows the secured creditor to prevent seizure of secured assets by other creditors; and it may also allow pursuit where the secured assets are sold to another party. See Diamond Report, pp. 9–10.


91 On monitoring see pp. 95–9, 102–6, 121 below.
against the proceeds of that disposition. The creditor may also seek
security in order to increase their influence over the market behaviour
of the debtor. A charge, for instance, may be so all-embracing as to give
the charge holder what amounts in practice to an exclusive right to
supply the debtor with credit in that potential second financiers will be
deterred from lending by the breadth of the existing charge. A creditor
may, furthermore, take security as an alternative to expending resources
on gaining such information as will allow him or her to quantify the
financial risk involved in lending. Both the taking of security and the
collection and analysis of information provide ways to limit and calculate
risks, but in some circumstances the former route may be preferred to the
latter on the grounds that it involves lower costs and greater certainty.
Finally, a creditor (A) may fear that if it is unsecured, some other, more
aggressive, unsecured creditors will act too quickly against the debtor
company when it faces hard times and that this may prejudice the
company’s survival and the repayment of the debt owed to creditor A.
Creditor A may thus be motivated to seek security in order to discourage
or protect against such precipitate action by unsecured creditors.

Bearing in mind the above attractions of security, it might be asked:
why do not all creditors always demand security when advancing goods
or money? A first reason is that the costs of negotiating security may be
excessive given the financial risk involved. Thus, where a trade creditor
advances, say, a small stock of timber to a building firm for later
payment, the sums involved may not justify the costs of drawing up a
security agreement. Other reasons for not taking security may be the
unfamiliarity of the small trade creditor with legal arrangements; the
custom of informality within trading relationships; the timescales being
worked to (with a large number of items being supplied at a high
frequency); and the anticipated high costs of monitoring security
arrangements.

Finally, the relative bargaining positions of the debtor and creditor
may come into play and large corporate debtors with unimpeachable
creditworthiness may insist on loans without security. If both parties are
rational and informed, however, even the most powerful debtor is likely

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92 See Carruthers and Halliday, Rescuing Business, p. 163.
93 Supplies may, however, be delivered under retention of title clauses: see pp. 125–7 and ch. 15 below.
94 See Carruthers and Halliday, Rescuing Business, pp. 305–6; Cheffins, Company Law, p. 82.
to be presented with a choice by the creditor: between a certain interest rate in combination with security and a higher interest rate without security. The rational creditor will set the difference in rates after calculating the extra risks of non-repayment that a lack of security brings. In choosing which of the options to accept, the debtor will calculate whether the extra interest attending the unsecured loan is a greater cost than is involved in negotiating security and implementing a security agreement. The interest difference will tend to be smaller with a large, reputable firm and a short-term loan than with a small, newly established firm seeking a long-term loan. (The extra risk to the unsecured creditor is smaller and more easily calculated in the former instance.) The costs of the interest difference will, in all cases, rise with the size of the loan. The expenses to the debtor of negotiating and implementing the security will perhaps vary to a lesser degree according to the size and reputation of the firm and would be unlikely to rise in a manner directly proportional to the size of the loan or security (the costs of drawing up the legal documents will seldom vary directly with the sum at issue). Overall, then, one would expect security to be demanded most often by creditors who are dealing with small firms with poor or non-assessable reputations and who seek large sums over long terms.

Fixed charge financing

A fixed charge attaches, as soon as it is created, to a particular property and the holder of the charge has an immediate security over that property. In a corporate insolvency the holders of fixed charges are the first to be paid out of the insolvency estate. A company that raises money by offering the security of a fixed charge may, moreover, not sell or otherwise deal with the property at issue without the consent of the charge holder. The floating charge, in contrast, attaches to a designated class of assets in which the debtor has, or may have in the future, an interest. The debtor, in the case of a floating charge, may deal with any of the property subject to the charge in the ordinary course of business.

The most common fixed charge securities created by companies are legal mortgages over land. Equitable mortgages can also be given over land or equitable interests in land and a fixed charge on chattels can be made by a company but this has to be registered in the Companies Registry. Intangible property, such as shares in another company, can also be the subject of a fixed charge.

Floating charges

The floating charge, as noted, attaches to a class of a company’s assets, both present and future, rather than to a stipulated item of property. The assets covered are of a kind that in the ordinary course of business are changing from time to time and it is contemplated that until some step is taken by those interested in the charge, the company may carry on business in the ordinary way and dispose of all or any of those assets in the course of that business. Central to the floating charge, accordingly, is the notion of crystallisation. The company is free to deal with the property charged until an event occurs that converts the charge into a fixed charge over the relevant assets in the hands of the company at the time. The events that the law treats as crystallising the floating charge are the winding up of the company, the appointment of a receiver, the appointment of an administrator and the cessation of the company’s business. Parties to a charge can, on some authorities, also agree contractually that a floating charge created by a debenture may be crystallised automatically on the occurrence of an expressly stated crystallising event.

Floating charges are commonly given over the whole of the undertaking of the borrowing company but the company, nevertheless, may deal with or dispose of such property without the approval of, or even consultation with, the charge holder. The floating charge, as a device, raises serious issues of fairness, notably as regards the balance between the protection it offers to secured creditors and the resultant exposure of the ordinary, unsecured creditor. Such matters, however, will be returned to in chapter 15; here the focal question is economic efficiency.


98 Under the Insolvency Act 1986 Sch. B1, paras. 2(b), 14; see further Goode, Commercial Law, pp. 681–6.

Why security? The economic efficiency case

Does the law’s providing for security lead to an economically efficient use of resources? Here again it is necessary to consider the position in relation to both healthy and troubled companies. In answering the question it will be assumed, in the first instance, that security is offered under a system of full priority – in which security interests prevail over unsecured claims in insolvency. An extended debate has been carried out in the USA on the economic efficiency case for security and a number of commentators from a law and economics background have pointed to a series of advantages of security, notably that it helps companies to raise new capital and it is conducive to economically efficient lending by reducing creditors’ investigation and monitoring costs.

Security facilitates the raising of capital A system of security, with priority, is frequently said to permit the financing of desirable activities that otherwise would not be funded. Thus, where a firm has a low credit rating but gains the opportunity to enter into a profitable activity subject to moderate levels of risk, it may be able to obtain funds by granting security when it would be unable to obtain unsecured loans. From the creditor’s point of view, the benefit of a security with priority reduces the risks of lending and such risk reduction will be reflected in a lower interest rate. A strong priority system, furthermore, assures the creditor that the security enjoyed will not be diluted by the debtor’s obtaining more loans by offering further security.

103 Priority assured by registration: see Companies Act 2006 Part 25; Boyle & Birds’ Company Law (6th edn, Jordans, Bristol, 2007) ch. 10. In the USA priority is secured
The fixed charge may encourage institutions such as banks to advance funds to companies but the disadvantage of such a charge, in efficiency terms, is that it restricts the freedom of the company’s management to deal with the assets charged in the ordinary course of business. This might not present great difficulty where the company’s main asset is land, but where the bulk of assets is represented by machinery, equipment, trading stock and receivables (104) such constraints might inhibit business flexibility at some cost. As for the fixed charge and insolvencies, enforcement issues are relatively simple, assisted by the requirement that such charges be registered. (105)

Turning to the floating charge, the efficiency rationale is that it allows the creation of security on the entire property of the borrowing company and so provides companies with an easy and effective way to raise money by offering considerable security to the lender. At the same time it involves minimum interference in company operations and management. For bankers, the floating charge offers an attractive way to secure loans. It gives them a broad spread of security together with priority over unsecured creditors of the company (commonly trade creditors or customers). (106) Any provider of finance to a company may ask for the security of a floating charge but such charges are normally encountered in the case of banks lending by overdraft or term loan and the purchasers of debentures in the loan stock market. (Such lenders will usually combine fixed charge security over stipulated assets such as land or buildings with a floating charge over the rest of the company’s assets and undertaking.) (107)

The Cork Report noted (108) in 1982 that the use of the floating charge was so widespread that the greater part of the loan finance obtained by companies, particularly finance obtained from banks, involved floating charge security and that the majority of materials and stock in trade of the corporate sector was subject to such charges. (109)


(104) See pp. 128–9 below; Oditah, Legal Aspects.

(105) See e.g. Boyle & Birds’ Company Law, ch. 10.

(106) But not with regard to the ‘prescribed part’ of funds under the Insolvency Act 1986 s. 176A: see pp. 108–10 below.

(107) The fixed charge will give priority over preferential creditors: see ch. 14 below.


(109) In the three banks studied by Franks and Sussman more than 80 per cent of all client companies involved in the rescue study had a floating charge held by the bank and the
As indicated, security offers a way to reduce loan costs by reducing the risks faced by lenders: if the company does meet trouble, the lender with security has a better chance of recovery than would be the case if all creditors drew from the same pool.\footnote{R3’s 12th Survey, Corporate Insolvency in the United Kingdom (R3, London, 2004), indicated that in 2002–3 (before the reforms of the Enterprise Act 2002) the overall returns from CVAs were 50% to secured creditors, 17% to unsecured creditors and 100% to preferential creditors; from administrative receivership the returns were 49.9% to secured creditors, 5.4% to unsecured creditors and 37.4% to preferential creditors; from liquidations (compulsory and creditors’ voluntary) they were 53.4% to secured creditors, 10% to unsecured creditors and 50.2% to preferential creditors; from administration they were 53% to secured creditors, 6.3% to unsecured creditors and 17% to preferential creditors. Franks and Sussman (‘Cycle of Corporate Distress’) reported that recovery rates for banks were 77% compared with ‘close to zero’ for trade creditors and 27% for preferential creditors and that, regarding the SMEs surveyed (‘Economics of English Insolvency’), the banks recovered on ‘average around 75% (median of 94%) of the face value of their debt’ with ‘other creditors, such as trade creditors, recovering very little, about 3%, unless their loans are secured against specific collateral’.} Such considerations are at their strongest where the form of security offers a level of risk reduction that is quantifiable. In the case of the floating charge there are, however, uncertainties inherent in the device and the relevant law (to be discussed below) which reduce the degree to which such quantification is possible.\footnote{See pp. 117–20 below.}

\textbf{Security reduces investigation and monitoring costs}  A further reason why security is claimed both to encourage lending and to produce economically efficient lending is, as noted, that it can offer the creditor a far more economical means of managing the risks of lending than is potentially provided by an investigation into the creditworthiness of the debtor.\footnote{See Bebchuk and Fried, ‘Uneasy Case’, p. 914; Buckley, ‘Bankruptcy Priority Puzzle’, pp. 1421–2.} The creditor granted a security that covers the amount of the loan is thus well positioned to extend credit at an appropriate interest rate but is not obliged to calculate the probability of default or the overall security value over the main bank debt averaged 99 per cent: see J. Franks and O. Sussman, ‘The Cycle of Corporate Distress, Rescue and Dissolution: A Study of Small and Medium Size UK Companies’, IFA Working Paper 306 (2000) p. 3. In a further study of 542 distressed private SMEs (‘Financial Distress and Bank Restructuring of Small to Medium Size UK Companies’ (2005) 9 Review of Finance 65) Franks and Sussman found that ‘in almost every case the bank was the prime lender … Virtually all of the banks’ loans were secured by either a fixed or floating charge or – often – both’: ‘The Economics of English Insolvency: Recent Developments’ in Getzler and Payne, Company Charges, p. 257. On limitations on the attractiveness of the floating charge post-Enterprise Act 2002 see ch. 9 below.

110 Such considerations are at their strongest where the form of security offers a level of risk reduction that is quantifiable. In the case of the floating charge there are, however, uncertainties inherent in the device and the relevant law (to be discussed below) which reduce the degree to which such quantification is possible. 111 See pp. 117–20 below.
expected value of its share of the borrower’s assets in insolvency. What the taking of security does not rule out, however, is the need to calculate the probability that corporate managers will devalue that security by such practices as asset substitution.

Security has also been said to reduce the risks of lending by encouraging broadly beneficial monitoring. Security, it is thus argued, can help to counter the tendency to produce overall efficiency losses when a firm’s shareholders and managers pursue certain activities in an attempt to maximise shareholder returns but in doing so increase the expected losses to creditors as a whole by a greater amount than the expected shareholder gains. Monitoring provides a response to such risks. Thus the creditor with security can seek to acquire information from the company in order to determine the probability of, say, asset substitution and, in doing so, may bring pressure on the company in a manner that encourages fiscally prudent behaviour. Such a secured creditor may accordingly demand the production of periodic financial statements and may go so far as to place a representative on the debtor company’s board. This creditor may react to such information by adjusting its estimation of risk and changing the interest rate charged or even adjusting the period of the loan to demand early repayment. In more interventionist mode, the creditor may take the additional precaution of imposing contractual limitations on the kinds of conduct or dealings that the debtor may engage in. Where the security exists but is incomplete (or where a secured creditor is reluctant to enforce security because

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113 This point assumes that the lender is not concerned about the resource or reputational costs of having to enforce their security.


115 On security being taken for ‘active’ rather than ‘passive’ reasons see Scott, ‘Relational Theory’, p. 950: ‘the function of secured credit is conceived within the industry as enabling the creditor to influence debtor actions prior to the onset of business failure. This conception is markedly different in effect from the traditional vision of collateral as a residual asset claim upon default and insolvency.’


117 Another option may be to purchase insurance to cover losses arising from default: see Cheffins, Company Law, p. 75. Yet a further strategy for the creditor is to reduce risks by diversification in the lending portfolio. As noted, however, a creditor’s incentive to monitor will reduce as the number of its debtors increases and the average loan sum diminishes.
of high transaction costs or reputational concerns) it might be expected that restrictions on management might, as noted, deal with limits on dividend payments, the maximum gearing of the company and the disposition of assets. Such clauses, however, can only offer incomplete protection for creditors since anticipating the kind of conduct that may prejudice their interests can be extremely difficult and it may be costly to draft such terms and to monitor and enforce compliance.\textsuperscript{118}

Competition in the loan market may, furthermore, limit the creditors’ ability to impose such constraints: the average trade creditor, for instance, does not normally attempt to draft contracts on a transaction-specific basis. Normal trading arrangements may involve sums of money that are too small and timescales that are too short to justify extensive contractual stipulations.\textsuperscript{119} The dilution of assets may also be subject to legal restriction\textsuperscript{120} but those in control of a firm may still enjoy considerable discretion in deciding whether to transfer assets to shareholders and, without the probability of sustained monitoring and enforcement, legal restrictions may offer only weak deterrence.

At this point it is worth considering when a creditor will possess an incentive to monitor a debtor’s behaviour.\textsuperscript{121} Here the key is the balance between monitoring costs and the size of the loan. Monitoring will be worthwhile if it costs less than the anticipated gain in risk reduction where the latter is calculated by multiplying the diminution in the probability of non-recovery that monitoring will produce and the size of the potential non-payment. It follows that small loans will justify only modest levels of monitoring.

Security is said to be liable to reduce the overall costs of creditor monitoring where a number of creditors have different levels of pre-existing information and monitoring costs.\textsuperscript{122} Some creditors (for


example, trade creditors) with continuing and day-to-day relationships with their debtors may enjoy low monitoring costs and may reduce their lending risks by utilising their stock of knowledge on debtor creditworthiness. Where such monitoring serves to encourage financially prudent management this will benefit the whole body of creditors.\(^ {123}\) Other creditors, such as banks, may not possess such bodies of information and it may be cheaper for them to reduce risks by taking security than by detailed monitoring.\(^ {124}\) Providing potential creditors with the choice of secured or unsecured loans thus may encourage economically efficient lending by allowing creditors to choose the lowest-cost ways of reducing risks and so of lending. The end result, it is suggested by proponents of security, will be a reduction of total monitoring and lending costs.\(^ {125}\)

A further suggested economic efficiency offered by security is the opportunity for creditors to develop an expertise in monitoring a particular asset or type of asset and, accordingly, to limit monitoring costs by avoiding the need to monitor the total array of the company’s financial activities.\(^ {126}\) Finally, it can be argued that, at least in some circumstances, the granting of security can serve to demarcate monitoring functions in a manner that proves more economically efficient than regimes in which many creditors all replicate monitoring efforts. Thus, where security is fixed over a key asset and control of this will benefit all creditors by fostering prudent management more broadly, there is an avoidance of duplicated monitoring and the markets will reward monitors and non-monitors appropriately by compensating secured monitors with prior interests in the debtor’s assets and by allowing unsecured non-monitors to charge low interest rates that do not have to reflect monitoring costs. The overall efficiency arises because even if such ‘key asset’ arrangements are not the norm, the opportunity of offering security allows the market to choose such arrangements where they lower costs all round.

Would such monitoring efficiencies not be achieved in the absence of security? Would the parties involved not simply negotiate the

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\(^ {123}\) See Triantis and Daniels, ‘Role of Debt’, p. 1080.

\(^ {124}\) See, however, ibid., pp. 1082–8, where banks are seen as playing the ‘principal role in controlling managerial slack’; Scott, ‘Relational Theory’.

\(^ {125}\) See, for example, Jackson and Kronman, ‘Secured Financing’.

contractual arrangements that best allow them to reduce risks? The argument for security here is that it provides lower transaction costs than other arrangements. This is argued to be the case not least because any attempts by creditors to negotiate priority relationships between themselves would be beset by free-rider and hold-out problems, especially where a firm’s creditors are numerous.

The efficiency case against security

**The incentive to finance economically efficiently** The core objection to the provision of security is that when corporate debtor A arranges a secured loan with creditor B this may prejudice the interests of non-involved third parties C, D and E and may create incentives to corporate economic inefficiency. Such an arrangement has the effect of transferring insolvency value from C, D and E to B because C, D and E are not in a position to adjust their claims against A or the interest rates they charge. This inability to adjust may occur for a number of reasons. The creditor may be involuntary, as where a party is injured by the company and is a tort claimant with an unsecured claim against the company. Such involuntary creditors cannot adjust their claims to reflect the creation of a security interest.

The inability to adjust may also be a practical rather than a legal matter. Thus, voluntary creditors with small claims against the firm (for example, trade creditors, employees and customers) may not have interests of a size that would justify the expenses involved in adjusting the terms of their loans with the company and in negotiating these changes with the company. Such expenses, indeed, might be considerable and would involve expenditure to gain information on the company’s level of secured debt, its likelihood of insolvency, its expected insolvency value and the extent of its own unsecured loan. In practice, small

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creditors may suffer from a degree of competition in the marketplace that rules out the negotiation of arrangements that adequately reflect risks.\(^{133}\)

If a small supplier of, say, tiles for roofing work is considering adjusting the terms on which credit is offered, that supplier may anticipate that competing small tile firms, who are ill-informed and cavalier concerning risks, may be willing to offer terms that undercut it in the market. The supplier will, accordingly, feel that it cannot adjust and, indeed, that resources spent on evaluating the need for adjustment (and its rational extent) would be wasted.

Trade creditors tend not to look to the risks posed by individual debtors but will charge uniform interest rates to their customers. It could be argued, nevertheless, that those trade creditors who are successful are those who build into their prices an interest rate element that, in a broad-brush manner, reflects averaged-out insolvency risks. They may, for instance, adjust their prices periodically until they produce an acceptable return on investment.\(^{134}\) The effect is to compensate, at least over a period of time, for difficulties of adjustment. This, it could be contended, is economically efficient because, within reasonable bounds, even small, unsecured creditors manage to attune rates to reflect average risks.

A first difficulty with this argument, however, is that it assumes a level of stability in the trade sector and leaves out of account those trade creditors who have gone out of business through their failures to adjust, perhaps in their early weeks and years. These lost enterprises involve costs to society. The argument also leaves out of account those ill-informed and involuntary parties who cannot adjust by averaging processes or by learning from the market. Many trade creditors, for example, will operate in dispersed, changing markets in which learning is difficult, the process of matching prices to risks may take a long time and may be delayed, distorted or prevented by changes of actors and the arrival in the market of numbers of unsophisticated operators who fail adequately to consider risks. As LoPucki concludes: ‘With a constant flow of new suckers and poor information flows, there is no a priori reason why the markets for unsecured credit cannot persistently underestimate the risk, resulting in a permanent subsidy to borrowers.’\(^{135}\)


Second, those who do adjust by ‘averaging’ approaches to pricing credit may be adjusting to economically inefficient distributions of risk. Thus, if risks are placed disproportionately on the shoulders of those who can only adjust by averaging methods, the heavy-risk bearers are liable to be the unsecured creditors who are least able to manage, absorb and survive financial risks and shocks. Even if rough adjustment by averaging was able to compensate for the sum, in pounds sterling, of the expected insolvency losses, small trade creditors would be unlikely to take on board the potential shock effect on their company of a debtor’s insolvency. They are like ships’ officers who can calculate the expected size of a hull fracture but not whether it will be above or below the waterline. There is an efficiency case for placing risks on those best able to calculate their precise extent, best able to survive them and most likely to avoid the further costs of shock: in short to place risks where they can be managed at lowest cost. The loading of risks on ‘averaging’ adjusters is not consistent with that approach.

Finally, the loading of risks onto small, unsecured creditors may cause competitive distortions that are economically inefficient. To give a simplified example, suppose a debtor company is in the house construction business and is considering whether to fit traditional timber or aluminium double-glazed windows in its new houses. It may buy timber windows on credit from a small, efficient carpentry company that does not demand security or aluminium frames from a multinational double-glazing firm whose lawyers insist on security. If the carpentry company adjusts its prices to reflect its high default risks (by a rule of thumb method) and by virtue of so doing charges more for windows than the multinational firm, the contractor will obtain the window frames on account from the multinational firm, in spite of the carpentry company having been the more efficient manufacturer. The allocation of risks has produced the distorted, and economically inefficient, purchasing decision.

Creditors, similarly, who grant unsecured loans on fixed interest rates will be in no position to adjust to the creation of new security interests by corporate debtor A. The resultant effect of such non-adjustment is that debtor A, in deciding to encumber further assets, knows that a group of creditors will not adjust their terms or rates. It is thus in a position to ‘sell’ some of its insolvency value to the secured creditor in return for a reduced interest rate.136

Such a favouring of the secured creditor will prove economically inefficient in so far as corporate decision-makers will have incentives to

act so as to increase value to shareholders and secured creditors even if such increases are less than the losses to non-adjusting creditors in the form of diminutions in their expectations on insolvency. A system of full priority, moreover, will give debtor company A an incentive to create a security so as to transfer value away from non-adjusting creditors in circumstances where the effect is to reduce the total value to be captured by all creditors on an insolvency.

As for the decision-making incentives of corporate managers, a further economic inefficiency may arise in so far as biases in favour of secured creditors may lead both to an excessive resort to secured loans (a resort encouraged by the ‘subsidy’ from non-adjusting creditors) and to excessively risky decision-taking. Excessive risk taking is liable to occur because a corporate manager, in calculating the risks attaching to any decision, will give insufficient weight to the interests of unsecured creditors. Thus, in balancing the company’s potential gains versus losses in any given transaction, the prospect of having to repay non-adjusting creditors less than the full sum borrowed will distort the decision. In social terms, the bearing of excessive risks by unsecured creditors may be especially undesirable since these creditors are frequently small and less able to survive losses than larger creditors, such as banks, who tend to be secured.

Investigation and monitoring The argument that security encourages information-gathering practices that conduce to economic efficiency can be pressed too far. It has been contended that security benefits all creditors in so far as the ability to gain credit on the basis of security evidences in itself a degree of creditworthiness. A major proponent of

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137 On the extent to which different non-adjusting creditors are hurt by the creation of a new security interest see ibid., pp. 894–5; LoPucki, ‘Unsecured Creditor’s Bargain’, pp. 1896–1916. For discussion of the point that numbers of ‘non-adjusting’ creditors may be too small to be significant see Armour, ‘Should We Redistribute in Insolvency?’, pp. 214–15.


139 See Hudson, ‘Case Against Secured Lending’, p. 61.

this signalling theory has, however, himself come to question it on the grounds that bad debtors may be both willing and able to mimic the signals of good debtors. Other counter-arguments to the signalling hypothesis are that the security interest may not in reality offer a clear signal since borrowing on a secured, rather than on an unsecured, basis is usually the preference (sometimes the insistence) of the creditor rather than the debtor company, and that the offering of security signals not so much the creditworthiness of the debtor as the nervousness of the relevant lender. It is also doubtful whether any signalling gains outweigh the costs of secured lending. Other commentators, moreover, have questioned the value of signalling on the grounds that firms may seek credit as much to help with short-term cash flow problems as to finance programmes of capital expansion. Signals relating to the former, rather than the latter, may be of little value to the array of prospective creditors.

The claim that security leads to economically efficient monitoring can also be treated with some caution. The notion that monitoring by a secured creditor will bring spill-over benefits to the advantage of creditors as a whole can be responded to by noting that those benefits are liable to be insignificant where creditors are concerned to ensure that there is no dilution of their particular security rather than to encourage good decision-making generally in relation to the company’s affairs. This point can be deployed, indeed, to turn the monitoring argument on its head. If security fixes on particular assets, it may offer a disincentive to monitor generally and, even where a specific item of equipment is monitored, the creditor may not examine whether it is being used productively. If, moreover, most small to medium-sized firms possess only one creditor who is sufficiently sophisticated to be able to monitor at all rigorously (as US evidence suggests), the tendency for that creditor

141 Schwartz, ‘Theory of Loan Priorities’, p. 244.
143 Scott, ‘Relational Theory’, p. 907, urges that proponents of security have not offered convincing reasons why security offers a means of overcoming informational barriers that is preferable to other mechanisms, such as the development of commercial reputations or long-term financial relationships. See also C. J. Goetz and R. E. Scott, ‘Principles of Relational Contracts’ (1981) 67 Va. L Rev. 1089, 1099–1111.
144 See Hudson, ‘Case Against Secured Lending’, p. 54.
to be the secured creditor means that any inclination to monitor may be easily exaggerated. It can further be objected that it is rash to assume that those in possession of security are well positioned to monitor management behaviour. There may, indeed, be circumstances in which unsecured, but well-informed, trade creditors may be better placed to monitor.\footnote{Bridge, ‘Quistclose Trust’, p. 339; cf. Triantis and Daniels, ‘Role of Debt’; Scott, ‘Relational Theory’. Nor should it be assumed that monitoring is inevitably beneficial: this will not be the case where the negative effects of monitoring activity (for example, interference and managerial resources expended on responding to monitors) exceed positive effects as exemplified by increased pressures to act prudently.}

Other factors may also militate against monitoring by secured creditors. They may have little interest in improving the profitability of their debtor company, since, unlike shareholders, they will not enjoy a proportion of profits but face a fixed rate of return.\footnote{F. H. Easterbrook and D. R. Fischel, ‘Voting in Corporate Law’ (1983) 26 Journal of Law and Economics 395, 403.} Creditors who lend to a large number of debtors may be reluctant to devote resources to detailed monitoring of each of their debtor companies, and lending institutions may lack the expertise and specialised trade knowledge necessary for assessing managerial performance effectively.\footnote{See Finch, ‘Company Directors’; Cheffins, Company Law, pp. 75–6.} Creditors, moreover, may be ill-disposed to monitor because they may consider that a corporate insolvency may result from causes other than mismanagement\footnote{See discussion in ch. 4 below.} and that monitoring at best offers only partial protection against insolvency. The creditor may be interested in security principally as a means of limiting the financial consequences to them of insolvency rather than as a mechanism allowing them to intervene in order to prevent corporate disaster.

Close inspection should also be made of the argument that security provides an economically efficient way for different creditors to co-ordinate their monitoring activities and avoid inefficient duplications of effort. If, as noted, small and medium-sized firms tend not to borrow from more than one creditor who is capable of monitoring, there is little need for such co-ordination and its value, accordingly, may be easily overstated.\footnote{See Bebchuk and Fried, ‘Uneasy Case’, p. 917.} The notion, moreover, that one creditor will benefit from the monitoring signals sent out by another creditor has to be treated with care.\footnote{See Triantis and Daniels, ‘Role of Debt’, pp. 1090–1103.} Thus, a large creditor such as a bank may end a relationship with
a debtor and so may send out a signal, but the action may have been taken for reasons unrelated to any assessment of managerial performance (the bank may have negotiated an unfavourable agreement). A bank may, in another context, appear to be happy with management but in reality it is content with its security; it may give distorted signals because it has taken discreet steps to increase its security or shift risks; or a bank may have negotiated policy concessions with the debtor that, again, are unknown to other creditors. Nor can it be assumed that different classes of creditors have common interests that lend harmony to their monitoring efforts. When the debtor company is healthy there may be a degree of commonality in their desires to reduce managerial slackness but when the debtor firm approaches troubled times the different classes of creditors will have divergent interests and misinformation and concealment may infect the monitoring and signalling processes.\textsuperscript{152}

Incentives to monitor may, moreover, be undermined by free-rider and uncertainty problems.\textsuperscript{153} Thus, in the case of the floating charge, monitoring is liable to be expensive because such a charge commonly covers the entire undertaking of the debtor and this may mean that monitoring in order to detect misbehaviour or calculate risks could involve scrutinising the whole business. It is not possible, as with a fixed charge, to keep an eye on the stipulated asset alone. The competitors of a creditor who spends time and money on monitoring will be able, at little cost, to benefit from such scrutinising and any resultant signalling (for example, through observed adjustments in the interest rates charged by the monitoring creditor). The competitors, accordingly, will be able to undercut the creditor on, for example, the pricing of loans.\textsuperscript{154} This free-rider problem gives the initial creditor a disincentive to monitor the debtor’s misbehaviour and to compensate for the higher risks that non-monitoring brings by imposing higher rates of interest. The overall effect is that the floating charge may offer a relatively expensive method of securing finance.

Legal difficulties may also compound the problems of those creditors who are secured by floating charges and who wish to lower risks (and interest rates) by monitoring. Close monitoring may render the creditor liable to a wrongful trading charge on the basis of their operating as a

\textsuperscript{152} Ibid., p. 1111.
\textsuperscript{153} See generally Levmore, ‘Monitors and Freeriders’, pp. 53–5; Scott, ‘Relational Theory’.
\textsuperscript{154} See Levmore, ‘Monitors and Freeriders’, pp. 53–5; Scott, ‘Relational Theory’.
The legal uncertainty attending this issue will again operate as a disincentive to keep rates down by monitoring.

Improving on security and full priority

The above discussion reveals that it is not possible to state in general terms whether the law’s providing security will ensure economically efficient outcomes. The key issue is whether the distortions and incentives to inefficiency that are caused by security and priority will, in the specific context, be outweighed by the resultant gains. Individual circumstances, accordingly, have to be considered and the case for security may differ greatly according to variations in such matters as the balance between sophisticated and non-expert creditors; the duration and sizes of loans; the types of companies seeking loans; the numbers of non-adjusting creditors; and the transaction costs involved in negotiating unsecured loans and contractual schemes of priority.

At this point it is necessary to consider whether arrangements other than security and full priority are likely, in some circumstances, to involve a more economically efficient use of resources. A host of suggestions has been put forward but here attention will focus on the most prominently advocated proposals.

Abolition of security

Abolishing security would place all creditors on an equal footing in relation to the post-insolvency distribution of assets and no secured creditor advantages would be provided for. It is to be expected, however, that powerful lenders, such as banks, would collaborate with corporate debtors to circumvent the abolition of security by devising arrangements that would offer them de facto priority over less sophisticated lenders. The company seeking finance would have an incentive to enter into such arrangements for the same reason that it would grant security, namely to transfer insolvency value from unsecured creditors to the major lender in order to obtain a loan or a better

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156 See Westbrook, ‘Control of Wealth in Bankruptcy’ and his conclusion (p. 842) that the ‘efficiency of security’ debate is ‘inconclusive’ and ‘also incomplete because the benefits and costs of control in its various aspects have been almost entirely ignored’.


rate of interest. Firms might thus ‘sell’ fixed assets to the banks in lease-back arrangements incorporating options to buy the assets back for a very low price when the lease terminates.159

Systems of security with priority may, however, provide a lower-cost method of achieving such priority regimes than arrangements depending on the negotiation of ad hoc contracts.160 This is because, with the former, the legal system is providing ready-made, ‘off the shelf’ contract rules based on common assumptions about the parties’ motives. Transaction costs are reduced because these ready-made arrangements specify the legal consequences of typical bargains.161 Lower transaction costs in this context can, however, be said to encourage the offering of security and this may increase the extent to which certain creditors suffer from the negative consequences of priority regimes (for example, transfers of insolvency value from non-adjusting, unsecured creditors; biases in investment; excessive risk taking; reduced monitoring incentives). Again the key balance is between the efficiency gains flowing from lower transaction costs versus the efficiency losses from the negative consequences listed.

**Fixed fraction regimes** Transfers of value from non-adjusting creditors can be limited by legal stipulations that a given percentage of secured creditors’ claims shall be treated as unsecured162 or that a percentage of the security’s net realisable assets shall be made available for distribution among the ordinary unsecured creditors.163 The Cork Committee proposed a 10 per cent fund in 1982 and section 252 of the

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162 In which case the secured creditors participate *pari passu* with unsecured creditors in the fund available to unsecured parties: see Bebchuk and Fried, ‘Uneasy Case’, pp. 909–11.

163 See Cork Report, paras. 1538–41. Cork’s 10 per cent fund applied to floating charges only, not fixed, and an upper limit was to be applied so that unsecured creditors would not receive a greater percentage of debts than the holders of floating charges. Note that the 10 per cent fund needs to be set in the context of a package of revisions proposed by the Cork Committee: see chs. 8, 13 and 15 below. See also DTI White Paper, *Productivity and Enterprise: Insolvency – A Second Chance* (Cm 5234, 2001) (‘White Paper, 2001’) para. 2.19.
Enterprise Act 2002 inserted a new section 176A into the Insolvency Act 1986 which built on this proposal. The new section applies where a floating charge relates to the property of a company which has gone into liquidation, administration, provisional liquidation or receivership. The section demands that the office holder shall make a ‘prescribed part’ of the company’s net property available for the satisfaction of unsecured debts and shall not distribute this part to the holder of a floating charge unless it exceeds the sum needed to satisfy those unsecured debts. The quantum of the ‘prescribed part’ (also referred to as the ‘ring-fenced sum’) is established by Order and has been fixed at 50 per cent of net property where that net property is less than £10,000.

The extent to which a ‘prescribed part’ rule avoids the problems associated with transfers from non-adjusting, unsecured creditors depends on the percentage of the secured claim that is treated as unsecured. The larger the percentage, the more the problems are avoided, but the less the value of any security taken, the greater the risk that powerful creditors will ‘write around’ such a rule and resort to alternative modes of achieving the effects of security. As has been pointed out, the effect of a redistribution may be to encourage creditors to take different kinds of security and the consequence of this may be to render unsecured creditors collectively worse off as a result of the prescribed part rules. This may happen because, on the one hand, unsecured creditors will receive a relatively small increase in their expected payout from the prescribed part.
part but, on the other hand, if the prescribed part rules encourage a fragmentation of capital structures, this may stand in the way of effective rescues and increase the probabilities of default (which will be the major cause of unsecured creditors’ losses). Given such points, Armour raises the question whether it might be desirable to extend the prescribed part policy so that the prescription applies to all security rather than simply to floating charges.168

A ‘prescribed part’ rule, moreover, benefits the group of unsecured creditors as a whole, not merely non-adjusters. This means that unsecured creditors who are able to adjust terms and rates will enjoy a windfall benefit from the ‘prescribed part’ fund and that not all of such a fund will be available for non-adjusters. A virtue of the ‘prescribed part’ approach does, however, reside in its certainty. The creditor who takes a floating security knows that, when making an advance, the security is only worth a set percentage of what would otherwise be its expected value. This is unlikely to reduce their willingness to lend significantly (at least where percentages allocated to the unsecured creditors’ fund are modest) since interest rates can be adjusted accordingly.169 If the negative effects of a ‘prescribed part’ regime on secured lending are likely to be less than the positive gains to unsecured creditors, the case for the device is strong.

A ‘prescribed part’ fund might also be argued to conduce to efficiency through more rigorous enforcement against corporate managers and the insolvency estate. This is the ‘fighting fund’ vision which sees the significance of the ‘prescribed part’ in terms of its providing financial resources to insolvency practitioners so as to allow their ‘hot pursuit’ of debtors attempting to hide monies or creditors trying to smuggle out assets before they enter into the estate.170 The overall effect of pursuit, and its possibility, would, on this view, be greater deterrence of aberrant behaviour by corporate directors, a likely increase in the fund of assets

168 Ibid. Armour notes two practical problems in such an extension of the prescription: avoidance strategies relying on asset transfer rather than securities would still be possibilities and a broader prescribed part rule would, unless targeted at non-adjusting creditors, give adjusting unsecured creditors an opportunity to free-ride at secured creditors’ expense (pp. 223–4).

169 The Cork Report took the view that a reduction in willingness to lend could be discounted as a real possibility (ch. 36, paras. 1534–49); Goode, ‘Is the Law Too Favourable to Secured Creditors?’, p. 67.

available for all creditors and, as a result, a greater chance of unsecured creditors gaining some real return. Economically inefficient insolvency wealth transfers might, accordingly, be reduced as well as insolvency procedures rendered more effective generally.

There is a counter argument, however, from the proponents of the ‘concentrated creditor’ theory. This theory urges that the use of the floating charge can generate significant and worthwhile efficiencies notably because concentrating a firm’s debt finance in the hands of a relatively small number of creditors can reduce total monitoring and decision-making costs. It follows from the concentrated creditor theory that a negative aspect of the ‘prescribed part’ provisions is that, in so far as they may deter the use of the floating charge, and, as a result, produce a dispersing of credit holdings, they are likely to undermine the advantages of concentration.

**Insurance requirements** Fixed fraction or ‘prescribed part’ regimes, as noted, look to unsecured creditors as a group and avoid distinguishing between adjusters and non-adjusters within that group. Where, however, classes of non-adjusters can be identified, it is possible to compensate these through insurance. It has been argued that companies ought to be compelled to purchase liability insurance against tort claims to the extent that these claims cannot be met from assets. This would control the adverse effects of limited liability: its restricting the compensation available for tort victims, its externalising risks to those victims and its extracting a subsidy from them. Damage awards, in such a scheme, would be met, first, out of any normal liability insurance possessed by the company. To the extent that such insurance proved inadequate, the claim would be made on the assets of the company in the normal way and,

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171 See J. Armour and S. Frisby, ‘Rethinking Receivership’ (2001) 21 OJLS 73. For further discussion of the theory see ch. 8 below.
finally, if the assets were exhausted and the claim remained, the ‘overtop insurance’ would cut in and provide funds.\(^{175}\) Such an insurance regime would not only offer a response to the problems of limited liability, it would also cover the claims of unpaid tort creditors in corporate insolvencies. This insurance route possesses an important advantage over proposals to defer other creditors (including secured creditors) to tort claimants in insolvency.\(^{176}\) Giving tort victims higher priority in insolvency would act as a considerable deterrent to those institutions considering offering secured loans to a company since they would be faced with the risk of giving way to huge tort claims in the queue for insolvency payouts. In contrast, an insurance requirement would constitute a general business expense that would prove unthreatening to potential creditors. Such a requirement might operate concurrently with a ‘prescribed part’ fund and tort victims could be excluded from participation in that fund.

The problems of moral hazard that are often linked to insurance would be controlled not merely by the usual premium adjustments that would follow claims but also by the requirement that ‘overtop insurance’ would come into play only after corporate assets were exhausted.\(^{177}\) It should be noted, however, that although insurance would provide compensation to tort victims, it would control, not eliminate, moral hazards. Corporate managers would not be fully deterred from tortious actions since risks would be shifted through the insurance mechanisms: in ‘overtop’ cases the insurer would meet a proportion of the tort costs. Nor can it be assumed that insurers will monitor managerial performance and act in ways that will ensure non-tortious conduct. The extent to which they will do this is liable to turn on such factors as the particular market’s propensity to reward a strategy of monitoring.\(^{178}\) The costs of monitoring have to be reflected in premium adjustments but competitors may undercut the monitor’s prices and so deter such watchfulness.


\(^{176}\) See, for example, Leebron, ‘Limited Liability’, pp. 1643–50.


The insurance ‘solution’ would also be limited in a number of other respects. Insurance cover will not always be available to any given company or operation. Where, for instance, companies are small and high-risk, and where moral hazard problems are severe, there may be an absence of willing insurers.\(^{179}\) Insurance policies, moreover, will have ceilings on the quantum of cover together with a variety of clauses excluding liability on different grounds or allowing policies to be terminated on short notice. It cannot, accordingly, be assumed that all tort victims will be fully compensated for losses.\(^{180}\)

These cautions concerning insurance do not mean that this is a device of insignificant utility in dealing with tort victims. They do, however, suggest that reforms of this kind should be treated as partial, not complete, answers.\(^{181}\)

**Information requirements** Transfers of insolvency wealth from non-adjusting to secured creditors would be avoided, it could be argued, if unsecured creditors were given such information concerning a debtor as would allow them to fix interest rates and loan terms in a manner truly reflecting risks.\(^{182}\) One option, accordingly, is to oblige companies seeking credit to identify, when contracting with any potential creditor, any security then operating.\(^{183}\) Relevant details of such securities might also be demanded: for example, information on whether they cover genuine new value or whether they are to provide current working capital.\(^{184}\) In the USA it has been proposed that secured creditors who seek to place unsecured creditors in a subordinate position would have to take

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181 For arguments, *inter alia*, that tort victims’ interests are well protected in the UK ‘through systems of mandatory insurance for the most empirically significant categories of tort claim, coupled with the Third Parties (Rights Against Insurers) Act 1930’, see Armour, ‘Should We Redistribute in Insolvency?’, p. 214.
182 See Diamond Report, para. 8.1.5: ‘My general approach is based on the notion that the law should make it easier rather than harder for parties to a security agreement … to achieve their objective and the interests of third parties are best served not by prohibiting others from doing what they seek to do but by making information on what has been done readily available and affording them protection against risks that they should not have to face.’
183 Actual information rather than making creditors rely on the constructive notice of the charges registered in the register of charges as per Companies Act 2006 ss. 860–5, 876.
184 See Hudson, ‘Case Against Secured Lending’, p. 58.
reasonable steps to convey their intentions to the unsecured creditors. To this end, the suggestion is that the Article 9 filing system be modified to serve the information needs of all creditors affected by the terms of a security agreement.\(^{185}\)

There are limitations, however, to the informational solution. Any regime requiring ‘reasonable’ information-giving would prompt a good deal of litigation and the legal uncertainties involved in reasonableness testing would increase overall credit costs. The supply of information might assist those unsecured creditors who are currently ill-informed and, as a result, are unable to adjust terms and interest rates to cope with securities granted to others; it would not, however, assist creditors who cannot adjust because they are involuntary. (It has been suggested that in the USA at least a quarter of the debt of financially distressed companies is owed to reluctant creditors: tort and product liability victims, government agencies, tax authorities and parties not in the business of extending credit or seeking credit relationships.)\(^{186}\)

Another limitation of the information approach is that it does little, without further stipulation, to prevent future transfers of value from current unsecured creditors to new secured creditors. When prospective unsecured creditors are given notice of present securities they may adjust accordingly but once the adjustment is made there is vulnerability to any future granting of security.

A further shortcoming of the information approach is that unsecured creditors have to be able to use the information they receive. As already noted, however, the financial sums involved in many loans may, individually, be too small to justify the time and money expended in adjusting loan terms, the constraints of time, contractual terms and competition may rule out adjustment, and the expertise of the unsecured creditor may be insufficient for such purposes.\(^{187}\) It has been suggested that competent unsecured creditors may well use the information on security that is

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made available and the less competent will free-ride in a manner that allows the price of credit to reflect the existence of security.\textsuperscript{188} This, however, is an ‘optimistic’ view\textsuperscript{189} and it cannot be assumed that unsophisticated creditors will find a more streetwise creditor to free-ride on, that the untutored will be justified in spending resources researching the existence of the more knowledgeable, or that there will be markets that will provide such tutoring and guidance on appropriate levels of credit pricing.

**No secured lending on existing assets** Unsecured creditors would be protected from dilution of their interests in insolvency if the law provided for security only on non-corporate assets (for example, the houses of the directors/shareholders of the company) or on new capital value (where the security attaches to the new machinery or buildings that are purchased with the loan).\textsuperscript{190} In such cases there would be no depletion of the company’s assets to the detriment of unsecured creditors in an insolvency and unsecured creditors would be protected even against the granting of new securities. Companies would still be able to raise capital for new projects but such a legal regime would not allow corporate managers to use corporate assets to secure short-term working capital or loans necessary for tiding the company over lean times and cash flow problems. A serious concern, accordingly, might be that any restriction on the capacity of firms to survive difficult times might lead to more frequent insolvencies and overall inefficiency.

**An adjustable priority rule** An adjustable priority rule would limit economically inefficient transfers of insolvency value by not making the claims of non-adjusting creditors subordinate to secured claims. Secured claims would, in insolvency, be treated as unsecured to the extent that other creditors’ claims are non-adjusting and the extra amount received by non-adjusting creditors would come at the expense of the secured claims. Adjusting unsecured creditors would receive what they would have received under a rule of full priority.\textsuperscript{191} It would not be feasible to


\textsuperscript{189} See Block-Lieb, ‘Unsecured Creditor’s Bargain: A Reply’, p. 2014; Levmore, ‘Monitors and Freeriders’; Scott, ‘Relational Theory’. Free-riding may, of course, reduce the incentive of the competent creditor to spend resources on processing information.

\textsuperscript{190} See Hudson, ‘Case Against Secured Lending’, p. 60. On purchase money security interests see the discussion in ch. 15 below.

implement such a regime by seeking to identify in particular instances which creditors had in fact adjusted to each security interest, but it has been suggested that a number of classes of non-adjusting creditors can be identified and reference could be made to these in fixing priorities.\textsuperscript{192} The main classes of non-adjusting creditors to be protected might thus include: creditors who extended credit before the creation of the security interest and who lack an adjustment mechanism in their loan contract; and creditors such as employees and customers who are not in the loan business, were not able to consider the security interest when contracting and did not negotiate credit terms with the debtor.\textsuperscript{193}

An adjustable priority rule might be less certain than a fixed fraction/‘prescribed part’ rule but it would offer superior protection to non-adjusters. Compared to full priority the adjustable priority rule increases the secured creditor’s exposure to risk (security would only offer incomplete protection) and transaction costs would increase in so far as secured creditors would have an incentive to acquire such information about the borrower as would allow them to set interest rates at levels reflecting the more complex and greater risks faced.

Would incentives to offer secured loans be diminished? In relation to tort creditors it has been argued that the prospect of adjusted priorities might alarm prospective creditors considerably because of their potential exposure to risk and the difficulty of quantifying it. Tort creditors may, for these reasons, best be dealt with through insurance mechanisms as discussed. The tax authorities might also be left out of account in an adjusted priority regime since the Inland Revenue is well positioned to spread its risks of non-payment across the taxation system and it may be appropriate to cost a proportion of failed collections into that system.\textsuperscript{194} The remaining non-adjusters might be included in an adjustable priority mechanism, however, since they are not unduly threatening to secured lenders. Such a mechanism does weaken security protections but if those giving loans and taking security are sophisticated creditors they will adjust their interest rates, or amounts of security taken, to reflect the increased risks they face and, accordingly, incentives to lend on security may not be reduced materially. The cost of secured credit may increase

\textsuperscript{192} Ibid., p. 908.
\textsuperscript{193} Not included in the list of non-adjusters are tort victims and governmental creditors such as tax authorities. The former might be dealt with by insurance as considered above.
\textsuperscript{194} Note that the Enterprise Act 2002 s. 251 largely abolished the preferential status of the Crown as creditor: see further ch. 14 below.
but this is the effect of restricting the economically inefficient transfer of insolvency wealth from non-adjusting to secured creditors. The reduction of such transfers that would result from an adjustable priority rule might, indeed, be expected to limit the incidence of overinvestment in risky activities that is a shortcoming associated with the full priority rule.195

Would economically efficient activities be impeded by an adjustable priority rule? This might happen when the efficiency gains of the activity (for example, the increases in wealth produced by an investment in new machinery) are less than the transfer of value to non-adjusting creditors (that is, the boost to the value of non-adjusting claims that flows from the new secured investment). Such circumstances, it has been suggested, will be encountered only rarely and, in any event, may be countered by non-adjusting creditors agreeing mutually beneficial compromises with secured creditors to allow economically efficient investments and activities to take place.196

Secured creditors might pursue another course, however, which would weaken the role of an adjustable priority rule. They might enter into sale and lease-back arrangements so as to achieve the effects of security but escape the contribution to non-adjusting creditors involved in the adjustable priority rule. The assets at issue would be sold to the ‘creditor’ and leased back by the ‘debtor’. On the debtor’s insolvency the assets would not form part of the insolvency assets and, accordingly, would not be covered by the adjustable priority rule. Such a strategy, it has been said, would be resisted by the courts in the USA, who might consider an arrangement a secured loan even if labelled a ‘lease’, and would look for a real economic difference between a lease arrangement and a secured loan if it was to be acknowledged as a lease for insolvency purposes.197

The English courts may be somewhat behind those in the USA in looking to the substance and function of arrangements rather than their form, but it can be argued that they are moving in this direction198 and are

198 See Bridge, ‘Form, Substance and Innovation’.
increasingly likely to resist the use of sale-based devices that are designed to avoid the rules governing security.\textsuperscript{199}

**Rethinking the floating charge** The floating charge gives a creditor security over present and future assets and commonly covers the entire undertaking of the borrowing company. Its usefulness to companies seeking funds and its attractiveness to creditors has been noted above but attention must be turned to the floating charge’s overall efficiency effects. A first matter is the value of a charge that, whatever its label or details, allows companies to trade freely but gives security over all their present and future assets. (The usefulness of such a charge to companies seeking funds has been noted, as has its attractiveness to creditors.) The Cork Committee found the floating charge to be too much a part of the UK financial structure, and too useful, to consider its abolition.\textsuperscript{200} The Crowther and Diamond Reports also favoured the availability of such a charge,\textsuperscript{201} and the benefits of such charges to companies are so large that abolition is unlikely to enter the policy agenda of a UK government.\textsuperscript{202}

The floating charge type of device does, however, give grounds for concern for another reason. It is a mechanism peculiarly conducive to the transfer of insolvency value from unsecured to secured creditors. The charge floats over the assets of the company and, accordingly, its existence ensures to a greater extent than would otherwise be the case that, on insolvency, unsecured creditors are paid out of working capital. The floating charge is an arrangement that might have been designed to allow large lenders to exploit their dominant bargaining positions and to work

\textsuperscript{199} On the use of other ‘devices’ to jump the priority queue see ch. 15 below.

\textsuperscript{200} See Cork Report, ch. 36, para. 1531; ch. 2, para. 110. In 2001, however, the DTI White Paper (on *Productivity and Enterprise*) proposed measures to ensure the use of collective insolvency procedures instead of administrative receivership, including restriction of the floating charge holder’s right to appoint an administrative receiver (White Paper, 2001). Such changes (and the reform of administration) were effected by the Enterprise Act 2002: see chs. 8 and 9 below.

\textsuperscript{201} See *Report of the Committee on Consumer Credit* (Lord Crowther, Chair) (Cmnd 4596, HMSO, 1971) (‘Crowther Report’) para. 5.7.77; Diamond Report, para. 8.1.5.

with the debtor companies so as to transfer wealth from unsecured creditors. The value of the charge to companies and lenders has thus to be weighed against its negative effects on unsecured creditors, and all possible steps have to be taken to reduce such effects or their consequences.  

A second worry is that the floating charge, as presently established in English law, is not the most economically efficient mechanism that can be devised to allow companies to combine borrowing on shifting assets with unrestricted commercial operation. A particular difficulty is, as noted above, the uncertainty of the unsystematised law governing its use. As Goode has argued:

principles and rules extracted with effort from a huge body of case law are no substitute for a modern personal property security statute in which all transactions intended to serve a security function are brought together in a uniform system of regulation with rules of attachment, perfection and priorities being determined by legislative policy rather than by conceptual reasoning.

Uncertainty attends such matters as the criteria applicable in distinguishing between fixed and floating charges (which are subject to different priority rules in relation to preferential claims on a winding up or the appointment of a receiver). On this distinction legal confusion has resulted, inter alia, from a good deal of litigation on the validity of claims to proceeds on the buyer’s liquidation and from confusion on such points as whether charges on book debts and their proceeds are to be treated as fixed or floating.

Such legal complexities and uncertainties impose considerable transaction costs on debtor companies and creditors and, in turn, lead to inefficiently high credit costs and business expenses. Further uncertainties compound the position. A key weakness of the floating charge, from the holder’s perspective, is that there is a risk of subordination to

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203 See the discussion of fixed fraction/’prescribed part’ regimes, information requirements and adjustable priority rules above.
204 Goode, ‘Exodus of the Floating Charge’, p. 201.
205 See, for example, the contributions in Getzler and Payne, Company Charges and the further discussion in ch. 9 below. For discussion of possible limitations on the attractiveness of the floating charge post-Enterprise Act 2002 see also ch. 9 below. On uncertainties attending automatic crystallisation clauses see Boyle and Birds’ Company Law, pp. 347–50.
206 See Diamond Report, para. 1.8.
subsequent secured and execution creditors. This means that the
security offered by the floating charge is exposed to potential dilution
and risks accordingly cannot be assessed. Certain devices (such as nega-
tive pledge clauses) can offer floating charge holders some protection
against dilution but that protection is not complete. Quasi-security
arrangements such as hire purchase contracts may also dilute the value of
the floating charge.

Other ways of classifying securities might, it is arguable, prove more
satisfactory. Thus it has been suggested that a classification of security
might be based on differences in purpose and function, as in Article 9 of
the USA’s Uniform Commercial Code, rather than the particular form of
transaction selected or the location of the legal title. Creditors would
be able to take security over all or any part of the debtors’ existing or
future property, and such issues as perfection requirements (filing or
possession) and priority rules would be laid down as matters of legislative
policy.

The main advantages of such an approach are said to include its
eradication of the uncertainties that arise from the need to distinguish
floating from fixed charges. The Article 9 approach still allows debtor

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207 A floating charge will be deferred to any subsequent fixed legal or equitable charge
created by the company over its assets: Wheatley v. Silkstone and Haigh Moor Coal Co.
(1885) 29 Ch D 715; Robson v. Smith [1895] 2 Ch 118; and if debts due to the company
are subject to a floating charge, the interest of the floating charge holder will be subject
to any lien or set-off that the company creates with respect to the charged assets prior to
crystallisation. If a creditor has levied and completed execution the debenture holders
cannot compel him to restore the money, nor, until the charge has crystallised, can he be

208 Brunton v. Electrical Engineering Corp. [1892] 1 Ch 434; Robson v. Smith [1895] 2 Ch 118;
English & Scottish Mercantile Investment Co. Ltd v. Brunton [1892] 2 QB 700; Re Castell &
Brown Ltd [1898] 1 Ch 315; Re Valletort Sanitary Steam Laundry [1903] 2 Ch 654.

209 See Goode, ‘Exodus of the Floating Charge’ and ‘Case for Abolition of the Floating
Charge’; Bridge, ‘Form, Substance and Innovation’ and ‘How Far Is Article 9
Exportable?’; R.M. Goode and L. Gower, ‘Is Article 9 of the Uniform Commercial
Code Exportable? An English Reaction’ in J. Ziegel and W. Foster (eds.), Aspects of
Comparative Commercial Law (Oceana, Montreal, 1969); R. Cuming, ‘The
Internationalization of Secured Financing Law: The Spreading Influence of the
Concepts UCC, Article 9 and its Progeny’ in R. Cranston (ed.), Making Commercial
Law: Essays in Honour of Roy Goode (Clarendon Press, Oxford, 1997); Cuming,
‘Canadian Bankruptcy Law: A Secured Creditor’s Haven’ in J. Ziegel (ed.), Current
Developments in International and Comparative Corporate Insolvency Law (Clarendon
Press, Oxford, 1994). For a view that urges caution in adopting the Article 9 approach
see G. McCormack, ‘Personal Property Security Law Reform in England and Canada’

210 See Goode, ‘Exodus of the Floating Charge’.
companies to deal with assets in the ordinary course of business while permitting immediate attachment of the security interest. Priority rules established in legislation would determine the circumstances in which such interests will be overreached by subsequent dealings. The argument thus goes beyond a call to rationalise case law; it urges that the fixed-floating distinction has involved a huge waste of time and expense and that this can be avoided by a unified concept of security.211

The counter-argument is that much might be done to clarify the law on floating charges and, in any event, it is easy to exaggerate the extent to which a purposive approach to classifying security will produce a case law that is more predictable and rational than one that emphasises formal origins.212 Closer attention might, in a purposive approach, be paid to issues of fairness between creditors but that is not to say that efficiency and certainty would necessarily be increased by assessing priority on the basis of broad considerations of function, fairness and practicality. Article 9 jurisdictions have encountered particular difficulties, for instance in separating functional securities from short-term rentals.213 On balance it can be concluded that there are strong arguments for removing unnecessary uncertainties from the English floating charge framework but it would be rash to assume that alternative approaches as seen in the USA will produce dramatically lower levels of legal contention.

**Unsecured loan financing**

Companies in the UK tend to rely heavily on short-term financing, far more so than companies in continental Europe, for instance, who make more use of longer-term loans. This short-term financing is usually provided by way


213 See Bridge, ‘Form, Substance and Innovation’. On fairness issues see ch. 15 below.
of unsecured loans in the form of bank overdrafts, trade credit, bills of exchange, acceptance credits and deferred tax payments.  

As noted above, efficiency may not always demand that security be taken for a loan. The costs of creating a security arrangement may not be justified by the sums or risks involved in a transaction and a series of transactions may be progressing with such frequency that there is no opportunity or interval for the negotiation of security.

Flexibility of financing may also be required for maximising wealth creation and this may be catered for by such unsecured borrowing as is offered by clearing bank overdrafts. When sums borrowed are no longer required, the overdraft regime allows them to be repaid quickly. Overdrafts are, moreover, comparatively cheap because the risks to the lender are less than are involved with term loans (advances on overdraft are legally repayable on demand, though banks usually undertake notice periods of, say, six or twelve months) and the loan interest is a tax deductible expense. The ongoing nature of corporate overdrafts may, moreover, lead to continuing relationships between a company and its bank. This relationship will often place the bank in a good position to monitor the company’s general strategy, to gain information on managerial decision-making and to assess risks of default. The bank can accordingly request forecasts, monitor financial statements on a monthly basis and watch movements in the overdraft balance on a day-to-day basis. This monitoring and informational position may offer the bank a more economically efficient means of limiting risks than is achievable through the process of negotiating security.

For the company, the downside of the overdraft is that if an overdraft loan is recalled (as it may be on short notice) the firm has to be in a position to repay. This can be difficult where, for instance, the money has been used to purchase fixed assets and the company may be forced to dispose of such assets quickly and for considerable loss if it is to make repayment. Overdraft lending, moreover, may be vulnerable to broad political changes or currents of financial thought. Thus, when governments require banks to restrict lending, overdrafts may be a primary target and companies may face swift curtailments in the availability or extent of their overdrafts.

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214 On trade finance and unsecured loans see Cranston, Principles of Banking Law, ch. 14.
217 Triantis and Daniels, ‘Role of Debt’; Scott, ‘Relational Theory’; Cheffins, Company Law, p. 75.
From the early 1990s onwards, the major clearing banks and the Bank of England were, as noted, concerned at the reliance of small companies on overdraft facilities for the purposes of financing long-term business expansion.219 These worries were prompted by feelings that such use of overdrafts evidenced both a lack of financial planning and an excessive reliance on funds liable to be subject to recall at short notice. The banks were also attempting to come to grips with the high levels of bad debts experienced at the end of the 1980s, with Third World debt problems and with a recession in industrialised countries. The banks’ response, as noted above, was to seek to move debtor companies away from overdraft borrowing and into term loans.

The unsecured overdraft is likely, however, to remain the first choice mode of raising short-term flexible finance for most companies. Its flexibility brings a considerable efficiency for the borrower because interest is charged only on the outstanding balance. Any cash flowing into the company will reduce almost instantly the balance of the advance and so the interest that has to be paid.220 Alternative sources of finance, in contrast, usually involve a fixed sum to be repaid over a fixed term and interest has to be paid on the full sum for the full term.

Other forms of unsecured credit, such as those mentioned above, bring benefits that can be similar to those offered with overdrafts. Thus, the unsecured loans involved in trade credit arrangements offer low transaction costs, they allow credit agreements to be tailored to the particular transacting parties and they make use of information derived from trade relationships (on, for example, creditworthiness) as a way of reducing risks in a manner that is swifter and more economically efficient than resort to security.221 It should not be assumed, however, that a trade creditor will always be well positioned to assess the broad competence of their debtor’s management. A trade creditor’s expertise in a specific sector may, for instance, be of limited value in assessing corporate debtor performance in a completely different sphere of operation.222 Where, of course, the value of a transaction is so small that a trade creditor would

not rationally engage in the expense of monitoring the debtor, the unsecured loan may still prove more economically efficient than taking security: the trade creditor may simply charge an interest rate that they hope will cover the risks of default.

Unsecured loans can assist wealth creation in another way – by assisting in the flow of money. To take an example, a supplier of machinery, in sending goods to a customer overseas, may accept a bill of exchange in the form of a cheque post-dated to a time after the arrival of the goods at their destination. The buyer of the goods can thus delay payment of the bill until the goods arrive but the seller can obtain cash immediately after dispatch by discounting the bill of exchange, by presenting it to a bank which buys it while charging a percentage discount. Use of the bill of exchange thus assists both the buyer and the seller and avoids delays in the use of funds.

For healthy companies, accordingly, unsecured loans provide a valuable means of acting economically efficiently in the marketplace. This efficiency derives not merely from the low transaction costs involved but also from utilising the monitoring and information-collecting capacities of creditors for the purposes of risk reduction and, in turn, for lowering the cost of credit.

All is not rosy in the garden, however, since a lack of security can lead to inefficiencies in the flow of cash between traders. Without security trade creditors are poorly placed to demand payments of outstanding debts. A secured creditor faced with non-payment has recourse to the charged assets and has rights (curtailed after the Enterprise Act 2002 reforms) to appoint a receiver or to apply to court for orders of foreclosure or sale. Such a response is not open to the unsecured trade creditor, and late payment of debts has been seen as a major problem over the last two decades.

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223 See, however, the discussion at pp. 99–102, 107–10, 114–17 above relating to non-adjusting unsecured creditors.

224 Usually the debenture contains provisions enabling the loan creditor or trustee to appoint an administrative receiver without resort to the court and in practice this was the most common remedy. The Enterprise Act 2002 has largely abolished the right to appoint administrative receivers in so far as charges created after the coming into force of the legislation on 15 September 2003 are concerned: see now the Insolvency Act 1986 s. 72A. Section 72B of the Insolvency Act 1986 (as amended by the Enterprise Act 2002 s. 250) provides for exceptional cases where floating charge holders may still appoint administrative receivers: see further ch. 8 below.

225 For a discussion of the impact of late payments on companies and of statutory measures to combat late payment see ch. 4 below.
Do unsecured loan arrangements, as they stand, however, conduce to economically efficient insolvency procedures? Here attention must be paid to the position of unsecured creditors in an insolvency and the way that this may affect their behaviour and expenses of doing business. When there is a corporate insolvency, secured creditors can remove their secured assets at will, if able to utilise receivership, free from any notion of *pari passu.*

Other suppliers of credit can also prevent their ‘debts’ from falling into the fund of corporate assets available for distribution: noteworthy here are ‘creditors’ who have used ‘self-help’ devices such as retention of title clauses or trust mechanisms. Unsecured creditors will see such ‘creditors’ escape the insolvency net but, in addition, the unsecured creditors must join the back of the queue for payment from the corpus of assets, a queue headed by the holders of fixed charges, followed by insolvency practitioners who incur expenses acting as office holders, then those with preferential debts (for example, sums owed to employees for remuneration) and then holders of floating charges. Only shareholders and certain deferred debts come after the unsecured creditors. Satisfaction of such prior claims means that unsecured creditors’ hopes of recovering anything of substance in the winding-up process are usually dashed. Nor, furthermore, could the unsecured creditor expect any assistance in the form of altruism from receivers who collected from the company’s assets for fixed and floating charge holders. Receivers are primarily concerned with generating funds for their debenture holders and this obligation takes precedence even over possible damage to the company’s and unsecured creditors’ interests.

The Enterprise Act 2002 reforms have, however, attempted to redress the balance of power from the institution of receivership and floating charge holder towards

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226 Note that a qualifying floating charge holder now has to resort to administration rather than receivership. See Insolvency Act 1986 Sch. B1, paras. 43, 44. On the *pari passu* principle of distribution see chs. 14 and 15 below.

227 See ch. 15 below.

228 See ch. 14 below.

229 See Insolvency Act 1986 s. 74(1)(f).

230 See Cork Report, paras. 1480 ff.: for unsecured creditors corporate liquidation is usually ‘an empty formality’ because ‘in all too many cases insolvency results in the distribution of the proceeds among the preferential and secured creditors, with little, or nothing, for the ordinary unsecured creditors’. Note, however, that the introduction of the ‘ring-fenced’ sum in IA 1986 s. 176A may give unsecured creditors some economic interest in a corporate insolvency.


232 *Gomba Holdings UK Ltd and Others v. Homan and Bird* [1986] 1 WLR 1301 at 1305; *Downsview Nominees Ltd v. First City Corporation Ltd* [1993] 2 WLR 86. Unsecured creditors *per se* are owed no duty by the receiver: *Lathia v. Dronsfield Bros. Ltd* [1987] BCLC 321. See ch. 8 below.
unsecured creditors. As noted above, the Act largely abolished the institution of administrative receivership and stipulated that qualifying floating charge holders can instead appoint an administrator out of court. The administrator owes a duty to consider all creditors’ interests.

Whether such a regime may be deemed unfair to the unsecured creditor is among those matters to be considered in chapters 14 and 15 but, for now, it should be asked why inefficiency may be produced. A first inefficiency may arise where there are unnecessary transaction costs: where, for instance, the legal costs faced by the unsecured creditors and creditors overall are higher than they should be because the relevant law is subject to avoidable and unnecessary uncertainties. (This is a matter to be returned to below when the processes for managing insolvency have been explored further.)

The second inefficiency of concern here takes us back to the balance between secured and unsecured creditors that was discussed above. Where unsecured creditors are unable to adjust to the granting of security there is liable to be a transfer of insolvency wealth to the secured creditor and unsecured creditors will bear excessive amounts of risk. This leads to the inefficiencies noted above, which need not be reviewed again here.

Ownership-based (quasi-security) financing

As already noted, companies can raise funds or gain the use of goods by using sale arrangements in a manner that substitutes for security. Since the celebrated Romalpa decision, trade suppliers of goods on credit have frequently used ‘retention of title’ clauses to stipulate that ownership of the goods shall not pass until payment for the goods has been received. Surveys suggest that the majority of suppliers employ such

233 See IA 1986 Sch. B1, para. 14. It is only the qualifying floating charge holder (QFC) that can appoint an administrator out of court under para. 14. The holders of other charges will have to apply for a court order. See further ch. 9 below.
234 See for example IA 1986 Sch. B1, paras. 3(1), 3(4).
236 Aluminium Industrie Vaassen BV v. Romalpa Aluminium Ltd [1976] 1 WLR 676. Note that prior to this decision, although title retention clauses were common on the continent, they were rare in the UK. (The plaintiff in the Romalpa case was a Dutch company, using its standard terms of supply.)
237 Or, indeed, until all sums due from the purchasing company (e.g. in respect of previous supplies) have been satisfied: Armour v. Thyssen Edelstahlwerke AG [1990] 3 WLR 810.
clauses in their conditions of sale.\textsuperscript{238} Retention of ownership operates in substance as security, but a ‘simple’ retention of title arrangement is not treated by English law as a security arrangement and, accordingly, there is no requirement of registration, as with a company charge or a bill of sale, in order for such a clause to be valid against third parties.\textsuperscript{239}

The value to the creditor/owner of retention of title is that on the insolvency of the debtor company the assets at issue do not belong at law to the company, cannot be claimed by the insolvency practitioner and are not available for distribution among the creditors. The creditors of an insolvent company cannot make any claim against goods that are owned by others but are in the possession, control or custody of the company.\textsuperscript{240} Powerful trade suppliers of goods are thus well placed to use their bargaining power to avoid the severe consequences, on a corporate insolvency, of status as unsecured creditors.

For a trade creditor, such as a supplier of goods and materials, a retention of title clause may prove more attractive than the taking of

\footnotesize{\textsuperscript{238} Spencer, ‘Commercial Realities of Reservation of Title Clauses’, surveyed fifty suppliers and found 59 per cent of respondents used such clauses (p. 221); Wheeler, Reservation of Title Clauses, examined fifteen receiverships and liquidations and found 92 per cent of suppliers of goods had ‘some sort of reservation of title provision’ (p. 5).

\textsuperscript{239} In a ‘simple’ retention of title clause the ‘security’ applies to the goods as supplied but a ‘complex’ retention of title clause seeks to apply to goods even when they have been altered or changed. The thrust of case law is that whereas simple clauses do not constitute charges, complex ones are regarded as charges and are registrable. For discussion of the case for definitions of ‘complex’ and ‘simple’ see J. de Lacy ‘Corporate Insolvency and Retention of Title Clauses: Developments in Australia’ [2001] Ins. Law. 64. The CLRSG document, Modern Company Law for a Competitive Economy: Final Report (DTI, London, 2001) (‘CLRSG, Final Report, 2001’) ch. 12, advocated a regime of notice filing which would link priority to the relative timing of registration. Simple retention of title clauses would not be registrable (para. 12.60). The Law Commission commenced a project of reform of the law of security interests following reference from the CLRSG and endorsed the approach of legislation along the lines of Article 9 of the US Uniform Commercial Code in its Consultation Paper No. 164 (2002) and in its Consultative Report Law Com. No. 176 (2004). In the Final Report on Company Security Interests (Law Com. No. 296, 2005) the Law Commission retreated, however, and simple retention of title clauses were not advocated to be covered by the proposed new system of electronic notice filing for companies. See further Goode, ‘Case for Abolition of the Floating Charge’; G. McCormack, ‘The Law Commission and Company Security Interests – A Climbdown’ (2005) 18 Sweet & Maxwell Company Law Newsletter; Company Security Regulations 2006; and ch. 15 below. See also D. Milman, ‘Company Law Review: Company Charges’ [2001] Ins. Law. 180; G. McCormack, ‘Retention of Title and the EC Late Payment Directive’ [2001] 1 JCLS 501 on the obligation on Member States to recognise contractually agreed-upon ‘simple’ ROT clauses in contracts for the sale of goods. See pp. 130–3 below.

\textsuperscript{240} See Snaith, Law of Corporate Insolvency, p. 197.}
security (for example, a floating charge) because the latter may be seen as an expensive and cumbersome resort to a legal framework; because retaining title, in comparison, involves a simple standard contractual term not requiring general disclosure; because the customer, when approached for security, might refuse and look elsewhere for supply (fearing that offering security signals a lack of creditworthiness or financial instability to others in the market); and because requests for security might drive customers away, in so far as such requests are seen as hostile actions evidencing a lack of goodwill and trust.241

A hire purchase agreement keeps the title to the relevant asset with the seller until the end of the stipulated hire period and is often used as a source of medium-term credit for the purchase of plant and equipment. The hire purchase company supplies the equipment which can be used immediately by the hirer who will make a series of regular payments (including an interest charge) and, after repayment, will become the owner by exercising a right to purchase for a nominal sum. Legal title does not pass to the hirer until payments under the agreement have been completed. The hirer, again, retains a secure position regarding any insolvency of the hirer, provided that the value of the asset at issue remains higher than the repayment sum outstanding and does so for the duration of the agreement. The hirer, in turn, enjoys the use of the equipment and only has to make an initial payment rather than the full purchase price. Hire purchase tends to be an expensive form of finance but the hirer company can claim tax relief on the interest element in the payments made and in regard to any investment allowances.

Leasing operates like hire purchase but at the end of the period of the lease the ownership of the asset still remains with the lessor. It is an arrangement that has grown in popularity for four reasons.242 First, the company may not have the funds to purchase a large asset, or, if it does, it may have a more profitable use for the cash. Second, leasing may provide tax advantages where investment allowances can be secured or where the lessor pays a higher marginal tax rate than the lessee (less tax will be collectable than would have been the case with a purchase). Third, leasing allows equipment to be updated flexibly and transfers the risks associated with technologically advanced fields to the lessor. Similarly, where a company is ill-positioned to calculate asset depreciation rates, it can transfer risks to the lessor. Finally, if leased assets can be kept off the balance sheet (for example, by classification

241 See Wheeler, Reservation of Title Clauses, pp. 38–9.
as operating leases) a company can show a higher return on assets in its accounts than would have been possible had the asset been purchased.

Factoring and invoice discounting involve a company raising funds by selling receivables, such as debts owed to the company, to a financial intermediary who will offer the company a cash percentage of their face value.\(^{243}\) (Factoring, in the alternative, may operate by the advance of a sum on the security of the receivables.) The company will obtain funds more rapidly than would have been the case had payment from the customer been awaited.

Factoring and invoice discounting have become increasingly important to UK companies. The growth rate of invoice financing exceeded the growth in the GDP in every year from 1987 to 2003 (except 1991) and in 2008 members of the Asset Based Finance Association (ABFA) made advances against invoices of £16.4 billion.\(^{244}\) It is, indeed, the need for finance that leads companies to use factors and invoice discounters. These are devices of particular value to small, fast-growing companies who experience late payment problems and wish to release funds tied up with debtors for use as working capital. Resort to factoring and invoice discounting allows a business to grow in line with its sales and can also be especially useful when a company has exhausted its overdraft facilities and is not in a position to raise new equity. Sales of receivables, moreover, do not have to be registered and borrowing ratios are unaffected.\(^{245}\) Sale and lease-back allows funds to be raised by a company selling assets to a financial intermediary but it also allows the company to continue using the assets by leasing them back. The company thus secures funds and only has to pay out rental charges (which are tax deductible) and a sale and lease-back may be preferred by the company to a mortgage because the latter will adversely affect the debt to equity ratio of the company since it appears as a debt on the balance sheet.\(^{246}\)

\(^{243}\) Factors in general will advance up to 80 per cent of invoice value: see Bank of England 1998, p. 28.


\(^{245}\) See Snaith, Law of Corporate Insolvency, p. 220. See generally Oditah, Legal Aspects.

\(^{246}\) See Samuels et al., Management of Company Finance, p. 584. Variants on sale and lease-back are sale of stock/inventory or assignments of work in progress, where the company, in the former case, sells its stock, e.g. of bonded whisky, to a bank, receives funds and has an option to repurchase on maturation (of the whisky) at a price reflecting the initial sale price plus interest. During the period of maturation the bank owns the whisky and the company has funds for investment in further projects: see further ibid., pp. 452–3.
A significant advantage of such asset-based financing is that it offers financiers an attractive security – namely ownership of the assets, receivables or leased equipment. Such arrangements also allow financiers to gain value from their specialist knowledge regarding the assets at issue and they are amenable to use by the new, growing business that lacks the track records or the security that is often required by the traditional lender. Devices such as leasing, moreover, take advantage of tax allowances (on, for instance, new equipment purchases). It has been argued, furthermore, that the House of Lords’ decision in Re Spectrum Plus Ltd will encourage resort to asset-based financing methods such as factoring. The decision makes it ‘more difficult, if not impossible’ for banks to establish charges over book debts in a manner that renders them fixed rather than floating ‘without micro-managing the debtor’s company’s dealings’ in those book debts and, as a result of the concomitant demotion in the priority of charges over book debts, companies are likely to find asset-based receivables finance to be available at lower prices than overdrafts that are secured by a floating charge. Balancing such considerations that favour the use of asset financing is the fact that this mode of raising money can prove to be relatively expensive for small firms who may find the arrangement fees that are charged to be high in relation to the sums advanced.

The broad efficiency case for the above quasi-security devices is that they provide ways to supply the financing that healthy trading companies need during their various stages of development. They are part of the flexible menu of financial devices that the market provides to trading companies and which help to increase cash flows. It could thus be argued that the growing use of financing methods such as factoring is strong evidence of their utility.

When attention is turned to the insolvency context, however, there are a number of efficiency concerns to be noted. A first caution is that quasi-security devices may produce transfers of insolvency wealth away from those unsecured creditors who cannot adjust to the use by others of such devices. The result may be the production of those inefficiencies that were discussed above in relation to security: thus, for instance,

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251 See Diamond Report; Crowther Report. On the use of other ‘devices’ to jump the priority queue see ch. 15 below.
companies may have an excessive incentive to rely on unsecured credit and their managers may be under-detected from making high-risk decisions that affect the interests of unsecured creditors. Many submissions to the Cork Committee, furthermore, argued that on the continent of Europe the wide use of reservation of title clauses had ‘virtually emasculated’ insolvency procedures as an effective remedy for unsecured creditors since there was generally nothing left in the estate for them.252

Quasi-security devices tend to be contracted for by the larger, better-placed companies who would otherwise be unsecured, and the effect is to exploit this superior positioning and produce distortions in the pricing of credit. This last point can, perhaps, be overstated because the costs of inserting a retention of title clause into a supply contract may be small (standardised contracting reduces costs in this respect), but there are, nevertheless, suppliers of certain types of goods who cannot retain title effectively and who may, as a result, have to bear undue expected insolvency costs. As the Cork Committee noted in relation to retention of title clauses: ‘Fuel supplied to heat furnaces or fodder supplied for livestock disappears on consumption and paint applied to the fabric of a factory becomes attached to the realty; the supplier of credit is necessarily left with an unsecured claim in the insolvency of the customer.’253

A second objection to the use of quasi-security is that it undermines many of the efficiencies that are associated with the system of secured priorities. Security, with priority, can be said to reduce the price of credit by reducing risks to lenders. They anticipate, when they are given security, that the protection they enjoy will not be diluted in value by subsequent actions of the debtor.254 If, however, the debtor looks to

252  Cork Report, para. 1624.
254  As the essence of a floating charge is that the company is free to deal with its assets in the ordinary course of business, it has been held that this includes being able to create fixed charges on assets within the class covered by the floating charge, having priority over the floating charge, in order to secure borrowing in the ordinary course of the company’s business: see Wheatley v. Silkstone and Haigh Moor Coal Co. (1885) 29 Ch D 715. In view of the court’s recognition (in Re Automatic Bottle Makers Ltd [1926] Ch 412) of the possibility of creating a second floating charge over a part of the assets covered by a
quasi-security and shifts its asset pattern so as to rely more heavily on the use of assets that are leased or subject to hire purchase agreements, retentions of title or other sale-based security devices, the protection offered to the secured creditor will be diminished. Fewer assets within the new pattern will enter the insolvent estate and the holder of, say, a floating charge will have a call on a slimmer body of assets. The efficiency loss is caused by the uncertainty faced by the secured creditors: if they cannot assess the level of protection that their security will offer they either will not lend or will cost into the price of credit the increased level of risk that they face. Uncertainty thus increases credit costs.

A third objection continues the theme of uncertainty. In so far as quasi-securities do not have to be registered, there is a lack of information available to creditors, secured and unsecured, concerning the position of a company’s indebtedness. The trade creditor, for instance, may deal with a customer who displays large warehouses with stocked shelves to the world but the title to these assets and stock may belong to a third party and the information relating to this position may well be unavailable to that trade creditor. This possibility will be anticipated by the rational trade creditor who will increase the cost of supply to reflect the unknown risks faced; but, again, uncertainty increases credit costs economically inefficiently.

The need for more information on quasi-security was recognised by the Crowther and Diamond Committees, which both argued in favour of a new register of ‘security interests’ which, for Diamond, would include ‘not only mortgages, charges and security in the strict sense but also any other transfer or retention of any interest in or rights over property other than land which secures the payment of money or the performance of any other obligation’. The Company Law Review Steering Group advocated a system of notice-filing in 2001 as did the Law Commission first floating charge and with priority over the first charge, it has now become standard practice to include in a contract of floating charge a ‘negative pledge’ clause, prohibiting the company from creating any charge over the assets covered by the floating charge with priority over the floating charge. On the question of establishing knowledge or notice of such a clause (thereby depriving a subsequent chargee of protection), see Hannigan, Company Law, p. 690.

Diamond Report, para. 9.3.2 (proposals that, inter alia, would cover retentions of title and hire purchase agreements and certain leasing arrangements). See Cork Report, para. 1639, which also argues that clauses reserving title that were not duly registered should be void against a liquidator, trustee, administrator or any other creditor. For support of the Diamond approach and a comparative view see de Lacy, ‘Corporate Insolvency and Retention of Title Clauses’. 
to varying degrees in 2002, 2004 and 2005. Registrable charges in the proposed Law Commission regime would have included floating charges, all charges on goods and complex retention of title clauses (where the title protecting the indebtedness shifts from one good to another on transformation), but not simple retention of title clauses where the seller merely retains title on transfer. The consultation exercise on the Law Commission’s proposals gained no consensus of support, however, and the Companies Act 2006 made no significant changes to the existing rules on the registration of company charges and retention of title clauses.

The above problems are compounded by legal uncertainties. Insolvency lawyers, like any others, will always succeed to an extent in rendering the application of laws uncertain: if necessary they will argue about the relevant facts as much as the applicable laws. There are degrees of uncertainty, however, and costs to companies will increase where the law is excessively complex or uncertain. The problem associated with quasi-security is that the law is fragmented, it treats essentially similar transactions in very different ways and causes unnecessary legal complications. As Diamond concluded: ‘The complexity and uncertainty of the law leads to expense and delay and hinders legitimate business activities … The variations in the different legal rules cause problems in determining priorities between competing interests and give rise to fortuitous differences in insolvency.’ On reservations of title in particular, another commentator suggested that the formal law was ‘uncertain in its application in almost every area. The most basic level of law in simple reservation of title clauses is open to differing interpretations.’


257 See Wheeler, Reservation of Title Clauses, pp. 34–6.

258 The findings of the Diamond Report, para. 1.8(c), and the Cork Report, para. 1627, noted how consultee after consultee had made a ‘cry for certainty’ to avoid the prospect of ‘interminable and expensive litigation’. Note, also, Cork’s response that, given *inter alia* the ‘illogical and complex’ law relating to security in respect of goods, ‘nothing that we propose in relation to insolvency law can prevent this’: para. 1628.

259 Diamond Report, paras. 1.8(d)–(e). On suggested solutions to these difficulties and Diamond’s proposals for a ‘new law on security interests to replace the multitude of different rules we have now’ see ch. 15 below.

260 Wheeler, Reservation of Title Clauses, p. 34. It is now, as noted, accepted that a simple retention of title (as opposed to a complex one) is effective: see A. Hicks, ‘Reservation of Title: Latest Developments’ [1992] JBL 398.
Finally, it could be cautioned that quasi-securities not only queer the pitch for security mechanisms but they may also fail to work well themselves. In the case of retention of title clauses, it has been suggested that even claimants with the strongest cases face a formidable series of obstacles to recovery, that those insolvency practitioners who act as administrative receivers or liquidators enjoy huge expertise and ‘repeat player’ advantages over claimants and that the overall result is that only 15 per cent of claimants succeed in recovery. It is, accordingly, conceivable that, as presently operated, a device such as the retention of title clause achieves the worst of both worlds: it is perceived (wrongly) as a huge threat by holders of floating charges and this escalates credit costs, but the device fails, at the end of the long and legally uncertain day, to deliver real protection to the quasi-secured creditor.

The ‘new capitalism’ and the credit crisis

Over the last twenty years the above building blocks of borrowing may not have altered but the modes of arranging corporate financing on the basis of these foundations have changed radically. In the world of the so-called ‘new capitalism’ borrowing relationships, credit arrangements and involved actors have all mutated dramatically and there has been a movement from ‘managerial capitalism into global financial capitalism’. The developments comprising this movement should be noted here since they are of considerable significance for insolvency law – not least because they involve an explosive fragmentation of debt.

The first such development has been the massive growth in the use of financial derivatives, and, notably, in credit derivatives. The latter are

261 Wheeler, Reservation of Title Clauses, p. 178. See also Spencer, ‘Commercial Realities of Reservation of Title Clauses’, in whose survey half of respondents said that their clauses had been challenged by receivers or liquidators. In practice the insolvency practitioner not only will consider whether the wording of the ROT clause establishes a prima facie claim but also will be influenced by the bargaining position of the supplier: see Leyland DAF Ltd v. Automotive Products plc [1993] BCC 389; A. Belcher and W. Beglan, ‘Jumping the Queue’ [1997] JBL 1 at 17–19.


263 Ibid. This section builds on V. Finch, ‘Corporate Rescue in a World of Debt’ [2008] JBL 756.

264 The total volume of outstanding credit derivatives contracts stood at £31,300 billion at the end of 2007 – a near doubling on 2006 figures – and an indication that the 2007–8 credit crunch had not halted the rise of the credit derivative market. That market is ten times the size it was in 2004: see G. Tett and P. Davies, ‘Upsurge in Credit Derivatives Defies Fears’, Financial Times, 16 April 2008. See also G. Tett, ‘Should Atlas Still Shrug? The Threat that Lurks behind the Growth of Complex Debt Deals’, Financial Times,
derivative contracts that transfer defined credit risks in a credit product or bundle of credit products to a counterparty – a market participant or the capital market itself. The trading of credit risk is a process that has been advanced by the growth of structured financing techniques and the securitisation of such risks. Securitisation is the process involving the rendering of a credit derivative into an investment product – as where a bank places loans in a special purpose vehicle (SPV) which then issues new securities such as bonds – allowing investors to buy credit-linked notes and to gain credit exposure to an entity or group of entities. The credit product itself might be the risk interest in a loan or a generic credit risk, such as an insolvency risk.

Complex structuring may take place when securitisation involves an SPV issuing an asset-backed security (ABS) secured over a wide range of assets, loans and receivables or issuing a collateralised debt obligation (CDO) involving a portfolio of bonds, loans and swaps. Buyers, in such markets, are able to purchase exposure to particular risks; bundles

15 January 2007, noting that global liquidity is made up of 75% derivatives, 13% securitised debt, 11% broad money and 1% bank funds. The volume of high-risk traded debt has risen sharply in recent years. In 2003 £500 million of bonds with a CCC credit rating were issued but this had risen to £2.2 billion in 2005: see G. Tett, 'High Risk Debt Issuance has Grown Sharply', Financial Times, 4 December 2006. On derivatives see further J. Benjamin, Financial Law (Oxford University Press, Oxford, 2007) ch. 4.


The use of a special purpose vehicle (SPV) involves use of a paper company where a bank places other mortgages or assets to remove them from its balance sheet. On SPVs see further N. Frome and K. Gibbons, 'Spectrum – An End to the Conflict or the Signal for a New Campaign?’ in Getzler and Payne, Company Charges, pp. 122–9, 132.

See G. Aggarwal, 'Securitisation – An Overview’ (2006) 3 Int. Corp. Rescue 285. In a securitisation the underlying assets are a pool of assets producing regular cash flows. Another type of asset-backed security is the repackaging, in which the underlying assets are a pool of bonds and a swap arrangement (under which the investor agrees to pay cash flows from bank bonds back to the bank in return for a different set of cash flows): see Fuller, Corporate Borrowing, pp. 108–9.

See V. Kothari, Credit Derivatives and Synthetic Securitisation (Vinod Kothari, India, 2002). In 2002 the then head of the Financial Services Authority, Sir Howard Davies, warned the City that synthetic CDOs were being described by some investment bankers as ‘the most toxic element of the financial markets today’: see J. Treanor, ‘Toxic Shock: How the Banking Industry Created a Global Crisis’, The Guardian, 8 April 2008, noting estimates that in 2007 about a third of the £300 billion CDOs sold contained US sub-prime mortgage loans.
of risks of different types; or an index of credit risks, covering risks in a
generalised, diversified index of names. They are, additionally, able to
trade in tranches representing risks of different levels or slices of risk in a
given market (e.g. the first 3 per cent of risk and so on).

A second important development has been the exponential growth of
the hedge fund and the private equity group as vehicles for making
investments in companies (especially troubled companies). These
funds are largely unregulated entities that invest in a wide variety of
domains and often use high levels of leveraging and complex financial
arrangements in order to increase their returns. They are prominent
in credit derivative trades – which are in the main unregulated and offer
opportunities for short trades in credit that are not permitted by the bond
market. In such a world ‘the whole landscape of leveraged lending has
changed’ with resort to complex mixes of asset classes, bonds, deriv-
atives, loans and equities and the use of newly devised and tailor-made

270 Fuller, Corporate Borrowing, pp. 116–18.
271 Rod Selkirk, Head of the British Venture Capital Association, has described the difference
between the hedge fund and the private equity group as follows: hedge fund
investors are experts in trading in public securities and derivatives whereas in private
equity the expertise lies in investing in companies and management teams: see P. Smith,
‘Private Equity Groups are “Distinct From Hedge Funds”’, Financial Times, 27
November 2006. The term ‘private equity’ encompasses investment types ranging
from venture capital focused on financing early stage businesses to leveraged buyouts
that employ debt to buy more mature companies. The growth equity segment of the
private equity industry (a fast-growing sector focused on supporting the expansion of
established growth companies) typically employs little or no leverage. For an outline of
the private equity industry see D. Walker, Guidelines for Disclosure and Transparency in
272 Hedge funds and non-bank credit investment groups held over 50 per cent of all lending
to higher-risk European companies in March 2007 – pushing banks into a minor role.
This offers a dramatic contrast with the position as recently as 2005 when banks
represented three-quarters of the market: see ‘Hedge Funds are Moving in on Banks’
see H. McVea, ‘Hedge Funds and the New Regulatory Agenda’ (2007) 7 Legal Studies
standards for the industry see J. Mackintosh, ‘Big Hedge Funds Agree Voluntary
273 See T. Hurst, ‘Hedge Funds in the 21st Century’ (2007) 28 Co. Law. 228, estimating that
’several hundred’ funds hold around US $1.3 trillion in assets and account for 40–50 per
cent of all market trading activity. Private equity is now said to own businesses employ-
ing around one in six of UK private sector workers: see J. Pickard and P. Smith, ‘Myners
274 See G. Tett, ‘Deals Galore in a World Awash with Cheap Money’, Financial Times,
instruments such as payment in kind notes (PIKs) and ‘hybrid financing’
deals using highly structured CDOs and ABSs. Low interest rates have
encouraged such heavily leveraged approaches in recent years as has the
dramatic globalisation of the credit derivatives market.

A third change has taken place in the traditional role of the bank –
which has shifted from that of primary lender to that of ‘originator and
distributor’.275 Instead of arranging loans and retaining these on their
own books, the banks have moved towards arranging and then selling on
the loans and loan risks to other investors.276 The change has been from
commercial long-term lending and durable client relationships towards
investment banking and arm’s-length trading. When companies encoun-
ter difficulties in this new world they are increasingly likely to turn not to
commercial banks but to hedge funds and private equity funds or to
other sources of ‘alternative capital’.

The sanguine view of such developments is that such active financial
trading swiftly identifies and attacks pockets of inefficiency and imposes
rigorous market disciplines on managers; that it places economically
inefficient operations in the hands of those who can extract value most
efficiently; and that it allows capital to flow easily around the world to
those places where it will work best.277

Sceptics, however, focused on a number of concerns even before the
credit crisis of 2007–8.278 The first was that the system leads to risk taking
that is unsustainable. It does so, they fear, because lending standards tend
to loosen as credit derivative markets encourage banks to believe, exces-
sively optimistically, that they can use credit derivatives to offset the risks
of loans. This, it is thought, leads such banks to lend more to companies
than they would otherwise do – and at lower rates to higher-risk bor-
rowers.279 Such a problem is allegedly compounded because the credit

276 As noted, the use of a special purpose vehicle (SPV) removes loans from its balance sheet.
277 See Wolf, ‘New Capitalism’.
278 See, for example, F. Partnoy and D. Skeel, ‘Credit Derivatives: Playing a Dangerous
Game’, Financial Times, 17 July 2006. In April 2008 the Governor of the Bank of
England commented on the failure of the major banks to create incentives for their
staff that are conducive to the reasonable control of risks.
279 The Finance Director of Northern Rock argued early in 2007 that securitising its loans
had reduced its risks and allowed it in turn to make more loans: see Tett, ‘Should Atlas
Still Shrug?’ Months later Northern Rock was experiencing a liquidity crisis and was
approaching the Bank of England for a £13 billion loan as lender of last resort. On the
2008 collapse of Lehmans with an estimated $400 billion CDS debt on its books see
derivatives market reduces the incentives for banks to monitor corporate
behaviour and managerial performance.280 This tends to take out of play
those institutions that, traditionally, are best placed to monitor director-
ial prudence. A related worry is that the investors in sold-on risks – often
the pension and insurance funds – are unlikely to carry out such mon-
itoring as they have no hands-on relationship with the corporate bor-
rower. The upshot pointed to is that this involves a moral hazard on the
part of borrowers who are not subject to rigorous financial disciplining.
In sum, both lenders and borrowers are excessively encouraged to bear
risks and this increases threats to solvency.281

A second fear relates to the systemic risks involved with credit derivatives.
The new concern is that the regulatory challenges of controlling such a
complex global credit market are extremely severe and that the monetary
tools of central banks do not work well to control credit conditions.282 This
has for some time given rise to worries regarding the stability of the system
and in turn for the welfare of companies – who may face liquidity crises that
are driven by global factors beyond their control. As for risk spreading and
systemic risks, the traditional view is that dispersing risks encourages
resilience and financial stability. In the wake of the credit crisis of 2007–8,
the charge is that opacities within the derivatives system made it difficult, in
the pre-crisis period, to trace risks and risk bearers so that concentrations
developed in a manner that made the general system highly vulnerable to
shocks.283 Another problem encountered was that of contagion, a process in

280 See F. Partnoy and D. Skeel, ‘The Promises and Perils of Credit Derivatives’ (U. Pa. Law
School Working Paper 125, 2006): the banks that financed Enron laid off $8 billion of
risk. See also the evidence of the Governor of the Bank of England to the House of
Commons Treasury Select Committee on 29 April 2008 regarding the failure of the
banks to create incentives for their staff that are conducive to the reasonable control of
risks: reported in G. Duncan and G. Gilmore, ‘Mervyn King: Banks Paying Price for
their Greed’, The Times, 30 April 2008.

281 See e.g. J. Plender, ‘The Credit Business is More Perilous than Ever’, Financial Times,
13 October 2006.

282 On the challenges of regulating hedge funds see Financial Services Authority, ‘Hedge
Funds: A Discussion of Risk and Regulatory Engagement’ (FSA Discussion Paper 05/4,
difficulties in controlling the 2007 Northern Rock crisis see Editorial: ‘All Are Losers in
the Rock Blame Game’, Financial Times, 10 October 2007. See further G. Walker, ‘Sub-

283 On the causes of the credit crisis see e.g. R. Tomasic, ‘Corporate Rescue, Governance
and Risk-taking in Northern Rock’ (2008) 29 Co. Law. 297; Technical Committee of the
International Organisation of Securities Commissions, Report on the Subprime Crisis:
which ill-informed parties afflicted whole areas of investment. When unmonitored expansions of credit were encouraged by low interest rates, when there were high levels of leverage and speculative trading, when there was unprecedented demand for high-risk subordinated loans, and when information flows were impeded by hugely complex contractual fragmentations, crashes resulted when ‘the music stopped’ on the risk shifting.284

The third general concern – again expressed before the 2007–8 crisis and repeated following it – relates to information flows and levels of transparency. The intricacies of credit derivative arrangements and the sophistication of the various vehicles for credit structuring mean that the relevant contracts are difficult to understand and it is extremely hard for regulators to ensure that processes are transparent and conducive to the supply of full and accurate information on risks.285 This is an area lacking standardised performance information.286 Investors, accordingly, may be poorly placed to evaluate the risks that are associated with opaquely packaged products.287 Such opacity may underpin the propensity of the risk-shifting process to move risk into the hands of investors who are ill-equipped to handle it.288 As has been commented: ‘The theory is that risk would be shifted to those best able to bear it. The practice seems to have been that it was shifted onto those least able to understand it.’289 A further effect is that investors in the company tend to


find it difficult to adjust their credit terms when they do not know whether a lender – for example, the company’s bank – has hedged its position with derivatives.\textsuperscript{290} The more general worry for those concerned with corporate financial health is that intrinsically volatile systems that involve poor transparency and appreciation of risk can, and, in 2008 did, lead to financial instabilities, excessively risky managerial strategies and solvency crises.\textsuperscript{291}

A final worry relating to insolvency risks is the possibility that the popularity of derivatives may impede recoveries in times of corporate trouble because the hedge funds or other holders of credit will enforce debts rapidly against defaulters. In the world of the ‘new capital’ the troubled company may have no friendly ear at the bank to turn to and creditors who have purchased derivatives may possess few motivations to explore turnaround possibilities. They may even have incentives to encourage corporate default and actively to enforce the terms of the loan agreement even where this destroys corporate value.\textsuperscript{292} These are matters to be returned to in chapter 7 below when discussing informal rescue strategies and practices.

It is perhaps too early to draw conclusions on the full effects of the new capitalism. This is not least because regulatory responses to the 2007–8 credit crisis are yet to fully emerge. Even in early 2008, however, steps were in train, for instance, to improve the transparency with which the hedge and private equity funds operate.\textsuperscript{293} It remains to be seen whether regulators will institute radical new steps that are designed to reduce the complexity and opacity of credit derivatives and credit markets. Possibilities being canvassed in late 2008 included: the creation of a

\textsuperscript{290} Ibid.
\textsuperscript{292} See Partnoy and Skeel, ‘Promises and Perils’, p. 22.
\textsuperscript{293} In January 2008 the hedge fund industry’s Hedge Fund Working Group (HFWG), representing leading hedge fund managers based mainly in the UK and chaired by Sir Andrew Large, announced that agreement had been reached on voluntary standards intended to codify best practice for the industry: see Mackintosh, ‘Big Hedge Funds Agree Voluntary Code of Practice’. (The HFWG was loosely modelled on the committee drawing up a voluntary code for the private equity industry under Sir David Walker, which published \textit{Guidelines for Disclosure and Transparency in Private Equity} on 20 November 2007.)
‘clearing house’ that would give investors more security by removing counterparty risk; moving towards a system of more standardised financial products rather than bespoke deals; regulatory reforms to demand that derivative contracts be disclosed in a detailed manner; and classifying those institutions that write credit default swaps as insurance groups – and thus subjecting them to increased oversight.\textsuperscript{294}

What can be said now is that the fragmentation of credit that has resulted from its securitisation has raised new issues of efficiency, expertise, accountability and fairness. It is often said that the credit derivatives market is conducive to efficiency in both the technical and economic senses – in lowering the transaction costs involved in the investment process and in ensuring that money flows to the locations of most productive use. After the 2007–8 crisis, newly urgent questions, however, have arisen concerning the quality and quantity of information that such markets generate and whether this can ensure efficiency in either of the above senses. Further issues relate to the resilience of the regime of ‘new capitalism’ and its potential to offer a stable environment for lowest-cost or economically efficient investment. Expertise, accountability and fairness are similarly all values that require the provision of foundational information flows. Without these it is difficult for informed expert judgements to be made, for controlling bodies to hold to account and for affected parties’ interests to be respected through the granting of representational rights that are underpinned with access to relevant data.

\section*{Conclusions}

The above discussion has reviewed the main mechanisms by which companies can finance their operations. Even a non-exhaustive view, however, indicates the range of legal instruments that are available for the financing of companies. Also made clear is the complexity of the trade-offs that have to be borne in mind in assessing the legal structures of financing. The needs of healthy companies as well as troubled companies have to be considered; the balance between credit and other financing arrangements has to be evaluated; and the needs of companies of different sizes and profiles have to enter the analysis. The purpose of this chapter has not been to evaluate the UK banking system and its

ability to service industry.\textsuperscript{295} It has been to map out the legal framework of borrowing and to consider whether this is, in structural terms, conducive to the economically efficient meeting of healthy and troubled companies’ needs.

A number of general conclusions can be drawn at this stage. First, it is clear that, at least in some contexts, there may be significant dangers of economically inefficient transfers of insolvency wealth from unsecured creditors to secured creditors or to those availing themselves of quasi-security devices. The nature of any efficiency loss will, as noted, depend on a number of context-specific factors: for instance, the number of different kinds of creditors that supply financing to a firm; the levels of risks being run by the company; the types of transaction being engaged in; the levels of transaction costs involved; and the nature of the competition in the various credit markets to which the company can turn. Where such transfers of insolvency wealth occur, they may prejudice healthy companies’ needs (corporate decisions on financial risks may, for example, be taken with distorted weightings being given to the interests of different creditors). Transfers of this kind may also affect the needs of troubled companies in so far as decisions as to the lives or deaths of troubled companies – decisions which affect different creditor groups in different ways – may also be made with unbalanced views of the interests of different creditor classes. Not only that, but corporate managers may possess incentives to subsidise their company’s secured loans by taking their unsecured credit from those unsecured creditors who are least well informed about risks, least able to adjust loan terms, least protected in insolvency and least likely to be capable of absorbing financial shocks.

It may also be concluded that certain courses of action have the potential to reduce economically inefficient insolvency wealth transfers. Procedures could be adopted so as to allow unsecured creditors to become more fully informed about the risks they are running. The value of informational steps should not, however, be exaggerated. They do not assist unsecured creditors who are involuntary or cannot adjust because of lack of resources, paucity of time or expertise, competitive pressures or other reasons. This does not mean, however, that there is no case for assisting those who can be put in a position to adjust and for

\textsuperscript{295} For an outspoken view see Hutton, \textit{The State We’re In}. See also the White Paper, \textit{Our Competitive Future: Building the Knowledge Driven Economy} (Cm 4176, December 1998), para 2.21; Cruickshank, \textit{Competition in UK Banking}. 

\textsuperscript{295}
adopting measures such as the registration of quasi-securities. Similarly, measures designed to increase information flows and transparency in credit arrangements will reduce economically inefficient wealth transfers but may also assist creditors in their monitoring of debtors and the encouragement of efficiency in decision-making. This will be of value to healthy as well as troubled companies.

As for involuntary, unsecured creditors who cannot adjust, other steps might be taken to reduce wealth transfers away from such a group. ‘Prescribed part’ rules as found in section 176A of the Insolvency Act 1986 are blunt instruments (they benefit all unsecured creditors) but they are known quantities which allow attendant risks to be calculated and which are unlikely to reduce the availability of secured credit. The ‘prescribed part’ regime may accordingly not impede trading materially but will provide funds of assistance in capturing insolvency assets and may reduce insolvency-driven inefficiencies. A step that might be taken is to introduce compulsory insurance against tort liabilities. This could reduce economically inefficient subsidies from a particular group of involuntary, non-adjusting unsecured creditors.

The above review also suggests that the collectivity of financing arrangements and the array of legal devices encountered in England is likely, in its present form, to impose unnecessary costs on both healthy and troubled companies. Where the financial markets supply a wide range of devices for obtaining finance and credit this might be thought to be consistent with the needs of healthy companies. Companies presented with such wide choices are thus able to select the types of, say, credit which will prove least costly to them given their size, profile, sector, financial plans, transaction patterns and so on. It is one thing, however, to provide a range of clearly identifiable modes of acquiring funds and another to present companies with a patchwork of legal devices that is so confused that they may have difficulty in identifying the kinds of borrowing relationships that they are considering or even have entered into. Where the legal gateways to borrowing are unnecessarily confused and uncertain, unnecessary transaction costs are again produced for both healthy and troubled companies.

We have seen, moreover, that just as confusion attends the legal categories of borrowing, it also permeates the system of priorities, so that the benefits of clear ranking are undermined by the capacity of ‘creditors’ to employ such quasi-security devices as retention of title clauses and thereby to bypass priority mechanisms. The costs of credit will inevitably rise as such uncertainties increase risks.
Addressing the confusions that are found in the range of credit arrangements demands that attention be given to the legal frameworks that establish the different credit devices. It also demands that thought be given to the application of these frameworks on the ground and the possibility of devising credit arrangements that not only are set up with clear legal frameworks but are operated in the business world in an efficient, fair, accountable and transparent manner. During the rest of this book such matters will be a central concern.
This chapter looks at what constitutes corporate failure, who decides that a company has failed and why some companies fail. From the insolvency lawyer’s point of view it is important to understand the nature and causes of corporate decline so that the potential of insolvency law to prevent or process failure can be assessed and so that insolvency law can be shaped in a way that, so far as possible, does not contribute to undesirable failures or prove deficient (substantively or procedurally) in processing failed companies.

The purpose of insolvency law is not, however, to save all companies from failure. The economy is made up of a vast number of firms, each engaged in marketing and product innovations that are designed to improve competitive positions and each being challenged in the market by other firms. Business life involves taking risks and dealing with crises, and the price of progress is that only those able to compete successfully for custom will survive. An efficient, competitive marketplace will thus drive some companies to the wall because those companies should not be in business: they may be operated in a lazy, uncompetitive manner, their products may no longer be wanted by consumers and managerial weaknesses may be placing their creditors’ interests at unacceptable risk. The role of insolvency law in such cases is not to take the place of the market’s selective functions but to give troubled companies the opportunity to turn their affairs around where it is probable that this will produce overall benefits or, where this is not probable, to end the life of the company efficiently, expertly, accountably and fairly.

It can also be argued, however, that insolvency laws and processes should be able to look beyond the immediate position of the company

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1 Where companies enter insolvency procedures orientated towards rescue (e.g. administration and Company Voluntary Arrangement) 79 per cent of cases result in some sort of rescue and, in 62 per cent of these, the rescue is of the entire business: see the R3 Twelfth Survey of Corporate Insolvency in the UK (2004) (‘R3 Twelfth Survey’) p. 30.

and should be sufficiently accessible to democratic influence to allow consideration of factors beyond the narrow confines of the firm or the strictly economic. Corporate failures may lead to the breaking up of teams with experience and expertise; to wasted resources and to run-on effects such as the unemployment of staff; harm to customers and suppliers; general impoverishment of communities and losses of confidence in commercial, financial, banking and political systems. A large corporate insolvency may, for instance, not only produce job losses and harm to the community, but also prejudice the availability of commercial credit as banks are shocked into newly restrictive lending policies. An insolvency often spreads ripples that extend considerably beyond the troubled firm.

What is failure?

Companies routinely encounter difficult times and survive them. Some firms, however, undergo formal or informal rescue procedures before regaining health and others may end up in liquidation. R3 reported in 2004 that 21 per cent of businesses survived insolvency and continued to operate in one form or another and administration procedures resulted in 66 per cent job preservation. In 2005 the number of companies liquidated per quarter ran at between 3,000 and 3,400. To talk of ‘troubled’ or ‘failing’ companies is accordingly to refer in a broadbrush fashion to companies encountering a variety of problems and in different stages of decline or regeneration. More precision can be brought to such discussions by distinguishing between companies that are in distress and companies that are insolvent.

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3 Of new companies, 80 per cent of VAT-registered businesses are still going after two years, falling to 70 per cent after three years: see J. Guthrie, ‘How the Old Corporate Tortoise Wins the Race’, Financial Times, 15 February 2007.

4 R3 Twelfth Survey, p. 4.

5 BERR Statistics and Analysis Directorate figures. Insolvencies in the recession of the early 1990s peaked at just under 25,000 per annum in 1992. The corporate restructuring company Begbies Traynor reported in October 2008 that stricter lending criteria and the inability to secure funding meant that a ‘staggering’ 4,566 companies faced critical problems: see J. Grant, ‘Businesses in Distress Double’, Financial Times, 20 October 2008. After a poll of 2,073 of its members in October 2008, R3 was reported as predicting that small and medium-sized company insolvencies were set to rise by a ‘catastrophic’ 41 per cent by the end of 2009 compared with where they were at the end of 2007: see J. Grant, ‘Insolvency Rate to Rise 41% by End of 2009’, Financial Times, 4 November 2008.
Distressed companies are those that encounter financial crises that cannot be resolved without a sizeable recasting of the firm’s operations or structures. Such distress may be seen in terms of default, where the company has failed to make a significant payment of principal or interest to a creditor. Alternatively, distress can be seen in terms of financial ratios. Thus, calculations based on a company’s accounts can be used to reveal profitability ratios, liquidity ratios and longer-term solvency ratios. Assessing whether a company is in distress may involve reference to these ratios individually or collectively, but the central issue is whether the company is revealed to be in such a state of crisis that drastic action is required.

A company is insolvent for the purpose of the law if it is unable to pay its debts. No legal consequences attach to a firm, however, simply by virtue of its insolvent state. Such consequences only follow the institution of a formal proceeding such as a winding up or the appointment of an administrator or administrative receiver. There is, moreover, no single

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7 In Belcher’s terms a ‘default proper’ as opposed to a ‘technical default’ of a loan term, which relates not to principal and interest payments but to other issues, e.g. retention by the firm of a minimum level of net worth.


9 Wruck defines financial distress as ‘a situation where cash flow is insufficient to cover current obligations. These obligations can include unpaid debts to suppliers and employees, actual or potential damages from litigation and missed principal or interest payments’: K. Wruck, ‘Financial Distress, Reorganisation and Organisational Efficiency’ (1990) 27 *Journal of Financial Economics* 419 at 421.

legal definition of inability to pay debts. Within the Insolvency Act 1986 and other insolvency-related statutes there are a number of tests of insolvency and these relate to the purposes of different legislative provisions. The two main reference points regarding the inability to pay debts are the ‘cash flow’ and the ‘balance sheet’ tests. The cash flow test is set out in section 123(1)(e) of the Insolvency Act 1986 and, according to this, a company is insolvent when it is unable to pay its debts as they fall due. (The fact that the firm’s assets exceed its liabilities is irrelevant.) The courts, moreover, will pay regard to the firm’s actual conduct so that insolvency will be assumed if the company is not in fact paying its debts as they fall due. A further issue is whether future debts can be considered as part of the cash flow test. This was discussed in the Cheyne Finance decision in which Briggs J said that, although Parliament had removed the requirement to include contingent and prospective liabilities in framing what is now section 123(1)(e), it had added the words ‘as they fall due’ which merely replaced ‘one futurity requirement with another’ and, accordingly, future debts could play a role in the cash flow test.

Insolvency under this test is a ground for a winding-up order or an administration order or for setting aside transactions at undervalue, preferences and floating charges given other than for specified forms of new value.

The balance sheet or asset test of section 123(2) of the Insolvency Act 1986 considers whether the company’s assets are insufficient to discharge its liabilities, ‘taking into account its contingent and prospective

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11 See Goode, Principles of Corporate Insolvency Law, pp. 85–9. Note that the Insolvency Act 1986 s. 123(1)(a) and (b) provides two specific alternative methods of establishing inability to pay debts to facilitate the proof of insolvency (i.e. for creditors) for the purposes of winding up or administration proceedings.

12 The difficulty with the cash flow test is that ‘its meaning is vague and imprecise and determining whether a person or company is, on a particular day, insolvent, is often difficult’. Keay and Walton, Insolvency Law, p. 16.


15 See K. Baird and P. Sidle, ‘Cash Flow Insolvency’ (2008) 21 Insolvency Intelligence 40; T. Bugg, ‘Cheyne Finance’ (2008) Recovery (Spring) 10. The Cheyne Finance case concerned the contractual drafting of an insolvency event of default clause, not a petition presented on grounds of cash flow insolvency, and Briggs J’s comments are, strictly, obiter. It is arguable, however, that the courts are likely to apply common approaches to the cash flow test when deciding either petition or default clause cases: see Baird and Sidle at p. 41.


17 Insolvency Act 1986 ss. 238–42 and 245, especially ss. 240(2) and 245(4).
liabilities’. This may involve assessing the value of assets and judging the amount the asset would raise in the market; though a difficulty arises through the Act’s failure to indicate whether valuations should be made on the basis of a ‘going concern’ or ‘break-up’ sale. Particular difficulties may arise where there is no established market value for the commodity. The test, furthermore, gives rise to potential problems in so far as there is no statutory definition of prospective liabilities. Standard accounting practice treats contingent liabilities more subtly than section 123(2) and that section does not include any particular basis for measuring assets and liabilities.20 The balance sheet test is also one of the tests prescribed for the purpose of grounds for winding up,21 administration22 or the avoidance of transactions at undervalue,23 preferences24 and certain floating charges.25 It is also a test relevant in considering the disqualification of directors26 and is the one test used in identifying insolvent liquidation for the purposes of assessing directorial liabilities for wrongful trading.27

Defining insolvency at law is further complicated by the use of further tests in statutes other than the Insolvency Act 1986. Thus, under the Company Directors’ Disqualification Act 1986, a company becomes insolvent for the purposes of potential directorial disqualification if its assets are insufficient for the payment of its debts and other liabilities together with the expenses of winding up, or when it goes into liquidation or when an administration order is made or an administrative receiver is appointed.28 Under the Employment Rights Act 1996, and for purposes concerning employee rights to payment from the National Insurance Fund on an employer’s insolvency and the employee’s job termination, the employer is deemed insolvent when a winding-up order or administration order has been made; a resolution for voluntary winding up has been passed with respect to the company; a receiver or manager has been appointed; possession has been taken by holders of debentures secured by floating charges; or any property that is the subject

21 Inability to pay debts for the purposes of winding-up orders can also be assessed in ways independent of insolvency: see Goode, Principles of Corporate Insolvency Law, p. 90.
22 Insolvency Act 1986 Sch. B1, paras. 11, 111(1).
23 Ibid., ss. 238, 240(2).
24 Ibid., ss. 239, 240(2).
25 Ibid., ss. 245, 245(4).
26 Company Directors’ Disqualification Act (CDDA) 1986 s. 6(2).
27 Insolvency Act 1986 s. 214.
28 CDDA 1986 s. 6(2).
of a charge and a voluntary arrangement has been approved under Part I of the Insolvency Act 1986.  

Finally, for the purposes of a member’s voluntary winding up under section 89 of the Insolvency Act 1986, the company’s directors must make a declaration of solvency but reference is not made to the cash flow or balance sheet tests. The issue is whether the company will be able to pay its debts in full, together with interest at the official rate, within such period (not exceeding twelve months from the commencement of the winding up) to be stipulated in the declaration.

Insolvency law thus defines ‘insolvency’ in different ways for different purposes. Legal definitions, moreover, are not the only measures for corporate failure. If economic criteria are employed, a company might be said to be failing if it cannot realise a rate of return on invested capital that, bearing in mind the risks involved, is significantly greater than prevailing market rates on similar investments. Such failure would not necessarily lead to ‘legal’ insolvency but, if lasting in nature, this is a possibility. Alternatively, a failure to produce appropriate financial returns might result in corporate financial distress or investor-driven changes in the company’s staffing and strategies.

Who defines insolvency?

A corporate insolvency can involve a number of concerned parties. These include creditors, shareholders, group subsidiaries, directors and managers of the company, employees, suppliers and customers. A host of professional advisers will also have a role to play and these may include financial and management consultants, lawyers, bankers and accountants.

As seen above, there is no simple objective point in corporate affairs when the law states that the company is insolvent. The law creates opportunities for action rather than laying down consequences for stipulated states of affairs. Different tests are applied for different purposes and there are judgements involved in assessing each test. Thus, the question of whether a firm fails on the cash flow test of ability to pay debts depends on a set of constructions. As Miller and Power have put it: ‘Corporate

29 See Goode, Principles of Corporate Insolvency Law, p. 92.
30 Thus we have seen that the Insolvency Act 1986 confines the term ‘insolvency’ to a formal insolvency proceeding: Insolvency Act 1986 ss. 240(3), 247(1). The phrase ‘unable to pay its debts’ embodies the concept of a state of insolvency: see Goode, Principles of Corporate Insolvency Law, p. 84.
31 See ch. 13 below.
failure is itself constituted out of an assemblage of calculative technologies, expert claims and modes of judgment. Not only different parties but also different professionals will possess distinctive ways of perceiving and constructing corporate events and of deciding how to respond to these. Accountants invariably have a choice of ways to portray a company’s performance in both healthy and troubled times. There is a variety of ways, moreover, to deal with financial challenges and distress so that insolvency becomes as much a negotiable or technical issue for the accountant as an objective one. The law, on this view, can be seen as overlaid on the facts as established by the accountants, so that ‘the calculative technologies of accountancy trigger legal processes and provide the knowledge of those processes that law comes to administer after the event’. The accountants can thus be seen as straddling the corporate process and not only providing auditing, consultancy and other services for healthy companies, but also dominating the legally created market for insolvency administration and the extra-legal market for corporate rescue. In these roles, the accountants carry out regulatory, advisory and managerial functions. The law says little in detail about the economic substance of corporate failure (it prefers to set down procedures for dealing with vaguely defined circumstances) and, because this is the case, it creates a ‘legal space in which such matters can be negotiated’. The legal process thus becomes highly dependent on extra-legal expertise: on the portrayals of corporate affairs that are presented by the accountancy and economic professionals who appear before the courts and pull the triggers created by the insolvency legislation. Central to such endeavours are the ratio analyses that have transformed the nature of corporate failure and opened it up to a new regime of judgment and assessment. The conception of

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34 Miller and Power, ‘Calculating Corporate Failure’, p. 54. 35 Ibid., p. 56.

36 Ibid., p. 58; though see the portrayals of insolvency practitioner work as obfuscatory rather than negotiatory in S. Wheeler, Reservation of Title Clauses (Oxford University Press, Oxford, 1991).

37 On the role of insolvency professionals in shaping insolvency processes see ch. 5 below.

38 Miller and Power, ‘Calculating Corporate Failure’, p. 59. For a classic multi-variant analysis looking at the ratios of working capital to total assets; retained earnings to total assets; earnings before interest and losses to total assets; market value of equity to book...
economic viability, in turn, becomes a matter of debate over accountants’
calculative technologies so that, at the end of the day, the accountants play
as much of a role in constructing the events of insolvency as do lawyers,
judges or involved parties.

The message for insolvency lawyers is that insolvency law, to be
understood, has to be seen as a tool in the hands of different profes-
sionals, one that is manipulated in different ways by those groupings.
The resultant processes are consequently not fully captured by images of
legal definition and the mechanical transposition of insolvency law into
practice.

**Why companies fail**

Companies can be said, in the main, to fail through either internal
deficiencies (such as poor management) or pressures exerted by external
factors (such as global credit crises). This section reviews the causes of
failure and the concluding section considers the potential impact of
insolvency law on these respective causes.


39 The R3 Twelfth Survey, p. 26, indicated that the three most frequently cited primary
reasons for failure were: loss of market; loss of finance; and managerial failings (fraud;
over-optimism in planning; imprudent accounting; erosion of margins; product obso-
lescence/technical failure; over-gearing). The normal risks of entrepreneurship have
been said to cause 63 per cent of European business failures: see R. Meuwissen, G.
Mertens and L. Bollen, *Classification and Analysis of Major European Business Failures*
(Accounting, Auditing and Information Management Research Centre and RSM
Erasmus University, Maastricht/Rotterdam, October 2005) (hereafter ‘Maastricht
Report 2005’). For a study of clothing companies and media/marketing companies in
failure see C. F. Pratten, *Company Failure* (Institute of Chartered Accountants in
England and Wales, London, 1991); C. Campbell and B. Underdown, *Corporate
Insolvency in Practice: An Analytical Approach* (Chapman, London, 1991); H. D. Platt,
*Why Companies Fail: Strategies for Detecting, Avoiding, and Profiting from Bankruptcy*
corporate failures down to mismanagement of one kind or another. A 1991 Harrison
Willis survey of 200 IPs listed the top ten reasons for failure as: (1) poor management; (2)
poor management information; (3) high gearing; (4) poor financial controls; (5) high
interest rates; (6) poor cash flow/cash management; (7) slow response to changing
markets; (8) excessive overheads/spending; (9) lack of strategic plan; (10) poor commu-
Internal factors

Poor financial controls

The immediate cause of failure in a company is a lack of cash available to pay bills when they are due. A common cause of corporate decline, accordingly, is failure to take adequate steps to control cash flows. In the normal course of business a company’s current bank account is liable to fluctuate from deficit to surplus levels as it issues funds to purchase materials, pays its work forces, produces its goods and then awaits the inflow of funds through payment of customers’ bills. (Such fluctuations may be compounded where the firm’s business is seasonal in nature.)

Managing cash flows involves the collection of relevant information and the organisation of this: normally the charting out of anticipated cash receipts and disbursements on a weekly or monthly basis. Planning cash flows will involve consulting with lenders, negotiating appropriate credit lines and presenting potential lenders with projected cash flows, plans for product or market development and, amongst other things, programmes for cost control. Such planning has to cope with a number of situations that can decrease liquidity. These situations include: trading losses that reduce cash flows and assets relative to liabilities; bad debts or other write-offs; needed investments in expansion; and falls in the value of assets (which reduce the company’s ability to raise cash by granting security).

The firm’s managers will aim to make arrangements with the firm’s bankers and other creditors so that funds are available to bridge the gaps between deficit and surplus and to continue funding production, marketing and sales activities. At the same time, the firm has to remain able to pay its own debts as they fall due. Funds, accordingly, must be negotiated to allow such obligations to be met. Where the firm’s creditors are no longer willing to lend (perhaps because they have lost confidence in the firm’s management), or where loan arrangements have not been negotiated, the firm may find it difficult to keep operating or to pay its debts unless it has taken other steps to deal with cash flow problems, such as maintaining a level of cash reserves sufficient to sustain itself between the troughs and peaks.

40 Poor financial controls are dealt with separately here from mismanagement but may be seen as a particular form of managerial failure: see Platt, Why Companies Fail.
41 See Pratten, Company Failure, p. 8. The use of credit management procedures and services (e.g. the use of business information reports, credit insurance and debt collection services) can minimise the risk of a company failing due to poor cash flow: see T. Byrne, ‘Credit Management and Cash Flow in Businesses’ (2007) Recovery (Spring) 38.
Over-dependence on short-term financing may, in turn, lead to financial difficulties. Thus, where a firm resorts to overdraft financing in order to fund long-term investment plans, it becomes highly vulnerable. If the bank withdraws the overdraft facility the firm may not have time to obtain alternative funding before it enters difficulties.\textsuperscript{42} Lack of control over current assets is a further major cause of corporate failure. When assets are purchased on credit they have to be used in a manner that allows interest payments to be paid and a profit made. If assets are unused or wasted, a company will be in financial trouble unless other activities can carry the losses. Managers must invest in assets such as equipment so as to meet market demands, but they must be wary of possible market changes that will reduce or remove the potential profitability of their equipment. Assets, accordingly, must be managed so that, overall, a firm has sufficient flexibility to cope with market changes. Attention has to be paid to the balance between long-term fixed asset costs (funds tied up with, say, machines) and variable cost items (e.g. labour and fuel costs which are more easily adjusted than fixed asset costs). Long-term assets (e.g. steel production plants) can be highly profitable but they carry greater risks than variable cost items due to their inflexibility, particularly if they are specialist in nature and there is no ready market providing a means to realise their value by sale. If the balance of a firm’s investment is tilted too far in the direction of long-term fixed costs, its ability to cope with slow markets diminishes and failure may result.

Similarly, problems may arise where the company operates with ‘high gearing’: arrangements that involve a high proportion of fixed interest commitments or fixed interest capital in relation to the firm’s total assets (i.e. all fixed and current assets). With high gearing a firm devotes a high proportion of its gross profits to the servicing of loan capital. It accordingly becomes highly vulnerable to changes in market conditions and interest rates.\textsuperscript{43} Poor control of gearing may thus cause firms to fail when general economic, or particular market, conditions deteriorate or when

\textsuperscript{42} The Bank of England has in the past expressed unease at the dependence of small UK businesses (highlighted by the recession of the early 1990s) on overdraft facilities to finance anything from working capital to long-term investment projects: see Bank of England, \textit{Finance for Small Firms}, Sixth Report (1999), p. 28.

there is a credit squeeze\textsuperscript{44} and there is some evidence that companies with high gearing are more likely to move into crisis than those with low gearing.\textsuperscript{45}

Inadequate financing is a further cause of failure. This may occur when the company fails to raise sufficient funds by debt or equity means to render its operation profitable. If funds, for instance, suffice for production purposes but do not provide adequately for marketing and sales activities, the company is unlikely to make ends meet. Over-expansion and over-trading may also produce severe problems when a firm increases its volume of business more quickly than it is able to raise the funds necessary to finance such operations properly.\textsuperscript{46}

Mismanagement

Most English company directors are untrained and unqualified.\textsuperscript{47} Poor management, moreover, has been said to account for around a third of company insolvencies.\textsuperscript{48} One survey has suggested that in 46 per cent of


\textsuperscript{45} See R. Hamilton, B. Halcroft, K. Pond and Z. Liew, ‘Back from the Dead: Survival Potential in Administrative Receivierships’ (1997) 13 IL&P 78, 80. Companies with cyclical markets and high gearing will be especially vulnerable – and such markets tend to be found in certain sectors, for instance, computer software, automotive, non-food retailing, construction and media.


\textsuperscript{47} An IOD report published in 1998 indicated that directors had become more professional since the beginning of that decade but that there were still ‘shortcomings’ in their behaviour (65 per cent of respondents had ‘prepared themselves’ for their boardroom role compared with just 10 per cent in 1990; the proportion of respondents taking training courses had also increased from 8 per cent to 27 per cent; but while 61 per cent of respondents – mainly senior directors of small to medium-sized companies – said directors should have a formal induction to the board, only 6 per cent had had such an induction themselves: IOD, \textit{Sign of the Times} (IOD, London, 1998)).

\textsuperscript{48} The SPI Twelfth Survey reported in 2004 that 32 per cent of company failure factors could be put down primarily to bad management. The notion of mismanagement can, however, be drawn sufficiently widely to produce far higher figures. See, for example, Campbell and Underdown, \textit{Corporate Insolvency}, pp. 1–3: ‘Companies become insolvent when their management fails to develop adequate long term strategic plans to deal with problems of profitability and cash flow.’ (The most frequent managerial failings noted in the SPI Twelfth Survey were excessive overheads, engaging in new ventures/expansions/
cases, companies fail because of matters primarily in the control of the management and that in almost a quarter of cases businesses would have been rescuable if directors had sought the right advice earlier.49 Some commentators have cautioned, however, that mismanagement often provides a more convincing explanation of which firms in a trade fail than of the number of firms that fail (which may be dictated by the nature of the market, the product and the role of available economies of scale).50 One aspect of poor management already discussed is an inability to establish adequate financial controls, and poor information collection and use is very often associated with poor financial controls. Lack of cost information is a major failing since successful corporate operation demands that managers possess knowledge concerning the profitability of the firm’s different activities. It is essential to know, for instance, if the price at which a product is being sold is producing profits for the company. Selling at a price below cost will soon lead to failure. Other informational deficiencies may involve the lack of cash flow forecasts, the absence of budgetary control data and the non-availability of figures on the values of company assets.51 Information, moreover, must flow properly through the firm and poor lines of communication have been said to be one of the main causes of failure.52 ‘Creative accounting’ techniques can disguise the true state of financial affairs in a company or can delay the emergence of accurate information about the firm. Such techniques, accordingly, can contribute to mismanagement generally and can reduce the company’s ability to respond successfully to market and other pressures.53 They can also lead managers, investors and bankers to expand corporate operations more rapidly, and at higher risk, than the true state of affairs merits. Creative accounting techniques may also camouflag
the firm’s true levels of debt or inflate profit and asset figures and, as a result, managers may be led to raise the gearing of the company in a dangerous manner.

It has been suggested that accountants in auditing and advisory roles might play a stronger role in ensuring that accurate information is available on a company’s financial position and in warning of dangers. Moves on two fronts might thus be considered: methods of reporting to management and shareholders could be rethought; and accountants’ training might be revised so as to improve their managerial advisory role. On the first front, however, it should not be assumed that auditing strategies and assumptions can be revised to reveal the ‘true position’ of a company. Uncertainties in markets and future prospects will always mean that such items as asset valuations contain elements of uncertainty. What can, perhaps, be done is to map out the location and extent of uncertainties in as clear a way as possible. A further key issue is whether auditors can make reliable assessments of the degree to which a company is at risk. Auditors suffer from a number of limitations in judging corporate prospects, not least their restricted knowledge of managers’ forthcoming strategies and decisions in a changing marketplace. There

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54 See, for example, Pratten, *Company Failure*, p. 48 and references to press reports therein. For doubts as to whether the present audit model is capable of identifying and dealing effectively with managers determined to perpetrate fraud see Maastricht Report 2005. The credit crisis of 2008 was reported as prompting auditors to hold ‘unusually early discussions’ with companies over year-end results focusing on their financing and ability to continue as a going concern, while the UK accounts watchdog, the Financial and Reporting Review Panel, warned that scrutiny in 2008 would be focused on banks, retailers, commercial property, leisure and house builders where it perceived the biggest risks to viability lay: see J. Hughes, ‘Auditors Seek Early Scrutiny’, *Financial Times*, 14 August 2008.

55 Pratten, *Company Failure*, p. 50.

56 See, for example, Power, *Audit Society*, p. 144: ‘The issue is rather a question of organisational design capable of building in “moral competence” and of providing regulated fora of openness around these competences.’

57 Pratten, *Company Failure*, p. 57. See M. Power, *Organised Uncertainty: Designing a World of Risk Management* (Oxford University Press, Oxford, 2007) where it is argued that the rise of risk management has also coincided with an intensification of auditing and control processes. On the accountancy profession’s concern at the ‘expectations gap’ – the difference between what audits do achieve and what it is thought they achieve, or should achieve – see the *Report of the Committee on the Financial Aspects of Corporate Governance* (Cadbury Committee) (December 1992) paras. 2.1 and 5.4; J. Freedman, ‘Accountants and Corporate Governance: Filling a Legal Vacuum?’ (*Political Quarterly* 285).
are dangers, moreover, that overt auditors’ warnings of risk might themselves contribute to corporate troubles.

As for training and advice, accountants might focus more on such topics as the causes of corporate failure, the requirements of success and the economics of pricing. They might, accordingly, strengthen their roles in advising corporate managers during the ongoing process of corporate decision-making. This, in turn, might be expected to improve information use and managerial decision-making more generally. The result could, for instance, be greater managerial awareness of the dangers involved in creative accounting or in failing to develop accurate costing figures.

Managers may also prove deficient by failing to respond to changes in the company’s environment. Thus, when key personnel depart from a company or markets or technologies move in new directions, a company’s managers must be capable of developing new staffing arrangements and new products and strategies to keep the firm competitive. Appropriate information and research and development systems are likely to be necessary if such lack of responsiveness is to be avoided. Being responsive, moreover, may demand that managers counter their natural inclinations to over-commit to strategies that they have set in train. It has been argued that corporate decision-makers tend to be psychologically biased in a number of ways that make it difficult to exit from losing strategies. One suggested bias involves an excessive focus on sunk costs and moneys already committed to a project. This produces a tendency, even when projections are bleak, to throw good money after bad in an effort to justify or make good on the past investment. A second bias favours adhering to initial estimations of potential gains and involves a slowness to adjust these to changes in market conditions. These biases, it is contended, affect the timing of decisions both to pull out of ill-fated projects and to seek help when the company meets more general financial difficulties.

58 Campbell and Underdown, Corporate Insolvency, p. 18.
59 Loss of an established competitive advantage has been said to be ‘generally fatal’ because it is so difficult to regain a competitively supreme position: see J. Kay, ‘Fallen Companies Rarely Make It Back to the Top’ Financial Times, 16 November 2007.
A further managerial failing may involve leaving the company particularly vulnerable to changes in the market or the broader environment: as where an excessive dependence on a particular supplier contract or customer is allowed to build up and inadequate provision is made for the departure of that supplier or customer.

Managers may fail simply because they lack appropriate skills. They may be brilliant engineers but poor financial directors. Lack of identification with the company’s interests may be another managerial failing. This may range from a targeting of personal rather than corporate objectives through to practices of defrauding the company for the purpose of making illegal personal gains. Fraudsters may, for example, forge cheques in their own favour or steal the stock of the company. Directors may engage in extravagant lifestyles at the firm’s expense, employees may turn their backs on corporate interests and parent or associate companies may milk successful businesses of their profits, put no investment back into those businesses but use the proceeds to fund other operations within a group. All of these forms of conduct, illegal and legitimate, may drive a firm into failure.

In the case of small businesses, it has been suggested that a fifth of all failures are attributable to marketing errors. A company’s managers may have conducted inadequate research into markets and competitors, they may have failed to set up effective organisations for marketing or may have adopted weak sales strategies. Managers of small firms may, indeed, have a general tendency to focus on product development and give too little attention to marketing.

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61 It has been argued, on the basis of a survey of over 730 medium-sized companies in the UK, France, Germany and the USA, that when managers are chosen from the members of the owning family the company tends to be poorly managed – and especially so if the CEO is selected by primogeniture. The reasons given in explanation are that this narrows the available pool of managerial talent drastically and that inherited rights to manage tend to reduce levels of effort. See Bloom, Inherited Family Firms.

62 The Maastricht/Erasmus study of 2005 suggested that 37 per cent of European business failures involve fraudulent or unethical behaviour by managers or employees (see Maastricht Report 2005, p. 8), but, for a view that fraud-induced failures are, in fact, rare, see Pratten, Company Failure, p. 6; K. Cork, Cork on Cork: Sir Kenneth Cork Takes Stock (Macmillan, London, 1988).


64 See Campbell and Underdown, Corporate Insolvency, p. 21. An analysis of sixty major failures in the European Union over the last twenty-five years concluded that failed companies tended to fall into four categories: the basically unhealthy; those with over-ambitious management; those failing to adapt to change; and those afflicted by dominant managers and fraudulent or unethical behaviour: see Maastricht Report 2005.
Managers may perform their own tasks competently but they may prove to be poor leaders. Poor management may thus lead to inadequacies of supervision, morale and productivity. As a result, the company may operate with high costs, low productivity and diminishing levels of profit. The governance structure of a company may also prove conducive to mismanagement. This may be the case with notable frequency in certain circumstances: where, for instance, a single individual dominates a company; where there is an imbalance on the board (between, for example, financial and technical experts); or where there is a lack of representation on the board (e.g. of accountants). Where procedures for briefing managers and board members are inadequate this, again, may lead to defective control mechanisms and poor decision-making in the company.

As for the characteristics of those managers that are associated with corporate failure, Stein has suggested that the following traits tend to be exhibited by insolvency-prone managers. First, all bad managers tend to be ‘out of touch with reality’, a condition in which they possess little consciousness of risks. This propensity tends to be found together with high levels of technical knowledge and a willingness to learn on the technological front, or else with high ability in marketing and sales. The area of risk tending to be neglected by such managers is that associated with growth and over-expansion. Second, bad managers tend to be very strong willed, autocratic, unwilling to delegate and able to impose themselves on their business partners and co-workers. Such

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66 See Argenti’s discussion of Rolls Royce’s troubles in the early 1970s: Corporate Collapse, ch. 5.
67 Stein, ‘Rescue Operations in Business Crises’. In 1996 the business information group CN published research indicating that nearly 4,000 company directors (four times as many as had previously been thought) had been associated with more than ten company failures: Financial Times, 28 October 1996. (CN reported that of the 2.6 million UK company directors on its database, 952,432 (or 37 per cent) had been associated with one or more failures in the previous seven years and one in twelve directors was a ‘serial failure’ associated with at least two collapses.)
68 A relevant portrait emerged when, in 2007, two directors of Independent Insurance were convicted of conspiracy to defraud (after the company plummeted from stock market darling to insolvency). The former Chief Executive’s own QC said, in mitigation, that ‘corporate arrogance’ had been fostered by his client’s belief that the company was ‘his baby’ and that with brilliance had come ‘an overbearing, unreasonable dominance, a management style that was simply unacceptable’: see M. Peel, ‘Former Insurance Executives Face Jail’, Financial Times, 24 October 2007.
dominance tends to be underpinned by their high abilities with regard to technical or sales issues and their uncritical attitude to growth. Almost all such individuals possess ‘remarkable stress tolerance’ and the high level of their assertiveness often translates into ambitious plans for corporate dominance of the market. In around half of such individuals there is a tendency to personal high living.

A different sort of manager is, according to Stein, also associated with corporate failure and this is labelled the ‘improvident’ manager. This individual tends to act in an ill-informed, ‘blind’ fashion in pursuit of favourable opportunities to advance in the market and tends not to carry out the necessary studies on the sustainability of an expansion or the financial underpinnings required for such a development.

Mismanagement, moreover, may be seen in the shape of single aberrant acts as well as in ongoing weaknesses. Corporate managers may make catastrophic mistakes or fail to deal with particular problems and, in doing so, may place the company in peril. A decision, for instance, may be taken to move the firm’s business into a market sector in which the firm is unable to compete, or a huge investment may be put into the production of a poor product. Corporate managers may also embark on a project so large that its failure will place the survival of the company at risk. Such managers may err, again, by buying other companies that are weak, over-priced and whose acquisition cannot be turned to advantage. Thus, a manager looking for growth will often acquire another company by paying a premium and will hope to find synergies and methods of cutting costs. Frequently, though, difficulties arise because the buying company’s directors have overestimated their understandings of the targeted firm, because the information systems of the companies are incompatible or because the expected synergies are not yielded when market realities are faced. Failure to deal with a key technological change may also constitute a managerial error that renders the firm’s survival uncertain. Most products become obsolete as technologies advance, substitutes come on the scene or consumers’ tastes change, and companies that fail to adapt in a suitable manner may go out of business.

70 See the discussion of the Rolls Royce RB211 project in Argenti, Corporate Collapse, ch. 5.
71 An example of this was British and Commonwealth’s acquisition of Atlantic Computers in the 1980s: see Pratten, Company Failure, p. 34. See also Campbell and Underdown, Corporate Insolvency, p. 23.
External factors

External pressures routinely place companies under stress. Astute managerial teams tend to cope with such stresses and their companies usually survive. Such pressures, however, can lead lesser managers to fail. In the extreme, some external shocks may be so severe that even the most skilled managers cannot save the company.

Changing markets and economic conditions are factors that almost invariably impinge on corporate activities. A business may fail because a demand swing is too severe for it to respond successfully: where, for example, consumers change a preference rapidly from one fashion design to another. The prices of raw materials may escalate in an unpredictable manner and to a degree that makes a company’s product or price unattractive to consumers. A major competitor may attack the company’s market with a level of commitment and aggression that pulls the financial carpet from beneath the company’s feet, and economic cycles (often compounded by drops in investor confidence) may produce slumps that are so severe and sustained that the company fails. Since 1970 the economy has been subjected to a series of shocks which have caused problems for many companies. These shocks have included the oil price rises of 1973–4 and 1979–81, the wage explosions of 1973–4 and 1978–80, and the credit squeeze of the early 1990s and the credit crisis of 2007–8.

Some trade sectors (notably manufacturing and construction) are more prone to failure and insolvency than others and the seasonality encountered in some sectors can place severe stresses on corporate solvency. The seasonality of the toy industry, with its focus on Christmas sales and discounting at other times of the year, has been said to explain the sector’s long history of corporate failures.


74 Pratten, Company Failure, p. 4.

75 The R3 Twelfth Survey suggested that the service sector is the most prone to insolvency and accounts for 49 per cent of cases.

Overseas producers can provide severe price competition and this has been identified as the probable cause of decline in UK manufacturing industries in such sectors as cars, motor cycles, machine tools, paper and textiles.\textsuperscript{77} Nor do pressures come only from markets. Governments and regulatory bodies may take actions that precipitate failures. The British Government’s high interest rate policy produced a surge of company failures in the second half of 1990, so that the number of companies entering receivership during those six months matched the figure for the whole of the preceding year. Companies also suffered shocks from high sterling exchange rates in 1980–1 and 1990–1, as well as from credit explosions in 1972–3 and 1986–9, and from the credit crisis in 2008.\textsuperscript{78} Rapid inflation made matters worse for companies during the 1970s, early 1980s and in 1990. Recessions resulted in 1974–5, 1980–1 and 1990–1.\textsuperscript{79} Adapting to such changes is particularly difficult for companies when the shocks cannot be predicted. Firms that relied on long-term fixed price contracts during the early 1970s were especially hard pressed by inflation.

Where companies operate with high levels of gearing and tight repayment schedules they will be particularly vulnerable to changes in overdraft costs when, as at the start and end of the 1980s, there are dramatic increases in the minimum lending rate.\textsuperscript{80} If governments impose squeezes on credit, lenders will tend to ration credit and give priority to those firms that are considered the best risks. These are unlikely to be new or small firms or those with existing problems, and, accordingly, the proportion of loans going to established large firms will tend to rise when money is tight. Small firms tend to be less capable of surviving such credit shortages than large firms. So, overall, the result tends to be a rise in the number of small firm failures.\textsuperscript{81} Governments may even precipitate

\textsuperscript{77} See Campbell and Underdown, \textit{Corporate Insolvency}, p. 19.
\textsuperscript{80} See Campbell and Underdown, \textit{Corporate Insolvency}, p. 19.
\textsuperscript{81} See R3 Twelfth Survey, p. 5. In September 2008, Richard Roberts, head of small/medium-sized enterprise analysis at Barclays, forecast that ‘We will probably see the [business]
corporate failures more directly when, for example, they withdraw or decline further financial aid, as occurred in January 1971 when the Government decided not to support Rolls Royce further in the RB211 engine affair, and, in October 2001, when anticipated state subsidies were not forthcoming and Railtrack was put into administration.

Regulators, be they agencies, government departments or European bodies, may impose critical stresses on companies by a number of routes. It is commonly complained by industry that the costs of complying with regulations are a burden (particularly for small businesses) and, on occasion, such costs can break the camel’s back. In response, however, it can be said that competent managers will generally be able to cope with regulatory burdens, and that if regulation kills firms because the managers of those firms are incompetent, or because regulation outlaws a product central to the company’s output, those firms should go to the wall because they are either uncompetitive or Parliament’s voice demands that they cease business. If regulators, for instance, enforce statutory rules prohibiting, say, the production of eggs in battery cages, and if battery producers fail to adapt by employing other processes, the stock fall by up to 150,000 in the course of the downswing. Growth has already stopped – closures have been higher than start-ups for some time.’ See J. Guthrie, ‘Barclays Signals End of an Era for Entrepreneurs’, Financial Times, 2 September 2008. See also Grant, ‘Insolvency Rate to Rise 41% by End of 2009’.

82 On 4 February 1971 a receiver was appointed: see Argenti, Corporate Collapse, p. 90.

83 See Bank of England, Finance for Small Firms, Eighth Report (March 2001) p. 7 and CBI, Cutting Through the Red Tape: The Impact of Employment Legislation (November 2000). The CBI argues that the direct costs to companies of new employment rights introduced since May 1997 could be over £12 billion. A Federation of Small Businesses Report, Barriers to Survival and Growth in UK Small Firms (London, 2000), suggests that small firms’ concerns rest on regulation. In 2005 the CBI warned again that excessive red tape was making it difficult for many small companies to overcome the effects of a challenging economic environment in the UK: see D. Prosser, ‘Tough Trading and Red Tape Hitting Small Manufacturers, says CBI’, Financial Times, 15 August 2005; and in 2006 a Federation of Small Business and Foreign Policy Centre report stated that EU legislation is implemented more stringently than necessary in the UK, imposing higher costs on small businesses and deterring them from taking on new staff: see J. Willman, ‘Small Business Hit by Overuse of EU Rules’, Financial Times, 7 September 2006.

84 On compliance costs and governmental responses see, for example, Better Regulation Task Force, Regulation – Less is More (Cabinet Office, London, 2005); P. Hampton, Reducing Administrative Burdens (HM Treasury, London, 2005).

85 Some surveys suggest that although red tape is often seen as a problem by small businesses, this does not stop such firms from taking an optimistic view of the UK climate for business start-ups. See e.g. J. Guthrie et al., ‘FT–Harris Poll: UK Holds Mixed View on Start-Ups’, Financial Times, 19 November 2007 (86 per cent of respondents were unhappy with red tape in the UK but 57 per cent of those offering an opinion saw the UK as a good place to set up a new company).
effect will be to drive those producers out of business in accordance with
the legislative will.

Regulators, however, may produce unjustifiable failures where they
regulate badly. They may, for example, vacillate in their demands, delay
licensing approvals unnecessarily and impose excessive costs on busi-
nesses. A failure to regulate may also produce insolvencies where, for
instance, effective regulation is necessary to sustain consumer confidence
in a product. The BSE crisis of 1996–9 demonstrated that regulatory
deficiencies relating to animal foodstuffs can produce dramatic levels of
corporate failure in the farming industry. Deregulation can also precipi-
tate failure by breaking down the entry barriers that have protected
enterprises and allowed relatively inefficient operators to survive.
Where, moreover, there is a rush of new entrants into a competitive
industry there may naturally follow a period in which the less efficient are
weeded out. Rates of failure can be expected to rise where the costs of
entry and exit to a newly deregulated sector are high.

Government taxation policies can also bring marginal companies to
the point of failure and industrial relations problems can break compa-
nies. If production is stopped by a prolonged strike the consequences for
a firm may be severe. Where the company’s own workforce is involved in
an industrial dispute the firm’s managers may have some control over
events and may have to shoulder some blame for mismanagement. If,
however, the dispute is between employers and workers at a key supplier
or customer, there may be little that even the most competent managers
can do.86

Unexpected calamities may also threaten companies. These may range
from natural disasters, such as earthquakes that destroy essential firm
assets, to the illegal acts of humans, for example the criminal behaviour
of a financial fraudster or an arsonist who burns down a firm’s premises.
Devastating losses may also result from new legal liabilities: thus a court
decision rendering tobacco companies liable to governmental bodies for
the cost of treating lung cancer sufferers might precipitate a series of
corporate failures. Penalty clauses in contracts may produce similar
effects where companies fail to deliver finished products on time.87

86 See J. R. Lingard, Corporate Rescues and Insolvencies (2nd edn, Butterworths, London,
1989) p. 3.
87 See Argenti, Corporate Collapse, p. 91 on the role of penalty clauses in the Rolls Royce
failure of 1971; Cork, Cork on Cork.
Where a company trades with other companies, the latter may cause failure involuntarily: where, for example, they owe debts and fail to settle these before or after their own failures. The actions of a firm’s creditors or investors may also bring about a downfall. Mention has already been made of the effects that a bank’s withdrawal of an overdraft facility may have. Lenders may withdraw credit through lack of confidence in a firm’s management, or as a result of government action (a credit squeeze), or because of instability in the global financial system (a credit crunch), or for reasons internal to the creditor itself, such as a new policy of shifting from overdraft to fixed-term lending. Similarly, investors in a company may take precipitate action for a number of reasons. They may lose confidence in the firm’s business or its management and the shares may drop to a point that triggers a crisis of confidence in the company’s creditors who then start pressing their claims. This process may spiral and bring about a company’s collapse.88

Late payment of debts

Special mention should be made of the late payment issue. Many large firms use the process of delaying settling the invoices of small suppliers as a means of extracting credit from those suppliers.89 Indeed, the evidence suggests that the problem of late payment is predominantly one of larger debtor companies failing to pay smaller suppliers – with the worst payers being in the construction, manufacturing, pharmaceuticals and retail sectors.90 Late payments of this kind may present small firms with considerable cash flow problems91 and such firms tend to be both ill-equipped to absorb financial shocks and poorly positioned to chase large debtors.92 In 2007 three-quarters of respondents to a Forum of Private

88 Pratten, Company Failure, p. 11.
89 A 2004 survey by the Better Payment Practice Group suggested that more than one in ten companies were happy to pay their bills late: see J. Moules, ‘One in Ten Companies Happy to Pay Bills Late’, Financial Times, 13 October 2004.
90 See DTI Consultation Paper, Improving the Payment Culture (DTI, July 1997) p. 11 and research by the Institute of Credit Management reported in D. Oakley, ‘Chart of Shame Lists Time Taken to Settle Bills’, Financial Times, 4 March 2008.
91 Lloyds TSB figures released in 1998 suggested that delay in receiving payment was the single biggest worry for small businesses: Guardian, 27 October 1998. The Federation of Small Businesses suggested in 1997 that late payment accounted for 5,000 of the 40,000 small UK company failures of 1995 (Financial Times, 29 January 1997).
92 SMEs in the UK have been said to spend in total over 11 million hours a week chasing unpaid invoices: see J. Moules, ‘Cheque in the Post Takes Up 11m Hours a Week’, Financial Times, 24 May 2005. An Institute of Directors survey of SME concerns found that late payment was the most frequently cited problem: see J. Eaglesham, ‘Labour’s “Fluffy Talk” on Business Problem’, Financial Times, 13 August 2007.
Business survey cited late payment as a ‘considerable threat to my business’s viability’.  

In 1998 a statutory response to the problem of late payments came with the passing of the Late Payment of Commercial Debts (Interest) Act. This was added to by the Late Payment of Commercial Debts Regulations 2002 to make up a body of legislation that allows businesses and the public sector to claim interest (at reference rate plus 8 per cent) on payments more than thirty days late and owed by businesses, large or small, or other organisations. A right of pursuit in the courts is given to claimants, but the Act allows collection agents to be used or the sale of interest to a third party such as a factoring firm.

Such a statute was intended to assist in changing the commercial culture that endorses late payment as a means of obtaining credit from companies in weak bargaining positions, but has it worked? In 2004 a series of surveys suggested that the 1998 legislation had failed to curb the problem of late payments. In February 2004 Experian, the business information group, surveyed 30,000 firms and found that companies

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93 See Eaglesham, ‘Labour’s “Fluffy Talk” on Business Problem’.
94 At the start of a six-month period the official dealing rate of the Bank of England (the base rate) will be made a fixed ‘reference rate’ for the subsequent six months. Thus for the period 1 July to 31 December 2008 the reference rate was 5.0% making the interest rate 13.0% (reference rate plus 8%).
95 From 1 November 2000, small businesses have also been able to claim from other small businesses as well as from large businesses and the public sector. From 1 November 2002 all businesses and the public sector were entitled to claim on debts incurred after that date. See also the Council Directive on Late Payment of Commercial Debts (2000/35, 29 June 2000) published OJ 2000 No. L2000/35; G. McCormack, ‘Retention of Title and the EC Late Payment Directive’ [2001] 1 JCLS 501. On the 1998 Act see S. Baister, ‘Late Interest on Debts’ (1999) Insolvency Bulletin 5. Reasonable debt recovery costs have been claimable by all business owners and managers since 7 August 2002: Late Payment of Commercial Debt Regulations 2002. The compensation entitlement varies in accordance with the size of the debt: for unpaid debts of £10,000 and over the creditor pays £100.00; for unpaid debts of £1,000 to £9,999.99 the creditor pays £70.00 and for unpaid debts of up to £999.99 the creditor pays £40.00. The entitlement to compensation for debt recovery costs does not affect the claimant’s other rights and the claimant may still go to court to recover specific fees and charges paid to specialist firms or advisers if felt necessary: see Small Business Service, Users’ Guide to Late Payment (DTI, London, 2002).
96 Under the revised legislation SMEs can ask a representative body to challenge grossly unfair contract terms used by their customers which do not provide a substantial remedy for late payment of commercial debts. A Code of Practice on payments was launched by BERR in December 2008.
97 This section builds on V. Finch, ‘Late Payment of Debt: Re-thinking the Response’ (2005) 18 Insolvency Intelligence 38.
waited an average of fifty-eight days for settlement of invoices. This was half a day longer than in 1998, when the Late Payment of Commercial Debts (Interest) Act was passed. Payment delays in the UK averaged twenty-seven days beyond agreed payment terms, compared to ten days in France, seventeen in Germany and twenty-one in Italy. The payment record of larger companies had worsened markedly from 1998, with the average payment period increasing by six days to seventy-eight-and-a-half days. A month earlier, a survey by the Royal Bank of Scotland revealed that the cash flows of two-thirds of small businesses had been disrupted by late payment and two-fifths of these had taken legal action to recover money owed to them. Later research by MacIntyre Hudson in May 2004 was even more pessimistic about the impact of the 1998 Act. It reported that only 43 per cent of owner-managers were even aware of the 1998 legislation and only 3 per cent had actually used this against their debtors. A mere 2 per cent said that the Act had helped them to overcome the problem of bad debt. In 2007 there were further protests that the legislation and regulations had failed. A survey of 600 companies during that year suggested that, if anything, late payment had become a worse problem in the last ten years. An Intrum Justitia ranking of 2007 placed Britain as the fifth worst European country out of twenty-two for delays in commercial payments – with an average of over forty days to achieve payment in the UK compared to twenty-two in Norway. In early 2008 the average payment time for all plcs was forty-four days and a series of interviewees told the Financial Times that the late payment problem had grown materially worse in the difficult trading conditions of 2007 onwards.

Why has the Act been so muted in effect? A major reason is that many companies, especially small ones, have proved reluctant to be seen to be taking aggressive action against a powerful trading partner. As Eddie Morrison of Bank of Scotland Corporate Banking said: ‘Many

100 Ibid. See also A. Bounds, ‘Rise in Legal Action on Unpaid Bills’, Financial Times, 2 December 2008.
owner-managers would view levying a late payment charge on a client as commercial suicide. A significant proportion of small businesses told MacIntyre Hudson that using the legislation ‘involved too much hassle’ and many smaller businesses will fear the cost and disruption involved in formal enforcement action.

It might be argued that the Act could be made more effective by providing that statutory interest should be automatically applicable without going to court, that companies should be entitled to generous costs when they enforce or that the response to late payments could be reinforced by the institution of a new, cheap summary legal procedure for collecting late payments without the need to resort to using a lawyer. Such reforms may be desirable but they would not remove the fear of prejudicing business relationships that is the common inhibitor of enforcement.

What hope lies in other strategies? One possibility is a more effective information disclosure, or ‘naming and shaming’ strategy. Current arrangements here seem unnecessarily weak. All plcs and their large private subsidiaries have a statutory duty to disclose in their annual returns the average period they take to pay debts but such disclosures may be poor indicators of tardiness beyond creditors’, as opposed to debtors’, notions of agreed payment dates. (Some debtors, for instance, may see payments as being late from the time a reminder or final demand is sent. This contrasts with creditors who will look to agreed dates for payment.) It is, moreover, straying beyond agreed dates, as understood by creditors, that is so important to smaller firms since this is what creates crippling uncertainties regarding cash flows. Most companies, furthermore, do not comply with the rules and make the due disclosures in the annual accounts. The FSB has suggested that only around 30 per cent of plcs comply with the disclosure obligations and has called on Companies House to enforce such requirements more rigorously. Companies House, however, has been quoted as saying that: ‘It is up to the accounting bodies

105 Although the 2002 Regulations now allow all businesses to claim reasonable debt recovery costs there is an overall limit of £100 for each late payment, on a sliding scale. See p. 166 above.
106 See Companies Act 1985 (Directors’ Report) (Statement of Payment Practice) Regulations 1997 which amended CA 1985 s. 234 and Sch. 7, Part VI, requiring directors to report details of their payment practices to suppliers as well as the average time it takes them to pay their average debt.
to enforce disclosure. It is nothing to do with us.\textsuperscript{108} For its part, the then DTI, through its Better Payment Practice Group, reportedly brought pressure to bear on the accounting bodies and reminded auditors of the duty to disclose payment periods in their annual returns. More action on this front would be required not only to produce compliance with disclosure requirements but also to ensure that average settlement times are not distorted by debtor conceptions of due dates.\textsuperscript{109}

Disclosure-based controls can also be brought into effect by non-governmental bodies. The FSB, for instance, has been publishing a private-sector payment performance table since 1999.\textsuperscript{110} The compilers of the FSB league tables, however, have to rely on disclosures by late payers in annual returns to Companies House. Such disclosures are, as noted, patchy, though, and it is likely that the poorest payers will not rank amongst the most assiduous suppliers of this kind of information. A way forward would be for the FSB to co-ordinate a blacklist based not on debtor confessions with all the attendant dangers of distortion and non-disclosure, but on creditor-supplied information that is subjected to a verification process prior to publication. This could operate through recording of creditor complaints about debtor companies and assistance in funding such a regime might be provided by BERR.

An alternative approach would be to rely on factoring. In such a system, the creditor would sell the debt to an intermediary factoring firm that would offer an immediate cash advance on the value of the outstanding invoice.\textsuperscript{111} The factoring firm would then take advantage of the interest terms provided for in the 1998 Act and the sum passed on to the creditor would correspond to the interest-enhanced payment. The factoring firm’s fee might be chargeable, by law, to the debtor over and above the invoiced sum plus statutory interest. Such a system might

\textsuperscript{108} Ibid.

\textsuperscript{109} In June 2007 ministers decided effectively to disband the Better Payment Practice Group as part of the downgrading of the small business service. This ‘gives out the wrong signals to the business community. Late payment (is) the factor causing the most significant negative impact on smaller companies, yet government have withdrawn support and reduced funding on the very initiatives aimed at tackling this growing problem.’ Miles Templeman, director-general of the IOD, cited in Eaglesham, ‘Labour’s “Fluffy Talk” on Business Problem’.

\textsuperscript{110} The FSB Payment League Tables are now compiled by the Credit Management Research Centre, Leeds University Business School.

\textsuperscript{111} In a factoring arrangement money is released against unpaid sales invoices. Up to 90 per cent of the value of the outstanding customer payment is advanced to the business within twenty-four hours of the invoice being raised. See further ch. 3 above.
improve recovery but, again, many small businesses might be reluctant to use this approach for fear of prejudicing a relationship with a supplier or powerful business partner.

A third possible way forward would be to take actions to encourage smaller companies to play the credit game more astutely. The routine use of prompt payment discounts might be put forward as a solution here but it may be difficult for many firms to use discounts productively because co-ordination between small firms would be required. Where such firms compete, the company offering an early payment discount to a powerful debtor may, in effect, be cutting its margins in the face of the large debtor company’s propensity to delay payment.

Similarly, it could be proposed that smaller companies should be encouraged to avoid dependency on a large creditor so that they can discontinue their trading relationships with late payers. This, however, may not be possible in many sectors and such a strategy might lead to a lack of competitiveness with firms that are willing to accept greater risks of late payment.

What, however, smaller firms can perhaps do at low cost is to state more routinely and clearly the date on which any invoice is payable.\textsuperscript{112} Such creditors, moreover, might be advised to research the creditworthiness of their debtors more thoroughly before advancing goods or funds. On this front there are growing opportunities. Increasingly, payment periods are being factored into company credit scores by credit ratings agencies. Thus, a Dun and Bradstreet (D & B) comprehensive reference will give data on a firm’s average payment behaviour (days beyond terms) that is based on an analysis of trade payment experiences post-invoicing.\textsuperscript{113} A company’s payment trend will be compared to the industry trend in a D & B report and a breakdown given of value bands of invoice against numbers of days late in settling. The effect of such data distribution may be that late payers will eventually all suffer from lower credit scores and the effects could be multiple. Their ability to obtain credit at lowest cost rates may be prejudiced and potential trade creditors will be able to identify poor payers – provided that they can afford to pay for a reference and the transaction justifies an investigation into payment records.

\textsuperscript{112} Evidence also shows that more small businesses are stating at the time the contract is made that they will exercise their right if payment is late. This is usually emphasised on all invoices and letters seeking payment. Better Payment Practice Campaign, Late Payment Legislation and Interest Calculator (www.payontime.co.uk).

\textsuperscript{113} D & B state that they collect and analyse more than a million trade payment experiences involving European businesses each year.
Credit insurers also provide information of relevance here. A creditor can subscribe to the services of a credit insurer and obtain, on a web-based pay-as-you-go basis, a credit opinion on a trading partner – actual or potential. This opinion will be based on a number of factors including an analysis of payment records. Such a service is inexpensive: an opinion on a UK firm is likely to cost under £10. What the opinion will not do, however, is give a precise disclosure of payment record as opposed to a cumulative opinion based on the whole basket of measures. The danger here is that a poor paying record might be disguised by stronger performance on other fronts.

Cultural change in larger companies has, as noted, also been canvassed as a way to counteract late payments. The problem here, however, is that many large companies may see late-paying as a badge of their strength in the marketplace. (Around one in ten companies have admitted that they would pay their customers late even if their own bills were settled promptly.) 114 Senior corporate staff may, quite understandably, see their main obligation to be the maximising of shareholder value and they may estimate that a policy of late-paying will serve such objectives. 115 They may, indeed, reject arguments that prompt payment is in their own corporate interest because it makes for better business relationships, it enhances reputations, it creates goodwill and encourages better after-sales service. This is a point to be borne in mind in considering the potential of ‘naming and shaming’ disclosure controls. It implies that such controls may have a primary value in alerting small firms to late payers rather than in shaming larger firms into behaving more honourably.

To summarise, there are good reasons for thinking that the 1998 Act will impact only modestly on late payments. It may be excessively naïve to believe that large corporations can successfully be shamed into paying invoices promptly. Nor can small firms be expected to enforce their rights to prompt payment against powerful companies with never a thought for comebacks.

Conclusions: failures and corporate insolvency law

In concluding on the internal and external causes of corporate failure, it should not be assumed that single causes or single patterns of causes are

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to be encountered when numbers of failures are analysed. Collapses generally result from the operation of a number of causes, and involve both external pressures and various internal failings. Argenti has suggested that three prevalent types of corporate failure are encountered in the business world.\footnote{Argenti, Corporate Collapse, ch. 8. In 1844 the Select Committee on Joint Stock Companies divided ‘bubble companies’ into three categories: those founded on unsound calculations and which could not succeed; those so ill-constituted as to render mismanagement probable; and those faulty or fraudulent in their object: see Farrar’s Company Law (4th edn, Butterworths, London, 1998) p. 622; Campbell and Underdown, Corporate Insolvency, pp. 23–5.} These types or ‘trajectories’ of failure are those associated with small companies, the ‘high rollers’ and the large companies. For small companies the typical failure involves never rising above a poor level of performance and surviving only for a short period.\footnote{See R. Cressy, Why Do Most Firms Die Young? (Kluwer, Netherlands, 2005). The SPI Eighth Survey suggested that 28 per cent of insolvent companies fail between the ages of five and ten years; 22 per cent between three and four years; 19 per cent between one and two years and 5 per cent after less than one year (SPI Eighth Survey, p. 8). The R3 Ninth Survey revealed an increase in the age of failed businesses, with 18 per cent aged two years or less and 43 per cent less than four years old (figures for the previous survey were 24 per cent and 46 per cent respectively). The first year failure rate had dropped from 5 per cent to 3 per cent between the Eighth and Ninth Surveys. See also Guthrie, ‘How the Old Corporate Tortoise Wins the Race’. New companies exploiting new products seem to be particularly prone to failure: see Pratten, Company Failure, p. 3.} In such companies the proprietor often possesses great determination and knowledge of a trade but lacks basic financial and business skills and is managerially incapable of leading the firm through troubled times. Where the company is new, moreover, it is vulnerable to recessions, high interest rates and other pressures because it has had little time to establish accumulated profits or secure contracts with customers and suppliers.\footnote{See J. Hudson, ‘Characteristics of Liquidated Companies’ (Mimeo, University of Bath, 1982). Hudson’s study found that the most dangerous period for companies involved in creditors’ voluntary liquidations and compulsory liquidation lay between their second and ninth years.} High rollers make up only a small percentage of companies and tend to be led by colourful, flamboyant characters who are attractive to investors. As with small firms that fail, however, the leaders of high rolling firms tend to lack managerial skills. There is a propensity to allow enthusiasm to produce over-trading which, when manifest, leads the firm’s bankers to refuse advances and precipitates failure.

With large companies that collapse, the management teams involved are usually professional but the long-established companies that encounter trouble tend to lose touch with their markets or grow slow and
inefficient. En route to failure, such companies tend to experience an initial downturn, a plateau and then a collapse. Large companies, however, will tend to possess greater resilience than small firms because they have larger reserves of assets that can be used to reorganise and they have greater negotiating power when approaching bankers and governments for assistance in attempting a turnaround.

Can corporate insolvency law contribute to the avoidance of undesirable corporate failures and the unwanted consequences of failure? In some respects, the law can be seen as largely irrelevant. It can offer very little assistance where external factors such as global financial crises, new foreign competitors, catastrophic trade disputes or natural disasters drive companies out of business. In other regards, however, the nature of insolvency law can impinge on corporate failure or success. First, it can do so in relation to the costs that such laws impose on healthy and on troubled companies. If, for instance, uncertainties attend the security and priority systems established by law, credit costs will be unnecessarily high, international competitiveness will be prejudiced and companies will face undesirable financial turbulence and stresses. If transaction costs are higher than they should be (because firms have to spend large sums on advisers in order to organise their credit and priority arrangements) then, again, unwarranted pressure is placed on companies and this may in some cases produce failure.

Insolvency law can also impact on the main internal causes of failure that have been discussed above: deficiencies of financial control and management. The extent of this impact should not be exaggerated, however. Corporate managers cannot be assumed to be wholly rational and mechanical followers of legal rules. A host of legal processes and rules nevertheless provides a framework of incentives for company managers.

Deficiencies of financial control are discouraged by the law in so far as failure to keep adequate records may be grounds for disqualifying a person from holding office as a company director on the basis that there has been general misconduct in the affairs of the company or

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119 ‘Simply put, a run of success can be dangerous. Outstanding companies often succumb to crises because their leaders were innovative years ago but continue to favour strategies and activities based on past success, which do not always translate well after changes in the business and consumer environment.’ Baum, ‘The Value of a Failing Grade’, p. 8.

120 See ch. 7 below and the ‘London Approach’.

unfitness on the part of the director.\textsuperscript{122} The rules on directorial disqualification and the system of investigation\textsuperscript{123} may also affect corporate failures in another way. A number of individuals, if unregulated, are likely to operate numbers of companies in cynical anticipation of their failure and employ phoenix operations to enrich themselves at the cost of creditors. The success with which insolvency law controls such phoenix operations may affect the incidence of corporate failure.\textsuperscript{124}

Managerial standards in companies may also be influenced by the regimes of monitoring that the law establishes and encourages.\textsuperscript{125} The provisions of insolvency law are relevant here in so far as these establish the regimes of security and priority that offer creditors specific sets of incentives to review the actions of corporate managers. Thus, for instance, the strong position in which current insolvency law places secured creditors gives creditors with fixed charges very few incentives to monitor corporate affairs beyond looking to see that the assets that are the subjects of their charges are not alienated or wasted.\textsuperscript{126} The amount of information that creditors may possess, and which allows them to monitor corporate behaviour, is again dictated in large part by insolvency law. When, for example, administrators are appointed by debenture holders, the information to be supplied to the administrator by company officers and the arrangements for reporting to creditors and creditors’ meetings are governed by the Insolvency Act.\textsuperscript{127}


\textsuperscript{124} See Insolvency Act 1986 s. 216, the purpose of which is to contribute towards the eradication of the ‘phoenix syndrome’, whereby companies are successively allowed to run down to the point of winding up, only to rise phoenix-like from the ashes as a new company formed and managed by an almost identical group of persons and utilising a company name similar to that under which the former company was trading. See further Company Law Review Steering Group (CLRSG), Modern Company Law for a Competitive Economy: Completing the Structure (November 2000) ch. 13; CLRSG, Modern Company Law for a Competitive Economy: Final Report (July 2001) ch. 15.

\textsuperscript{125} See generally Finch, ‘Company Directors’.


\textsuperscript{127} Insolvency Act 1986 Sch. B1, paras. 47, 49–51. See ch. 9 below. The terms of debentures routinely give creditors rights to consultation and information on such matters as the value of assets subject to floating charges and borrowing levels: see ch. 3 above.
The regimes of personal liability for directors that are established at law may, again, create incentives to manage in a particular way. The rules on wrongful trading, for instance, and the possibilities of actions for misfeasance may provide deterrents to errant directors. In the case of misfeasance actions, these may be brought by shareholders or creditors against past or present company officers who breach any fiduciary or other duty owed to the company, and insolvency law’s priority regimes dictate shareholders’ and creditors’ own incentives to pursue directors. Shareholders are unlikely to act if they will not recover sufficient funds from a director to pay creditors in full before taking their own share, and unsecured creditors are unlikely to pursue actions unless the company’s available funds will pay the creditors in full before them.

Insolvency law may also affect the levels of skill that corporate managers have to exhibit and this will have an effect on failure levels. The relatively low standard historically expected from directors’ duties of skill and care has now been augmented by the adoption (in the Companies Act 2006’s statutory statement) of a similar definition to that contained in section 214(4) of the Insolvency Act 1986. The deterrence element in the wrongful trading provisions themselves is provided by requirements of reasonable diligence and the courts’ capacity to order personal contributions to corporate assets where directors fail to show that they have taken proper care. Company law may, furthermore, choose to require a variety of different levels of competence, training and professionalism from directors and this is likely to bear on the propensity of a given company to fail.

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128 Under Insolvency Act 1986 ss. 214 and 212. On the effectiveness of s. 214 as, inter alia, a deterrent, see ch. 16 below.
130 On funding and incentives for liquidators’ actions against directors see chs. 13 and 16 below.
131 See CA 2006 s. 174(2): a director must display the care, skill and diligence that would be exercised by a reasonably diligent person with both (a) the general knowledge, skill and experience that can reasonably be expected of a person carrying out the same functions as the director in relation to that company and (b) the general knowledge, skill and experience that the director actually has. See also Finch, ‘Company Directors’; Norman v. Theodore Goddard [1991] BCLC 1028; Re D’Jan of London Ltd [1994] 1 BCLC 561; CLRSG, Modern Company Law for a Competitive Economy (March 2000) ch. 3, (November 2000) ch. 13, Final Report (July 2001) pp. 42–5. See further ch. 16 below.
133 On directorial levels of care and professionalism, see Finch, ‘Company Directors’ and ch. 16 below.
If it is accepted that one cause of corporate failure is the taking of unjustifiable risks by directors then insolvency law has relevance beyond the imposition of duties of care and personal liabilities for breach of these. Insolvency law affects the balance of risk bearing in the company. If, as suggested in chapter 3, unsecured creditor interests and risks are underrepresented in corporate affairs because of the present framework of insolvency law, it follows that corporate decisions are liable to under-value such interests, that excessively risk-laden decisions will be taken and that an unjustifiable number of failures will occur. The expected costs to unsecured creditors will not be internalised by the company or fully recognised by corporate managers.

Corporate failure through excessively high gearing may again be influenced by the insolvency/corporate law regime. Thus, it might be argued that the law places many creditors in a position from which they are not able to judge with accuracy the financial position of a prospective borrower and the risks involved in a loan. Company law, for instance, does not at present demand that retentions of title be registered and lenders who are ignorant of a debt applicant’s true position may be inclined to grant credit in circumstances that would not have prompted a loan if relevant knowledge had been to hand. The overall effect of poor information may be that firms find it too easy to operate with high gearing. Excessive gearing will also tend to be accompanied by high levels of interest because creditors will demand high returns in order to reflect the high risks that poor information imposes on them. This combination of high gearing and high interest payment levels leads, in turn, to high prospects of corporate failure.

Finally, insolvency law affects levels of corporate failure because it creates the set of incentives that holds sway in the processes for ending corporate lives. Undesirable failures may be caused where certain parties possess incentives to call a halt to corporate activity at times when this is not in the general interest of involved parties. If, for example, the law on wrongful trading operates with a particular level of severity it will give directors of troubled companies a particular motivation to cease business operations at any given time in the process of corporate difficulties. An excessively severe wrongful trading law could thus lead to premature closures of companies which might have revived but have not been given a chance of

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turnaround because the directors have been fearful of the consequences to them of trading on. Similarly, the regime of priorities gives certain creditors incentives to act where this is in their own interests but not those of others. Thus, one of the considerations behind the reforms effected by the Enterprise Act 2002 was that, under the former regime of administrative receivership, banks secured with floating charges could be inclined to appoint a receiver in circumstances where it would overwhelmingly serve the interests of unsecured creditors and shareholders to have an administrator appointed specifically to promote the survival of the company and its undertaking.135

Nor do all dangers stem from premature curtailments of corporate activity. When the company faces insolvency and when creditors’ interests would best be served by an orderly running down of the business, it may be the case that directors will be pulled in the direction of continued trading by their interest in preserving their employment and business standing. Wherever directors do continue to trade in these circumstances, there is a prospect that the company will descend into a more damaging failure than would otherwise have been the case and the additional loss will fall not on the directors but on the company’s creditors.136

Insolvency law also sets out timescales and procedures to be adopted when companies are in trouble. Levels of corporate failures can be affected by the use or non-use of cooling-off periods and moratoria, as encountered in the Chapter 11 procedures found in the USA.137 The variety of rehabilitation procedures offered by insolvency law can also affect the possibilities of failures and recoveries.

In many respects then, insolvency law, like company law, can affect a company’s chances of survival or failure in difficult times. Insolvency law can also impinge on overall levels of success or failure. It is important, accordingly, to bear in mind the reasons why companies do fail when the challenges facing insolvency law are considered. Attention should be paid, for instance, to those areas of greatest contribution to failure, of greatest imposition of transaction costs and greatest impediment to recovery programmes. What insolvency law (and indeed company law) should, as a general rule, seek to avoid is loading risks and stresses on those points in corporate life where companies are at their most vulnerable.

135 See chs. 8 and 9 below; DTI/Insolvency Service White Paper, Productivity and Enterprise: Insolvency – A Second Chance (Cm 5234, 2001) ch. 2.
137 See ch. 6 below.
Corporate insolvency processes are not mere bodies of rules: they are elaborate procedures in which legal and administrative, formal and informal rules, policies and practices are put into effect by different actors. Those actors, in turn, have cultural, institutional, disciplinary and professional backgrounds which influence their work. They also operate under the influence of a variety of economic, career and other incentives and are subject to a host of constraints ranging from legal duties and professional obligations to client and own-firm expectations. The Cork Report, in an oft-quoted statement, urged that the success of any insolvency system is very largely dependent upon those who administer it, and socio-legal scholars have emphasised how insolvency law is not applied in a mechanical way but is manoeuvred around or manipulated by means of administrative structures ‘designed and imposed by dominant actors’.

This chapter looks at how insolvency law and turnaround processes are made operational by those actors who dominate such procedures: the insolvency practitioners (IPs) and turnaround professionals (TPs). In accordance with the discussion in chapter 2, it will be asked whether present practitioner and professional regimes can be supported as efficient, expert,

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fair and accountable. This will demand examinations of both the ways that these actors carry out their tasks and the ways that they are regulated.4

Insolvency practitioners

Four separate insolvency procedures for companies all involve IPs: Company Voluntary Arrangements (CVAs); administration orders; administrative receiverships,5 and liquidations. These all differ markedly in their characteristics and in their approaches to the balancing of interests.

CVAs are in essence agreements between companies, their shareholders and their creditors for the satisfaction of corporate debts or for schemes of arrangement of the companies’ affairs. Subject to protection for secured creditors6 and preferential creditors,7 the parties to the agreement are free to agree almost any terms. Party involvement in the agreement is, moreover, governed by statute: thus a proposal for a CVA needs the approval of 75 per cent of the company’s unsecured creditors and over 50 per cent of its shareholders.8 The CVA, if approved, is

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4 See Insolvency Regulation Working Party (IRWP), Insolvency Practitioner Regulation – Ten Years On (DTI, 1998) (‘IRWP Consultation Document’); IRWP, A Review of Insolvency Practitioner Regulation (DTI, 1999) (‘IRWP Review’). The IRWP had, as members, representatives of each of the professional bodies that authorise insolvency practitioners, as well as the DTI/BERR Insolvency Service, with the Association of Business Recovery Professionals (R3) (formerly the Society of Practitioners of Insolvency) in attendance. See further V. Finch, ‘Insolvency Practitioners: Regulation and Reform’ [1998] JBL 334.
5 The Enterprise Act 2002 largely replaced the administrative receivership regime with the new administration process: see EA 2002 s. 250, Insolvency Act 1986 Sch. B1, s. 72A. See also ch. 8 below. The general prohibition on appointing administrative receivers that was introduced by the 2002 Act applies to holders of ‘qualifying floating charges’ (see now Insolvency Act 1986 s. 72A) but is subject to six exceptions relating to capital markets, public/private partnerships, utilities, project finance, certain financial markets and registered social landlords/housing authorities: see ss. 72B–72G of the IA 1986 Sch. 2A as modified by the IA 1986 (Amendment) (Administrative Receivership and Capital Market Arrangements) Order 2003 (SI 2003/1468). Transactions that predate the implementation of the EA 2002 (15 September 2003) will still allow holders of qualifying floating charges both to appoint administrative receivers and to block the appointment of an administrator.
6 See Insolvency Act 1986 s. 4(3). 7 Ibid., s. 4(4).
binding on all those who were entitled to vote at the creditors’ meeting and the company may continue to trade. An IP will be involved in giving effect to the terms of the CVA but, in doing so, he or she can be seen to be implementing what is in essence a private contractual agreement insulated from public interest concerns.

Administration was originally provided for by the Insolvency Act 1986 but it was a formal procedure and required a court order. The reforms of the Enterprise Act 2002 inaugurated a new corporate administration regime, which will be discussed in chapter 9 below. In the ‘new’ administration procedures the rescue of the company as a going concern is the priority and the administrator has to sustain a company’s business while plans are made for its future. The administrator can thus be involved in the day-to-day management of the company as well as in formulating rescue plans. A company is protected from creditors’ demands when under an administration order and it can continue to trade but proposals for rescue have to be agreed by creditors.

The Cork Report anticipated that in rescue operations an administrator might take on board society’s interests and employment considerations when deciding whether to sustain a business. The Insolvency Act 1986, however, makes no mention of such factors and the administrator looks no further than to the interests of creditors viewed solely as creditors.

Administrative receivers (ARs) are appointed without court involvement by debenture holders who hold security over the whole (or

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9 Or would have been so entitled if they had notice of the meeting: Insolvency Act 1986 s. 5 (2)(b).
10 The IP will in practice usually have been involved in the drawing up of the proposals. On the significance attached by major creditors to the professional reputation of the IP involved see D. Milman and F. Chittenden, Corporate Rescue: CVAs and the Challenge of Small Companies, ACCA Research Report 44 (ACCA, London, 1995). Note that the Insolvency Service expects authorisation of the first ‘voluntary arrangement practitioners’ in 2008 (via s. 389(a) Insolvency Act 1986) (re persons who are not IPs): see IS Annual Report 2006–7.
11 See Insolvency Act 1986 ss. 8–27. CVAs were also introduced by the Insolvency Act 1986 ss. 1–7.
12 See Insolvency Act 1986 Sch. B1, para. 3(1).
13 See Insolvency Act 1986 s. 8(3) for the specific purposes for which an administration order can be made.
14 On the moratorium see Insolvency Act 1986 Sch. B1, paras. 42–4; M. G. Bridge, ‘Company Administrators and Secured Creditors’ (1991) 107 LQR 394. See also ch. 9 below.
15 Para. 498.
substantially the whole) of the company’s assets. The IP acting as an AR has a central function of realising company assets in order to meet the claims of the debenture holder and, in so doing, he or she can continue the business and can sell it as a going concern. On such a sale the AR distributes funds received to the creditors in due order of priority. The responsibility of the receiver is to the creditor who requested the appointment and not to the company or other creditors. In essence this is, accordingly, a creditors’ remedy that does not demand that the AR pays any heed to the wishes or interests of the company or to its directors, shareholders, other creditors (other than minimal obligations to report) or the interests of employees or the broader public.

Liquidators are appointed in signification of the end of a company and are responsible for collecting-in the company’s assets, realising them and distributing the proceeds to the company’s creditors. If there is a surplus, this can go to the shareholders. In compulsory liquidation a winding-up petition is made to the court and, if granted, the court orders that the company be wound up. In a creditors’ voluntary liquidation the shareholders resolve initially to put the company into liquidation and the creditors effectively take control away from the shareholders at the subsequent creditors’ meeting when they appoint a liquidator. The IP, acting in both types of liquidation, looks to the interests of all creditors but also acts in the public interest in so far as he is under a duty to report directorial unfitness to the Disqualification Unit of the BERR’s Insolvency Service as part of the disqualification process of the Company Directors’ Disqualification Act 1986 (CDDA).

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18 Insolvency Act 1986 ss. 99, 100, 166. On liquidation generally see ch. 13 below.

IPs may be involved in the above four procedures but other actors also have roles to play. Thus the Official Receiver (OR), an appointee of the Secretary of State, has important investigatory functions to perform when acting in cases of liquidation.

The evolution of the administrative structure

Over the last two centuries accountants have sought to dominate insolvency work and have striven with some success. For most of the second half of the nineteenth century many accountancy firms earned the vast majority of their fees from insolvency practice and it was, indeed, this work that boosted not only accountants’ incomes but also their professional organisation. Accountants throughout this period consistently emphasised their superior professional expertise to lawyers in the insolvency field. By the time that the Cork Committee deliberated, however, a number of worries had arisen, notably regarding the qualifications of those persons engaged in insolvency work. The Cork Report itself was concerned that arrangements prior to the date of its inquiry were open to abuse and did not command public confidence. The Report accepted the case for a scheme of IP regulation operating under ministerial control and covering all persons, other than the OR, who hold office as liquidators, trustees in bankruptcy, administrative receivers, administrators or supervisors of voluntary arrangements. The regime envisaged by Cork anticipated that IPs would be provided by the private sector but would be required to be members of an officially recognised and regulated professional body capable of exercising disciplinary supervision over an individual acting as an IP. In the case of IPs who did not belong to a recognised professional body (RPB), these would be licensed

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20 Corporate insolvency procedures do not, of course, exhaust the work of IPs. They are also involved in the personal side of insolvency (bankruptcy) as nominees and supervisors of IVAs and as trustees in bankruptcy. See Finch, ‘Insolvency Practitioners’, pp. 353–4; Fletcher, Law of Insolvency, chs. 3, 4, 7; D. Milman, Personal Insolvency Law, Regulation and Policy (Ashgate, Aldershot, 2005).

21 Especially in compulsory liquidation: Insolvency Act 1986 s. 136. The OR is a civil servant and officer of the court. There are currently thirty-five OR offices in England and Wales: see Insolvency Service website, www.insolvency.gov.uk (visited 15 January 2008)


23 Flood and Skordaki, Insolvency Practitioners, p. 10.

24 Cork Report, ch. 15.

individually by the (then) DTI (now BERR) with a view to ensuring proper levels of competence, skill and integrity.

The Insolvency Act 1986 gives legislative effect to the Cork vision and restricts action as an office holder in any designated insolvency proceeding to persons qualified under the 1986 Act. Qualification is achieved by the methods advocated by the Cork Report, namely membership of, and authorisation by, an RPB or licensing directly by the Secretary of State. Acting as an IP in any designated proceeding when not qualified to do so constitutes a criminal offence.

There are now eight RPBs which may grant authorisation. This will only be forthcoming for individuals, not firms, and only on demonstrating, through professional examinations, a prescribed level of technical knowledge and expertise in accountancy and law. Since 1990 all applicants to become qualified IPs have been required to pass an examination organised centrally by the Joint Insolvency Examining Board (JIEB), whichever RPB they belong to. They must also be able to demonstrate a minimum level of appropriate experience. Those who apply for qualification to the Secretary of State rather than to an RPB must generally pass the JIEB examination, though a discretion to make exceptions exists. There are now 1,700 IPs in the UK who are authorised and regulated by the Secretary of State directly or by an RPB.

See Insolvency Act 1986 Pt XIII and the Insolvency Practitioners Regulations 2005 (SI 2005/524) and IA 1986 s. 390. Major changes to the rules governing the authorisation and responsibilities owed by IPs were made by the 2005 Regulations: for example, Regulation 6 gives criteria for determining whether a candidate for authorisation is a fit and proper person; Regulation 7 gives requirements as to requisite experience and training; Regulation 11 gives details on annual returns for authorised persons to the Secretary of State. See Regulation 10, Sch. 2, Part 2 concerning the need for IPs to lodge a bond in the form of a security or caution. See further L.S. Sealy and D. Milman, Annotated Guide to the Insolvency Legislation 2006/7 (10th edn, Thomson/Sweet & Maxwell, London, 2007) vol. I, p. 429. Excluded from the qualification requirement are ORs and receivers appointed by the court or by holders of fixed charges. On the lack of equivalence of rules relating to IPs and ORs see G. Pettit, ‘A Level Playing Field?’ (2007) Recovery (Autumn) 3.

See Insolvency Act 1986 s. 389. For authorisation personally from the Secretary of State or from a ‘competent authority’ see IA 1986 s. 392 and the Insolvency Practitioners Regulations 2005 (SI 2005/524).

The Association of Chartered Certified Accountants (ACCA), the Insolvency Practitioners’ Association (IPA) and the Institute of Chartered Accountants in England and Wales (ICAEW); the Institute of Chartered Accountants in Ireland; the Institute of Chartered Accountants in Scotland; and the Law Societies of England and Wales, of Northern Ireland and of Scotland.


On insolvency matters the Secretary of State’s functions are exercised through the Insolvency Service (IS), which is an executive agency of the BERR. It is headed by a chief executive, the Inspector General, and employs around 2,150 staff.\textsuperscript{31} The IS is responsible for, amongst other things, advising on the form and effectiveness of insolvency legislation, ensuring that the RPBs regulate their members properly with suitable rules that are effectively enforced and authorising and regulating Secretary of State authorised IPs.\textsuperscript{32} The Secretary of State issues a Framework Document setting down objectives for the IS and, as well as monitoring the RPBs, the IS runs a twice-yearly ‘licensing forum’ for discussion of authorisation and regulatory issues with the RPBs.

The bulk of RPB-authorised IPs are accountants, with the dominant membership coming from the Institute of Chartered Accountants of England and Wales (ICAEW). Many of these are not full-time IPs but are general accountancy practitioners, some with audit and investment business clients.\textsuperscript{33} The RPBs act as self-regulators in so far as they exercise control over their own qualified members, but the system constitutes governmentally monitored self-regulation since the IS supervises the regulatory process, conducts regular visits to each of the RPBs and seeks to ensure that standards are maintained. For their part, the RPBs operate a variety of control measures designed to control and correct misconduct. A range of disciplinary penalties applies to members and includes the sanction of expulsion from membership – which, for an RPB-authorised practitioner, will produce automatic revocation of authorisation.

The RPBs have, since 1994, carried out monitoring visits to all IPs.\textsuperscript{34} There are differences in style and form of regulation among the eight RPBs (each,

\textsuperscript{31} IS Annual Report 2006–7. Prior to 1 April 2006 the Companies Investigation Branch (CIB) was part of the main DTI (now BERR) but it is now under the auspices of the Insolvency Service. Figures given by the IS since 2005–6 thus include CIB personnel.

\textsuperscript{32} The IS also takes, \textit{inter alia}, disqualification proceedings against unfit directors (1,200 disqualification orders/undertakings were secured in 2006–7: IS Annual Report 2006–7) and carries out, through its ORs, the functions of liquidators in compulsory liquidations and trustees in bankruptcy. The IS also monitors, on a day-to-day basis, those IPs directly authorised by the Secretary of State. The IRWP Review (p. 22) recommends that this monitoring function ought to be contracted out to a professional body so as to leave the IS to concentrate on its functions as a regulator of the RPBs’ regulatory activities.

\textsuperscript{33} On the historical evolution of the dominance of the accountancy profession over insolvency work see Flood and Skordaki, \textit{Insolvency Practitioners}, ch. 3.

\textsuperscript{34} In January 2005 the ICAEW and the IPA took their monitoring back in-house (on abolition of the Joint Insolvency Monitoring Unit). On resultant changes in their
for instance, has its own complaints mechanism) and these reflect variations in traditions as well as powers of intervention. A degree of consistency of approach derives, however, from the RPBs’ common subjection to a memorandum of understanding with the Secretary of State\(^{35}\) and to monitoring by reference to common standards required and approved by the IS.

Establishment of the Society for Practitioners in Insolvency (SPI), a multi-disciplinary trade association, paved the way for lawyers and accountants to develop a shared professional perspective on insolvency work.\(^{36}\) Around 80 per cent of all IPs belong to this body, now known as R3 (the Association of Business Recovery Professionals),\(^{37}\) and its activities include assisting with training, continuing professional education and ethical issues as well as the issuing of guidance notes.

Harmonisation of the RPBs’ approaches is assisted, in particular, by the RPBs’ system of best practice guidance. Statements of Insolvency Practice (SIPs) are issued under procedures agreed between the insolvency regulatory authorities (the RPBs and the IS) acting through the Joint Insolvency Committee (JIC), a co-ordinating forum.\(^{38}\) SIPs, the status of which is now ‘required practice’,\(^{39}\) are commissioned by the JIC, produced by R3, approved by the JIC and adopted by the regulatory authorities within each of their own regulatory regimes.\(^{40}\) Differences of regulation do, nevertheless, remain within the overall system. The IS, working within a statutory framework, has, for instance, no sanction against its IPs other than removal of authorisation. The eight RPBs can

\(^{35}\) The memorandum covers authorisation, handling of complaints, monitoring activities, best practice and exchange of information between RPBs.


\(^{37}\) On 28 January 2000 the SPI renamed itself R3: the Association of Business Recovery Professionals.

\(^{38}\) The JIC meets four times a year and acts as a forum for discussion of insolvency issues and professional and ethical standards and includes representatives from each of the RPBs and the IS. (R3 has observer status.) The JIC is also the profession’s principal source of contact with the Insolvency Practices Council, a body established to provide an additional public interest input into standard setting in the profession.


\(^{40}\) See Joint Insolvency Committee Annual Report 2006, p. 2. Statements of Insolvency Practice (SIPs) have been issued on a number of topics, including liquidators’ investigations into the affairs of an insolvent company, records of meetings in formal insolvency proceedings and remuneration of insolvency office holders. On remuneration see pp. 186–8 below.
make their own regulations and impose their own penalties and the RPBs responsible for solicitors have statutory powers of intervention.

Further harmonisation of approach is encouraged by the Insolvency Ethical Guide which was published by the IS and introduced in January 2004. It operates as a standardising measure across all insolvency practitioners, regardless of the particular authorising body. During 2006 and 2007 the JIC engaged in the process of revising a draft Insolvency Code of Ethics for putting out to further consultation.

**Evaluating the structure**

*Efficiency*

In 2004 57 per cent of respondents to a survey of R3 members stated that the regime for regulation did not work efficiently. Frequently made criticisms are said to be that regulators have not established an information and monitoring system that would underpin effective regulation – and that this is because of insufficiencies of time, money, organisation, co-ordination and clarity of objectives. Such internal concerns have been echoed from outside the profession where criticisms of IP performance have focused on the charges made for services rendered and the value for money that has been supplied. Matters came to prominence in 1997 when, in three large insolvencies, accountants acting as IPs charged huge fees but recovered little for creditors. The three accounting firms handling the administration of the Maxwell empire reported fees of nearly £35 million and the receivers to the Robert Maxwell estate, accountants Buchler Phillips, recovered £1.672 million, but their bills, together with those of solicitors Nabarro Nathanson, came to £1.628 million, leaving only £44,000 for creditors. In *Mirror Group Newspapers plc v. Maxwell* Ferris J described the fee claim as ‘profoundly shocking’, adding: ‘If the amounts claimed are allowed in full, this receivership will have produced substantial rewards for the receivers

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43 Press comments on IPs’ fees have used terms such as ‘obscene’, ‘vultures’ and ‘vampires’: see Flood and Skordaki, *Insolvency Practitioners*, p. 23.
44 See ‘Insolvency Experts in Firing Line over Fees’, *Financial Times*, 1 August 1997. The collapse of the Bank of Credit and Commerce International (BCCI) yielded fees of over $169.2m for Touche Ross, and the administrators of Polly Peck International charged (with legal fees) nearly £25m.
and their lawyers and nothing at all for the creditors of the estate. I find it shameful that a court receivership should produce this result in relation to an order of more than £1.5 million.\(^{46}\)

Mr Justice Ferris noted increased concern at the generally perceived high level of costs in insolvency cases and other judges had already spoken out on the subject. Mr Justice Lightman expressed concern in a November 1995 lecture to the Insolvency Lawyers’ Association\(^{47}\) and, returning to the topic in 1998, he noted the ‘visceral disquiet’ in the press on the subject.\(^{48}\)

How then should charging levels be approached? At present, those who have power to fix the remuneration of office holders fall into two categories. In the first, there are liquidation committees, creditors’ committees, general bodies of creditors, or (in some cases) those persons appointing the office holder. In the second, there is the court, which may act in exercise of an original jurisdiction or in an appellate capacity.\(^{49}\) In the case of most IPs, who act as receivers, their fees are fixed by the debenture holders (usually the banks) and are based on time and expenses.\(^{50}\) In liquidations, IPs may charge a percentage of the value of assets realised or distributed, or they may bill by time, bearing in mind also any complexities, exceptional responsibilities and so forth.\(^{51}\) The creditors’ committees authorise remuneration. This has given rise to the criticism that, in a professionally comfortable arrangement, accountants,

\(^{46}\) Mr Justice Ferris passed the issue to a taxing officer, Master Hurst, whose judgment was delivered in April 1999: see Mirror Group Newspapers v. Maxwell and Others [1999] BCC 684. Buchler Phillips was awarded 99 per cent of its claim and no wrongdoing was found in its conduct. Blame was laid on the way Maxwell had organised his business: ‘Many assets which on the face of it appeared to be the personal property of Mr Maxwell were either worthless or, because of the immensely complex financial labyrinth which he had constructed, could not ultimately be recovered as personal property.’ See J. Kelly, ‘The Recovery Position’, Financial Times, 22 April 1999.


\(^{50}\) Under the Insolvency Regulations 1994 (SI 1994/2507) Regulation 36A, as inserted by the Insolvency (Amendment) Regulations 2005 (SI 2005/512), an IP is obliged, on request in writing by a creditor, director, contributory or individual, to supply free of charge, and within twenty-eight days, a statement setting out, \textit{inter alia}, the number of hours spent on a case, and the hourly rate charged for staff.

\(^{51}\) See also Regulation 36A, note 50 above.
sitting in creditors’ committees, are left to authorise the payment levels of their fellow accountants.52

The criteria governing the judicial fixing and approval of insolvency appointees’ remuneration are set out in a 2004 Practice Statement53 that was produced in the wake of continuing judicial concern regarding the level of fees claimed by some office holders.54 The Practice Statement applies, *inter alia*, to liquidators, provisional liquidators, special managers, administrators, trustees in bankruptcy, licensed IPs and interim receivers. It covers applications to court for the approval of remuneration levels and also to challenges of remunerations that have already been fixed. The objective is to ensure that remuneration is fair, reasonable and commensurate with the nature and extent of the work properly carried out. The guiding principles to be considered include the value of the service rendered, the fairness and reasonableness of the amounts claimed, the balance between the complexity of the work done and the value of assets dealt with. The appointee must give an account of the work charged for that breaks it down into individual tasks, and explains why particular tasks were undertaken; why they were undertaken by particular individuals; and why they were carried out in the given manner. The amount of time charged for must be justified,55 the charge rates for the appointee and his or her staff must be detailed and an account must be given of the likely achievements that the work undertaken will further. The court may, in addition, appoint an assessor or a Costs Judge to produce a report on the claimed remuneration.56

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56 For judicial views on the merits of appointing assessors rather than Costs Judges, see Ferris J in *Re Independent Insurance Co. Ltd (in provisional liquidation) (No. 2)* [2003] 1 BCLC 640. An important role of the assessor may be to advise the judge on fee levels: see
The costs of the IS have in the past also been the subject of criticism. Before April 2004 fees raised by the IS were paid to the (then) DTI (now BERR) and there was no direct relationship between the fees charged and the cost of the function they related to. This meant that fees raised for one function might be used to cross-subsidise other actions. Since April 2004, though, fees have been set to recover costs and a system of average costs per process has been applied.

Criticism has furthermore attached in the past to the use made of the Insolvency Services Account (ISA) – the account into which creditors’ money, as realised by trustees in bankruptcy and liquidators, must be paid. In 1996–7 this account generated banking fees of £16 million and a £37 million surplus investment income, but did not pay more than a low rate of interest (subject to tax) to creditors. The overall effect, said critics, was to penalise creditors – most strikingly in those years when the investment account produced a surplus.

The Cork Committee received strong and widespread criticism of the ISA regime, particularly with regard to the low rate of return on compulsory deposits. The requirement that an IP deposit surplus funds in the ISA was also attacked as providing an incentive for liquidators to protract proceedings and delay the submission of accounts. Cork urged that the administration of insolvency was a public service and should be paid for out of general taxation rather than funded by creditors. The existing system, said Cork, was costly, time-consuming and unfair and,


See Justice, Insolvency Law: An Agenda for Reform (Justice, London, 1994) paras. 5.7–5.11; Cork Report, ch. 17, paras. 847–55. In 1991–2 the IS paid a surplus of £5 million to the (then) DTI (Financial Times, 2 September 1992) and in 1992–3 the surplus was £9 million: Justice, Insolvency Law. Net income from the Insolvency Services Investment Account in the years 1995–6 and 1996–7 was £45 million and £31.4 million respectively.


Ibid., p. 201. For further criticism see Justice, Insolvency Law.
instead, liquidators should be obliged to deposit funds in an interest-bearing account. As an alternative to public funding of the IS, Cork recommended that there should be a levy on the registration of new companies.\textsuperscript{63}

The rationale for use of the ISA was, moreover, undermined by the 1986 Insolvency Act. Historically the ISA was used to prevent unscrupulous practitioners misappropriating funds but the 1986 Act set up a licensing and bonding system\textsuperscript{64} that offered protection from, and compensation for, such abuse. The Government took these points in its 2001 White Paper\textsuperscript{65} when it concluded that paying the bulk of the interest generated on insolvency funds into government coffers could no longer be justified.\textsuperscript{66} Action has since been taken so that, after 1 April 2004, moneys from voluntary liquidations do not have to be paid into the ISA (though the requirement remains for compulsory liquidations)\textsuperscript{67} and under the 2004 Regulations, deposits earn interest at a ‘competitive’ rate that can be varied by the Secretary of State.\textsuperscript{68} Additionally, with effect from 6 April 2008, unclaimed dividends in administrations and administrative receiverships can be paid into the ISA.\textsuperscript{69}

\textsuperscript{63} Cork Report, p. 201.
\textsuperscript{64} IPs must obtain and deposit with their authorising RPB (or the Secretary of State) a bond issued by an insurance company by which it makes itself jointly and severally liable with the IP for the proper performance of his duties: Insolvency Act 1986 s. 390(3); Insolvency Practitioners Regulations 2005, Regulation 10, Sch. 2, Part 2. The bond must be for the general sum of £250,000 and for additional specific sums in accordance with the prescribed limit applicable to particular cases in which the IP is to act. (The amount of required cover is calculated by reference to the value of the assets of the insolvent with a minimum of £5,000 and a maximum of £5 million.) See further G. Todd and S. Todd, ‘Insolvency Practitioners have to be Bonded – Is it as Simple as it Seems?’ (2006) 19 Insolvency Intelligence 129.
\textsuperscript{65} DTI/Insolvency Service, Productivity and Enterprise: Insolvency – A Second Chance (Cm 5234, July 2001).
\textsuperscript{66} Ibid., para. 1.51.
\textsuperscript{67} See Insolvency Act 1986 s. 415A (as inserted by Enterprise Act 2002 s. 270); Insolvency Practitioners and Insolvency Services Account (Fees) Order 2003 (SI 2003/3363) as amended by the Insolvency Practitioners and Insolvency Services Account (Fees) (Amendment) Order 2008 (SI 2008/3), Insolvency (Amendment) Regulations 2004 (SI 2004/472), Insolvency Proceedings (Fees) Order 2004 (SI 2004/593). Liquidators of voluntary liquidations may still pay into the ISA if they wish. For cases commenced before 1 April 2004 (to which earlier fees orders still apply) see further the Insolvency Proceedings (Fees) (Amendment) Order 2006 (SI 2006/561).
\textsuperscript{68} See Enterprise Act 2002 s. 271. The rate of interest from 10 July 2007 was 7 per cent.
\textsuperscript{69} See the Insolvency (Amendment) Regulations 2008 (SI 2008/670).
Expertise

When the Cork Committee considered the qualifications of IPs, it noted that the absence of some ‘minimal qualification’ was much criticised. The Committee then stressed that ‘a certain degree of knowledge and experience’ was essential for the IPs to discharge their functions adequately. They needed to be familiar with the relevant law on debtor–creditor relations; the organisation and proceedings of courts dealing with insolvency; the investigation of business dealings and transactions of insolvent debtors; the pursuit and recovery of assets fraudulently disposed of; voidable preferences; and the distribution of assets to creditors. The IP, moreover, had to be capable of taking complete control of a business of some size and complexity and of carrying it on to sell as a going concern or to make other proposals for its continuance as an economic unit.

The Cork Report, as noted, served as a foundation for the systems of entry screening, qualification and monitoring that have been described above. It can be argued that the current regime’s reliance on professional control through different ‘home’ RPBs encourages a breadth of expertise in IPs. Thus, accountancy and lawyer-based IPs are required to display qualities of general professional expertise in a manner that would, perhaps, not be the case if IPs were regulated as a discrete, more narrowly defined, profession.

Questions have, nevertheless, been raised about the scope of IPs’ skills. A 1995 analysis of CVAs asked whether IPs are the right people to carry out these arrangements since, by training, they know best ‘how to kill companies’. IPs have, in the past, been found to possess a limited knowledge of CVAs, and it was suggested that the ‘going concern’ departments of the major accountancy firms might be better equipped to engage in corporate rescues than the IPs who are actually involved with insolvencies. The statistics historically revealed that receiverships and liquidations were

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70 Cork Report, para. 735.
71 On IPs’ ‘vital’ use of due diligence to find the value of a company and any aspects enhancing its worth see C. Parr, ‘Due Diligence: Seek and You Shall Find’ (2008) Recovery (Spring) 42.
72 See IRWP Review, pp. 35–6. IPs may also receive expert assistance from specialists. Thus, it is said that members of the Non-Administrative Receivers Association (NARA) can provide IPs with advice in relation to fixed-charge receiverships: see D. Smith, ‘Partners in Insolvency’ (2007) Recovery (Autumn) 7.
73 See Flood et al., Professional Restructuring, p. 17.
75 Flood et al., Professional Restructuring, p. 17.
popular in comparison with administrations and CVAs, and Flood et al. argued that a senior accountant captured the essence of the IP vision of insolvency work in saying ‘We are debt collectors’. As will be argued below, however, in the last decade there has been a revision of insolvency roles so that participants in corporate and insolvency processes are encouraged to see corporate decline as a matter to be anticipated and prevented rather than responded to after the event and, in this development, turnaround professionals have gained a new prominence. Furthermore, the reforms of the Enterprise Act 2002 attempted to foster a ‘rescue culture’ by replacing the regime of administrative receivership with provisions that give pride of place to the new administration process. The control of this reformed rescue procedure lies principally in the hands of IPs. Thus the training, expertise and approach of IPs may now increasingly be orientated towards including managerial skills so as to encourage them to give proper weight to rescue in reviewing options for troubled companies. As one IP described it: ‘the emphasis has shifted from “pathology” to “preventative medicine”… “managing change” has become a critical new discipline’. The law may set up a variety of insolvency procedures but here we see that the machineries of implementation can have a very considerable role in shaping insolvency processes on the ground.

A concern voiced in recent years is not so much that IPs lack skills but that, within the insolvency process, there is often an imbalance of skills in favour of IPs. This topic, however, will be considered in dealing with fairness.

**Fairness**

Does the present regime of implementing insolvency processes ensure fairness to affected parties? If IPs are allowed to act where conflicts of

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76 *Ibid.* 77 See pp. 221 ff. and chs. 6–9 below.
79 See further V. Finch, ‘Control and Co-ordination in Corporate Rescue’.
81 This section of the chapter builds on V. Finch, ‘Controlling the Insolvency Professionals’ [1999] Ins. Law. 228. As for fairness to regulated IPs, the R3 survey of 2004 suggested that 62 per cent of responding members thought that the regime did not operate fairly: see Verrill, ‘R3 Regulation Survey’.
interest arise, there is a potential for unfairness or bias, and insolvency processes have the capacity to throw up a plethora of conflicts of interests for IPs. The latter, and their firms, for instance, may have ongoing links with different companies or creditors who are involved in various ways in an insolvency; relationships with the directors of individual companies may create conflicts; personal interests and other appointments held may be relevant; the IP’s firm may have financial interests present or future that are potentially affected by advice or decisions relating to a troubled company; and the quantity of work or remuneration that an IP receives may be affected by actions or recommendations made.

It is, accordingly, necessary to consider how the present system controls such conflicts. The Insolvency Act 1986 does not expressly prevent an IP from acting where there is a conflict, but in considering whether a person is fit and proper to act as an IP, the Secretary of State must take into account whether, in any case, the applicant has acted as an IP but has failed fully to disclose to persons who might reasonably be expected to be affected circumstances where there is, or appears to be, a conflict of interest between his so acting and any interest of his own (personal, financial or otherwise) without having received appropriate consent. The Secretary of State must also consider whether the insolvency practice of the applicant is, has been, or will be carried on with the independence, integrity and professional skills appropriate.

These provisions do not apply to the RPBs who also authorise persons to act as IPs, but the RPBs and the BERR do issue guidance on conflicts of interest. The Secretary of State’s ‘Code of Conduct’ warns practitioners to be vigilant about potential conflicts of interest between their IP work and any personal, professional or financial commitments which might impair their objectivity or appear to do so. Specifically prohibited in the Code is acting as a liquidator after having acted as an administrative

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82 The Insolvency Practitioner Regulations 2005 specify the matters to be taken into account by the Secretary of State in determining whether a person is fit and proper to hold an IP licence (Regulation 4). Section 419 of the Insolvency Act 1986 empowers the Secretary of State to make regulations prohibiting persons from acting as IPs where conflicts of interest may arise.

83 Insolvency Practitioner Regulations 2005 Regulation 4(f).

84 See Insolvency Practitioner Regulations 2005 Regulation 4(e).


86 See IS, Guidance to Professional Conduct and Ethics for Persons Authorized by the Secretary of State as IPs, www.insolvency.gov.uk/guidanceleaflets/conductethics/conductethics.htm (visited 11 January 2008).
receiver, and the appointment of auditors as liquidators or administrative receivers, except in the case of a members’ voluntary liquidation, where it is beyond reasonable doubt that the company is solvent and that all debts can be satisfied within a twelve-month period. Similar rules are issued by the accountancy bodies in a combined approach through the ICAEW, and the ICAEW’s Statement on Insolvency Practice expresses rules on accepting appointments along similar lines to the Secretary of State’s Code of Conduct. A key notion is that of the ‘material professional relationship’. This arises where ‘material work is being carried out, or has been carried out, during the previous three years, and means that an IP who is a member of a recognised accountancy body should not act as an IP in relation to a company if they, or their partners, have been auditors to that company or if they have carried out one or more ‘significant assignments within three years of the onset of the company’s insolvency. (Such requirements do not, however, rule out an IP acting in a members’ voluntary liquidation as long as he has given ‘careful consideration’ to all the implications of acceptance in the particular case and is satisfied that the directors’ declaration of solvency is likely to be substantiated by events.)

The courts, for their part, have stressed that IPs must consider not only their own personal or professional interests and connections but also whether persons with whom they are associated have held appointments that would lead to a lack of independence. Harman J has stated that it would be most unlikely (but not totally impossible) that a director could ever be a proper liquidator of a company. In Re Lowestoft Traffic Services

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88 As defined in ICAEW, Insolvency Practice, paras. 7.0 and 7.1. See also IS, Guidance to Professional Conduct and Ethics, Annex of Particular Circumstances, Group A(i).

89 See ICAEW, Insolvency Practice, para. 7.0(ii): ‘where a practice or person has carried out one or more assignments, whether of a continuing nature or not, of such overall significance or in such circumstances that a member’s objectivity in carrying out a subsequent insolvency appointment might or reasonably could be seen to be prejudiced’.

90 See ICAEW, Insolvency Practice, para. 10.0.

91 See Re Corbenstoke Ltd (No. 2) [1989] 5 BCC 767.
Co. Ltd\textsuperscript{92} Hoffmann J stated that the public interest required that a liquidator should not only be independent, but also be seen to be independent, and he displaced a liquidator from office following considerable creditor disquiet at the appointment.\textsuperscript{93} Conflicts of interest, moreover, arise where an IP holds a number of appointments and acts for more than one company involved in an insolvency: where, for example, a group is liquidated and the IP acts as liquidator for the parent company and the subsidiary companies. The courts have, however, tended to adopt an accepting attitude to such conflicts, seeing them as inevitable and routinely handled by experienced IPs.\textsuperscript{94} The ICAEW Statement on Insolvency Practice acknowledges the possibility of conflicts but states that it would be ‘impracticable’ for a series of different IPs to act.\textsuperscript{95} Where a direct conflict may arise, the courts may work around this by allowing IPs to secure the appointment of independent persons to deal with specific issues of conflict. Thus, in \textit{Re Maxwell Communications Corp.}\textsuperscript{96} Hoffmann J declined to appoint an additional administrator where the existing administrators had acted for Robert Maxwell personally. He considered the conflicts to be only distant possibilities and able to be dealt with by allowing the existing administrators an area of discretion.

As for powers of control, the courts may remove liquidators,\textsuperscript{97} administrative receivers,\textsuperscript{98} administrators,\textsuperscript{99} supervisors of CVAs\textsuperscript{100} and voluntary liquidators.\textsuperscript{101} Parties aggrieved by the acts of liquidators may apply to the courts to reverse or modify these,\textsuperscript{102} although the courts are generally reluctant to interfere in the administration of insolvency.\textsuperscript{103}

\textsuperscript{92} [1986] BCLC 81; [1986] 2 BCC 98.
\textsuperscript{93} The liquidator had been appointed at a creditors’ meeting where the chairman (a director) had used proxy voting to outvote the creditors, who favoured another IP. See also \textit{Re Rhine Film Corporation (UK) Ltd} [1986] 2 BCC 98.
\textsuperscript{94} See Dillon LJ in the Court of Appeal in \textit{Re Esal (Commodities) Ltd} [1988] 4 BCC 475.
\textsuperscript{95} See ICAEW, Insolvency Practice, para. 22.0; Anderson, ‘Insolvency Practitioners’, p. 14.
\textsuperscript{96} [1992] BCLC 465, 469. In the \textit{Insolvency Act} 1986 s. 172.
\textsuperscript{97} Insolvency Act 1986 ss. 171–2.
\textsuperscript{98} See \textit{Re Keypack Homecare Ltd} [1987] BCLC 409. Liquidators may still be removed in some cases without the court being involved: see \textit{Insolvency Act} 1986 ss. 171–2.
\textsuperscript{99} Ibid., s. 45. \textsuperscript{100} Ibid., Sch. B1, para. 88.
\textsuperscript{101} Ibid., s. 108. See \textit{Re Hans Place Ltd} [1993] BCLC 768; \textit{Re Edennote Ltd} [1996] 2 BCLC 389. The passing of the Human Rights Act 1998 opened the possibility of judicial oversight – covering the actions of ORs and possibly also those of IPs carrying out functions of a public nature. Challenges based on the protection of property rights (Article 1 of the First Protocol) or privacy (Article 8 of the Convention) may, for example, be made in the courts: see A. Arora, ‘The Human Rights Act 1998: Some Implications for Commercial Law and Practice’ (2001) 3 \textit{Finance and Credit Law} 1; R. Tateossian,
Creditors, or members of the company, who are aggrieved by the actions of an administrator may similarly apply to the court under the 1986 Act. IPs also owe common law duties of care and good faith to the company, and liquidators in compulsory windings up and administrators are considered to be officers of the court and obliged to act honourably. It should not be forgotten, furthermore, that under the Human Rights Act 1998 and Article 6 of the European Convention on Human Rights, 1950, there is a right, inter alia, to an independent and impartial tribunal. Where, accordingly, IPs act as office holders and determine rights, conflicts of interests may be pointed to and human rights issues raised.

The Enterprise Act 2002 restricted the right of the floating charge holder to appoint an administrative receiver but, before that Act was passed, there were fears that harmful conflicts of interest were involved when investigating accountants were appointed as receivers. A common business occurrence was that a bank, with concerns about the viability of a debtor company, would appoint accountants, often IPs, to investigate and report on the company’s financial situation and prospects. If these investigators reported that it was possible to save the company, and devise an action plan for the bank accordingly, they would


See Insolvency Act 1986 Sch. B1, para. 74 – arguing that the administrator is acting, has acted, or is proposing to act in a way which (would) unfairly harm(s) their interests: see ch. 9 below. On liquidation, liquidators and administrative receivers can be found liable for breaches of duty (or ‘misfeasance’) under the Insolvency Act 1986 s. 212 and administrators can be similarly liable for misfeasance/breach of duty under para. 75 of Sch. B1 of the Insolvency Act 1986 (it is not now necessary regarding administrators for the company to be in liquidation): see chs. 8, 9 and 12 below.

Re AMF International Ltd (No. 2) [1996] 2 BCLC 9; Re Home and Colonial Insurance Co. Ltd [1930] 1 Ch 102; Re Windsor Steam Coal Co. (1901) Ltd [1929] 1 Ch 151; Pulsford v. Devenish [1903] 2 Ch 625.


Such investigating accountants may also be called in by directors of the company who seek reassurance that it is proper to continue trading. The directors may be concerned about future liability under the Insolvency Act 1986 s. 214, ‘wrongful’ trading: see ch. 16 below.
receive fees for the investigation and planning tasks. If, on the other hand, the investigators advised the bank that the safest way to secure repayment of funds was to appoint a receiver, there was a high probability that the investigating firm of accountants would pick up the lucrative receivership work that ensued.\textsuperscript{110} This was because they could argue that the investigating accountants were already familiar with the company’s books, figures and position and because the bank was usually the largest secured creditor and was likely to be well placed to insist on the appointment of the receiver of its choice. The investigators were subject to real conflicts of interests: they were in a position to report on the company’s viability but had a chance of privileged access to work and to assets. They were likely to ensure that the bank (which was effectively the investigating firm’s real client) obtained as much of the insolvency assets as possible. The real danger was that such conflicts could produce biased advice to creditors and might exacerbate the existing propensity of large secured creditors to look to their own, not the company’s or body of creditors’, interests and to end the lives of companies before they had been given a reasonable opportunity of recovery. No independent ombudsman reviewed complaints on these matters and there was no compensation scheme. The regime was characterised as ‘the Chaps regulating the Chaps’\textsuperscript{111} but concerns on this front are, in the wake of the Enterprise Act 2002 reforms, of more historical than practical interest.\textsuperscript{112}

Conflicts of interest may not, however, be the only sources of unfairness within the administration of insolvency regimes. Unfairness may arise where the parties involved in transactions are ill-matched in terms of information, expertise or power. Such inequalities may mean that the interests of certain parties are not fairly represented in the procedures or in the outcomes of insolvency processes. Socio-legal commentators on insolvency have thus emphasised the extent to which the rules on insolvency, which may speak loudly of fairness, are manipulated by

\textsuperscript{110} Conflicts of interest appear stark where the investigation has been carried out for no fee and the only way the accountant can recover costs is by appointment as receiver: see J. Wilding, ‘Instructing Investigating Accountants’ (1994) 7 Insolvency Intelligence 3 (who states that ‘in nearly all cases if the bank decides to appoint a receiver subsequent to an investigation, then it is the investigating accountant who will be appointed’).


\textsuperscript{112} On Enterprise Act 2002 reforms see chs. 8 and 9 below.
experts to the advantage of their clients, or even themselves.113 Wheeler’s examination of the enforcement of retention of title clauses revealed that small trade creditors, who sought the protection of such clauses, were confronted in the enforcement process by the IPs who tended to act for large, secured creditors (in receiverships) or for the body of creditors (in liquidations) and who constituted the ‘dominant actors’ in the process. This domination flowed from their de facto positions as the possessors of the assets at issue; their superior knowledge concerning the assets and their utility to the company; their superior financial capacity and legal competence; and the familiarity with insolvency processes that flowed from their status as repeat players in the insolvency game. On this account, IPs used this superiority to protect the source of their fee income – the insolvency estate – from diminution by, amongst others, the holders of retention of title clauses. The procedures that were encountered were not properly ‘negotiations’: they were ‘defence strategies’ put up by the IPs.114 What the IPs did was erect barrier upon barrier so as to defeat claims on the estate. They would thus ‘fob-off’ claimants; insert delays into processes; demand answers to never-ending lists of questions; employ bluffing; and confront the claimant with a mass of legal and administrative technicalities.115 The overall picture, therefore, is neither of negotiations between matched parties, nor of independent fair-minded officials holding the ring between different interests. It is of highly trained practitioners acting for the economically powerful and gaining the advantage over less well-resourced parties.

What can be done to reduce such unfairness? In relation to conflicts of interest it has been suggested that concerned parties should be able to have recourse to a professional tribunal or an arbitration body.116 There might, accordingly, be an appeal body established by the licensing bodies of IPs, and directors, creditors, employees or others aggrieved at the appointment of, say, a receiver, might put their case to such a body without recourse to the courts. The basis for complaint would be that the relevant provision of the professional code of conduct had not been followed and the arbitrator would be able to rule on compliance with the code. An ombudsman could also be established117 by the profession and investigatory as well as

113 See Wheeler, ‘Capital Fractionalised’; Wheeler, Reservation of Title Clauses; Carruthers and Halliday, Rescuing Business.
114 Wheeler, Reservation of Title Clauses, p. 96.
115 Only 24 per cent of suppliers used lawyers in the study discussed in ibid., p. 101.
117 See Justice, Insolvency Law, para. 5.19.
reporting powers might be exercised by such a person. The case for such an arrangement is considered in the next section.

**Accountability**

The accountability of IPs is provided for, in the main, by the self-regulatory regimes outlined above. Attention should be paid to those concerns that are traditionally expressed in relation to self-regulatory mechanisms. These include the tendency of such mechanisms to exclude ‘outsiders’ from policy- and rule-making processes; the lack of accountability of self-regulators to the public rather than to members; the tendency of self-regulators to favour members’ interests rather than those of the public; their generally poor record of rule enforcement; their anti-competitive effects (for example, through the imposition of excessive restrictions on access); their low levels of procedural transparency, information disclosure and reason giving; and the failure of voluntary schemes of self-regulation to control those persons who are both most likely to cause mischief and least likely to participate in such schemes.

Criticisms of IP regulation echo the above points in some respects, with advocates of independent regulation stressing the protectionism and lack of objectivity of self-regulation.

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118 As noted, IPs are held accountable in some respects by statute (see Insolvency Act 1986 s. 212, Sch. B1, para. 75 (misfeasance)), statutory obligations to file periodic returns at the Companies Registry, and the Insolvency Practitioners Regulations 2005. For a review of IP regulation by the IP regulators see IRWP Review. (This section of the chapter builds on Finch, ‘Controlling the Insolvency Professionals’ and ‘Insolvency Practitioners’.)


120 See Justice, *Insolvency Law*, p. 27.


Some lay involvement is found, however, in the IPs’ complaints procedure. Complaints against IPs are generally handled by the RPBs and the process is regulatory rather than remedial – it is concerned with maintaining professional standards as opposed to providing redress.123 Typically cases are investigated by an assessor from the RPB, progressed to an investigating committee or panel or, if serious, to a disciplinary panel. An appeal from a disciplinary panel lies to an appeal tribunal and it is these tribunals that have considerable lay input. Sanctions include withdrawals of licence, suspensions, reprimands, fines, costs awards and exclusion from membership.124 The RPBs report annually to the IS with figures on complaints handling but some commentators have argued that there should be greater and more easily accessible information on what classes of complaint are being (or have been) investigated by the RPBs – with one source disclosing rulings and actions taken.125

The quality of RPB monitoring and enforcement has, in the past, been brought into serious question. In 1993 the IS conducted an inspection of around fifty-five IPs and found that half of these were failing seriously to meet their statutory requirements. Ten per cent of those inspected generated very serious disciplinary problems which led to the withdrawal of licences and criminal prosecutions.126 Pressure from the DTI (as it then was) led, as a result, to the establishment of a Joint Insolvency Monitoring Unit (JIMU) by the RPBs and to a regime of regular, random inspections. This regime of regular inspections still continues despite the abolition of JIMU at the end of 2004, but is now conducted in-house by the RPBs. The head of IP regulation at the IS noted in 2005 that these new monitoring arrangements can involve differences in approach127 but that overall compliance with principles of good regulation and enforcement

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124 Ibid.
125 Rumney and Smith, ‘Sorting Out the Bad Apples’, argue that the absence of such an information source is a ‘glaring omission’ in current arrangements (p. 37).
126 A. Jack, ‘Insolvency Regime to be Tightened’, *Financial Times*, 22 January 1993. To conclude that the above problems stemmed from self-regulation might, however, be unfounded. The (then) DTI, in the same period, found many serious regulatory breaches among the 150 IPs that it regulated directly and disciplinary action (including deregulation) also resulted.
127 Chapman, ‘Insolvency Service’s View of Regulation’, p. 25, stating that, for example, the ICAEW has moved to a ‘holistic approach’ while the IPA has adopted an approach which ‘focuses on qualitative outcomes’.
made such differences ‘less important’. The IS also monitors the complaints systems of the RPBs during three-yearly monitoring visits.

In their 2007–8 review of IP complaints handling, Walters and Seneviratne suggested that the public might think it odd that 1,700 IPs were subject to eight different complaints mechanisms. The review noted that lawyer-IPs were subject to the independent oversight of an ombudsman but accountant-IPs were not and that directly licensed IPs were not subject to an RPB-administered disciplinary apparatus. Walters and Seneviratne concluded: ‘It is clear beyond peradventure that the insolvency regulators’ complaints procedures are out of step with comparable procedures in the legal profession.’

A series of general concerns about the IP regulatory system had already been identified when, ten years into the current IP regulatory regime, the Insolvency Review Working Party (IRWP) issued a Consultation Document. Major worries were the absence of systematic external review of the IS as an authorising body and the absence of a greater degree of external involvement both in the writing and enforcement of rules and in monitoring the degree to which the authorising bodies act in the public interest. Other issues were the lack of flexibility, particularly on sanctioning techniques, found in the IS authorisation regime and the scope of the work covered by the regulatory regime. (The IRWP noted that questions had arisen concerning both the need for an IP to be in control of some matters that are regulated but are not insolvency matters and also whether some activities currently carried out by unregulated individuals – for example, non-administrative receivers – should be incorporated into the insolvency regime.) A further problem was said to be posed by unscrupulous ‘ambulance chasers’ who targeted persons in financial distress and provided them with poor advice at an extortionate price. The complex, fragmentary nature of the regulatory regime for IPs was also a concern as was the absence of a single regulator for an insolvency profession. A plurality of regulators leads, on some accounts, to confusion when members of the public seek the relevant complaints authority, to duplication of resources and to unnecessarily high costs as well as differences in regulatory style and inconsistencies of regulatory response. The ‘part-time’ nature of much IP work was another worry with the absence of a dedicated

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128 See ibid. The principles offered are proportionality, accountability, consistency, transparency and targeting.
129 Walters and Seneviratne, Complaints Handling, p. 79.
130 IRWP Review, p. 15.
131 Ibid., p. 15. A point echoed by Walters and Seneviratne, Complaints Handling, p. 79.
regulatory system under which only full-time professionals would be allowed to act. Final problem areas were identified in the liability of IPs to disciplinary action under two regimes – for example, as solicitor as well as IP – and the ‘practitioner-led’ nature of insolvency regulation.

Reforming IP regulation

Proposals for reforming IP regulation have ranged from the radical to the modest and the major options can be dealt with under four headings: insolvency as a discrete profession; an independent regulatory agency; departmental regulation; and fine-tuning profession-led regulation.¹³²

Insolvency as a discrete profession

It might be argued that many IPs engage in insolvency work as their primary role and that they should be controlled by a single professional body. Against such a suggestion, however, it can be said that the majority of IPs are in general practice as either accountants or lawyers and that there is benefit in having the relevant RPBs monitoring and regulating the full range of their members’ activities, not just insolvency; that the interweaving of insolvency and general practice work, notably the use, in insolvency work, of general practice infrastructures and staff support mechanisms, calls for such ‘full-range’ control.¹³³ In order to establish a discrete insolvency profession it would, moreover, be difficult to avoid demanding that all IPs be full-time insolvency workers. Such a requirement, it could be cautioned, would lead to a thinning of the ranks of IPs, a reduction in the breadth of experience of the average IP and an undesirable narrowing of the range of practitioners available to debtors, creditors or others. It is the part-time nature of much IP work, it can be said, that ensures that there are sufficient IPs in practice to meet demand when insolvency peaks and to offer choice to the public.¹³⁴

¹³² For proposals see IRWP Consultation Document; Justice, Insolvency Law; IRWP Review. Not under discussion here is a return to the pre-Cork world that placed unqualified debtor/creditor appointees in charge of insolvency processes, a position that the Cork Committee viewed as incapable of sustaining public confidence.

¹³³ The IRWP Review (p. 35) contends that co-operation with regulators is likely to be higher where regulation is by professional peer group rather than a body distanced from the home profession and that more rigorous regulation is likely to be provided by a peer group ‘with its own reputation and self-interest at stake’.

¹³⁴ See IRWP Consultation Document, p. 27.
Establishing an insolvency profession might thus enhance accountability in one respect and diminish it in another. It would provide one body to be held responsible for regulation in the sector and would offer a focus for public attention. It would, on the other hand, offer little assurance that the public interest was being considered more properly in self-regulatory decision- or policy-making than under the present system. It would, moreover, replace dual scrutiny (as IP and as accountant or lawyer) with single scrutiny by the insolvency regulatory agency. If there is seen to be value in having specialist scrutiny of work done qua accountant or lawyer during insolvency processes then abandoning dual scrutiny may materially weaken accountability in spite of the capacity of a specialised profession to develop particular expertise in insolvency work. Transparency of regulation might be expected to be unaffected by professionalising insolvency practice in itself though the consistency brought by a move to a single professional body could have some enhancing effect. As for efficiency and effectiveness, the move to a less flexible single profession might prove detrimental if a move to full-time professionalisation prejudiced the production of a cadre of qualified IPs from which clients could choose.

On balance, the enhanced focus offered by a single profession does not seem to compensate for the losses involved in such a reform, notably the ensuing narrowing of experience that would be offered by the average IP, the shrinking of the body of IPs and the loss of dual scrutiny.135

An independent regulatory agency

An alternative to the ‘single profession’ approach would be retention of dual controls (by the IP regulator and the ‘home’ RPB) but with IP regulation given over to a single independent agency. At present, insolvency practitioners (IPs) number around 1,700136 yet are regulated by eight recognised professional bodies (RPBs). It is not surprising, therefore, that calls for rationalisation are regular.137 More remarkable is how many professionals seem to accept the case for rationalisation. In the

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135 The IRWP Review (not unsurprisingly) also concluded that regulation through the present professional RPB should be retained (p. 36).
136 See note 30 above; Walters and Seneviratne, Complaints Handling.
137 See V. Finch, ‘Regulating Insolvency Practitioners: Rationalisation on the Agenda’ (2005) 18 Insolvency Intelligence 17.
autumn of 2004 an R3 survey of members revealed that 79 per cent of respondents believed that there should be a single regulator.\textsuperscript{138}

Why did nearly four out of five respondents favour a single regulator? The R3 returns suggest that what advocates of reform were looking for was an increase in the efficiency of regulation and an increase in fairness.\textsuperscript{139} What most of them did not favour was a shift from self-regulation to governmental regulation – 69 per centfavoured self-regulation and less than half thought that public perceptions of regulation would be improved by external regulation.

Other professions have been through the mill of regulatory reform and it is worth reviewing the case for a single IP regulatory agency in the context of other movements towards ‘single regulator’ regimes.\textsuperscript{140} The best known of these movements produced the Financial Services Authority (FSA) in November 2001 when it took over the functions of nine different regulatory bodies. More recently, there have been debates about the case for a single legal services regulator and the Clementi Report of 2004 reviewed a number of institutional reforms that ranged in radicalism and included a single regulator option.\textsuperscript{141}

In the financial services and legal sectors a number of concerns and rationales have underpinned debates about regulatory reform and it may be useful to assess whether these have resonance in insolvency. With regard to legal services it was argued at the time of the Clementi Review that seven concerns about the regulatory system provided a platform for reform.\textsuperscript{142} Those concerns related to, first, the complaints system, and in particular the failings of the solicitors’ complaints system. A second worry was a perception that self-regulation was suspect because it no longer commanded public confidence, or (on a harder-line view) because it was inherently flawed. A third issue concerned what has been dubbed ‘the regulatory maze’ – the institutional complexity of a regulatory system in which more than twenty regulators exercised a diversity of

\textsuperscript{138} See Verrill, ‘R3 Regulation Survey’, p. 27. (Though 59 per cent of R3 members stated that none of the existing regulatory bodies was best qualified for the role of single regulator.)

\textsuperscript{139} As noted, 57 per cent of respondents pointed to room for improvement on efficiency and 62 per cent on fairness: ibid.


sometimes overlapping regulatory functions. A fourth point that critics made was that the regulatory system left considerable areas of service provision uncontrolled – that there were ‘regulatory gaps’ that could prejudice consumer interests. A fifth issue was whether the regulatory system could cope with new ways of providing services, new business structures and multi-disciplinary partnerships, or whether it locked providers into old-fashioned structures. Accountability and transparency were a sixth anxiety and concerns centred on issues such as public involvement in regulatory decisions and policies and the adequacy of information flows for consumers. A final issue was the efficacy of various price control mechanisms and their effect in limiting the cost of legal services.

In the financial services sector, the drive towards control by a single regulator agency has been said to have centred around five failings of the pre-FSA regime. The first weakness was that, due to the changes in products, it had become difficult to regulate according to the function being carried out. This meant that the boundaries between regulators no longer reflected the economic reality of the industry. It was argued, secondly, that the proliferation of existing regulators (nine in number) did not achieve the economies of scale that were obtainable with a single regulator. Similarly, it was contended that economies of scope were not being achieved as a single regulator could deal with cross-sector issues more efficiently than a multiplicity of regulators. A fourth criticism of the pre-FSA regime was that it failed to offer a single, coherent regulatory approach or philosophy – one that might much more easily be provided

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144 In January 2006 the Law Society formally split into three distinct bodies, each with its own Chief Executive: the Law Society, the Legal Complaints Service (LCS) and the Solicitors Regulation Authority (SRA). The Legal Services Act 2007 set up the Office for Legal Complaints to administer an ombudsman scheme that will deal with all consumer complaints regarding legal services. The Legal Services Board was set up by the 2007 Act as a single independent oversight regulator with the responsibility of supervising approved regulators. For arguments that the RPBs controlling IPs should not combine regulatory and representative roles and that there should be a clearer distinction between the functions of R3 and the RPBs see G. Jones, ‘RPBs and Conflict’ (2007) Recovery (Spring) 3.
by a unitary regulator. Finally, as in legal services, it was argued that a multi-agency regime did not offer the levels of accountability and transparency that a single agency could develop.

In the insolvency context it is clear that a number of the above concerns have been voiced by various parties and that, on some fronts, responses are already being implemented. Thus, regulatory proliferation and institutional complexity are problems that have been acted on in so far as the Joint Insolvency Committee (JIC) and the Insolvency Practices Council (IPC) were put in place following the ‘Ten Years On’ review of insolvency regulation of 1998. These two bodies have taken numerous steps that are designed to encourage consistency of approach across regulators, to make regulation more efficient and to make regulatory processes simpler and speedier. Concerns about accountability and transparency have also been responded to in so far as the IPC offers increased public oversight of the profession. It remains the case, however, that R3 members and others are still worried about regulatory efficiency, fairness and complexity.

That said, the case for independent regulation seems to have little support among R3 members who, as noted, strongly endorse self-regulation and who doubt whether external regulation will improve the profession’s image. Here there seems a contrast with experience in the solicitors’ profession where, at least on complaints issues, many commentators and participants allege that in the years up to 2004 there was a collapse of confidence in self-regulation. It may well be the case that insolvency practitioners are prepared to argue that they have at no time suffered the kinds of attacks on self-regulation that solicitors have experienced during the last decade.

Might, however, a new insolvency regulatory agency produce a more efficient and coherent regulatory regime than alternative arrangements? On efficiency, it might be objected that creating an independent agency could increase regulatory costs for a number of reasons. First, the existing RPBs rely to a considerable extent on regulatory services that are

147 IRWP Consultation Document; see further Finch, ‘Insolvency Practitioners’. On the JIC see p. 185 above. The IPC was created in 2000 and comprises a team of five lay members and three professional advisers. It examines ethical and professional standards in the insolvency profession and puts proposals to the RPBs and, in so doing, meets with public interest groups and takes part in dialogues with the JIC, the IS, the RPBs and R3. Its chairman at the time of writing is Mr Geoffrey Fitchew.

148 See Finch, ‘Controlling the Insolvency Professionals’; Verrill, ‘R3 Regulation Survey’.

149 See Clementi Report, p. 2 and the consequent changes referred to above.
volunteered by members and the JIC operates, in turn, on the goodwill of the licensing bodies for staffing and accommodation. Such volunteered services are cost free to those involved in insolvency services. It is true that, at the end of the day, professional costs under such a system will be borne by the general users of accounting or legal services (many of whom will be subsidising insolvency regulatory work), but the effect is to produce low-cost controls that would be difficult to match in a fully costed, unsubsidised and independent regime.\(^{150}\) A second fear could be that a new independent agency might tend to put up costs by regulating in an excessively restrictive manner.\(^{151}\) Under the present system, the RPBs exert control with reference to the standards of acceptable professional conduct. These may be formulated in broad terms, non-legalistically.\(^{152}\) An independent regulator, exerting control not through professional codes and standards but through enforceable rules, is more likely to become enmeshed in legalism and the minutiae of compliance.\(^{153}\) The fear is that this would, again, tend to increase costs, would demand that IPs devote more time to compliance work and would be likely to reduce the general efficiency of insolvency regimes.

The responding argument is that a move from control by professional standards to control via rules could be expected to lead to greater transparency and increased assurance to the public and that this more than justifies the modest addition in costs that may be involved. It might also be contended that a dedicated agency would be better positioned to keep its eye on how IPs perform in relation to insolvency matters than would be the case with a professional body concerned also with a host of other affairs.

Turning to coherence, proponents of a single agency would argue that it is likely to be better placed than current regulators to develop a single, transparent and consistent set of regulatory policies and processes. In response, though, it might be replied that a single self-regulatory body might offer such coherence and openness and that rationalisations and harmonisations can provide these gains without losing the advantages of professionally based regulation. It has been contended, moreover (notably by the Chairman of the JIC),\(^{154}\) that the JIC benefits from the diverse backgrounds of the licensing bodies, as it can draw on their experience in

\(^{150}\) This is not to say that ending such subsidies might not prove attractive to some members.


\(^{153}\) Ibid.

other regulated areas, that the successful innovations (as well as the pitfalls) that have been experienced in other areas can be learned from, and that such cross-fertilisation would not be available with one regulator.

Would accountability and fairness be enhanced by a single independent regulator? An independent regulatory agency might, on the one hand, be seen as ‘another unelected quango’ but it would be accountable by the usual methods to ministers, to Parliament and its select committees, to consumer representative organisations and, through disclosures, to the public more generally. It would thus be more accountable on a broad basis than a self-regulatory body answering only to its membership. An independent regulator would not offer the same degree of accountability as a departmental regulator headed by a minister (who would answer directly to Parliament) but there is a case for establishing regulation at a distance from the Government since the latter may be involved in insolvency as a creditor. Fairness would for this reason be better furthered by an independent rather than a departmental regulator.

Fairness might also be served in so far as a single independent regulator might be perceived as holding the ring more evenly both between different regulated practitioners and between practitioners and their clients or the public. Here it should be noted that fairness may be a particular concern in insolvency processes: first, because a variety of interests have to be served in particularly difficult circumstances; and, second, because many insolvency processes involve a public interest which merits fair treatment like any other.155

It could be argued that fairness might be served by institutional steps short of establishing an independent regulatory agency. An insolvency ombudsman might play an important role in ensuring that parties involved in insolvency are treated fairly and without maladministration.156 The case for such a body will be returned to below but it should be noted at this stage that arguments for an ombudsman may apply to independent and departmental as well as to self-regulatory systems. The rationale for an independent agency is not weakened, in turn, by any assumption concerning the establishing of an ombudsman, since the need for fairness is applied across ‘first instance’ insolvency processes independently of any machinery for redress that is created.

To summarise, the case for an independent regulator is largely based on its potential to produce improvements in coherence, clarity,

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155 See Finch, ‘Controlling the Insolvency Professionals’.
156 See Justice, *Insolvency Law*, para. 5.19.
consistency and fairness. Significant questions arise, however, concerning its added cost and potential to result in more legalistic, narrower and more restrictive regulation than is optimal.

**Departmental regulation**

The regulation of IPs might be given over completely to the IS of the BERR with the RPBs relinquishing their supervisory role.\(^{157}\) In terms of accountability, this could be claimed to offer an improved arrangement. At present, the chief executive of the IS (the Inspector General) is responsible for the day-to-day operations of the service. The minister for Employment Relations and Postal Affairs sets the IS a number of published targets and performance against these is monitored by the IS’s Steering and Directing Boards. Members of Parliament can write to the Inspector General of the IS on operational issues and the Inspector General is accountable to, and reports to, the BERR ministers on the progress and performance of the IS with regard to its performance targets\(^ {158}\) and the IS, in addition, acts in pursuit of the standards set down under the Insolvency Service Charter.\(^ {159}\) Work targets, and figures representing the extent to which these are achieved, are published by the IS in its Annual Reports.\(^ {160}\) The Parliamentary Commissioner for Administration (PCA) also has the right to investigate and report on the actions of the IS (though functions of Official Receivers as officers of the court are beyond PCA jurisdiction). Such mechanisms might not offer an unquestionably satisfactory regime of accountability\(^ {161}\) but they offer more democratic input (via ministers) than is available with RPBs and they manifest a commitment to the public interest.

\(^{157}\) Not under discussion here is a system in which all IPs would be civil servants provided and authorised by BERR. Such a regime would constitute nationalisation of the private practitioner-led machinery now encountered and is unlikely to appeal to the major political parties. Departmental provision of all IPs would give rise to difficulties (notably the BERR’s ability to meet variation in demand for such services – a capacity offered by the private marketplace that would be hard to match) even if costs were passed onto users of insolvency services.


\(^{160}\) See, for example, the Annual Report 2007/8.

Like the proposal for independent agency regulation, departmental control offers a unified scheme able to formulate, and work to, a single set of objectives but it is open to the same objections concerning duplications of jurisdictions, costs and jeopardy. As for expertise, the IS, unlike a new agency, would be able to draw on over a decade of experience in the field (though both would be able to buy in expertise from the body of existing specialists).

Departmental regulation may address public interest concerns more openly than resort to a mixture of private RPBs but, as noted above, a departmental system does not offer the same impartiality as an independent agency. The bias that outsiders may fear when viewing a departmental regime is that of leaning towards the preferences of the Government in power. In some regulated sectors where valuable franchises or contracts are handed out this may be a special concern.\textsuperscript{162} Insolvency regulation involves no allocation of such valuables but it usually demands that assets be distributed and government departments, moreover, may be involved as creditors of firms or individuals involved in an insolvency or bankruptcy. It is important, therefore, that IPs should be seen to be acting in a professionally independent manner, free from conflicts of interest.\textsuperscript{163} Overall, then, departmental regulation rates generally lower than independent regulation as far as perceived fairness is concerned.

\textit{Fine-tuning profession-led regulation}

The IP regulatory regime now in operation incorporates a large element of self-regulation in so far as most IPs are members of the RPB that supervises them (albeit under IS oversight). Self-regulatory regimes, in general, are said to possess a number of virtues:\textsuperscript{164} those regulating tend to be specialists in the relevant area; they have excellent access to information at low cost and are in constant touch with developments in the profession; they know which regulatory demands will be seen as reasonable and liable to be complied with readily; they can monitor behaviour easily and in a variety of ways; they tend to know ‘where the bodies are buried’; and they can investigate matters in a less formal way than external regulators. They can, furthermore, employ general

\textsuperscript{162} As, for example, in the television, radio or rail sectors.

\textsuperscript{163} See Anderson, ‘Insolvency Practitioners’; Lightman, ‘Office Holders’.

\textsuperscript{164} See p. 199 above.
professional standards and requirements to achieve results and influence cultures rather than rely on enforcing detailed rules;\textsuperscript{165} they are financed by practitioners; and they are highly adaptable to changes in the economic, legal and social environments.

Such claims can be made in various forms and with different degrees of conviction for the current IP regulation regime and, rather than move to radical change, it may be preferable to fine-tune that regime. It is worth considering five main suggestions. The first of these is that the existing regulatory bodies should be further co-ordinated, rationalised or amalgamated.

Numerous commentators, including Phil Wallace, Chairman of the IPC Committee at the ICAEW,\textsuperscript{166} have argued that eight RPBs is too many for the number of IPs (currently 1,700). Here there seems a strong \textit{prima facie} case for reform and a first question is whether amalgamation of RPBs can be accomplished so as to offer a simpler structure, but one that retains some of the advantages of diversity in ‘home background’. A second issue is whether amalgamations short of establishing a single self-regulatory body would produce a coherence of policy and a consistency of process that outweighs the supposed advantages of diversity. A further key issue is whether public participation in processes and policies can be ensured at sufficient levels to ensure public confidence in the self-regulatory system.

On current co-ordination, it has been noted above that the RPBs already do co-ordinate in a number of respects. They are bound, for example, by a memorandum of understanding with the Secretary of State and they operate with a Joint Insolvency Examination Board. To continue with the present regime and encourage further emphasis on co-operation and consistency (for instance, by making joint insolvency monitoring mandatory across RPB- and IS-authorised IPs) would require no new structures and would offer dual control by ensuring that lawyer and accountant IPs would remain regulated both as IPs and as lawyers or accountants (such control being beneficial where it is difficult to tease apart IP and home professional work).


\textsuperscript{166} See ‘Regulatory Harmonisation’.
It may be argued that co-ordination would still leave too many authorising bodies for under 2,000 IPs; that this would be both inefficient and confusing to the general public or affected parties who may have a complaint about an IP and who would be uncertain about where to pursue this. The inefficiency point, as already noted, however, may be overstated, since it may be efficient to build on existing professional mechanisms for such a small number of IPs rather than to set up new regimes. Complaints issues, moreover, may be addressed by combining a co-ordination strategy for regulation with a unification policy for complaints: by establishing, for example, an Insolvency Ombudsman (a proposal returned to below).

Rationalisations and amalgamations might be employed to reduce the number of RPBs or to create a unified system without resort to an independent regulatory agency. The broad difficulty with both strategies is that, whereas control via existing professional bodies reduces potential ‘problems’ of dual discipline and double jeopardy, strategies of rationalisation and amalgamation introduce this issue in a new form. This point is, however, turned on its head if dual discipline is seen as a virtue. Less contentious is the suggestion that dealing with questions of dual control is liable to increase overall regulatory costs.

One means of amalgamating would be to establish a single sub-contracted body by agreement between the authorising bodies and to delegate functions of monitoring to this while retaining the responsibility for disciplining and sanctioning IPs in the home professions. As the Consultation Document notes, however,167 an agreement would give rise to potential confusions and conflicts of functions and responsibilities. It would also court the danger of confusing lines of accountability. At present the RPBs are overseen by the Secretary of State. Establishing a sub-contracted body under the umbrella of the authorising bodies would mean that individual RPBs would not exercise control over it and the Secretary of State’s monitoring would be placed at a further distance.

A second way to improve the current regime would be to harness the monitoring capacity of the accountancy or solicitors’ firm and to authorise firms as well as individuals as IPs. One advantage would be that transfers of work between different IPs might be made administratively simpler and cheaper. It could also be said that clients tend to see themselves as dealing with firms, not individuals, and to see responsibility for good or poor performance as attaching to the firm. The reality

167 IRWP Consultation Document, p. 29.
of much IP work, moreover, is that the IP uses the resources of the home firm, that the efficiency or otherwise of the insolvency work done may depend as much on the general professional performance of the firm and its employees as on the activities of the relevant individual. Regulating the firm would make it explicit that the support structure and internal controls of the firm are essential to the work of the IP and themselves require regulation.\textsuperscript{168}

To regulate firms expressly would give them an incentive to ensure that their IPs operate to high standards. The firms, moreover, are far better placed than the RPBs or any external regulators to gain information on how IPs are doing their job, to review performance periodically and to remedy or sanction instances of under-performance. To attach IP functions to firms would mean that any qualified IP within the firms might carry out insolvency functions. This might involve some loss of personalisation within insolvency processes, since there would be no guarantee that individual X (rather than firm Y) would carry out the functions at issue. A move to regulate at firm level would, however, improve scrutiny of the context within which IPs operate and would do so without removing responsibility from the individual IP.

A third proposed improvement to the present machinery (and, as noted, a potential addition to a ‘single regulator’ or a departmental regime) would involve the establishment of an Insolvency Ombudsman. This idea has been put forward by a number of parties, including the Cork Committee and Justice.\textsuperscript{169} An Ombudsman would handle complaints relating to individual cases rather than deal with general issues and the ombudsman process would only come into play after other alternative routes were exhausted (at present each RPB has its own complaints procedure). The Ombudsman might take a variety of different actions, including requiring organisations to correct matters, referring issues back to an organisation for reconsideration, facilitating conciliation between parties and making awards.

Creating an Ombudsman would offer a central location for complaints and a better and simpler public profile for insolvency complaints mechanisms. Establishing such a post has, however, been opposed by

\textsuperscript{168} Ibid., p. 19.
\textsuperscript{169} See Cork Report, paras. 1772–3; Justice, \textit{Insolvency Law}, p. 25. Ombudsmen are now found in other professional fields. Thus, for example, there is a Legal Services Ombudsman as well as Ombudsmen in the insurance/unit trust, banking, building society and pension sectors. See R. James, \textit{Private Ombudsmen and Public Law} (Ashgate, Dartmouth, 1997).
the IRWP on the grounds that it is doubtful whether an extra tier of complaints procedure is needed when, at present, all RPBs already operate mechanisms; that the extra costs involved might be considerable and would have to be borne by those affected by insolvency; that delays could be caused since such an Ombudsman might have a heavy workload and office holders might not be able to complete the insolvency procedure until the complaint has been finally resolved; and finally that an ‘expectations gap’ might be created in so far as affected parties might anticipate the provision of effective remedies and do so in an unrealistic manner. The IRWP also doubted whether the Ombudsman device could readily be applied in the insolvency area where there was the absence of a customer or client relationship.

The last two of the above arguments may be the weakest: the possibility of an expectations gap would, on such an approach, remove the case for most systems of scrutiny, review or appeal yet there may be real value in many instances in providing a means of scrutinising the propriety and efficiency of administrative processes, especially where there are likely to be parties dissatisfied with the substantive outcomes of decisions. Nor is it clear why the value of an Ombudsman depends on the existence of a client relationship. Provided that aggrieved parties can be identified, the Ombudsman will have a role in investigating maladministration.

The value of a new complaints system would lie in the handling of complaints outside the RPBs. At present some RPB complaints mechanisms involve reference to independent assessors who scrutinise the handling and determination of complaints, but not all do so. (Even if a separate Ombudsman is not established, each authorising body should be compelled to operate a mechanism in which either complaints are decided by independent assessors or complaints decisions are reviewed by such assessors.) An Ombudsman might also, however, take a broader view of the insolvency process than a body focusing on the behaviour of a particular member practitioner. In insolvency proceedings there is a lack of a speedy and cheap way for a creditor or group of creditors to challenge the conduct of an IP, and the position of a debtor is

even weaker. Matters can be raised by a multiplicity of routes: through the courts under the Insolvency Act 1986 or by resort to the relevant professional body. A host of parties may also be involved: solicitors, estate agents, accountants and other advisers. To make the services of an Ombudsman available to creditors and debtors or other aggrieved parties would provide a mechanism for cutting through such complexities and for appraising the respective responsibilities and performances of a range of professionals in a way not linked to a particular RPB’s perspective. Such an Ombudsman might also be given a general power to make (non-binding) recommendations to the Secretary of State on issues relating to insolvency processes.

A fourth reform that is consistent with both the retention of self-regulation and improved accountability would involve establishing a new independent oversight body, but leaving the RPBs to regulate. At present there is a limited form of oversight offered by the Insolvency Practices Council (IPC). This body comprises a majority of lay members and exercises a number of functions: it keeps under review the appropriateness of IPs’ professional and ethical standards; puts proposals to the bodies devising professional and ethical standards for IPs; recommends issues to those bodies for consideration; and considers whether standards, once adopted, are properly observed and enforced.

The IPC’s first chair was appointed in December 1999 and it came into being in the spring of 2000. The IPC is not designed to operate independently of the existing regulatory regime but to be a body linked to present mechanisms. The IRWP Review rejected the notion of setting up an ‘overriding body’ to oversee current structures. It did so on the grounds that the IS offers public accountability through its link to

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175 See *inter alia* Insolvency Act 1986 s. 6; Sch. B1, paras. 74, 75.
176 The legal and the accountancy professions offer examples of recent movements towards independent oversight. The Legal Services Board was set up by the Legal Services Act 2007 as an independent oversight agency and the Accountancy Foundation was set up in 2002 as an independent regulator of the accountancy profession. The Foundation’s functions are now carried out by the Professional Oversight Board (POB), a part of the Financial Reporting Council. (The POB exercises powers delegated by the Secretary of State under Pt 11 of the Companies Act 1989 in accordance with the Companies Act 1989 s. 46: see Companies Act 2006, Pt 42, s. 1252.)
177 On the origins of the IPC see IRWP Consultation Document.
178 The IPC is made up of an independent chairman with five lay members to provide a majority and three IPs: see p. 206 above.
the Secretary of State and through its role in overseeing the RPBs: ‘it would not be a sensible task for any new body, set up to reflect the public interest in insolvency regulation, to second guess what the DTI and the IS are already doing’.\(^{180}\)

The Review also recommended that the IS should be released, so far as possible, from the duty it has to monitor practitioners directly authorised by the Secretary of State ‘so that it can concentrate wholly on its high level function as a regulator of regulators’.\(^{181}\)

Such proposals, however, seem strongly to have reflected the hold that current institutional arrangements had on IRWP affections and, again, fail wholly to convince. The public input being proposed is as modest as it is possible to imagine. The IPC does not draft standards, it merely makes suggestions to R3, which will continue with the drafting of standards. Indeed, the Review specified that the IPC’s remit ‘would not extend to the operational activities or responsibilities’ of RPBs or the IS.\(^{182}\)

The IRWP’s opposition to a more powerful, more independent insolvency oversight board was based on the view that such an accountability mechanism would ‘obscure’\(^{183}\) the ministerial accountability to Parliament that operated via the IS. The Review did, however, concede that the (proposed) IPC:

would be a more appropriate forum for continuing interface with the general public than the Service can be … At present when the IS reacts to concerns from the general public … [i]t does so as part of what might be termed the ‘ministerial post bag’ process. The new Council, by contrast, would provide a dedicated (and a visible) contact point for raising such concerns.\(^{184}\)

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\(^{180}\) Ibid., p. 43.  
\(^{181}\) Ibid., p. 7.  
\(^{182}\) Ibid., p. 48. See Sikka, ‘Turkeys Don’t Vote for Christmas’, p. 7, who comments: ‘The IPC will, however, be a toothless tiger unable to intervene in any specific or live case … [T]he IRWP proposals would not dampen down public anxieties about self regulation, insolvency practices, the absence of an Ombudsman or a compensation scheme.’ There is evidence, however, that the IPC will go public in attacking malpractice and tackling issues of creditor and public concern. The IPC’s Annual Reports of 2004, 2005 and 2006, for example, expressed strong concern about possible misselling of IVAs to debtors on low incomes and made various recommendations to IPs. The 2006 Annual Report also focused on concerns in the corporate insolvency sector regarding the growth of ‘pre-packs’ (see ch. 10 below) and regarding cutbacks in the work of the IS in investigating the reports made by IPs on the conduct of directors of insolvent companies (see ch. 16 below). The IPC’s Annual Report 2000 stated, however, that the IPC was ‘not an Ombudsman’, it could not adjudicate on individual cases, but it was ‘anxious to learn about general areas of concern’ (p. 2).

\(^{183}\) IRWP Review, p. 50.  
\(^{184}\) Ibid., p. 49.
Such an awareness of the failings of accountability through the IS and the minister might have led the IRWP to the view that a focused, independent oversight board might have a role to play in supplementing any accountability through the IS, but unfortunately it did not.

There is, it seems, a case for an independent Insolvency Review Board that would exercise oversight of the overarching kind that the IRWP rejected. Such a board would be independent of the RPBs and the IS and would identify areas where, in the public interest, standards and guidance should be produced, modified or enhanced; provide an interface with the public; publish an Annual Report to the Secretary of State and the RPBs; and offer a forum for constant review of the insolvency regulatory system. It would provide a visible contact point for the voicing of public concerns. It might be objected that the co-ordinating role of such a body can be fulfilled by the JIC and IPC and so it would have no purpose. What this option would, however, offer is an added element of accountability through the independence of its supervision. It might also resolve the difficulty that the Insolvency Service both regulates some practitioners and also acts in some ways as a ‘regulator of regulators’. Independent oversight would allow these functions to be teased apart and would strengthen public input into standard-setting which is currently vulnerable to accusations of weakness. The Board would not become involved in complaints handling in relation to individual cases. It would be IP-funded and its members might come from consumer groups, professional organisations, employee, business and management groups and the judiciary. They should have an understanding of insolvency but only a small minority (if any) should be IPs.

A special reason for establishing such a board is the fragmented nature of existing responsibility for insolvency procedures. The BERR has the major responsibility now but that Department is ill-positioned to take a detached view of the area since it is routinely involved in many aspects of procedures. There is also some diffusion of responsibility between the BERR, the Department for Constitutional Affairs and other government departments (for example, where particular issues such as the family home or the employment implications of insolvency processes are raised). An Insolvency Review Board would have broad strategic relevance and offer a level of policy co-ordination that is at present lacking. Insolvency is an area peculiarly marked out by fragmented responsibility and diversity of inputs: therein lies the special case for a co-ordinating

185 See Justice, Insolvency Law, p. 28.
body. The argument for such an institution seems strong in all scenarios of reform, except, perhaps, those involving the setting up of an independent regulatory agency for insolvency which could carry out such functions as might be allocated to an Insolvency Review Board.\(^{186}\)

In order to counter the case for an IRB, the existing regulators might have to show that the present structure provides sufficient public oversight into the profession. It might also be necessary to establish that there is, in the insolvency field, no tension between regulatory and representative functions as is allegedly encountered in legal services regulation. That said, it can be noted that concerns about complaints and fairness have not been shown to be as acute in the insolvency arena as in the legal services field and, accordingly, there may be a lesser onus to improve external supervision.

A fifth proposal for reform is precautionary rather than remedial in nature and stems from the Select Committee on Social Security’s report of 1993 on the work of the Maxwell insolvency practitioners.\(^{187}\) The suggestion is that there should be a system of independent monitoring of the progress of all insolvencies over a certain value. When originally made, the proposal met with a cool response from the Conservative Government,\(^{188}\) which argued that the task of monitoring insolvency processes should be left with creditors since it was their interests that were paramount; that it was unclear that independent monitoring would add significantly to creditors’ efforts; and that the Government was not disposed to increase the costs associated with insolvency by instituting additional regulation. The counter-view, however, is that creditors cannot be assumed always to be sufficiently well informed, expert and well placed to be entrusted with protecting public and private interests in insolvency processes and that, even if creditors were well informed, expert and well placed, their commitment to protecting the broad public, as opposed to their own private, interests could by no means be taken for granted. Such involvement of the public interest is likely to occur in very large cases of insolvency – as the Maxwell episode demonstrated – and there seems a strong case for allocating a monitoring task in these cases to an Insolvency Ombudsman or an Insolvency Review Board, as discussed below.

To summarise, there are a number of ways in which the accountability of IPs might be improved. Persuasive arguments, for instance, point towards

\(^{186}\) On the case for an independent regulatory agency to replace the RPBs and the IS, see Finch, ‘Insolvency Practitioners’, pp. 343–4.

\(^{187}\) See Justice, Insolvency Law, p. 8.

\(^{188}\) For the Government response to the Report see Cm 2415, 1993.
the increased external scrutiny that an Ombudsman or Insolvency Review Board would bring. The case for radical institutional reform in the shape of a new regulatory agency, a new discrete profession or an expanded and exclusive role for the IS, seems, in contrast, not to be made out.

Accountability can also be developed through open and accessible processes. An important question, therefore, is whether the procedures adopted by IPs are transparent and amenable to inputs from affected parties. Those procedures will be dealt with in later chapters and, accordingly, will not be reviewed here. What should be considered at this point, however, is whether IPs are, because of their institutional make-up, predisposed to encourage or obstruct accessibility and transparency. On this point it can be argued that professionals, at least when they act for a client, tend to put client interests before accessibility or transparency, and, in doing so, will rapidly take refuge behind professional status, knowledge and expertise. When IPs act as receivers for debenture holders, for instance, there is evidence that they are slow to volunteer information to other parties (who might reduce the insolvency fund available for the client or for fee payment) and that they may exploit their positions or expertise and knowledge by deliberately ‘muddying the waters’.189 Within the different context of liquidation – where the IP owes duties to all creditors – there tends to be a relatively greater degree of openness and willingness to impart information.190 Even in liquidation procedures, however, institutional factors may lead to a lack of transparency and poor access. Thus, it has been argued that IPs have been strongly concerned, in the 1980s and 1990s, to build up their professional status and that, if creditors’ meetings in insolvent liquidation are observed: ‘What is revealed is that IPs, as an emerging professional group, use the meeting space to establish, within their own group, power and territory and that creditors, in whose interests the meeting is being held, are, in fact, marginalised and relegated to the role of audience.’191 Trade creditors, it is argued, are likely to be particularly disadvantaged as IPs tend, at such meetings, to direct their comments

189 See Wheeler, Reservation of Title Clauses, p. 107; see also ibid., pp. 65, 89–90. Again note must be taken of the Enterprise Act 2002 and the substantial replacement of administrative receivership with administration – the collective orientation of which might be expected to shift IPs towards a more inclusive approach to their functions than is seen in their stances as portrayed in Wheeler’s work.

190 Ibid., p. 76.

towards fellow professionals (often IPs representing large creditors). The trade creditors become ‘largely a silent observing body only’ and cannot participate in any active sense. Overall the creditors’ meeting can be seen as a series of ‘almost private exchanges between the dominant professional actors’. The tendency to exclude ‘outsiders’ was noted above in outlining common criticism of self-regulatory mechanisms, and here we find echoes in Wheeler’s account of the IPs’ work at the creditors’ meeting. It reinforces the fear that where professionals are involved with non-experts and non-repeat players, there is unlikely to be transparency and wide accessibility.

Conclusions on insolvency practitioners

Could greater efficiency, expertise, fairness and accountability be achieved by turning away from professional self-regulation and implementing insolvency laws through other mechanisms? Few would argue for a move back to the pre-Cork era in which any person, whether qualified or not, could be appointed as a receiver or liquidator. Implementation through a cadre of court officials or specialist civil servants might, however, be considered. It should be borne in mind that:

The institutional locus of [insolvency] work has substantial concern for all parties. It determines the relative weight of public and private interests. It affects what motivations underlie the behaviour of professionals … how insulated will be the market from governmental intervention and what mechanisms, such as inspection or self-regulation, governments will initiate or support in order to ensure a public or political interest is served.

The professional or disciplinary bases of those applying insolvency laws can, in turn, shape processes so that different knowledge bases, perceptual frameworks and bodies of expertise define and construct the issues and machineries of insolvency in different ways. They also ‘locate the solution to the problem in different institutional sites’. If, for example, lawyers play a central role in insolvency processes, proceedings are likely to take place in judicial or quasi-judicial settings in an adversarial fashion. Such processes may place a strong emphasis on fairness but they are likely to be expensive and time-consuming. In contrast, less adversarial procedures conducted by specialist civil servants may be cheaper

and swifter but are more likely to be tainted by perceptions that political influences, biases or unfairnesses have intruded.

It has been seen above that present arrangements are open to attack on a number of fronts but resort to court officials or civil servants would bring difficulties too. In both cases it would be necessary to use bodies of highly specialised officials and these ‘quasi-professionals’ might be as prone to exclude outsiders from insolvency processes as any current professionals. Court servants would be reached through judicial processes and dangers of legalism might attach to their use. Civil servants within a specialised unit might well be thought by the public to be susceptible to governmental influence unless their unit or agency was placed at a remove from the minister. Lack of accountability would then be a charge liable to be made. In the case of both sets of public officials, there would be concerns about their lack of business experience and their narrowness of professional background. In the case of current private practitioner IPs, it can be argued, first, that they offer a choice of professional background and, second, that there is value in having IPs with the breadth of training and experience in the private business sector that use of private professionals brings.

In conclusion, then, there seems to be no strong case for replacing private, professional IPs with public officials, of one kind or another, as the main implementers of insolvency procedures. There are, however, good reasons for tightening the mechanisms whereby IPs are regulated, and a number of valuable reforms have been considered above. Not least of these are the proposals to rethink the duties of IPs to the broad array of interests involved in insolvencies and to subject the current IP regulatory regime to more stringently independent oversight. The framework of laws that governs insolvency is of considerable importance but equal attention should be paid to those who shape the application of those laws.

**Turnaround professionals**

It could be argued that, without the need for any legal changes, another type of actor is, at least partially, replacing the IP as a proponent of insolvency work. The following chapters on corporate rescue will describe how the last decade has seen a shifting in the focal point of corporate rescue work. That period has seen a new emphasis on seeking to effect turnarounds in the fortunes of troubled companies – and doing so at a stage before formal insolvency procedures come into play.\(^{199}\) This

\(^{199}\) This section draws on Finch, ‘Doctoring in the Shadows of Insolvency’.
change of focus has brought a burgeoning group of new actors onto the
scene. These are the individuals and organisations that assist banks and
companies in effecting pre-insolvency turnarounds. They come with a
variety of labels, notably: turnaround professionals, company doctors,
business recovery specialists, interim turnaround executives, risk con-
sultants, solutions providers, independent business reviewers, asset-
based lenders, private equity providers, debt management companies,
credit advisers and insurers, and cash-flow managers.200

When, however, more and more work for distressed companies is
carried out in this pre-insolvency or ‘twilight’ zone,201 issues are raised
about the growing role that is being played by the turnaround profes-
sionals. Does the use of such specialists actually produce processes that
are more rescue-friendly? Are these persons qualified experts who are
properly accountable? Do their interventions raise questions of fairness
between creditors?

The Cork Report cautioned that if those who administer insolvency
systems do not have the confidence and respect, not only of the courts
and of creditors and debtors but also of the general public, then ‘com-
plaints will multiply and, if remedial action is not taken, the system will
fall into disrepute and disuse’.202 These comments were directed at those
who administered formal insolvency procedures but similar concerns
might be voiced about turnaround specialists because these actors, like
IPs, play key roles in rescue processes and, like IPs, may be instrumental
in putting into effect business solutions that impact on the interests of a
host of creditors and other stakeholders.

The efficiency and accountability of the turnaround
professional system

Are TPs subject to a control regime that is efficient and that is ac-count-
able? In formal terms, it is difficult to argue that the TP regime con-
stitutes an efficient quality control mechanism to the same degree as the

200 See D. MacDonald, ‘Turnaround Finance’ (2002) Recovery (Winter) 17; R. Bingham,
Turnaround Practitioner - Advisor or Director?’ (2002) 18 IL&P 3. On the role of
credit insurers in turnaround see G. Jones, ‘Credit Insurance: A Question of Support’

201 See D. Milman, ‘Strategies for Regulating Managerial Performance in the Twilight

IP system (a matter to be returned to in the discussion of expertise below). Could it be contended, however, that the TP system is efficient since TPs’ activities contribute to the delivery of lowest-cost rescues? On this point, what is hard to deny is that TPs offer a range of services that are rescue relevant. The market, moreover, has clearly encouraged the development of a group of specialists that offer a wide variety of rescue services. It is, though, difficult to quantify the contribution of TPs to rescue and there are a number of reasons why this is so. First, a number of factors may have an effect on both the incidence of rescue attempts and the success or otherwise of such attempts. Assessing, for instance, the degree to which any particular development – such as the advent of the new cadre of turnaround professional – has impacted on rescue is impossible. Other relevant developments include the Enterprise Act 2002’s reforms relating to administrative receivership and administration, the Government’s newly invigorated espousal of rescue and the major lenders’ revised approaches to rescue.\textsuperscript{203} Statistics on overall numbers of corporate liquidations or of rescues, accordingly, would tell us little about the value of the turnaround professional – there are too many possible (and interlinked) drivers of rescue attempts as well as of success or failure. Second, there is an absence of statistical data on the extent to which TPs’ interventions produce successful rescues. There is, moreover, likely to be a continuing paucity of such data – and again for good reasons. What constitutes a ‘rescue’ is hard to define, even when referring to formal, statutory rescue processes.\textsuperscript{204} In relation to such processes a rescue can be thought of as a major intervention necessary to avert eventual failure of the company.\textsuperscript{205} Characterising a formal rescue as successful raises a host of further issues, notably: for which parties is the rescue a success?\textsuperscript{206} Is rescue of the company or rescue of the business what matters? Is the true measure of rescue the protection of employment or creditor value? How much downsizing or reorganisation constitutes failure?

When the focus is on turnaround activities, however, the difficulty of drawing a boundary line around ‘rescue’ services is yet more extreme. No longer is the focus on major actions that are taken to avert a failure that is

\textsuperscript{203} See chs. 6–12 below.
\textsuperscript{204} See e.g. A. Belcher, Corporate Rescue (Sweet & Maxwell, London, 1997) p. 12; and ch. 6 below.
\textsuperscript{205} See Belcher, Corporate Rescue.
\textsuperscript{206} On stakeholders’ divergent views on the objectives of rescue see J. Roome, ‘The Unwelcome Guest’ (2004) Recovery (Summer) 30 and see further ch. 7 below.
clearly identifiable and seen to be approaching. Turnaround professionals may assist companies in meeting challenges when those companies are in states ranging from relative health to absolute crisis. The essence of beneficial turnaround activity, moreover, is widely argued to be early intervention – and certainly action at a stage in corporate troubles that is early enough to prevent these from becoming chronic.\(^\text{207}\)

The most successful ‘rescues’, accordingly, are likely to be those that are at no time ever labelled as ‘rescues’ – that is in the nature of preventative activity.

It might be responded that some statistics could be collected on such matters as the number of bank-induced referrals to turnaround specialists and the proportion of these that lead into formal insolvency procedures. Again, however, there would be difficulties in defining what constitutes such a referral. If, for instance, a bank recommended to a debtor company that it sought advice from a risk consultant or a solutions provider, would this be counted as a rescue-relevant referral? It might be suggested that a referral might be categorised as a ‘rescue-referral’ if it is made when the company is in a state of ‘near insolvency’ or ‘acute crisis’ but these terms lack precise meaning and it is to be repeated that much of the preventative work of turnaround professionals is likely to be done before companies reach such desperate straits.

What can be offered as an indication of the contribution of turnaround specialists to rescue is an account of the services that these professionals bring to the rescue party and which conduce to rescue. The list is impressive and includes: conducting independent business reviews (IBRs); carrying out external reviews of managerial performance; advising on financial, operational and managerial restructurings; devising financial plans; arranging the provision of new funds; providing new managerial skills; planning strategic realignments; implementing cash flow management systems and negotiating with customers, suppliers and other stakeholders.\(^\text{208}\)

What, it might be posited, is added by using turnaround professionals to provide the above services? Surely these are all functions that have been and could be carried out by companies on the advice of their major creditors? The turnaround professionals, however, would argue, first, that niche specialists, in such matters as refinancing, are able to develop


a higher level of skill and a more extensive list of contacts than generalists. Second, they would point to the benefits of using professionals that are independent of the major creditors. Such independence may mean that the troubled company’s directors are less threatened by turnaround specialists than by creditors’ staff and are thus liable to be more co-operative. Turnaround professionals, for their part, are increasingly inclined to work alongside existing managers and to improve the performance of those who are already in place. As the Chief Executive Officer of the Society of Turnaround Professionals (STP – now IFT), Nick Ferguson, has put it: ‘There has been a tendency to dispense with the existing management of a troubled company but people now recognise that it is worth trying to keep them, to hold their hand and to mentor them.’

On the accountability of TPs, it can be argued that this tends to be modest in the absence of statutory controls and because a high premium is placed on the independence of these specialists. Independence encourages a level of trust, especially in the minds of those less committed creditors whose co-operation may be needed in order to effect a rescue. This allows for more effective negotiations on rescue proposals; it means that business reviews carry an authority that might not be present if they had been carried out by previously involved parties; it allows more objectivity in analyses of managerial capacities and it provides a fresh perspective on the company and its problems. From the point of view of the troubled company’s directors, a degree of trust in an independent TP may concentrate the mind wonderfully. It will often be the case that the need for urgent action within the company is only accepted when that necessity is hammered home by an authoritative and independent outsider.

Independence also encourages the development of a cadre of professionals who are specialists in gaining trust and co-operation through effective facilitation. A senior manager of a credit insurer made the point thus:

The key is how to build trust between stakeholders that allows them to discuss confidently more creative and supportive options that might save

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209 N. Ferguson, ‘Advice Squad’ (2005) Director (April) 31. The STP was renamed the Institute for Turnaround (IFT) in June 2008. Another turnaround specialist typified the relationship with existing directors: ‘I work with incumbent management rather than threaten their future’: see C. Wray, ‘A Day in the Life of a Company Doctor’ (2002) Recovery (September) 51. It is likely that the directors of a troubled company will feel more comfortable with an informal turnaround procedure than a formal rescue procedure which removes them from office.
some corporate lives … There is also a key role for highly skilled facilitators here. Neither the banks nor credit insurers have the resources to spend weeks investigating, planning a strategy and then enforcing that strategy. Company doctors and, increasingly, the Big Four accountancy firms are becoming interested in this role. The beauty of it is that the ‘independent’ facilitator can engage all the key stakeholders and bridge the gap of trust between the banks and insurers.210

A further advantage of independent facilitation is that this provides an often urgently needed boost to information flows within the troubled company. Establishing such information provision is seen by many as a central contribution that the TP can make. One highly experienced TP put it: ‘You need great communication skills because usually it is communication that has fallen apart in the company and people aren’t telling anyone anything because they are too scared or too busy.’211 He added that, in many troubled companies, the existing directors (or some of them) often knew what had to be done to effect a turnaround but it required the input of a TP to allow the necessary messages to strike home and cause action within the company.

It might be contended, however, that it is easy to overstate the independence of turnaround specialists. In most cases, TPs are hired at the prompting of the banks212 and observers might, accordingly, think that the banks will call the tune in the turnaround. There are, however, factors that militate against such a bank bias. First, it is the case in the vast majority of turnarounds that, although the hiring of the TP is at the instigation of the bank,213 the client and paymaster is the company itself. The turnaround specialist, accordingly, is obliged to act in the interests of the company not the bank.214 Second, turnaround professionals are repeat players in relation to corporate difficulties and they have reputational incentives to avoid bank biases. If their reputations for evenhandedness were to diminish this would affect their business prospects since their success in achieving turnaround will in no small part turn on the trust they are able to generate amongst stakeholders and on the

210 Jones, ‘Credit Insurance’, p. 22.
211 Les Otty, Director of Business Turnaround, BDO Stoy Hayward: interview with author, 8 April 2005.
212 See e.g. Bingham, ‘Poacher Turned Gamekeeper’.
213 Often, as noted, on the recommendation of a ‘catalyst’, for example an investigating accountant appointed by the bank. Author’s interview with Les Otty, 8 April 2005.
214 STP members are, as indicated above, required to give the company advice free from ‘external or adverse pressures’ which would weaken their independence: STP Code of Ethics, Appendix, para. A.2.
authority with which they can deliver business reviews and proposals for reorganisation, refinancing and so on. To the extent that the clients of turnaround professionals are paying for services that have value by virtue of their independence, the market is valuing their rescue-enhancing rather than bank-serving effects. The market, it seems, is increasingly willing to value such services and rescue-enhancing effects.

**Turnaround professionals and fairness**

When companies have entered into a statutory insolvency procedure it is clear that the law obliges IPs to act fairly when carrying out functions within these procedures.\(^{215}\) The duty to act fairly, moreover, has substantive and procedural aspects. The IP who acts as an administrator, for instance, is obliged to pursue his functions ‘in the interests of the creditors of the company as a whole’.\(^{216}\)

Such an administrator would also be obliged to act procedurally fairly. This flows from the administrator’s status as an officer of the court (a public official)\(^{217}\) and because the administrator’s substantive duty to

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\(^{215}\) As noted above, whether as officers of the court (administrators and liquidators in compulsory liquidations) or as professionals governed by their relevant RPB’s code of ethics. What fairness involves in any particular case will be assessed by the courts. (Challenges on the basis of unfairness can be mounted in, for example, the ‘new’ administration procedure under Insolvency Act Sch. B1, para. 74(1).) On judicial scrutiny of IP activities in the ‘new’ administration procedure see J. Armour and R. Mokal, ‘Reforming the Governance of Corporate Rescue: The Enterprise Act 2002’ [2005] LMCLQ 28; R. Mokal and J. Armour, ‘The New UK Corporate Rescue Procedure – The Administrator’s Duty to Act Rationally’ (2004) 1 Int. Corp. Rescue 136; V. Finch, ‘Re-invigorating Corporate Rescue’ [2003] JBL 527; Finch, ‘Control and Co-ordination in Corporate Rescue’ and ch. 9 below.

\(^{216}\) The ‘new’ administrator owes statutory duties to act in the interests of creditors as a whole and to perform his functions as quickly and efficiently as is reasonably practicable: see Insolvency Act 1986 Sch. B1, paras. 3(2), 4. He must pursue a single hierarchy of objectives set out in para. 3(1) and paying off the secured creditors ranks last in those statutory objectives (in doing so he is under a positive duty not to harm the company’s other creditors: para. 3(4)(b)). See ch. 9 below.

\(^{217}\) See Insolvency Act 1986 Sch. B1, para. 5. As an officer of the court the administrator is bound by the rule in *Ex p. James* (1874) 9 Ch App 609 (obligations to act honourably and fairly). As a public official the administrator must act procedurally fairly and principles of judicial review necessitate the challenged actions of the administrator meeting demands of rationality: see e.g. *Associated Provincial Picture Houses Ltd v. Wednesbury Corporation* [1948] 1 KB 223; *Council of Civil Service Unions v. Minister for the Civil Service* [1985] AC 314. See further Mokal and Armour, ‘New UK Corporate Rescue Procedure’; Finch, ‘Control and Co-ordination in Corporate Rescue’ and ch. 9 below.
consider the interests of all creditors carries an obligation to act reasonably by recognising the procedural rights of such creditors.\textsuperscript{218} Can it be argued that turnaround specialists are, or should be, obliged to act according to similar canons of fairness?\textsuperscript{219} A difficulty in making this argument is that a distinction might be sought to be drawn between situations that obtain before and those that are encountered after a company has entered a formal insolvency process. Once the company has entered a statutory insolvency procedure (which may be pre- or post-insolvency)\textsuperscript{220} insolvency law is based on the premise that such procedures involve impositions and that those parties who have to make concessions within such procedures must be given process rights in return for these concessions. The CVA procedure, for example, can be used pre-insolvency\textsuperscript{221} and involves a variety of procedural protections for creditors (for example, the need for proposals to be approved by specified majorities)\textsuperscript{222} Such protections can be seen as a \textit{quid pro quo} for creditors having to submit to proposals that bind them\textsuperscript{223} and to a moratorium on enforcing their rights in the ‘small company’ CVA.\textsuperscript{224} In contrast, it might be argued, parties in informal situations – before statutory insolvency procedures come into play – are free to protect

\textsuperscript{218} As demanded by \textit{Wednesbury}. On the ‘new’ administration see ch. 9 below.
\textsuperscript{219} The STP/IFT \textit{Code of Ethics}, para. 3.1 requires members to act with honesty, fair dealing and truthfulness in all professional appointments and to strive for objectivity in all professional judgements. Objectivity here requires having regard to all considerations relevant to the task in hand and no others. Paragraph 5 of the Code requires the declining of any assignment that would create a conflict of interest. Advice has to be impartial and frank, free from any external or adverse pressures or interests that would weaken the member’s professional independence (STP/IFT \textit{Code of Ethics}, Appendix, para. A.2).
\textsuperscript{220} A company is insolvent for the purposes of the law if it is unable to pay its debts. Legal consequences only attach to a company, however, on the institution of a formal proceeding, such as winding up or administration: see ch. 4 above.
\textsuperscript{221} Unless it is being invoked in conjunction with an administration order made under the Insolvency Act 1986 Sch. B1.
\textsuperscript{222} The proposal for a CVA needs to be approved by 75 per cent of creditors voting in person or by proxy by reference to the value of their claims. It also requires the approval of 50 per cent in value of the shareholders present at the shareholders’ meeting. If approved the scheme becomes operative and binding upon the company and all of its creditors (save for secured or preferential creditors who have not consented: Insolvency Act 1986 s. 4(3) and (4)). See further ch. 11 below.
\textsuperscript{223} As noted above, the Insolvency Act 1986 s. 4(3) and (4) specifies that the CVA proposal cannot affect the rights of secured or preferential creditors without their consent.
\textsuperscript{224} See Insolvency Act 1986 s. 1A and Sch. A1 (inserted by the Insolvency Act 2000) and ch. 11 below.
themselves by exercising whatever rights they may possess. There is no need to demand that they act altruistically or recognise any participatory rights of other parties since those parties are not being forced to accept any proposals or settlements.

If the above distinction between pre- and post-formal scenarios is accepted, it can be contended that issues of procedural fairness are not to the fore when, say, a company employs turnaround professionals to devise restructuring plans and applies these in informal processes. It might be responded that, in reality, it is often the case that when a company employs a TP a plan of action will be imposed on less well-resourced creditors and that powerful creditors will negotiate for solutions that are not so much in the best interests of all creditors as they are designed to improve their own positions by increasing their security or equity. (There is evidence, indeed, that during periods of rescue, bank credit tends to contract but unsecured trade credit tends to expand, sometimes dramatically.) From the point of view of an unsecured creditor, it could be pleaded, it matters little whether a bank-orientated strategy impacts on it by means of a formal process such as a CVA or an informal turnaround strategy. Why, therefore, should procedural protections avail in the case of the CVA but not in informal turnaround? One answer, perhaps, is that insolvency law has to draw a line at some point between formal processes, which involve formal, legal protections, and informal processes, which involve contractual and market-driven protections (for example, the unsecured creditor’s freedom to refuse to trade or to enforce a debt). It might be argued that what is really at issue here is where the formal/informal line should be drawn. Advocates of greater protection for vulnerable creditors might contend that some informal procedures should be made formal by the imposition of a statutory scheme of processes and protections. This would cover the situation, for instance, in which a floating-charge-holding bank negotiates with the company’s turnaround specialists and then presses the company to take steps that do not appear to unsecured creditors to be in their interests (for example, the bank persuades the company both to

225 These may be existing or newly negotiated contractual rights and statutory rights, for example to levy execution for the debt. On informal rescues and reconstructions see ch. 7 below.


227 On arguments for placing the London Approach on a statutory footing see ch. 7 below.
increase the bank’s security in return for continued lending and to demand improved credit terms from unsecured creditors). To such advocates of greater protection, it could be replied, first, that the law already offers such unsecured creditors a set of rights that allows them to enforce their debts; second, that if the actions being taken by the company mean that it is likely to be unable to pay its debts, the Insolvency Act 1986 already allows the unsecured creditors to apply for the appointment of, say, an administrator; and third, that to advance the threshold of formal insolvency proceedings further into the activities of non-insolvent companies may create a set of serious uncertainties that would prejudice entrepreneurship. These uncertainties would be considerable, it might be cautioned, because there would be vagueness in the boundary between ordinary healthy commercial activity and activity producing some risks to some creditors which would give rise to extra obligations of fairness.

On behalf of TPs, further arguments might be mounted to suggest that the growth of TP activity positively enhances fairness in most informal turnaround schemes. First, it could be emphasised that the TP generally acts for the company not the bank and that, if he is an IFT member, he is ethically bound to act fairly and to give advice free from outside pressure (from the bank, for example). Second, it could be argued that the work of a specialist TP enhances fairness through improved transparency. The TP carries out a central function – the gaining of creditor agreement to a way forward for the company. In repeatedly performing this function TPs become expert facilitators and mediators. They are the parties who lubricate the machinery of negotiation that is necessary for agreements to be devised. As one turnaround specialist indicated, when talking of a large and successful reorganisation, the first success factor was: ‘Communicate directly with all the stakeholders. Many of the banks had no direct contact with the company. We held one to one discussions with each institution to ensure that their issues and concerns were addressed. This was critical to building support for the restructuring.’

The TP, accordingly, can be held out as the person who plays a key role in making turnaround processes open, transparent and intelligible. In doing so, it can be argued, the TP conduces to processes that are more open and fair than would be the case without professional facilitation.

TPs have an independence from the main creditor bank that allows them to perform the facilitation function in a way that, say, the employee of the bank’s ‘intensive care’ unit would find extremely difficult.

This argument, however, can be pushed too far. It would be an exaggeration to see most informal turnaround processes as inclusive of all creditor voices and interests. Negotiations are often carried out secretly, press coverage is usually avoided and TPs will tend to view negotiations as an exercise in keeping key players on side. Trade or small unsecured creditors are, accordingly, often left out of these processes and dealt with only when they create difficulties on discovering what business solutions are being negotiated. It should also be noted that the modern tendency to finance companies from a variety of credit sources means that TPs often have to conduct negotiations with a large number of banks, venture capitalists, bondholders, distressed debt holders and others. The number of these creditors and the divergence of their attitudes, approaches and expectations\(^ {231}\) makes the TP’s task all the more difficult and, in so far as it does, this will make it increasingly unlikely that negotiations will be conducted in a sufficiently inclusive manner to prove receptive to the voices of trade and smaller unsecured creditors.\(^ {232}\)

**Expertise**

In asking whether the TPs system ensures expertise in the supply of specialists, it has to be acknowledged, first, that turnaround professionals, as a group, display some of the characteristics commonly associated with the self-regulatory professions.\(^ {233}\) The Society of Turnaround Professionals was established in late 2000 and was renamed the Institute for Turnaround (IFT) in June 2008. The STP’s stated mission was to be the ‘principal source of the highest quality practitioners implementing and advising upon successful turnarounds for the benefit of the national economy and all stakeholders’.\(^ {234}\) The Society saw its creation as ‘part of

\(^{231}\) On such divergent expectations see Roome ‘Unwelcome Guest’ and further ch. 7 below.


\(^{233}\) On professional self-regulation generally see Baldwin and Cave, *Understanding Regulation*, ch. 10; see also p. 199 above.

\(^{234}\) STP home page (www.stp-uk.org). See now the IFT home page.
the drive towards the rescue culture in the UK’ and reported that its advent was encouraged by the UK Government, the clearing banks, other financiers, private equity providers and leading accountancy firms.\textsuperscript{235} The STP claimed that, in a very short time, it generated a membership of leading and expert professionals. These did not all possess the same qualifications but all had ‘extensive experience of implementing, initiating and advising’ on recovery strategies. They comprised the following: independent company chairmen and chief executives (sometimes known as ‘company doctors’); other independent company executives with particular skills relevant to turnaround (for example in finance, operations, manufacturing and so on); specialist advisers on turnaround with accountancy or consulting backgrounds; and senior representatives from a variety of stakeholders who specialise in turnaround, including bankers, institutional investors, asset lenders and venture capitalists. As at 2007 there was an STP membership of 188, of whom 122 were full members and 66 were associate members.\textsuperscript{236}

The STP’s objectives were stated in the kind of terms that are commonly expressed by a self-regulatory body. It aimed to advance the theory and practice of corporate turnaround; to provide high standards of practice and professional conduct; and to provide a forum for involved parties to discuss issues relating to turnaround. The Society also combined representative and regulatory roles – to ‘make the case for corporate turnaround to the business community, the UK Government, academia and the media’.\textsuperscript{237} As for quality controls, the STP expressed an intention to regulate members within agreed professional standards with the assistance of other professional bodies, where appropriate; and to organise and conduct examinations for members and others in subjects requiring an understanding of the theory and practice of corporate turnaround.

Are STP/IFT controls as rigorous as those that govern insolvency practitioners? It will be remembered that the Cork Report called for eligibility to act as an office holder in a designated insolvency proceeding to be restricted to persons qualified under the 1986 Act.\textsuperscript{238} Such qualification was to depend on membership of an approved professional body and the Cork Committee was clear that any acceptable professional body

\textsuperscript{235} Ibid. \textsuperscript{236} N. Ferguson, ‘STP Update’ (2007) Recovery (Spring) 42. \textsuperscript{237} STP home page. \textsuperscript{238} See Insolvency Act 1986 Pt XIII and the Insolvency Practitioners Regulations 2005 (SI 2005/524) and Insolvency Act 1986 s. 390. See p. 182 above.
would have to meet five conditions.\textsuperscript{239} It would have to insist on the observance by members of an ethical code of professional conduct, breach of which would involve professional sanctions; there would have to be a professional obligation to account strictly for moneys belonging to third parties; membership would have to be confined to those who have passed a competitive examination (including a paper on insolvency); there must be an effective disciplinary system with powers to deprive defaulting members of the right to practise; and there must be a system of practising certificates, renewable annually.

Turnaround specialists differ from IPs in so far as they are subject to no mandatory regime of training, experience or qualification. Those who are full members of the IFT are, however, subject to a regime of quality control that is principally governed by a system of accreditation. This demands that a prospective member evidences that he or she has engaged in over 1,200 hours of turnaround in the last five years; presents three case studies that he or she has carried out; provides a referee from the stakeholder community connected to each of these three case studies; produces a professional reference; and submits to an interview with a panel comprising, amongst others, two IFT members and an R3 member. Members and associate members of the IFT are also required to sign up to the Institute’s Code of Ethics. This Code is enforced by means of a disciplinary process, which is operated on behalf of the IFT by the Association of Chartered Certified Accountants (ACCA).\textsuperscript{240} Breach of the Code may result in suspension or expulsion from the IFT. Membership of the IFT, accordingly, offers a kite-mark of quality to prospective clients, though the latter are perfectly free to engage a turnaround specialist who is not a member of the IFT.\textsuperscript{241}

When comparing the regulatory regime for IPs with that governing turnaround professionals it can be concluded that, at the date of writing, there is a good deal of work to be done if turnaround professionals are to be able to claim that their accreditation system offers quality and

\textsuperscript{239} Cork Report, para. 758.

\textsuperscript{240} If a member of the IFT is also a member of an RPB he is subject to the disciplinary process of that RPB; if not he must agree to be governed by ACCA enforcement of the IFT Code.

\textsuperscript{241} A number of turnaround specialists offer their services outside the umbrella of IFT membership. The other organisation that offers membership to such specialists is the UK chapter of the Chicago-based organisation, the Turnaround Management Association (TMA). The TMA requires adherence to a Code of Ethics but operates no accreditation system akin to that operated by the IFT.
performance controls to match those that are applicable to IPs or which were demanded by the Cork Committee. The IFT system, for instance, does not involve a compulsory competitive examination including written papers nor does the IFT have the power to deprive defaulting members of the right to practise turnaround – this follows from the non-mandatory nature of the IFT regime. Whether there should be equivalence in the regimes governing turnaround professionals and IPs is, however, an issue for discussion rather than assumption. Much may depend on the tasks that are carried out by TPs, the nature of the clients they serve, the ability of such clients to assess quality of service and the importance of the service to the client.

On the first issue, there is a range of tasks that are carried out by TPs. These include, as already noted: conducting independent business reviews; scrutinising existing management; providing new management skills and recruitment work; negotiating with stakeholders on rescue packages (as well as on the terms of pre-packaged insolvencies to cover the possibilities of failure); designing financial plans for rescue together with the offering of advice and assistance on refinancing; producing rationalisation and restructuring solutions; offering risk management advice; and providing credit insurance and advice.

On refinancing options, a host of specialists offer a variety of services, including: invoice discounting; asset-based lending (on raw materials, finished goods, plant and machinery, commercial property and so on); networking with private investors (‘business angels’), factors and other debt financiers.

The above turnaround activities can take place at various points in the progression of a company’s affairs. Turnaround work may include the rescue of companies without recourse to formal insolvency procedures and the rescue of businesses following voluntary arrangements. It may involve the ‘pre-packaging’ of potential administration procedures as underpinnings to informal rescue attempts. Turnaround specialists may also act to facilitate the rescue of companies via formal insolvency procedures.

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242 The IFT can, of course, deprive defaulters of the right to offer services as a member of the IFT.
244 See Lester, Young and Hawes, ‘Help is at Hand’.
245 See Harris, ‘Decision to Pre-pack’. See further ch. 10 below.
246 See IPA information page (www.ipa.uk.com).
Turning to the nature of the clients served by TPs, are these well-informed, repeat players who are able to assess the expertise of the TP and the quality of the service that they receive, or are they poorly placed and in need of regulatory protections? The major lending banks that trigger most appointments of TPs constitute well-informed, highly expert players that may deploy specialist business care units to liaise with TPs. On any list of consumers in need of regulatory protections they will tend to be placed fairly low down in the order. Most TPs, however, are hired, as noted, by troubled companies rather than their banks and the directors of these companies may not be so capable of looking after their own interests as are the major lenders. Such directors are not always repeat players\(^{247}\) and, if not, their lack of expertise in coping with financial challenges may be a reason why they are resorting to a TP. When, moreover, a company encounters financial troubles it may be extremely difficult for the directors to shop around for a TP of known high quality or to research this – the situation may be urgent and all management hands may be on the pumps.\(^{248}\) There may be a strong case for saying that the directors should be able to enjoy confidence in the turnaround services they purchase by employing a TP who is a member of a self-regulatory profession. A separate question is whether that protection should be guaranteed to anyone who employs any TP. This will be returned to below.

The ability of the consumer of turnaround services to evaluate the service is, as noted, of relevance here. A distinction can be drawn, here, between search, experience and credence services.\(^{249}\) The quality of search services can be evaluated in advance of use. (The fish can be seen to be decayed or fresh in the supermarket before purchase.) Experience services can be evaluated after purchase. (The restaurant meal can be evaluated on consumption.) Credence services are difficult to evaluate even after delivery. (The quality of ‘disease-preventative’ food

\(^{247}\) This may, of course, change if the IFT is successful in seeking to persuade more directors to bring in TPs at the very early stages of corporate troubles. It should also be borne in mind that a proportion of directors may have prior experience of corporate failure: see the data provided by CCN, the credit investigation agency, reported in N. Cohen, ‘Dangerous Directors’, Financial Times, 16 December 1996.

\(^{248}\) In some cases, it should be noted, the bank that applies pressure to appoint a TP may bring its experience as a repeat player to bear and advise the company’s directors on choices of TP. When such advice is given this may ameliorate the poor informational position of the director-consumer.

supplements may never be known because consumers may not be able to identify the causes of their ongoing good health.) The case for regulation becomes stronger when, on a scale from search to credence, the services on offer approach the credence end. At that end of the scale the market will control price and quality quite poorly because of informational difficulties. The case for regulating will also be the more compelling when the importance of obtaining a high quality of service is the greater. This will be so when the difference between good and poor service affects interests and has the more serious consequences (in money, lives, reputations and so on).

With regard to turnaround services, these may be said to occupy a position around the centre of this scale. Once the service is experienced there are some ready indicators of success or failure – notably in the change of corporate fortunes that follows. On the other hand, the causal connection between any change in such fortunes and the TP’s actions may not always be easy for the consumer of services to discern. (Did market conditions or other factors produce the change?) It may also be difficult to assess the counterfactual and say what would have happened with an alternative service provider. What can be said with more confidence is that in turnaround the quality of the service delivered is usually of high importance to the client and often to other parties also. A poor TP may fail to rescue the business and extensive economic, employment and wider social costs may ensue.

Such considerations suggest that there is a case for regulatory controls over the quality of TP services – at least if the market will fail to provide such controls. On this point, a concern is that if a significant number of consumers of TP services are non-repeat players and in poor positions to evaluate service quality, the market may be somewhat slow to prevent poorly performing or ill-qualified turnaround advisers from surviving in business by exploiting poorer-placed consumers. A particular danger may be that poorly informed directors may be tempted, under the pressure of time, resources and creditor demands, to select a TP on price with little reference to quality of service. Such directors may, accordingly, be prone to hire non-accredited practitioners of turnaround and to run excessive risks of suffering from poor advice and guidance. This suggests that there is a need, not only to control the quality of TP services, but also to make subjection to the self-regulatory system mandatory. If it is not mandatory then small companies, in particular, may

250 On internal and external causes of corporate failure/distress see ch. 4 above.
suffer from the poor services of ‘maverick’ turnaround advisers who are not quality controlled.

It might, however, be no easy matter to install a mandatory regime. The problem of boundary definition is acute since, as seen above, TPs provide a wide range of services – from management consultancy for healthy companies right through to rescue advice for companies that are going through formal insolvency processes. In the case of some of these services, it might be hard to justify mandatory regulation since market forces may control matters such as quality of service and price quite acceptably. The boundary problem means, moreover, that a mandatory regime might bring a number of dangers. It might, for instance, prove over-inclusive so that persons offering any advice to a company might be potentially covered by the mandatory rule. Any uncertainties, indeed, on the extent of a mandatory regime might discourage consultants from offering advisory work and this might be counter to the interests of companies generally. These difficulties militate in favour of a non-mandatory approach to self-regulation.\textsuperscript{251} It can be pointed out, moreover, that those practitioners who elect not to join the self-regulatory system for TPs may still be regulated by other bodies and by certain statutory regimes. Thus, TPs who are accountants or lawyers will be controlled by the self-regulators of those professions and, if a TP is involved in financial advice, he or she may be covered by the financial services regulatory requirements.

To conclude on the TP regime’s assurance of expertise, it can be said that there has been a progression to the point where the foundations of a professional self-regulatory system have been laid. Further work needs to be done, though, to match the position obtaining with IPs and boundary issues mean that there are liable to remain difficulties with the provision of turnaround services by persons who are not members of such self-regulatory systems. These are non-trivial difficulties since, as noted, the consequences of poor service provision may be severe.

Conclusions

In this chapter we have seen that there may be a case for reforming the regulatory regime for IPs and that new regulatory challenges have also

\textsuperscript{251} It is, of course, conceivable that a government might legislate to make the IFT regime mandatory in the wake of a turnaround disaster involving a ‘maverick’ turnaround adviser. The author is grateful to Les Otty for this point.
arisen with the arrival of TPs on the scene. Regarding IPs there seems, as noted, to be no strong case for replacing private practitioners with public officials as the main implementers of insolvency procedures. There may be a case, though, for tightening the mechanisms used to regulate IPs and a number of potentially valuable reforms have been canvassed above, including proposals to rethink the duties that IPs owe to the array of interests involved in insolvency processes and to subject the current IP regulatory regime to more stringently independent oversight.

The emergence of the turnaround professional, we have seen, raises fresh issues of efficiency, accountability, fairness and expertise. It can be argued, albeit in the absence of cut-and-dried statistics, that turnaround specialists are making a contribution to effective rescue-seeking. The market, at least, seems convinced that the rescue outputs of turnaround specialists are increasingly to be valued. The accountability of TPs appears to be modest but there is a rationale for this in so far as the market appears to value their independence as a factor that facilitates rescue.

As for procedural fairness within turnaround, informal rescue procedures do not provide all creditors with the same protections that are provided by statutory insolvency processes. This is not, however, a situation that is necessarily to be deplored. A distinction has to be drawn at some stage between informal and formal procedures and, in any event, the law offers a general set of protections for those who have provided credit to the troubled company. It cannot be guaranteed that turnaround professionals will always consult the whole array of interested parties when carrying out reconstruction negotiations. A number of factors, however, may encourage turnaround professionals generally to favour processes that are accessible, transparent and procedurally fair. One such factor is the incentive that turnaround specialists have to protect their reputations as even-handed and effective negotiators of corporate solutions.

On matters of expertise within the TP regime, it can be said, on the one hand, that these professionals are able to deploy a new set of specialist skills and services in seeking to turn the affairs of troubled companies around. On the other hand, these specialists are not all as comprehensively regulated as insolvency practitioners nor are they all subject to the sorts of rigorous quality and entry control regimes that the Cork Committee considered were appropriate for IPs. There are, moreover, serious problems of service boundary definition that would make it difficult to advocate that all turnaround professionals should be subject to a mandatory scheme of regulation.
In summary, there seems no reason for observers of TPs in action to experience fears analogous to those expressed by Cork when that Committee was looking at unlicensed insolvency practitioners. There is, however, more work to be done to devise measures of success for turnaround professionals and to develop the regulation of these specialists. The movement of rescue work further into the pre-insolvency period has shifted a number of familiar debates and raised a host of new challenges. Those challenges will remain to be faced for some time to come.
PART III

The quest for turnaround
Rescue

This part of the book assesses the role of rescue procedures in insolvency. We begin by considering what rescue involves, the reasons why rescue may be worth attempting, the different routes to rescue and the UK’s new focus on rescue and ever-earlier responses to corporate troubles. The chapter then considers how different countries’ rescue regimes can be compared.

What is rescue?

Rescue procedures involve going beyond the normal managerial responses to corporate troubles. They may operate through informal mechanisms as well as formal legal processes. It is useful, therefore, to see rescue as ‘a major intervention necessary to avert eventual failure of the company’. This allows the exceptional nature of rescue action to be captured and it takes on board both informal and formal rescue strategies.

Central to the notion of rescue is, accordingly, the idea that drastic remedial action is taken at a time of corporate crisis. The company, at such a point, may be in a state of distress or it may have entered a formal insolvency procedure. Whether or not a rescue can be deemed a success raises a further set of issues. Complete success might be thought to involve a restoration of the company to its former healthy state but in practice this scenario is unlikely. The drastic actions that rescue

2 Belcher, Corporate Rescue, p. 12; Harmer, ‘Comparison of Trends’.
3 See ch. 4 above, p. 146.
necessarily involves will almost inevitably entail changes in the management, financing, staffing or *modus operandi* of the company and there are likely to be winners and losers in this process. As Belcher observes: ‘All rescues can be seen as, in some sense, partial.’⁴ This observation also serves to point out that a rescue may be ‘successful’ from the point of view of some parties (for example, shareholders or employees) but not from the perspective of others (for example, managers or creditors). Assessments of rescues may accordingly have to be qualified in order to reflect these different points of view.

A distinction can also be made between the company and the business. Thus, even where a company is liquidated, successful steps may be taken to retain aspects of the business as operational enterprises, to sustain the employment of groups of workers and to ensure the survival of some economic activity. Similarly, successful results may be obtained where the company is taken over and loses its individual identity accordingly.

The timescales used to judge a rescue may also affect judgements as to its success or failure. Some rescues may produce a short-lived survival of the company or the business and, before success is deemed to have been achieved, it may be necessary to consider whether the rescue efforts have produced sustained results.

As for the end products of rescues, these may be various.⁵ The company may be restored to its former state, as noted, but it is more likely to be reorganised (where, for example, managerial reforms are instituted), restructured (where, perhaps, closures of elements of the business are involved), refinanced (as where new capital is injected or debts are rescheduled), downsized (where operations may be cut back, workforces reduced or activities rationalised), subjected to sell-offs (where parts of the business are sold to other firms or even to managers in management buyouts (MBOs)) or taken over (as where the market for corporate control operates with regard to a troubled company and a takeover prompts drastic managerial changes).⁶

Why rescue?

Some visions of insolvency processes and laws are highly unsympathetic to the whole notion of corporate rescue. As was seen in chapter 2, the ‘creditor wealth maximisation’ vision, which sees insolvency as a process of collecting debts for creditors and as a response to the ‘common pool’ problem, is in tension with the notion that keeping firms in operation (and protecting interests beyond those of creditors) is an independent goal of insolvency law. It may be the case, in some circumstances, that maximising potential returns to creditors will demand some sort of rescue activity but this will not always be the case and a failed rescue may reduce creditors’ returns materially. On most occasions, those economic theories that focus on creditor interests will hold that the collective actions of liquidation will reduce transaction costs for individual creditors and make for administratively efficient processes. It is efficient, on such a view, to decline to save ‘hopeless’ companies and to allow the market to redeploy resources swiftly, and at least cost, to more productive uses.

In chapter 2 it was argued, however, that the creditor wealth maximisation vision was excessively narrow and that, in looking at insolvency processes, attention should be paid to interests beyond those of creditors: to social and distributional goals; to public as well as private interests; and to values such as expertise, fairness and accountability. Whether existing English rescue procedures perform adequately with regard to these factors is best considered when the details of different procedures are examined in the chapters below. At this stage it is worth noting that an

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7 If regimes are largely creditor-driven it is likely that prospects for rescue will be less than where regimes are debtor-driven: see Harmer, ‘Comparison of Trends’, pp. 147–8. On classifying jurisdictions as pro-creditor or pro-debtor regarding, inter alia, the general position on insolvency, see P. Wood, Allen & Overy Global Law Maps: World Financial Law (3rd edn, Allen & Overy, London, 1997).


9 Rescue is likely to increase returns to creditors where there is a good prospect of turning corporate fortunes around (for example, by coping with a short-term dip in the market) or where the company is worth more as a going concern than as assets sold off piecemeal.


approach going beyond creditor wealth maximisation – in short a ‘social’ as opposed to an ‘economic’ approach – leaves scope for rescue and justifies rescue activity with reference to a number of objectives and values. In relation to the technically efficient achievement of social and distributional goals, regard can thus be had to the potential of a rescue procedure to achieve a number of results. These may include the preservation of a business that, in the longer term, is worth saving or is worth more as a going concern than if sold piecemeal; the protection of the jobs of a workforce; the avoidance of harms to suppliers, customers and state tax collectors; and the prevention of damage to the general economy or to business confidence in a sector.

For its part, the Cork Committee laid the foundations for a ‘rescue culture’ and was clear on the legitimacy of considering the broader picture. A good, modern system of insolvency law, said Cork, should provide a means for preserving viable commercial enterprises capable of making a useful contribution to the economic life of the country:

We believe that a concern for the livelihood and well-being of those dependent upon an enterprise which may well be the lifeblood of a whole town or even a region is a legitimate factor to which a modern law of insolvency must have regard. The chain reaction consequences upon any given failure can potentially be so disastrous to creditors, employees and the community that it must not be overlooked.

12 ‘Technically efficient’ in the sense that whatever social and distributional goals are set by society, the aim should be to produce these at minimal cost and without waste.


15 Cork Report, para. 204. See also paras. 203 and 198(j). When read together these paragraphs indicate that, in the Cork Committee’s view, insolvency law should provide mechanisms not only to rescue potentially profitable organisations but also to ensure that a commercial enterprise can survive even if there is no immediate prospect of a return to profitability, if it is in the economic interests of the community. See also Hunter, ‘Nature and Functions of a Rescue Culture’, pp. 497–9; and on the social costs of failure see Carruthers and Halliday, Rescuing Business, pp. 69–70.
In the period since the Cork Report, the rescue culture has strengthened and been endorsed by the judiciary as well as bankers and politicians.\(^\text{16}\) In *Powdrill v. Watson*\(^\text{17}\) Lord Browne-Wilkinson stated in the House of Lords:

> The rescue culture, which seeks to preserve viable businesses, was, and is, fundamental to much of the Act of 1986. Its significance in the present case is that, given the importance attached to receivers and administrators being able to continue to run a business, it is unlikely that Parliament would have intended to produce a regime as to employees’ rights which renders any attempt at such rescue either extremely hazardous or impossible.\(^\text{18}\)

The British Bankers’ Association publicly endorsed a rescue culture in its 1997 paper, *Banks and Businesses Working Together*.\(^\text{19}\) The Blair governments also sought to encourage a movement towards a more US-style philosophy of enterprise that was less censorious of business failures and more encouraging of rescue. Peter Mandelson, when Trade Secretary in 1998, made a number of speeches that advocated a reassessment of attitudes to business failure and a need to encourage entrepreneurs to take risks.\(^\text{20}\) He announced the need to reconsider the position of the Crown as preferential creditor\(^\text{21}\) so that hard-pressed companies were not driven into insolvency by demands relating to tax debts. The 1998 White Paper, *Our Competitive Future: Building the Knowledge Driven Economy*,\(^\text{22}\) echoed such sentiments and, in 1999, a joint DTI and Treasury initiative was mounted in order to further the rescue culture

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18 [1995] 2 AC 394 at 442 (quoted in Hunter, ‘Nature and Functions of a Rescue Culture’, p. 511). For further judicial references to the rescue culture see e.g. *Re Demaglass Holdings Ltd* [2001] 2 BCLC 633 (Neuberger J); *On Demand Information plc (in administrative receivership) and another v. Michael Gerson (Finance) plc and another* [2000] 4 All ER 734 (Robert Walker LJ).


21 On the subsequent abolition of the Crown’s preferential status see ch. 14 below.

22 Cm 4176, December 1998, paras. 2.12–2.14.
and examine how it could be made to work more efficiently. More recently, the Enterprise Act 2002 removed the Crown’s preferential rights to recover unpaid taxes ahead of other creditors and reduced the role of administrative receivership. It did so following promises from the then Chancellor, Gordon Brown, that steps would be taken to ‘reduce the penalties for honest failure and to create a modern and fair commercial system’.

A key issue in any process that purports to be rescue-orientated is whether it provides for intervention at a sufficiently early stage in proceedings and action of a sufficiently speedy nature to allow the above ends to be achieved. In R3’s Survey of Business Recovery of 2001, the rescue professionals who responded indicated that in 77 per cent of cases there was, by the time they were appointed, no possible action that could be taken to avert company failure.

The trade-offs between achieving ‘social’ ends and the costs imposed on various parties have, moreover, to be taken into account. Many rescue activities will involve the forestalling of enforcement actions by certain parties and the use of periods of grace in which realignment efforts are made. During these periods, certain interests will suffer. Creditors, for example, may be prevented from realising their securities. Distributional and social goals may demand that creditors make certain concessions for the purposes of rescue but considerations of both efficiency and fairness impose limits on the sacrifices that can be justified. In assessing such trade-offs, balances have to be drawn between the probabilities of achieving certain desirable ends and the (usually far higher) probabilities of imposing costs on parties who are asked to make sacrifices.

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25 R3’s Ninth Survey. Business preservation rates were, overall, 18 per cent, with hotel and catering having the highest preservation rate (28 per cent).
26 On the political consequences of such choices see Carruthers and Halliday, Rescuing Business, p. 155.
28 Ibid., pp. 61–71 and see the discussion of the policies of (1) redistribution determined by relative ability to bear costs and (2) allocating the costs of business failure to those who stand to benefit most from business success.
A final issue to consider under the heading of technical efficiency is whether a rescue regime is conducive to low cost and effective co-ordination between the different actors that may be involved in working towards a turnaround. A rescue generally involves a number of parties who carry out a variety of roles and tasks and the challenges of co-ordinating roles and actions vary across such tasks. What is clear is that if such involved parties do not work together harmoniously, a considerable amount of unproductive friction will result and this will stand in the way of completing such tasks as collecting the data relevant to the rescue and the taking of timely actions and decisions. These are matters to be given special consideration in chapter 9 when looking at the administration procedure.

To move to another benchmark of chapter 2, attention should also be paid to the propensity of any given rescue procedure to allow business judgements to be taken by experts. (The argument for expert decision-making may, like those for fairness and accountability, be the more important where democratically established goals for rescue are difficult to identify.) Where, for instance, a rescue procedure involves a handover of control from a specialist insider (for example, a director) to a generalist outsider (for example, an insolvency practitioner), this may involve the expenses of parties coming up to speed with the particular company’s financial, operational and market positions but also dangers that judgements will be made by persons who are not fully familiar with the relevant market sectors and business circumstances. Experts should also be allowed to exercise their expertise. A consideration in judging a rescue regime is, accordingly, whether it gives the expert sufficient information and time to be able to effect a rational, balanced judgement. ‘Expert’ decisions may amount to little if those taking them are, by force of circumstances, ill-informed and subjected to unduly tight deadlines.

30 On the tendency of US rescue processes to place more faith in management than the English system, see Carruthers and Halliday, Rescuing Business, pp. 509–10. See also pp. 280, 287–8 below.
32 See Belcher, Corporate Rescue, pp. 240–1.
Rescue procedures also stand to be judged according to their fairness. Issues here are whether those processes allow equal weight to be given to the voices of various affected parties; whether the processes are open to self-interested manipulation by certain individuals or groups; and whether those administering the processes are (and can be seen to be) operating even-handedly.

Finally, considerations of accountability are relevant. Acceptable levels of supervision and approval should be instituted so that opportunities for opportunistic behaviour are curtailed and regimes are not only fair but also capable of generating the degree of consent that is necessary for effective rescues to be achieved. This, in turn, demands that supervisory functions are not allocated in a way that itself allows manipulation. The transparency and accessibility of processes must also be sufficient to allow affected parties to apprise themselves of relevant facts and to ensure that such parties’ representations are considered. Again, however, the costs of supervision and access have to be borne in mind and the pitfalls of excessively legalistic procedures and undue levels of court supervision should be avoided.33

In relation to issues of both fairness and accountability it should be emphasised that different groupings may possess widely divergent interests and incentives when the company meets troubled times.34 Shareholders and directors will tend to favour ensuring that the company continues to operate for as long as possible. The former are residual claimants in insolvency and have little to lose by trading on. The directors may wish to prolong operations in order to eke out or stabilise their employment.35 Both shareholders and directors will thus tend to gamble on further business activity since they will enjoy whatever gains result. Corporate creditors, in contrast, will tend to favour ceasing operations sooner rather than later since they will bear the losses that result from any continued trading.36 Employees, again, will tend to favour continuing trading in the hope of securing their jobs and in the knowledge that further losses will be borne by other parties. Insolvency practitioners, as noted in chapter 5, may possess incentives to encourage companies to

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33 See Phillips, Administration Procedure, pp. 11–12.
35 Directors may not bear the financial risks of continued trading but their inclination to trade on should be constrained by fears of personal liability for wrongful trading, fraudulent trading, breach of duty or of disqualification: see ch. 16 below.
36 Carruthers and Halliday, Rescuing Business, p. 244.
move towards formal insolvency procedures because these are likely to generate fee income. Such acute divergences of interest make it especially important that rescue regimes are not only fair and accountable but seen to be so.

**Informal and formal routes to rescue**

Troubled companies and their directors, creditors or shareholders are able, as noted, to take informal as well as formal steps in order to effect rescues – most rescues are, indeed, achieved through informal action.\(^{37}\) Informal actions do not demand any resort to statutory insolvency procedures but are contractually based. They are usually instituted by directors or creditors and they may involve the use of professional help: where, for instance, a ‘company doctor’ or firm of accountants is appointed (usually on a creditor’s insistence) to investigate the company’s affairs and to make recommendations. Such informal steps may result in the kinds of remedial action already referred to: changes in management, corporate reorganisations or refinancings, for example. Alternatively, under the ‘London Approach’, co-ordination of a creditors’ agreement in accordance with informal guidelines may be achieved with the Bank of England acting as an honest broker in making efforts to persuade reluctant parties to pursue such informal settlements.\(^{38}\)

Formal arrangements under which rescues may be attempted are provided for in the Insolvency Act 1986\(^ {39}\) and include company voluntary arrangements (CVAs),\(^ {40}\) receiverships and administrative receiverships\(^ {41}\) and administration.\(^ {42}\)

From the company management and shareholders’ point of view, a general advantage of informal rescue is that publicity concerning corporate troubles may be minimal, the stigma of formal insolvency may be avoided and the goodwill and reputation of the company preserved. Avoiding the adverse publicity that would often follow the commencement of a formal insolvency proceeding can have a significant impact on the ability of a company to survive and on the realisable value of its

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\(^{38}\) See ch. 7 below. In 1998 the Financial Services Authority took over from the Bank of England as banking regulator.

\(^{39}\) See also Companies Act 2006 s. 895; chs. 9 and 11 below.

\(^{40}\) Insolvency Act 1986 ss. 1–7. \(^{41}\) Ibid., ss. 28–69, 72A–H. \(^{42}\) Ibid., Sch. B1.
assets. The cost of informal procedures is also likely to be lower than where court proceedings are involved. Delays and attendant costs may, furthermore, be reduced where rescues are managed without hostile litigation. Informality also ensures flexibility so that terms can be adjusted and renegotiated in a way that formal procedures (such as approval processes) do not allow. From the point of view of company directors, a further considerable advantage of informality is that this avoids the intervention of an insolvency practitioner in the role of a formal scrutiniser of directorial actions. Where rescues are formal, IPs possess extensive powers to investigate corporate affairs together with a duty to report on the conduct of directors. Such IPs will, moreover, assume control of the company. Informal rescues thus avoid the investigations and changes in power and control that directors may fear. Another incentive for management to see that the company remains outside formal insolvency is that formal insolvency procedures carry with them the stigma of (usually culpable) failure. In terms of external perceptions, particularly in employment markets, it may be ‘bad news’ for management to be associated with a company which has had recourse to formal insolvency procedures.

From the point of view of many banks and secured lenders, informal rescue may be attractive in ways that can outweigh attendant risks. It not only offers the prospect of repayment in full, if ultimately successful, but

44 But see discussion of the London Approach in ch. 7 below.
45 ‘Formal insolvency not only crystallises parties’ rights, but also their attitudes’: Brown, Corporate Rescue, p. 11.
46 See e.g. Insolvency Act 1986 ss. 234–7. Once an administrative receiver has been appointed, an administration order made, or the company has gone into liquidation, the relevant IP is under a duty to submit to the Secretary of State a report on the conduct of the directors of the company: Company Directors’ Disqualification Act 1986 s. 7(3) and the Insolvent Companies (Reports on Conduct of Directors) No. 2 Rules 1986. This could lead to action being taken for the disqualification of those directors: see ch. 16 below.
47 Though a cessation of power would, from that point, reduce dangers of subsequent liquidator actions for fraudulent or wrongful trading under the Insolvency Act 1986 ss. 213 and 214: see ch. 16 below.
48 See Segal, ‘Rehabilitation and Approaches’, p. 132.
49 Ibid., where the point is made that we have not yet reached the stage in England (as arguably occurs in the USA) of regarding the reorganisation of companies in difficulty through the use of court procedures as ‘being an acceptable, even standard, tool of business management’.
also provides an opportunity to acquire a fresh injection of funds from other sources (such as shareholders or other banks) and allows such well-positioned creditors to extract enhanced or new security, or priority, as the price for supplying further funds to the company. A bank, for instance, may improve its position by taking a floating charge as security and, even if an informal rescue ultimately fails, the bank will often have improved its security position and may then be able to appoint an administrator of its choosing out of court.50

A disadvantage of informal rescue, however, is its potential to prejudice the interests of less-well-placed creditors. Informality may be attractive to directors, but, from the point of view of certain creditors, a deficiency of informality may be the absence of investigative powers and the lack of an inquiry into the role of directors in bringing a company to the brink of disaster. A fundamental weakness of informal rescue is, furthermore, that the agreement of all parties whose rights are affected will generally be required if the rescue is to succeed. Informal rescues demand that parties with contractual rights agree to compromise, waive or defer debts, or alter priorities. Dissenting creditors, accordingly, have the power to halt informal rescues by triggering formal insolvency procedures, including liquidation. This renders the informal rescue a fragile device that is dependent on a high degree of co-operation from a range of parties.51 In contrast, a formal procedure such as administration involves a moratorium on the enforcement of a wide range of creditors’ rights and so creates a more sustainable space within which a rescue can be organised.

The new focus on rescue

Since the late 1990s, corporate insolvency law and processes have changed in a way that places a new emphasis on rescue and on early actions to respond to corporate troubles. It can be argued that a fundamental

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50 I.e. if holding a ‘qualifying floating charge’: see Insolvency Act 1986 Sch. B1, para. 14. The administrator may then even be implementing a ‘pre-packaged’ administration: see further ch. 10 below.

51 Brown, Corporate Rescue, p. 13. In an informal bank rescue, for example, the negotiations between the banks are intensive and, as will be seen in ch. 7 below, negotiation and resolution may become even more difficult if there is a multiplicity of interests to be catered for in the form of hedge funds, distressed debt traders, etc. Even within the grouping of banks different rights and obligations need to be ironed out: ‘Some banks may start out as secured, while others start out as unsecured.’ Segal, ‘Rehabilitation and Approaches’, p. 133.
philosophical change has now occurred so that the law, in combination with corporate and creditor practice, has moved from a focus on *ex post* responses to corporate crises to one that increasingly involves influencing the ways that corporate actors manage the risks of insolvency *ex ante*. This movement, it can be said, is consistent with those increasing appetites to audit and to risk manage that are to be observed more generally across public and private sector activities. It can, in addition, be contended that, in parallel with such a philosophical shift, a revision of insolvency roles has taken place so that participants in corporate and insolvency processes have become more encouraged and inclined to see corporate disasters as matters to be anticipated and prevented rather than to be responded to after the event.\(^{52}\)

**The philosophical change**

From at least the times of the Cork Report, commentators on insolvency processes have stressed that the furtherance of rescue demands that interventions from outside troubled companies should take place at the earliest opportunity.\(^{53}\) Now, however, we may be seeing the start of a shift that institutionalises anticipatory approaches to corporate troubles. That shift can be seen in legislation, corporate reporting requirements and bank strategies.

On the legislative front, the Enterprise Act 2002 effected a significant change of stance by introducing a number of reforms that were designed to assist troubled companies and to do so by fostering a rescue culture.\(^{54}\) As will be detailed in chapter 9 below, it replaced the regime of administrative receivership with provisions that gave pride of place to the new

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52 This section builds on V. Finch, 'The Recasting of Insolvency Law' (2005) 68 MLR 713. On the case for considering the roles of different institutions in insolvency law and procedures see J. Westbrook, 'The Globalisation of Insolvency Reform' (1999) NZLR 401, 413. See also ch. 5 above.


administration procedure and it also ring-fenced a set portion of funds for the benefit of unsecured creditors.\textsuperscript{55}

The Enterprise Act did more, however, than further rescue. It arguably encouraged those involved with potentially troubled companies to think about insolvency risks in advance of the final crisis – to manage such risks \textit{ex ante} rather than \textit{ex post}.\textsuperscript{56}

The timescales set up by the Enterprise Act have this effect. The administrator must present proposals to creditors within eight weeks of his appointment and must commence a creditors’ meeting within ten weeks of the administration’s start.\textsuperscript{57} This means that the party that is going to appoint an administrator – which will usually be the bank that holds a qualifying floating charge\textsuperscript{58} – will have to be in a position to inform the administrator about the company, its businesses, prospects and risks at the very earliest stages of the administration process. This is not least because the notice appointing an administrator must be accompanied by a statement by the administrator that, \textit{inter alia}, he consents to the appointment and that ‘in his opinion the purpose of the administration is reasonably likely to be achieved’.\textsuperscript{59} When, accordingly, a bank is faced with a troubled debtor company and approaches a potential administrator, it is likely to be made very clear to the bank that such a statement will not be forthcoming unless the administrator is supplied


\textsuperscript{56} On the rise of the pre-packaged administration – the ‘pre-pack’ as an aspect of the movement towards anticipatory action – see ch. 10 below and V. Finch, ‘Pre-packaged Administrations: Bargains in the Shadow of Insolvency or Shadowy Bargains?’ [2006] JBL 568.

\textsuperscript{57} See the Insolvency Act 1986 Sch. B1, para. 52. Para. 52(1) sets out exceptions from these requirements.

\textsuperscript{58} That is per Sch. B1, para. 14. After the Enterprise Act 2002 reforms there are three methods by which a ‘new’ administrator can be appointed: see Sch. B1, paras. 12, 14–15, 22.

\textsuperscript{59} Para. 18.
with all of the information that is needed in order to evaluate the prospects of achieving the purpose of the administration.\textsuperscript{60}

For the bank this is no small matter. If it has loaned funds to a number of companies and a proportion of these are liable to encounter some financial difficulties at some time in their corporate lives, it will have an incentive to institute monitoring procedures that, in an ongoing manner, will place it in a position that allows it potentially to instruct an administrator at very short notice. Those monitoring procedures are likely to involve analysing and updating information that is supplied by the debtor company in compliance with lending conditions that require the company to keep the bank appraised of the former’s financial position, its prospects and business risks.\textsuperscript{61} The bank, moreover, is liable to demand that the debtor company should identify any business risks that are potentially threatening to the company and to state what is being done to manage those risks. The overall effect can be expected to be a driving forward of both a new awareness of insolvency risks and a new rigour in dealing with these before the company’s position becomes terminal.

It might be responded that too much is being made of a modest reform here and that the banks monitored their debtors long before the Enterprise Act 2002 came onto the scene.\textsuperscript{62} That, however, would be to understatement the effect of the Enterprise Act. The imposition of new time-frames for action in that Act means, as indicated, that incentives to monitor are given a new urgency. The Enterprise Act, moreover, did not merely institute new time pressures. Under the former regime of administrative receivership, the bank that loaned funds under the security of a floating charge operated in something of a comfort zone. It knew that if the company entered troubled waters it could enforce its security quickly by appointing an administrative receiver who would act entirely in the interests of the bank so as to realise assets, if necessary, and settle the debt. The ‘new’ administration procedure, established by the

\textsuperscript{60} The Enterprise Act 2002 replaced the alternative purposes of the old administration regime under the Insolvency Act 1986 (former) Part II with a hierarchy of objectives: all ‘new’ administrations (whether instituted by court order or out of court) have the same statutory objectives. See para. 3(1) of Sch. B1, Insolvency Act 1986.


\textsuperscript{62} On bank monitoring see chs. 7 and 8 below; and J. Armour and S. Frisby, ‘Rethinking Receivership’ (2001) 21 OJLS 73.
Enterprise Act, replaced administrative receivership as the process for enforcing floating charges.\textsuperscript{63} It still placed the banks in a strong position relative to unsecured creditors\textsuperscript{64} but it brought changes that the banks would not necessarily have welcomed. First, in contrast with receivership, it provided that administrators should act in the interests of the company’s creditors as a whole\textsuperscript{65} and, second, it set down inclusive procedures and enforcement provisions that ensured that the interests of creditors as a whole would be taken into account and protected when the administrator took decisions or made judgements about the company’s prospects.\textsuperscript{66}

For the banks, these changes brought significant new challenges. The bank’s interests fell to be protected in the face of inclusive procedures that gave all of the company’s creditors a voice. These procedures were, as a result, potentially drawn out in operation and were also capable of leading to legal attacks on a number of fronts.\textsuperscript{67} The administrator’s statutory objectives were set out in a complex series of contingently phrased subsections that did little to assuage bankers’ fears that administrators would be too bogged-down in procedural constraints and

\begin{itemize}
\item \textsuperscript{63} The replacement is subject to six exceptions: see Insolvency Act 1986 ss. 72B–G. See further ch. 8 below.
\item \textsuperscript{64} Though see Enterprise Act 2002 s. 252 which inserted a new s. 176A into the Insolvency Act 1986 to ring-fence, for the benefit of unsecured creditors, a prescribed proportion of funds otherwise available for distribution to the holders of floating charges. See also Insolvency Act 1986 (Prescribed Part) Order 2003 (SI 2003/2097). On whether, on the wording of s. 176A, a floating charge holder with an unsecured balance is entitled to participate in the prescribed part see G. McPhie, ‘New Legislation’ (2004) \textit{Recovery} (Autumn) 24. The Insolvency Service is of the view that the floating charge holder is not so entitled, as is His Honour Judge Purle QC in \textit{Permacell Finesse Ltd (in liquidation)} [2008] BCC 208 and as is Patten J in \textit{Re Airbase (UK) Ltd, Thorniley v. Revenue and Customs Commissioner} [2008] BCC 213 (Ch): see A. Walters, ‘Statutory Redistribution of Floating Charge Assets: Victory (Again) to Revenue and Customs’ (2008) 29 Co. Law. 129.
\item \textsuperscript{65} Insolvency Act 1986 Sch. B1, para. 3(2).
\item \textsuperscript{66} On inclusiveness and challenges to the administrator see Insolvency Act 1986 Sch. B1, paras. 49–58, 74–5.
\item \textsuperscript{67} The administrator is subject to a duty (under Sch. B1, para. 4) to perform his functions as quickly and efficiently as is reasonably practicable. Under para. 74(1) a creditor or member can challenge the administrator by claiming that he is acting or has acted or proposes to act so as to unfairly harm their interests. Para. 74(2) allows the same parties to mount a challenge on the grounds that the administrator is not performing his functions as quickly or as efficiently as is reasonably practicable. Para. 75 allows misfeasance actions to be brought (by, \textit{inter alia}, a creditor) against administrators and the company does not have to be in liquidation for such an action to be commenced.
\end{itemize}
litigation to be able to protect the banks’ interests effectively. These challenges arguably created new needs for the banks to work harder to maximise their potential control of the new administration process and to do so by engaging in anticipatory actions – notably by collecting more, better and earlier information on the company’s state of affairs and its prospects. The banks had gained incentives to follow the rugby-playing advice to ‘get your retaliation in first’. In this way the insolvency process was shifted in its focal concern – away from debt collecting and towards the management of insolvency risks.

In reply to the above argument it might be contended that the Enterprise Act 2002 may encourage the banks to take steps other than to increase their ex ante monitoring of companies. Thus, it might be forecast that, daunted by the uncertainties and complexities of the 2002 Act, the banks may be induced to shift their lending practices away from using floating charge securities and towards more lending via fixed asset security. The result of this, it might be suggested, would be a fragmentation of security as the floating charge loses dominance in favour of a mixture of lending arrangements. The overall effect, it could be contended, would be a diminution in incentives to monitor the activities of the debtor company. This would happen, the argument runs, because it is the concentration of a company’s borrowing in a single credit arrangement that makes it worthwhile for the creditor to monitor the company’s behaviour – a scenario that was arguably fostered by the floating charge under pre-Enterprise Act arrangements.

Turning to corporate reporting requirements, it can be argued that concerns to monitor companies ahead of troubles have been reinforced by other changes in corporate procedure, notably in reporting requirements through the passing of section 417 of the Companies Act 2006. This section was promulgated in the wake of the short-lived notion of the


70 On ‘creditor concentration’ and its encouragement of monitoring see Armour and Frisby, ‘Rethinking Receivership’; Armour ‘Should We Redistribute in Insolvency?’; On limitations of the ‘concentrated creditor theory’ see ch. 8 below.
Operating and Financial Review (OFR) and demands that (unless the company is subject to the small companies’ regime) the directors’ report includes a ‘business review’ that informs members and helps them to assess how the directors have performed their duty to promote the success of the company. The review must contain a fair account of the company’s business and a description of the principal risks facing it. It must offer an analysis of development and performance but (in requirements going beyond the former provisions of the Companies Act 1985) must, in the case of quoted companies, report on the main trends and factors likely to affect the business’s future development and performance. Information about the company’s supply chain and arrangements that are essential to the business must be included.

The importance of the new reporting requirements, in insolvency terms, lies in their potential effect in furthering processes in which company directors not only manage serious risks but also disclose to stakeholders how they are managing such risks. This emphasis on managing and controlling risk, the foundations of which were established by the Turnbull Report, goes a significant step further than the Cadbury Code on Corporate Governance of 1992, which established the principle that senior managers are responsible for the maintenance of an internal control system.

It can be anticipated that companies may set out to comply with the new requirements and to identify risks and describe risk management systems in different ways. One group will ‘box-tick’ and confine itself to


72 Companies Act 2006 s. 417(5).

73 Ibid. s. 417(5)(c).


‘boilerplate’ reviews that offer a broad-brush identification of the main risks and uncertainties facing the company and its subsidiaries. A second group will go further and seek to identify the main risks faced and the ways in which these are managed. A third group, however, will take the opportunity to improve its performance by embedding its reporting and risk management systems within the general structure of management and decision-making within the company. Companies in this group will seek to develop best practice methods so that their reports not merely will identify key business risks but will be able to isolate risks that potentially threaten the viability of the business and deal with these alongside other categories of serious and less serious risk. Such companies will describe how the various categories of risk are managed, how risk management systems are organised, evaluated, updated and reported on within management. They will describe how risk management responsibilities are allocated, how information on risks is collected and disseminated and how outsourced risks are dealt with. These section 417 reports will be used by leading companies to persuade stakeholders that the managers of the company are both able to identify any risks that threaten either the business or its achievement of corporate objectives, and are able to manage the full array of risks in a systematic and auditable manner.

The emergence of best-practice reporting is liable to lead, in turn, to a new emphasis on managing insolvency risks in a more open and more preventative manner. This development is likely to be driven ahead as investors and the major lenders to companies – the banks – see the value of best-practice disclosures in informing them about both the risks their debtors are facing and the quality of their debtor companies’ managerial responses to such risks. A key point here is that, although the requirement to report on factors likely to affect future business development only applies to quoted companies (of whom many will already produce reports on such lines), this institutionalisation of the requirement may well encourage the banks to demand at least elements of such reporting from a wider range of companies to whom they lend. The banks may thus be increasingly inclined to use their lending power to insist that

76 The Financial Times commented that ‘it is in companies’ interests to produce an insightful statement. There is a lot of investor pressure for this kind of information to be made available. In fact, almost half leading listed companies already produce such information although it may not be grouped under one heading in their annual reports.’ (Financial Times, Editorial, 26 November 2004.)
companies who borrow from them conform to processes akin to best practice reporting. In doing so, they will not only gain new stocks of information but also sharpen their focus on how insolvency risks are managed. Another step away from debt collecting and towards a preventative philosophy will have been taken.

That step, moreover, is reinforced by the Government’s response to the Enron/WorldCom international accounting debacles.\textsuperscript{77} This took the form of the Companies (Audit, Investigations and Community Enterprise) Act 2004. This statute encouraged a higher level of pre-insolvency scrutiny of corporate management by introducing a new rigour to directorial disclosures to auditors. Section 9 of the 2004 Act inserted section 234ZA into the Companies Act 1985 to demand that directors state in their directors’ report that there is no ‘relevant audit information’ that they know of and which they know the auditors are unaware of.\textsuperscript{78} To such ends, directors must take all the steps that they ought to take as a director in order to become aware of any relevant audit information and to establish that the company’s auditors are aware of that information. Directors are to take those steps and make enquiries as required by their duty to exercise reasonable care, skill and diligence as assessed on a combined objective/subjective standard as specified in section 214 of the Insolvency Act 1986.\textsuperscript{79} The 2004 Act, moreover, made directors criminally liable if they make a false statement of the above kind – if they knew (or were reckless that) it was false and if they failed to take reasonable steps to prevent the report from being approved.\textsuperscript{80} The effect is to enhance auditors’ powers of scrutiny and, regarding potential risks to companies, shifts the focus of attention further in advance of the point when such risks have turned into insolvency realities.\textsuperscript{81}


\textsuperscript{78} Section 234ZA applied to directors’ reports from financial years beginning on or after 1 April 2005. It has been replaced in equivalent terms by s. 418(2) of the Companies Act 2006.

\textsuperscript{79} On Insolvency Act 1986 s. 214 see ch. 16 below.

\textsuperscript{80} See now the replicated rules in Companies Act 2006 s. 418(5)–(6).

\textsuperscript{81} On governmental concerns to increase the transparency and accountability generally in corporate operations see the White Paper, Company Law Reform (Cm 6456, March 2005), especially ch. 3.
Increased attention to managerial performance and directorial business risk management has also been encouraged by other changes. Thus, a more intense spotlight has come to rest on directors as the Department of Business Enterprise and Regulatory Reform (BERR) has stepped up its use of disqualification powers. As we will see in chapter 15, a significant reform introduced by the Insolvency Act 2000 was the permitting of disqualification undertakings to be accepted by out-of-court agreement between a director and the Disqualification Unit of the Insolvency Service. The disqualifications involved are identical to those that would be imposed by a court and the streamlined process offered by the 2000 Act has produced a dramatic rise in disqualifications – from a little under 400 in 1995 to 1,200 in 2006–7 (of which 80 per cent were by way of undertakings). It is in more rigorous control of managerial diligence that the increasing scrutiny of pre-insolvency management can principally be seen.

It has also been suggested that the Crown’s loss of its preferential status since September 2003 may put yet more monitoring pressure on directors. This loss, the argument runs, may make the Crown ‘increasingly vigilant in seeking to recoup some of this loss, possibly by funding actions against directors’. In the face of the above kinds of pressure it is to be expected not only that many directors will feel that they are under ever more intense scrutiny but also that they will feel the need to respond to this by making more certain that they can justify the actions and judgements that they have effected.

This series of developments points towards a shift from ‘debt collection’ to ‘risk management’ approaches in corporate insolvency law and procedures. Such a shift might be explained by citing new governmental concerns to maximise rescue opportunities. There is, however, another account that links a recasting of corporate insolvency philosophy to

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83 Insolvency Service Annual Report 2006–7, p. 15.
84 See Enterprise Act 2002 s. 251. (Paras. 1, 2, 3–5C, 6 and 7 of the Insolvency Act 1986 Sch. 6 are deleted.) See further ch. 14 below.
86 On the Blair Government’s espousal of rescue objectives see e.g. Productivity and Enterprise: Insolvency – A Second Chance (Cm 5234, July 2001); Secretary of State for Trade and Industry’s statement at HC Debates, col. 53, 10 April 2002.
other identifiable and deep-seated movements in the cultures of public and private governance. What is observed in relation to recent insolvency developments is in line with the elements of what has been dubbed the ‘audit explosion’. As described by Power, audit is ‘an emerging principle of social organisation which may be reaching its most extreme form’. At its heart is the idea that control systems within organisations – be they corporations or government departments – must be auditable and audited. In public and private systems ‘there is a commitment to push control further into organisational structures, inscribing it within systems which can then be audited’. Such ‘demands and aspirations for accountability and control’ are accompanied by a new emphasis on allocating increasing scrutiny powers to outside monitors and developing the role of independent scrutiny as a substitute for professional judgements or trust. Audit becomes a way of reducing risks through the review of control systems. It can be seen in those corporate governance requirements from Cadbury to the Companies Act 2006 that seek to create layers of regulatory systems so as to allow performance at one level to be measured and held accountable at another. It is also exemplified in the new culture of quality assurance – as encountered in the idea of total quality management (TQM). This seeks to make management control systems transparent, accountable and accessible to stakeholder scrutiny and input. Such appetites for the ‘layering’ of control processes, moreover, are only encouraged by accounting debacles such as Enron and WorldCom which produce political currents in favour of ever more transparency and accountability.

The appetite to audit is echoed in another new drive – towards seeing governmental, regulatory and business challenges in terms of needs to manage risks. Thus, in recent years there have been explosions of initiatives to spread risk management across government, of ‘risk-based’

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88 Power, Audit Explosion, p. 47. 89 Power, Audit Society, p. 42. 90 Ibid., p. 6.
91 Ibid., pp. 1, 47; Power, Risk Management of Everything, pp. 10–11: ‘the risk management of everything is characterised by the growth of risk management strategies that displace valuable – but vulnerable – professional judgement in favour of defendable process’.
approaches to regulation \textsuperscript{93} and of risk-centred strategies for corporate management. \textsuperscript{94} In the regulation field, for instance, this development can be seen in regulators’ growing inclinations to move away from securing results through externally imposed ‘command and control’ regimes that target errant corporate behaviour directly and towards ways of pushing regulatory tasks down into the regulated organisations. The new hope lies in using regulatory systems that target enforcement actions according to analyses of the risks presented by regulated companies and which adjust regulatory activities in a way that is ‘responsive’ to the internal control processes of regulated companies. \textsuperscript{95} Some such systems, indeed, may more actively deploy monitoring, review and incentive systems to audit and influence the self-control mechanisms of corporations. \textsuperscript{96} Within the environmental field, in particular, the last two decades have seen a mushrooming of schemes that see the auditing of private management systems, rather than external regulation, as the route to optimal results. \textsuperscript{97} This is a development that creates a new role for intermediaries:


\textsuperscript{97} Power, Audit Society, pp. 62–5.
‘consulting markets thrive in the margins of regulatory initiatives. Where central agencies wish to effect management changes in target organizations, management consultants take on the role of mediating regulatory compliance and economic strategy.’

Risk has developed as an organizing concept so that, whether governmental, regulatory or business challenges are found in the public or private sectors, they are approached as questions of risk management. The twin appetites for audit and risk management, moreover, combine to create a pervasive thrust towards dealing with problems or meeting opportunities through auditable risk management systems.

The parallels with recent changes in the field of corporate insolvency are manifest. As will be seen in chapter 7, the banks are increasingly concerned to deal with corporate troubles by subjecting companies’ management and risk control systems to external scrutiny. They look for measurable quality from management teams. In troubled times they push their ‘care’ down into management structures and increasingly use independent specialist professionals to evaluate and assist those who underperform and bring the company into danger. The common cultural factor across all these public and private fields is an appetite for, and a faith in the value of, exposing managerial or control systems to measurement, audit and review. The move from debt collection to insolvency risk management is as consistent with that culture as the changes that have recently been seen in public management, regulation or corporate management.

As far as bank strategies are concerned, an additional respect in which insolvency law and practice has moved from a reactive towards an anticipatory philosophy has been in the approaches that the banks have adopted when lending to potentially troubled companies. The banks have long used the conditions of loan agreements to keep in touch with corporate performance and managerial behaviour. They have used

100 See Power, Risk Management of Everything, pp. 27–8: ‘The private world of organizational internal control systems has been turned inside out, made public, codified and standardized and repackaged as risk management.’
negative covenants in which the borrower agrees not to undertake certain behaviour or change the business in specified ways. They have employed positive covenants to ensure that the borrower supplies the lender with a variety of information on a regular basis and they have used financial covenants (positive as well as negative) to regulate different aspects of financial performance such as gearing, liquidity, profitability or levels of borrowing or working capital. Such conditions have given the major lenders a good deal of power to monitor corporate managers. Since the late 1990s, however, it is arguable that UK banks have adopted a newly organised and proactive approach to their debtor relationships – one that seeks to respond to corporate troubles at a far earlier stage of development than formerly. This approach is manifest in the increasing rigour with which the banks now attend to three things: early warning signals for corporate troubles; the quality of a company’s management (most notably its capacity to steer a path through troubles); and the company’s performance in managing the business risks it faces.

New attention to early warning signals is founded on the more active monitoring of data. The British Bankers’ Association issued a Statement of Principles in 1997 (revised in 2001 and 2005). This document makes it clear that when banks lend to small and medium enterprises, they will normally agree what sort of monitoring information will be required. Included within that information will be a comparison of forecasts and actual results (based on a number of stated performance indicators) as well as details on how the company’s bank accounts are

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103 On the conditions under which lenders will deal with lending risks through monitoring as opposed to other methods (e.g. increasing security or raising interest rates) see G. Triantis and R. Daniels, ‘The Role of Debt in Interactive Corporate Governance’ (1995) 83 Calif. L Rev. 1073; S. Franken, ‘Creditor and Debtor Oriented Corporate Bankruptcy Regimes Revisited’ (2004) 5 EBOR 645; T. H. Jackson and A. T. Kronman, ‘Secured Financing and Priorities Among Creditors’ (1979) 88 Yale LJ 1143; R. Scott, ‘A Relational Theory of Secured Financing’ (1986) 86 Colum. L Rev. 901. See also ch. 3 above.

104 BBA, Statement of Principles.
used. The banks now monitor such information on an ongoing basis and use it not only to place the debtor in a risk category but also to provide early warning signs of trouble. There are, indeed, indications that lenders see the provision of early warning signals as by far and away the main purpose of deploying covenants in loan agreements. When difficulties are signalled it will be usual to refer the company to an ‘intensive care’ unit of the bank – or ‘Business Support Team’. At this stage, the bank’s involvement becomes more active and may involve the appointment of an accountant to conduct an independent business review (IBR). The bank and the debtor company will then agree a way forward after considering the recommendations that emerge from the IBR. Companies in such circumstances are heavily reliant on the bank’s support and, at this stage, managers will have little choice but to accept the turnaround strategies initiated by the bank.

Turning from early warning signals to the control of management, there has been a similar movement towards pre-insolvency action. The approach of Barclays Bank in the post-millennium period exemplifies this change. When a company is first introduced to a Barclays’ Business Support Team, that unit will focus increasingly on the quality of the management group and the need to help it to deal with the troubles confronting the company. This will involve, first, a structured approach in assessing the strengths and weaknesses of the company’s management and whether it is capable of meeting the challenges faced. If changes

105 See Armour and Frisby, ‘Rethinking Receivership’, pp. 92–3: ‘banks increasingly differentiate the riskiness of their borrowers, and charge accordingly’. The companies will pay a premium rate (a) because they present higher insolvency risks and (b) to pay for the higher level of care that they receive from the bank.


108 Armour and Frisby, ‘Rethinking Receivership’, p. 92; BBA, Statement of Principles, para. 2.3.

109 See Armour and Frisby, ‘Rethinking Receivership’, who comment (at p. 93): ‘should bank support be withdrawn at this stage, the company would be insolvent in the “cash-flow” sense’. (On cash flow and balance sheet tests and definitions of inability to pay debts see ch. 4 above.)

110 See Otty, ‘Banking on the Managers’ (Mr Otty was then Business Support Director at Barclays); J. Dewhirst, ‘Turnabout Tourniquet’ (2003) Financial World 56. The Royal Bank of Scotland set up a Specialised Lending Services Division in 1993 which focuses on restructuring, rescue and intensive care. More than 1,000 companies are in the unit’s care at any one time and its head, Derek Sach, claimed that the Division returns around 80 per cent of businesses back to good health: see Financial Times, 31 January 2005, p. 24.

are needed in that team, or if ‘skills or experience gaps’ need to be filled, then additional or replacement personnel will be introduced through specialist suppliers.\footnote{E.g. FD Direct or Proturn Executive in Barclays’ case: see \textit{ibid}.} This may involve bringing on board experts in rescue. As a leading rescue professional commented: ‘Introducing the concept of turnaround professionals and helping to find the appropriate individual are becoming an increasingly important part of our solutions tool bag.’\footnote{\textit{Ibid.}, p. 12.} Reference to such specialists is facilitated by the emergence of these providers within the marketplace (a matter returned to below) and a significant role is played, in this regard, by organisations such as the Institute for Turnaround, Protorn and EIM Turnaround Practice.\footnote{The Society of Turnaround Professionals was established by R3 and was retitled the Institute for Turnaround in 2008: see ch. 5 above and ‘Turnaround Talk’ (2001) \textit{Recovery} (September). On the work of the turnaround specialist see R. Bingham, ‘Poacher Turned Gamekeeper’ (2003) \textit{Recovery} (Winter) 27. On turnaround professionals and governance issues see ch. 5 above and V. Finch, ‘Doctoring in the Shadows of Insolvency’ [2005] \textit{JBL} 690.} Once again, the effect of this change is, in practice, to focus attention on an earlier stage of corporate troubles than ever before. It is a development driven, not least, by the concern of the large banks to use their monitoring skills to gain market advantage. As Barclays’ Chief Executive, Matt Barratt, said of the new attention to managerial performance: ‘The ability to make good decisions regarding people represents one of the last reliable sources of competitive advantage.’\footnote{Otty, ‘Banking on the Managers’. For a mid-credit crisis view that the banks have learned lessons from past recessions and are now able to spot customers’ problems earlier see A. Sakoui, ‘The Delicate Task of Restructuring Lehman Begins’, \textit{Financial Times}, 27 October 2008.}

Alongside such new attention to early warning signals and to management has come an increasing lender interest in the way that companies are dealing with risks. When Business Support teams become involved with a company’s management, or when independent business reviews are carried out, a central task will involve identifying the key business issues and risks that have to be responded to. At such times the capacity of managers to recognise and to meet these challenges comes under review and a spotlight is placed on the risk management capabilities of the team of directors and senior managers in place. Banks and review teams will not, in such processes, confine their attention to assessing the probability of insolvency or of turnaround – they will be looking to see
whether the managers in position can overcome the company’s troubles on their own or whether they need active assistance to manage the risks at issue. This, once more, involves a newly proactive approach in dealing with the prospect of corporate insolvency. There may be some evidence, moreover, that a considerable amount of insolvency-related work is now being done at such earlier stages in corporate troubles. Armour and Frisby, for example, reported in 2001 that, in their survey of a number of accountants, banks and lawyers who were regularly involved in receivership, their interviewees stated that only a minority of firms that are the subject of an IBR subsequently enter formal insolvency proceedings.\footnote{Armour and Frisby, ‘Rethinking Receivership’, p. 94. (The authors do, however, caution about the lack of qualitative data on this issue.) See also the Royal Bank of Scotland’s claim to turn around 80 per cent of companies in its intensive care: p. 267 above.}

Reinforcing such a movement towards insolvency risk management has been a developing stakeholder confidence in the ability of specialists to devise and implement rescue strategies. One managing director of a mergers and acquisitions group summarised the market changes over the decade to 2002 in the following terms:

Turnaround opportunities are increasing because tighter market conditions, high leverage, bad management and over-trading are squeezing poor performers out. In the past, if a company was facing insolvency, it was seen to be prudent to cut one’s losses and liquidate what was salvageable to pay off key creditors. Nowadays, investors and businesses have sophisticated mechanisms for quantifying and evaluating risk. So the focus is shifting toward bespoke solutions to what can be temporary strategic problems.\footnote{A. Lester (of Aon), (2002) Recovery (Winter) 18.}

As a culture of rescue and recovery has been developed by lenders and encouraged by the Government,\footnote{See e.g. Productivity and Enterprise: Insolvency – A Second Chance (Cm 5234, July 2001); the Secretary of State for Trade and Industry’s statement at HC Debates, col. 53, 10 April 2002; Frisby, ‘In Search of a Rescue Regime’.} the market has responded by providing the skills that are designed to prevent corporate disaster. Thus, one business underwriting manager has written of recent changes: ‘The growing culture of rescue and recovery from a commercial and statutory viewpoint has raised the profile of turnaround finance. There is a cadre of better quality professionals around to assist businesses in turnaround, as well as assisting the lender. Lenders are now more likely to examine the possibilities of rescue and seek alternative solutions.’\footnote{C. Hawes (GE Commercial Finance), (2002) Recovery (Winter) 18.}
chapter 5, a burgeoning group of new specialists has come onto the scene. They all have a role in assisting banks or companies to effect turnarounds but come with a variety of labels, notably: turnaround professionals, company doctors, business recovery professionals, risk consultants, solutions providers, debt management companies and cash flow managers.120 Very often the main lending bank will call in such actors as part of a process in which the troubled company’s management capacity is reviewed; a strategy for turnaround is devised; arrangements for reorganising and refinancing are set up; and a programme for implementing necessary changes is put into effect. Banks’ incentives to monitor the signs of corporate distress can be expected to grow as they develop confidence in the turnaround capacities of their own staff and of relevant specialists. This, in turn, is likely to produce an increasing bank inclination to intervene in corporate affairs before troubles become potentially terminal.

If such a shift in inclination is typified as a movement from debt collection towards risk management, it might be questioned, first, whether it is possible to quantify this shift – to state how much more work in response to corporate decline is now being done at the informal turnaround as opposed to the formal statutory procedure stage. Second, it might be asked whether the banks are not so much moving towards a focus on risk management as merely relocating their debt collection activities from the formal to the turnaround stage.

On the first issue, a fundamental difficulty in quantifying the amount of work done in the turnaround period is that this will usually be carried out in an undisclosed manner in order to protect the reputation and business prospects of the troubled company.121 What can be pointed to, however, is the dramatic growth in the amount of turnaround servicing that is now being offered by a growing number of specialists.122

121 See Finch, ‘Doctoring in the Shadows’.
122 See MacDonald, ‘Turnaround Finance’; Finch, ‘Doctoring in the Shadows’. As for the relative proportions of work on corporate troubles that are done through turnarounds and formal procedures, little light, unfortunately, is thrown on the issue by statistics on the ratio between those firms which have undergone turnaround activity (e.g. IBRs) and those of these which subsequently enter formal proceedings. Such statistics leave out of account the number of firms who enter formal procedures without going through any prior turnaround activities.
On the second question, it would be unrealistic to contend that the banks do not, at least at times, act in their own best interests, with the primary aim of debt repayment, whether they are operating at the turnaround or formal procedures stage of corporate decline.\textsuperscript{123} As noted above, though, there is increasing evidence that in, say, operating intensive care procedures, the banks are routinely prepared to stimulate activities that are designed to enhance the troubled companies’ risk management systems and prospects rather than merely to produce early debt repayment. It should be emphasised, moreover, that when banks instigate the intervention of a company doctor in the affairs of a troubled enterprise, that company doctor will, in the vast majority of cases, be employed not by the bank but by the company and will be legally and professionally obliged to act in the interests of the company and not the bank.\textsuperscript{124} It is to be expected, moreover, that the earlier that a bank intervenes in the declare of a company’s fortunes, the greater will be the bank’s incentive to pursue rescue, rather than debt recovery, objectives. This is because the earlier the intervention, the smaller will be the risk of non-repayment to the bank and the greater the prospect of successful turnaround.

All of the above points, however, must be set in the context of the ‘new capitalism’ (as discussed in chapter 3). In the developing world of credit derivative trading there may be new possibilities of dealing with risks that lead a bank towards exit from its relationship with the troubled company rather than in the direction of doctoring and rescue. In relation to the USA, in particular, it has been argued that, thanks to the explosive growth of credit derivatives, debt holders such as banks and hedge funds will often deal with the risks attached to a troubled company by buying credit or loan default swaps, which trigger payments if the company fails. This brings two noteworthy effects that may prejudice rescue: uncertainty regarding the creditor’s position and a ‘decoupling’ of creditor and company interests that involves incentives to oppose restructuring and rescue. As one practitioner has said of such creditors:

\textsuperscript{123} On the banks’ tendencies to better their own positions during rescue processes see Franks and Sussman, ‘Cycle of Corporate Distress’.

\textsuperscript{124} If the company doctor is a member of the Institute for Turnaround (IFT) he will be obliged by that Institute’s Code of Ethics to act for the company in a manner that is impartial and free from any external pressures or interest that would weaken his professional independence (Code of Ethics, Appendix, para. A.2).
Where their interests lie is less predictable, especially if they also hold credit default swaps. Their financial interests may be best served by forcing a default if they are on the right side of a credit default swap position. The problem is compounded by creditors not having to disclose derivatives positions, making it very difficult for companies and regulators to find out their real intentions.\textsuperscript{125}

In so far as the derivatives market facilitates dealing with risks by methods that may ‘decouple’ the creditor from the company, it is to be expected that this may cut against the trend for banks to indulge in doctoring. Similarly it can be said that rescues may not be encouraged by a process of risk spreading that makes interests and incentives ever more complex and opaque. What, however, of the prevalence of such derivatives-based decouplings of creditor and corporate interests? The pioneering commentators in this area suggest that, in the absence of disclosure requirements regarding strategies for risk spreading, ‘we simply do not know’ the extent to which economic exposures are shed in this way.\textsuperscript{126} As for the position in the UK, these are not uncharted issues. In relation to the collapse of the Marconi restructuring talks in 2002, difficulties allegedly arose because some banks had used credit derivatives to lay off risk to the extent that they stood to gain more from Marconi defaulting than from a restructuring.\textsuperscript{127} Looking forward past the 2007–8 credit crisis, these are matters to be monitored since the credit derivatives market is global and UK creditors are just as free as their US counterparts to ‘decouple’ from the company without being subject to any organised provisions calling for disclosure on the extent of that decoupling.

\textsuperscript{125} See H. Hu and B. Black, ‘Equity and Debt Decoupling and Empty Voting 11: Importance and Extensions’ (2008) 156 University of Pennsylvania Law Review 625. An administrator, Tony Lomas of PWC, appointed to Lehman Brothers International (Europe) stressed in 2008 that, in the wake of Lehman’s collapse, funds and other counterparties of Lehman faced having their positions ‘frozen for some time’ because of the complexities of resolving individual positions and that such complexities were serious impediments to restructuring: see Sakoui, ‘Delicate Task of Restructuring Lehman Begins’.

\textsuperscript{126} Michael Reilly of the financing and restructuring practice at Bingham McCutchen, reported in F. Guerra, ‘Derivatives Boom Raises Risk of Forced Bankruptcy for Companies’, Financial Times, 28 January 2008. For proposals on the mandatory disclosure of actions that ‘decouple’ credit holders from economic exposure see Hu and Black, ‘Equity and Debt Decoupling’.

Recasting the actors

The philosophical changes outlined earlier are matched by a recasting of the roles fulfilled by the various actors that are commonly concerned with troubled companies. The preceding discussion serves to outline how the major lenders to companies, the banks, have shifted their focus of attention. At the end of the 1980s it was easy for a floating-charge-holding bank to rely on the power to appoint an administrative receiver and to stand at a distance from a troubled company. It knew that it could intervene quickly at the right time and recover its debt. Today the position is different because of legal, procedural and cultural changes. The bank is far more likely to be aware of corporate troubles at an earlier stage than formerly and to intervene by exerting a considerable degree of scrutiny or influence over the company’s directors. It will often be concerned to use its voice rather than merely to exit when the company first encounters trouble. It will not be fatalistic about financial difficulties but will use its intensive care teams where possible to prevent troubles from developing to the point where they cannot be turned around. In redefining its role the bank will have constructed a flexible relationship with a healthy company that can slide seamlessly into another form when the company encounters trouble.

As for company directors, a shift towards preventative approaches to insolvency involves a change in role. It is to be expected that as banks move from debt collection to prevention and the monitoring of risk management, directors will be subjected to regimes of scrutiny and assessment that both come into effect at an earlier stage in corporate decline than formerly and involve a greater depth of review. Directors, accordingly, will be held to account more fully as this shift in approach strengthens. Their expertise, as well as their management and risk control systems, will be placed under the microscope. On an optimistic view, it might be argued that company directors stand to gain in such a regime as they will be offered new levels of assistance by banks and independent consultants. They will have moved away from the agonies of the former regime in which the troubled director would be inclined to pursue a lonely and secretive path through troubles – a progress accompanied by the fear that the bank would discover what was going on and call the show to a halt by appointing an administrative receiver. Under the new

system, the director has to operate in a highly transparent way but when troubles are met, he or she has allies who will step in to help.

Pessimists, however, will be inclined to turn this argument on its head. They will warn that if banks increasingly demand that dangers of insolvency should be dealt with through risk management systems that are auditable, this produces a number of dangers. It may make company directors inward-looking and inclined to see the banks as unwelcome overseers who are to be resisted rather than welcomed as allies. These directors, as a result, may become procedurally defensive and more concerned to create an acceptable record of their behaviour for bank scrutiny than to exercise proper business judgement. Such defensiveness may not merely chill entrepreneurial behaviour but may reduce the flow of useful information to the banks. It may devalue communications between debtors and creditors as these become ritualistic exercises in formal compliance and this may, in turn, render the banks less, not more, able than formerly to spot incipient difficulties or to help companies when they meet troubles. Within companies, information may, as a result, be organised in less and less useful ways because it becomes structured by needs to box-tick, defend and avoid blame rather than to meet business objectives.

Whether the optimists or pessimists are on firmer ground goes beyond the current discussion but much may depend on the skill of the banks in setting up monitoring and assistance regimes that enable them to audit but, at the same time, give directors the freedom and confidence to make and apply business judgements without undue fear or constraint. Much may also turn on the extent to which companies can successfully embed auditable risk management systems within the general processes of wealth creation and governance.

Turning to the role of the insolvency practitioner, one recent change has been a general reorientation of approach. There has developed, as noted in chapter 5, a growing culture of rescue friendliness and with this has come a new emphasis on the IP’s role in averting disaster. As one IP described the movement: ‘the emphasis has shifted from “pathology” to “preventative medicine”… “managing change” has become a critical new

129 See Power, Risk Management of Everything, pp. 43–58.
discipline’. For IPs, however, the most dramatic change of recent years has been the replacing of administrative receivership with the post-Enterprise Act administration procedure. The post-Enterprise Act administration involves processes that are inclusive and which, with the departure of administrative receivership, oblige the IP to act in the interests of creditors of the company as a whole rather than in pursuit of the bank’s interests alone. These developments, when put together, involve a significant recasting of the IP’s role. The administrator in the ‘new’ administration procedure is given the difficult task of devising the best way forward while serving a variety of creditor interests and ensuring that a host of creditors’ voices are all respected in decision- and policy-making. A central, and newly acute, challenge will be to effect a balance between acting decisively in order to achieve the best outcome for the company and conducting deliberations in an open and accessible manner so that these are acceptable to all parties. The IP’s role has been moved in the direction of mediator as opposed to implementer or technician.

Unsecured creditors are the actors whose role perhaps changes least in the shift towards preventative approaches. That role, nevertheless, does change. For a start, unsecured creditors are given what amounts to a speaking part in the new regimes of corporate insolvency. Their voice has a new power in two respects. First, in the post-Enterprise Act administration process, they have a right to be listened to and the IP has a duty to heed their interests when deciding strategy. Second, their voice is given a potential role in the movement towards more open, transparent and accountable management that is driven by the new intensive care regimes run by the banks. When troubled managers, as never before, have to explain to banks and others how they are dealing with business partners, this stimulates the granting of access and influence to those unsecured creditors who have a continuing commercial relationship with the troubled company. The incentives of such creditors to use their voices may, furthermore, be increased by improvements in their potential returns through insolvency processes – as seen in the ring-fencing (or ‘prescribed part’) provisions of the Enterprise Act 2002.

132 See paras. 3(2), 49, 51–7. See ch. 9 below.
133 See Enterprise Act 2002 s. 252 (inserting a new s. 176A into the Insolvency Act 1986). This, as noted, provides that a prescribed part of funds otherwise available for distribution to holders of floating charges shall be retained for the benefit of unsecured creditors. See also Insolvency Act 1986 (Prescribed Part) Order 2003 (SI 2003/2097); ch. 3, pp. 108–10 above.
As for the judges, new concerns to deal with insolvency by preventative means bring some issues newly towards the centre of the stage. An important challenge for the judges is to develop the law in a manner that allows banks and others to assist troubled companies where this is in the general interests of creditors. At the same time, the judges must be concerned to avoid such assistance being used in a self-serving manner so that it prejudices the interests of creditors who are not procedurally involved – as where unsecured creditors’ interests may be harmed by banks using intensive care processes to protect themselves at the expense of others (for example by insisting on excessively low-risk strategies when more enterprising behaviour would be more reasonable and would benefit unsecured creditors).

Finally, mention must again be made of the new actors that have become involved in rescues. As noted already, the modern emphasis on prevention and rescue has been accompanied by the advent of new specialists: turnaround professionals, company doctors, risk consultants, solutions providers, independent business reviewers, asset-based lenders, private equity providers and others. These parties offer their services to assist both major lenders and companies when troubles are encountered. Their role is often dual – to scrutinise and monitor on behalf of a major lender and also to assist with the devising and implementation of turnaround solutions. Their growth in number and importance is a measure of the current advancement of concerns to deal with insolvency risks by preventative approaches.

**Comparing approaches to rescue**

In analysing English rescue procedures it is helpful to consider how other jurisdictions deal with the central challenges of rescue. The purpose of such comparisons is not to argue that English law should follow other countries but to set out key choices with clarity and to show that there may be a wide variety of ways to achieve rescue objectives.

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What then are the important issues to consider in such a comparison? A first must be the priority that an insolvency regime gives to rescue. Is, for instance, insolvency law seen merely as a means of debt collection for creditors or does it place importance on rescue to the extent that creditors’ rights are placed on the procedural back burner or even modified? Can the regime be said to be creditor or debtor friendly? Does it, for example, involve a moratorium on the enforcement of creditors’ rights and does it allow broad access to the rescue process? A second issue is whether the regime is fault-based. Does it, for instance, treat the directors as responsible for corporate troubles to the extent that they are seen as blameworthy and in need of tight regulation and monitoring? Does it give priority to setting down heavy penalties for directors who misbehave?

A third key consideration relates to the managerial and oversight functions within rescue processes and to whom these are allocated. Regimes may be placed under the control of the courts, the directors, independent professionals or even the market, and they will have quite different characteristics. A court-driven rescue approach, for instance, will tend to be characterised by formality but alternative rescue regimes will rely more heavily on contractual or negotiated forms of dealing.

A fourth issue is whether the rescue process as a whole is focused or diverse. A focused process will rely on a small number of procedures and gateways to rescue whereas the diverse system of rescue may involve a host of different processes and philosophies.

Finally, an important comparative dimension is the financial context within which rescues operate. Rescue opportunities and processes may be heavily influenced by the structures that are available in a jurisdiction for raising corporate finances. Here the informal conventions governing such matters as banking arrangements may be as important as formal statutory structures. A further issue is how the law of a country or its


137 On creditor-oriented and debtor-oriented regimes, their comparative efficiency and the governance structures of firms see Franken, ‘Creditor and Debtor Oriented Corporate Bankruptcy Regimes’.

138 Hunter contrasts a ‘rescue culture’ – marked by a bias in favour of preserving businesses – with old notions ‘that the insolvent trader should be regarded as morally defective, and that individuals, partnerships and corporations who or which cannot pay their debts must, as part of the settled scheme of things, be made bankrupt or wound up’: Hunter, ‘Nature and Functions of a Rescue Culture’, p. 499.
bankers makes provision for funding within the rescue context: is, indeed, any special regime available for rescue purposes?

We will see, in the chapters that follow, that present English rescue procedures might be portrayed as giving strong priority to the protection of creditor interests and limited priority to rescue; as quite heavily fault-based and oriented to the control of errant directorial conduct; and as reliant on strong supervision of directors by independent insolvency practitioners and the courts. The English system is also quite diverse in so far as a number of rescue processes and gateways (informal and formal) may have relevance to a troubled company and it is set within a financial system that strongly favours the secured creditor.

The corporate insolvency regime encountered in the USA offers a set of contrasting characteristics and it is worth outlining these, as well as noting the alleged strengths and weaknesses of the US approach.139 Chapter 11 of the United States Bankruptcy Code (dating from the Bankruptcy Reform Act 1978) is a ‘reorganisation’ procedure whose policy objective is strongly oriented to the avoidance of the social costs of liquidation and the retention of the corporate operation as a going concern.140 There is no requirement that the debtor be insolvent or near insolvent in order to apply for Chapter 11 protection: the process is an instrument for debtor relief, not a remedy for creditors.141 As in England,

139 Chapter 7 of the US Bankruptcy Code is the most common form of bankruptcy. It is a liquidation proceeding in which the debtor’s non-exempt assets are sold by the Chapter 7 trustee and the proceeds distributed according to the Code’s priorities. It is available for individuals, couples, partnerships and corporations.


141 See generally P. Lewis, ‘Corporate Rescue Law in the United States’ in Gromek Broc and Parry, Corporate Rescue, p. 333.
a central purpose of the process is to preserve the value of the enterprise where this is likely to be greater than the liquidation value. Chapter 11 is, however, to English eyes highly sympathetic to the debtor, almost always started by a voluntary petition by the debtor and marked by the following characteristics.

There is an automatic moratorium or stay on enforcement of claims against the company and its property. This is triggered by the filing of a Chapter 11 petition. Secured creditors and landlords will usually initiate court action to seek to lift the stay but the moratorium will be upheld if the court finds that the debtor has provided the creditor with ‘adequate protection’ of their property interests. (This usually consists of periodic payments.) The debtor, in turn, must seek court permission to use cash as he is subject to a lien. Such issues, however, are often resolved by the parties by means of an agreement that is approved by the court. There is provision in Chapter 11 for ‘cramdown’ whereby a plan that is confirmed by the court may be imposed on a class of objecting creditors. (Generally a secured class may be crammed down if it receives the value of its collateral plus interest.) Objecting creditors are shielded by the ‘best interest’ test under which the court must be satisfied that each objecting creditor will receive, under the plan, as much as they would in liquidation. There is, in addition, a ‘feasibility’ test under which the court must find that the debtor is reasonably likely to be able to perform the promises it makes in the plan. It is nevertheless the case that in US law prior legal rights may be more dramatically affected than in England in order to effect a reorganisation and a new start for the company. Even unliquidated and unaccrued liabilities, for instance, can be restructured and constrained in Chapter 11.142 In English administration there is no division of creditors into classes and there is nothing equivalent to the US notion of class cram-down.

An important cultural difference between England and the USA concerns the issue of fault, as Moss has observed:

In England insolvency, including corporate insolvency, is regarded as a disgrace. The stigma has to some extent worn off but it is nevertheless still there as a reality. In the United States business failure is very often thought of as a misfortune rather than wrongdoing. In England the judicial bias towards creditors reflects a general social attitude which is

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inclined to punish risk takers when the risks go wrong and side with creditors who lose out. The United States is still in spirit a pioneering country where the taking of risks is thought to be a good thing and creditors are perceived as being greedy.¹⁴³

This cultural difference is reflected in the allocation of managerial and control functions. Under Chapter 11, the pre-petition management may remain in control throughout the proceedings,¹⁴⁴ though in law the bankruptcy estate vests not in the debtor company but in a separate conceptual entity: the debtor in possession (DIP).¹⁴⁵ The DIP is akin to a

¹⁴³ Moss, 'Chapter 11', p. 18; see also Carruthers and Halliday, Rescuing Business, p. 246; Westbrook, ‘Comparison of Bankruptcy’, p. 143, who argues that in the USA business failure is more readily seen as ‘the inevitable downside of entrepreneurship and risk’. See also M. Draper, 'Taking a Leaf out of Chapter 11?' (1991) 17 Law Society Gazette 28.


trustee. An examiner or trustee can be appointed under Chapter 11 if the creditors convince the court that investigation of the directors is necessary but the DIP is in virtually the same position as the trustee except for the latter’s powers of investigation and entitlement to compensation.

Before the Enterprise Act 2002, it was the position of the secured creditor that offered the most dramatic contrast between the US and English approaches. In England, as we have seen in chapter 3, there is the concept of a floating security that hovers over the company’s assets and crystallises into a fixed security when financial disasters happen. There is no equivalent in the USA and receivership on the pre-2002 English model is unknown there. The security holder in England had a level of control over rescue procedures that a US banker could only dream of. (Westbrook has quipped that ‘if an American banker is very, very good, when he dies he will go to the United Kingdom’.)

In England the floating security holder was able, when affairs went wrong, to appoint a receiver and manager of the entire business – an ‘administrative receiver’ – whose task was to obtain the best realisation for the secured creditor that was reasonably practicable. This is unthinkable in the USA. An underpinning English assumption here was that banks would do everything possible to save a company prior to inserting a receiver. In contrast, it has been argued that US businesses regard banks as ‘uncertain and fickle business allies at best’. As noted above, all changed with the Enterprise Act 2002, however, when (as will be discussed in chapter 9) the floating charge holder’s power to institute receivership was very largely replaced by the new administration procedure and an obligation on the administrator to act in the interests of all of the company’s creditors. The 2002 Act thus can be seen as moving English law in the direction of Chapter 11 but, as has been pointed out, it still differs in important respects: administration still hands control to an outsider; there is no method for ‘cramming down’ secured creditors (i.e. forcing them to accept a reorganisation plan); and there is no provision in

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146 Under s. 1104(a) of the Code (as amended by BAPCPA 2005) a court may appoint a Chapter 11 trustee upon showing of cause or if such appointment is in the best interests of the creditors, equity holders and other interests in the estate; and that trustee can also dismiss or convert the Chapter 11 case if the court concludes that to do so is in the best interests of the creditors and the estate. BAPCPA 2005 also adds s. 1104(e) obligating the US Trustee to move for the appointment of a trustee if reasonable grounds exist to suspect fraud by the debtor’s board of directors or high-level management.

147 Westbrook, ‘Comparison of Bankruptcy’, p. 87.

148 Ibid., p. 88.

England for attracting new finance in times of trouble by means of statutory super-priority funding arrangements.

The part to be played by a company’s shareholders also differs somewhat in the USA and England, and again reflects differing attitudes to corporate distress. In the USA, the shareholders have historically been given a role in rescue proceedings, although this influence may be waning. The inclusion of shareholders has been said to flow from a commitment to the entrepreneurial ethic and, again, a belief that financial troubles often stem from external forces. It produced an emphasis on preserving not merely the business but the troubled company itself. In England, the tendency is to view the prior shareholders as at least in part responsible for the company’s troubles (along with their directors) and to have interests that can be treated as having expired once a formal legal insolvency proceeding has started. The products of rescues tend to reflect this divergence of approach. In England most insolvency practitioners tend to look to sell the business but in the USA it can be the case that a rescue produces an agreed composition between the company and its creditors with the former equity owners keeping some ownership.

The parts played by professionals also differ. In English administrations a key individual is the insolvency practitioner. This is the person who, rather than the directors, runs the rescue operation. Rescues under the English system tend to be dominated by a small number of London-based specialist accountants. In the US system, with its DIP regime, bankruptcy tends to be locally operated and to involve lawyers rather than accountants.

The level of court supervision involved in the rescue process is also linked to the above factors. In English administration (before and after the Enterprise Act 2002) the central role of the independent insolvency practitioner means that little court supervision is required. In the USA the power of the DIP and the possibility of cram-down are balanced by

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considerable court protections for creditors in the reorganisation. In short, the US regime is closely regulated by the Bankruptcy Court whereas English administration relies more heavily on the administrator’s discretion and the agreement of the creditors.

In terms of legal focus, the US rescue system is concentrated on the Chapter 11 reorganisation, whereas in England a number of insolvency processes possess a rescue function: notably schemes of arrangements under sections 895–9 of the Companies Act 2006, company voluntary arrangements under the Insolvency Act 1986, and administrations. As will be seen below, the use of a variety of procedures raises issues of consistency and coherence in the English system.

Finally, note should be taken of the different financial contexts within which the Chapter 11 and English rescue procedures operate. In England it is usual for companies to raise a good portion of their capital by resort to bank loans secured by floating charges. This is consistent with English judicial and legislative policy which encourages financing through secured loans at interest rates that are reduced by giving secured creditors high levels of protection. In the USA, financing is more often achieved through the bond market and the secured creditor ‘does not enjoy the general sympathy of the public or the courts’.151 Where credit is obtained contractually through hire purchase or retention of title arrangements, the English courts tend to approach rights issues with a high respect for the sanctity of contract, whereas US courts look more directly to the need to protect parties collectively in a rescue scenario.

Chapter 11 procedures have been criticised on a number of fronts.152 A first concern has been the delay and expense involved. Delay is inevitable since Chapter 11 gives debtors 120 days after filing so as to propose a reorganisation plan. This is followed by sixty further days to obtain creditor and shareholder approval. Extensions to such periods have in the past been frequent and it was usual for creditors to be held at bay for one or more years. The Bankruptcy Abuse Prevention and

151 Moss, ‘Chapter 11’, p. 18.
Consumer Protection Act (BAPCPA) 2005, however, prohibits extensions of the debtor’s exclusive period in which to file a Chapter 11 plan beyond eighteen months after the start of Chapter 11 proceedings (plus two extra months to permit solicitation).153

Why do Chapter 11 cases take so long to process?154 A major reason is that the professionals have few incentives to act quickly. Chapter 11 is based on judicial oversight and lawyers’ fees accordingly tend to be very considerable. Under the old Bankruptcy Code, courts linked such fees to creditors’ returns, but the present regime allows market rates to be charged for services rendered.155 The BAPCPA 2005 amendments, however, sought to address some of these issues and bankruptcy judges are now charged to manage the case actively to reduce cost and delay. This includes holding ‘status conferences’ as are ‘necessary to further the expeditious and economical resolution of the case’.156

The expenses of litigation tend, furthermore, to be fuelled where the DIP approach leaves managers in control of a company since this may produce a lack of trust between creditors and management: a position that often gives rise to litigation that stands to be paid for out of the estate.

The US judges could place Chapter 11 processes under a tighter rein, but bankruptcy judges are ill-placed to do this because of their workloads. In any event, judges who are in doubt about a Chapter 11 case have tended to opt for the line of least resistance, which was to give the parties more time to think, often granting significant extensions, sometimes of periods of over two years. As for shareholders, their inclination will tend to be to wait rather than liquidate since they have little to lose by this. As for workforces, the indications are that firms tend to have shed half of their workers before a plan is confirmed. These results have prompted some commentators to argue that the millions and millions of dollars

154 Note Justice Small’s ‘Fast Track Chapter 11’: see Boshkoff and McKinney, ‘Future of Chapter 11’.
156 11 USC s. 105(d)(1). See further Lewis, ‘Corporate Rescue Law in the US’.
spent on lawyers and accountants might have been better used to repay creditors through swifter liquidations.\textsuperscript{157}

The utility of\textit{ Chapter 11} for small companies has been particularly subjected to question. The National Bankruptcy Review Commission argued in 2000 that for small firms\textit{ Chapter 11} is too long and costly. This line of argument is supported by statistics that reveal that\textit{ Chapter 11} produces a far higher success rate for large firms than for small firms.\textsuperscript{158}

Lengthy\textit{ Chapter 11} proceedings give rise to further concerns. One often-voiced comment is that unhealthy distortions of competition can result in some markets. It has thus been argued that when seven US airlines filed for\textit{ Chapter 11} protection in the 1990s they were able to keep capacity levels artificially high and slash fares to below-cost levels (since their creditors could not enforce). The healthy competitors of these airlines were, as a result, placed under extreme and unfair financial pressures.\textsuperscript{159} The effect of long\textit{ Chapter 11} moratoria has also been said to prevent insolvency law from fulfilling an important function: the weeding out of companies who use resources inefficiently so as to allow the redeployment of those resources for more efficient uses and to leave


\textsuperscript{158} A study by Edith Hotchkiss at Boston College, Massachusetts, examined 200 public companies that emerged from\textit{ Chapter 11}. She found 40 per cent to suffer from operating losses for the next three years and a third of the sample had to restructure their debt a second time, often under court protection: reported in\textit{ Financial Times}, 3 October 2001. Note, however, that amendments were made to small business bankruptcy cases by the BAPCPA 2005, e.g. the small business debtor now has a 180-day exclusivity period (50 per cent longer than the 120-day norm for other\textit{ Chapter 11} cases): see Lewis, ‘Corporate Rescue in the US’.

\textsuperscript{159} See C. Daniel, ‘Airlines Seek Shelter in a Storm’,\textit{ Financial Times}, 19 October 2004; Galen, ‘A New Page for\textit{ Chapter 11}’ p. 2. Franks and Torous also note ‘serious concern’ in the USA that\textit{ Chapter 11} is used by some firms to secure competitive advantages: see Franks and Torous, ‘Lessons from a Comparison’, p. 463. Broude, however, cautions that a\textit{ Chapter 11} filing may fail to produce a competitive advantage because, even when it reduces costs, it affects sales and market positions: ‘you’ll think twice before buying a laptop made or sold by a company that is in\textit{ Chapter 11}’ (‘How the Rescue Culture Came to the United States’, p. 197). Other commentators have recounted how airlines in\textit{ Chapter 11} in the early 1990s (for example, Continental, Pan American, Eastern) found that the\textit{ Chapter 11} stigma discouraged passengers: ‘Going Bust for Survival’,\textit{ Financial Times}, 3 October 2001.
the field to those firms who are able to act efficiently. Here there is a contrast with the Canadian Companies’ Creditors Arrangement Act (CCAA) under which the courts are more likely to terminate reorganisation proceedings at an early stage: for example, on failure to gain a creditors’ vote.\textsuperscript{160}

The DIP regime gives further grounds for concern. An important worry is that Chapter 11 allows existing managers to trigger the process. This renders Chapter 11 open to abuse as a device employed not for genuine reasons of reorganisation but in order to reap a market advantage or for another purpose. It has been suggested that Chapter 11 is open to use, inter alia, to settle tort liabilities or legal judgments; to reduce labour costs; to reject pensions obligations; or to resolve environmental damage liabilities.\textsuperscript{161} The absence of an early scrutiny of the reorganisation plans by an independent professional (as in English administration) or a court (as in Canada) means, first, that ‘abuses’ of Chapter 11 for tactical reasons are not picked up and, second, that proposals that have no real chance of success are allowed to run. The latter scenario means that the early liquidation of non-viable companies is prevented. Where, as in Canada, there is more aggressive court screening of applications for protection, this not only brings more rapid liquidation in hopeless cases but also encourages the firm’s managers to produce and disseminate, at an early date, a body of information about the financial condition of a debtor and a reasoned case for the proposal. This points to a further difficulty of DIP. It is the debtor who draws up financial statements in order to file for Chapter 11 and such a debtor may be liable to present a misleading picture of the company’s profitability. Chapter 11 procedures

\textsuperscript{160} See G. Triantis, ‘The Interplay between Liquidation and Reorganisation in Bankruptcy: The Role of Screens, Gatekeepers and Guillotines’ (1996) 16 International Review of Law and Economics 101 at 112. The BAPCPA 2005, as noted above, limited the DIP’s ability to obtain potentially unlimited extensions to its initial 120-day exclusive period to file a plan: s. 1121(d) states that the period cannot extend beyond eighteen months from the order for relief. On corporate rescue procedures in Canada see Brown, Corporate Rescue, ch. 24; ‘CCAA v Chapter 11’, Cassels Brock, Business Reorganization Group e-communiqué, vol. 9, no. 5, June 2005. Canadian bankruptcy law has been undergoing reform: the amending Bill-C12 received the Royal Assent on 14 December 2007 and the new laws are predicted to come into force in December 2008.

can be criticised as not creating, as in Canada, scrutiny processes that will favour the production of early, accurate information. This, in turn, conduces to a lack of trust and to higher litigation costs.

A further worry about Chapter 11 may seem exaggerated. To leave the old managers at the helm of a firm may be ‘like leaving an alcoholic in charge of a pub’ but corporate troubles do not always stem from mismanagement and, where managers have performed poorly, creditor pressure in the USA will tend to have resulted in the introduction of new managers at an early stage of the reorganisation. The Chapter 11 process, as has been noted, tends to be associated with high managerial turnover and ‘is not a safe haven for management’.

In other respects, however, there may be cause for concern about the role of the managers under Chapter 11. Some commentators argue that such managers are poorly disciplined by the Chapter 11 regime. A key objective of Chapter 11 is to solve problems of financial distress but the regime may be so soft on managers that it fails to correct the underlying inefficiencies of which the financial distress was a mere manifestation. If a regime gives strong rights to creditors (as English insolvency law does) those creditors will have an incentive to monitor managers and will be able to punish managerial slackness by demanding changes of underperforming staff. The same creditors will be able to prompt restructuring and asset divestments that enhance efficiency. Managers, in short, will be kept on their toes by the looming presence of the empowered creditor. Chapter 11 may be said to blunt this disciplinary role of creditors by its orientation towards rescue rather than enforcement.

This point can, however, be exaggerated. As already noted, creditors in the USA can bring pressure to bear so as to institute managerial changes, and a number of other factors may give managers an incentive to act efficiently. Firms may operate salary schemes that incentivise efficiency, shareholders may monitor managers, and the market for corporate control, as well as that for managerial talent, may again create healthy

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162 Moss, ‘Chapter 11’, p. 19. For a comparison of the UK’s management replacing scheme and the US’s DIP approach see McCormack, ‘Control and Corporate Rescue’.


164 See e.g. Triantis, ‘Interplay between Liquidation and Reorganisation’, p. 104.

165 Ibid.
incentives. In relation to one worry, though, it is less easy to find reassurance. Chapter 11 may induce even operationally efficient managers to run unjustifiably high business risks. Within Chapter 11 the managers are liable to identify their interests with those of the equity holders and may be likely to indulge in speculative business actions. If these succeed, the benefits will flow to the shareholders but, if they fail, the creditors will bear the losses and the reorganised estate reduces in value. Managers have little to lose from such high-risk activity. In one reported US case the company officials sought to save the business by resorting to the gaming tables of Las Vegas.

From an English perspective, there are perhaps three final reservations about Chapter 11. The first is that the US Code gives the shareholders some role in the rescue process. Moss argues: ‘Where in reality there is nothing properly left for shareholders this seems to enable them to use blocking tactics so as to extract value from the situation in which equitably they should receive none.’ It should be noted, however, that Chapter 11 is a procedure which is not triggered by insolvency or near insolvency, and it may accordingly be responded that shareholders do have a genuine interest until the point of insolvency arises. A way out of this problem would be to provide that where a Chapter 11 filing does happen to involve a company that is in insolvency or likely to become insolvent, the court should be empowered to reduce the role of the shareholders. A second reservation about Chapter 11 concerns the latter’s complex system of classes: a system designed to offer protection to creditors who may suffer from cram-down. The US classes regime makes for a drawn-out process that is legalistic and does not conduce to the quick sale of a going concern: a position that sits oddly with Chapter 11’s strong rescue orientation.

166 The BAPCPA 2005 introduced new scrutiny over, and limitations on, the circumstances in which debtors may pay senior managers bonuses (or KERPs – Key Employee Retention Plans) in order to induce them to remain with the company. The hope was to stop managers rewarding themselves excessively for working through Chapter 11 and to link any bonuses closely to the requirements of the company: see Lee and Bannister, ‘Taming the Beast’, p. 2. On posited unintended consequences of the reforms – ‘The law reduces both the carrots given to managers and the sticks they wield without putting much in their place’ – see Gapper, ‘The Danger of Rewriting Chapter 11’.


168 See Moss, ‘Chapter 11’.

169 Ibid., p. 18.

170 For a view that Chapter 11 has lost its role as a device for the protection of equity, see J. Ayer, ‘Goodbye to Chapter 11: The End of Business Bankruptcy as We Know It’ (Mimeo, Institute of Advanced Legal Studies, 2001).
A final ‘English’ worry may relate to the tension in Chapter 11 between rescue of a company and rescue of a business. Preservation of the company may reflect a US concern to encourage investment in entrepreneurial enterprises but in England more emphasis might be placed on saving the business, preserving employment and protecting the wider business community from the fallout of an insolvency. English administrative receivership was (and still is where applicable) well suited to rescuing the business alone and indeed, the post-Enterprise Act 2002 administration procedure prioritises rescuing the business in those circumstances where this will lead to a better result to creditors as a whole than either rescuing the company as a going concern or effecting a winding up. There may, moreover, be good grounds for adopting this position, one of which may be that shareholders are liable to be lower-cost risk bearers than employees or business partners since, inter alia, they are liable to be able to spread risks and absorb losses more efficiently than the latter.

A look at the US position should not, however, blind us to the approaches that other jurisdictions adopt, nor should lessons be learned exclusively from the US experience. Other countries have their own special characteristics. The South African system, for instance, relies very heavily on judicial supervision. There is no floating charge in South Africa and no receivership, but the regime of judicial management involves the court appointment of an insolvency practitioner to take control of the business with the object of paying the company’s debts and restoring the company to financial success. The process involves the courts throughout, with the master supervising the judicial manager and even calling creditors’ meetings. The narrowness and expertise of this

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171 See Insolvency Act 1986 ss. 72A, 72B–72G and further ch. 8 below.
172 See Insolvency Act 1986 Sch. B1, para. 3’s ‘hierarchy of objectives’: M. Phillips and J. Goldring, ‘Rescue and Reconstruction’ (2002) Insolvency Intelligence 76. The effect of these provisions is that the administrator is not obliged to rescue the company at all costs – rescuing the company (as a going concern) gives way to other arrangements (e.g. rescue of the business or part thereof) if these would give a better result to creditors as a whole (see para. 3(3)(b)). On rescuing the business within the company and rescuing a ‘balance sheet insolvent company’ see further R. Stevens, ‘Security after the Enterprise Act’ in J. Getzler and J. Payne (eds.), Company Charges: Spectrum and Beyond (Oxford University Press, Oxford, 2006) pp. 155–7.
173 See Sealy, ‘Corporate Rescue Procedures’.
174 On reform developments see further A. Loubser, ‘South African Corporate Rescue’ in Gromek Broc and Parry, Corporate Rescue, pp. 316–17. See also p. 315, where the author reviews the failings of judicial management as ‘highlighted in a substantial number of publications’.
process has led most lawyers and businessmen to prefer to use the scheme of arrangement procedure that resembles that set out in the English Companies Act 2006 ss. 895–9.175

Many noteworthy features are, of course, shared by different regimes. The French and German systems, for instance, have a single entry point to the insolvency process and the company is then assessed for the most appropriate outcome.176 This contrasts with the English system in which rescue procedures may be triggered by directors, floating charge holders or creditors according to a number of procedures. In some countries the rescue mechanism is triggered by petition to the court with the company having to be insolvent (as, for example, in Australia)177 or likely to be insolvent (for example, in Germany and Ireland). In England there is a requirement of likely insolvency for some procedures, but the US Chapter 11 involves no requirement of current or near insolvency at all.178

Countries vary on the priority they give to rescue and the balance they effect between creditor and debtor interests. In Japan, for instance, equity and employees are a primary consideration and informal rescues rather than legal bankruptcy procedures are the norm.179 Banks and trading partners with shares will usually attempt to effect a rescue, and commitments over a number of years are not uncommon. If, however, matters are resolved in court, the legal process looks to give returns to creditors. In Germany there is also a strong emphasis on the informal resolution of

175 See Close Corporations Act 69 of 1984 s. 72: a special composition procedure that is more suitable for small businesses, being straightforward and less costly than judicial management. See Loubser, ‘South African Corporate Rescue’, p. 315.
problems and staying out of court by relying on support from the banks. Creditors in Germany may opt either for a straight liquidation, for a reorganisation or for a restructuring by transfer. Creditors can veto any plans drawn up by the court and firm, but shareholders play no part in the process.

In France the law used to be hard on creditors. In the redressement judiciaire process a court-appointed official will help managers to draw up a plan and the law is directed towards the securing of jobs by keeping troubled firms alive. Creditors have no say over which plan the court accepts and the broad body of creditors have one representative (court-appointed) during negotiations. French law thus offers a stark contrast with English law which puts creditors first. The reforms of 2005, however, introduced a new rescue procedure – ‘preservation’ – where creditors are given a say in the approval of the rescue plan through the use of creditors’ committees but only, it must be said, regarding businesses above a certain threshold.

It has been noted that as far as running the formal rescue process is concerned, English law places the insolvency practitioner in a prime position, whereas Chapter 11 can give the DIP a central role. Bankers, as floating charge holders, are also given leading insolvency roles in New Zealand, Australia, Ireland and Sweden. The Irish and German regimes place the insolvency practitioner at centre stage, though in the glare of a judicial spotlight, and creditors make the final decision. In France the courts make the key decisions. Voting arrangements also vary markedly across regimes. In English administration a simple majority of creditors (by value of claims) is required but in a company voluntary arrangement or a scheme of arrangement a 75 per cent by value majority is required. In the USA a two-thirds majority of the value and number is required, whereas in Germany it is a simple majority. In Irish examinations the majority has to be numerical, representing also a 75 per cent majority by value of claims represented at the creditors’ meeting. In France the court decides the final outcome, and in some countries (for

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180 See further Ehlers, ‘Statutory Corporate Rescue Proceedings in Germany’.
181 See D. Brown, ‘Corporate Rescue in New Zealand’ in Gromek Broc and Parry, Corporate Rescue, p. 262: ‘Unlike the UK, New Zealand did not adopt the concept of an “administrative receiver” … the Receiverships Act 1993 (NZ) applies to all types of receiver, whether the grantor is personal or corporate, and whether out of court or appointed by the court.’
183 A majority in number voting is also required in a CVA.
example, the USA and Ireland) there is a process of cram-down, whereby the court can overturn the creditors’ decision.\textsuperscript{184}

Moratoria periods again differ. Chapter 11 involves an initial period of 120 days (with a maximum extension to eighteen months)\textsuperscript{185} whereas in Australia it is twenty-eight days (extendable to sixty), in Ireland it is sixty-three days (extendable to ninety-three), and in Sweden it is typically a maximum of three months (extendable three-monthly to a year). New Zealand introduced a new business rehabilitation scheme for companies (voluntary administration) similar to the voluntary administration operating in Australia but with some flexibility regarding time periods.\textsuperscript{186}

Finally, mention should be made of rescue financing and the provision made for this. In Chapter 11, post-petition financing and supplies can be obtained and priority given to their lender. Super-priority financing is also available in Germany, France, Australia, Sweden and New Zealand, but it is not available in England, although it was proposed by the DTI’s Insolvency Service in 1993 and raised again in the business rescue mechanisms consultations in 1999–2000.\textsuperscript{187}

To summarise this comparative sketch, other countries display a variety of players, processes and priorities in their insolvency and rescue regimes, but in all regimes certain difficult decisions have to be made on such matters as: Who controls corporate rescue operations? What sort of oversight regimes are appropriate? How should rescue needs be balanced against creditors’ rights? Should rescue processes be triggered only on insolvency or near insolvency? Whose voices shall be heard in rescue procedures? Chapters 7–10 below examine how these issues and others are dealt with in England.

Conclusions

In the UK there is a greater stress than ever before on taking early steps to confront corporate troubles and to effect rescues and turnarounds before

\textsuperscript{184} See IS 2000, Annex A. \textsuperscript{185} 11 USC s. 1121(d).
\textsuperscript{186} The NZ Companies Amendment Act 2006 came into effect on 1 November 2007 making amendments to the NZ Companies Act 1993. On voluntary administration see now NZ Companies Act 1993 ss. 239A ff.
\textsuperscript{187} DTI/IS, Company Voluntary Arrangements and Administration Orders: A Consultative Document (October 1993); IS 2000. On the extended, but ultimately fruitless, discussions on super-priority financing that preceded the Enterprise Act 2002 reforms see McCormack, ‘Super-Priority New Financing’. See also ch. 9 below.
there is any need for formal actions. It has been noted, however, that the
growth of the credit derivatives market may provide creditors with new
options of risk management that cut against the broader trend to pursue
rescue options. As for the evaluation of rescue procedures, these are
processes that can be assessed in accordance with the measures set out
in chapter 2 and, in making such evaluations, interests in addition to
those of creditors have to be borne in mind. Rescues involve parties
acting with very divergent concerns and interests and rescue processes
often demand that important decisions be taken in the most difficult and
urgent of circumstances. The procedures that are used in attempts to
turn companies around might, accordingly, be expected to be open to
serious question when assessments of legitimacy are made. Such assess-
ments demand that the particulars of different rescue arrangements –
informal and formal – be dealt with and these are considered in the
chapters that follow.
Informal rescue

For most troubled companies, entering into formal insolvency procedures is a course of last resort only to be pursued when informal strategies have been exhausted. Informal procedures, as noted in chapter 6, will often prove more attractive than formal steps and stakeholders will hope that informality may avoid the negative consequences that are often the result of commencing an Insolvency Act process. ¹ Those consequences may include: the precipitation of contractual breaches across financing arrangements; liquidations of collateral; ² rating agency devaluations; shocks to market confidence; reductions in employee morale; and reputational harms to brands and directors as individuals. Informal processes are likely to offer more flexibility than statutory arrangements and they will be more amenable to the early and proactive involvement of major creditors. They also offer a less confrontational forum for ‘marketplace’ negotiations than many a formal procedure. ³

It is understandable, accordingly, that informal strategies of various forms are of increasing importance to companies and their advisers. Different modes of informal action are reviewed in this chapter but, before looking at particular approaches, it is worth considering the different parties that may be interested in an informal rescue and the stages of events that commonly lead up to the selection of an informal rescue strategy.


² On the destructive propensity of asset-based lenders to seek to liquidate collateral when they hear of a company’s difficulties (and the problems of controlling such creditors) see Armour, ‘Should We Redistribute in Insolvency?’, p. 219.

Who rescues?

When a company encounters problems it has long been the paradigm that informal rescue processes are started when its major creditor, the bank, becomes concerned and starts to take action – either by making enquiries of the directors or by taking a more hands-on approach to overseeing managerial performance. It was noted above, indeed, that the banks have recently taken the ‘rescue culture’ to heart and many of them have established teams of specialists that are dedicated to the provision of turnaround services to debtor companies. As discussed in chapter 3, however, the last decade has seen radical changes in the credit market and the arrival of new actors with fresh interests in troubled companies.

Three significant changes are to be highlighted. First, alternative lenders of different kinds have burst onto the market to supplement (and often to supplant) the banks. These include the hedge funds, private equity groups, investment banks and distressed debt investors. It is now the case that a troubled company’s fate is increasingly dependent on a hedge fund rather than a traditional bank. Second, underperforming companies that seek liquidity can now choose from a huge range of debt financing options including asset-backed lending, subordinated debt products (e.g. mezzanine debt) and debt capital market products (e.g. high-yield bonds). Third, the rate at which debts are sold means that the group of lenders with interests in a rescue may well be fluid during the rescue or restructuring process and that various investors in debt will see their debt in a very different way from traditional bank lenders.

4 See ch. 6 above. See also J. Franks and O. Sussman, ‘Financial Distress and Bank Restructuring of Small to Medium Size UK Companies’ (2005) 9 Review of Finance 65: the average company in the sample spent seven-and-a-half months with the banks’ Business Support Units (BSUs) and somewhere between half to three-quarters of these companies emerged from the BSU without going into formal insolvency proceedings (pp. 76–7); Armour, ‘Should We Redistribute in Insolvency?’ p. 212.


6 See L. Verrill, ‘ILA President’s Column’ (2007) Insolvency Intelligence 112 (on how ‘the market is now dominated by hedge, vulture or “opportunity” funds and private equity houses’).

It has been the commodification of credit that has driven changes in the body of rescue-interested actors. Banks have increasingly sold their loans to outside investors, such as hedge funds, and non-bank investors have joined lending syndicates. In the case of riskier European companies, non-banks can now account for up to 80 per cent of the loan finance in private equity deals.8 The growth of the European bond market in the 1990s introduced a new group of unsecured creditors to large-scale insolvencies and rescues. Unlike the traditional dispersed unsecured creditors, bondholders are now willing and able to participate in rescues of troubled companies.9 Until recently, corporate bonds were generally held by long-term investors such as pension funds and life assurance companies but now such papers are traded and often used by hedge funds and banks’ proprietary trading desks who are exploiting trades that combine bonds and credit derivatives.

Hedge funds and private equity groups10 have, by such processes, become increasingly important players in the rescue game.11 Such funds and groups can bring positive qualities to potential rescue scenarios. They tend to be driven by rational profit-directed motives and are able to act quickly (notably to raise funds) in order to institute remedial steps such as restructurings. They tend to be faster moving than the more heavily regulated and more bureaucratic banks. They would also claim to be more flexible in approach, less constrained regarding allowable types of investment and more creative concerning rescues and restructuring than banks.12 Overall, their proponents would say that they increase general liquidity and improve rescue prospects.13 The critics of hedge

10 ‘Hedge fund’ is not a legally defined term but most hedge funds tend to have the following characteristics: they are investment funds in which managers deploy investors’ capital; they are subject to little regulation; they may leverage their investments; they invest more freely than regulated mutual funds; and managers share in the fund returns. See T. Hurst, ‘Hedge Funds in the 21st Century’ (2007) 28 Co. Law. 228. On the likelihood of private equity firms ‘with a stomach for risk’ making ‘a killing’ in restructurings and subsequent sales if the debt of companies in distress falls below its fair value see P. Davies, H. Sender and C. Hughes, ‘Restructuring Enters a Brave New World’, Financial Times, 5 February 2008.
11 Hedge funds are said to represent 35 per cent of the primary leveraged European loan market: see STP, ‘Corporate Restructuring in Europe’ (STP, London, 2 March 2006).
12 Tett and Hughes, ‘When Time Runs Out’.
13 See M. Prangley, ‘Providing Support to Management in a Highly Leveraged Market’ (2007) Recovery (Summer) 26. The supplanting of the banks in US rescues has been said to have increased rates of rescue: see Tett and Hughes, ‘When Time Runs Out’. 
funds would counter that the long-term effects of such funds’ highly leveraged and short-term approaches may be uncertain and may include the generation of high levels of systemic risk within financial markets. On the accusation of short-termism, private equity firms would say that they differ from hedge funds in so far as the latter take a short-term, or trader’s, view of the company whereas private equity looks for a longer relationship with the company (typically three to seven years before resale). Private equity firms also claim to differ from hedge funds by bringing to the table not only cash but the skills required to restructure the business successfully.

Such developments may be welcomed for bringing liquidity and creativity to the rescue process but the involvement of a host of new parties in rescue processes may have a downside. The buyers and sellers of credit – as discussed above – are joined, within turnarounds, by a number of other types of organisation with various rescue interests and roles. Noteworthy here are credit insurers and turnaround advisory firms. Co-ordinating a rescue when such numbers of organisations are involved may present challenges – especially when the group of interested parties is not constant but is subject to change. In such a fragmented world of competitive credit (and often high leveraging) the power of the lenders to impose traditional banking covenants on deals is weakened as is the ability of key lenders to step in early and insist that the company takes certain steps to deal with its troubles. The challenges of co-ordinating different types of creditors may, furthermore, be compounded because such holders of debt may have very different objectives in mind when looking at the troubled company. They may have different operating methods, values and assumptions and they may operate to different timescales. Thus, a hedge fund with a second-lien loan and a share of equity may have different motives and modes of operating from a bank or holder of bond derivatives. Similarly, banks may be concerned to

14 See Hurst, ‘Hedge Funds’.
15 For a counter-view, arguing that some hedge funds do take the longer view and are managerially active, see R. Tett and B. Jones, ‘Hedge Funds – A Fad or Here to Stay?’ (2007) Recovery (Summer) 22.
18 Prangley, ‘Providing Support to Management’.
19 See EHYA, Submission on Insolvency Law Reform.
restructure in a controlled manner so as to leave debts on balance sheets rather than to take equity, whereas bondholders may look to reduce debt levels and maximise creditor recoveries through their equity holdings in businesses with lowered gearings.\(^{20}\) As Chris Laughton has said of the purchasers of distressed debt: ‘Some of them will be prepared to take a medium (or occasionally long) term view … but many look for a quick gain. For these investors, operational turnaround is much less valuable than their deal gain on balance sheet restructuring.’\(^{21}\)

Credit trading may also induce the banks to depart markedly from their traditional stances – and in a manner that, again, may reduce rescue options because of divergent interests. As noted in chapter 6, a reported complexity that emerged in the 2002 Marconi rescue effort was that some banks had used credit derivatives to lay off risk so that they could potentially gain more from Marconi defaulting than from agreeing to a restructuring.\(^{22}\) Hu and Black have said, indeed, that the ‘uncoupling’ of creditor and company interests may routinely occur when there is trading in credit default swaps (CDSs) and that, as a result of such trading, creditors may possess incentives to vote against a rescue plan.\(^{23}\) In such situations, derivative trading by some banks but not others may mean not only that the banks have different interests from other groups of creditors but also that not all banks will have consistent interests.\(^{24}\)

Co-ordination difficulties may also be exacerbated because, as noted in chapter 3, the modern credit derivatives market does not render interests transparent. Various parties (who may be difficult to identify) may hold hugely complex combinations of interests (in, for instance, intricate mixtures of bonds, equity shares and other forms of paper). This may mean that such parties’ positions are difficult to assess and that deals and compromises have to be devised by expert intermediaries who may find it difficult to locate all the interested parties and to persuade them that the proposed deal is the

\(^{20}\) Roome, ‘Unwelcome Guest’.


\(^{23}\) See H. Hu and B. Black, ‘Equity and Debt Decoupling and Empty Voting 11: Importance and Extensions’ (2008) 156 University of Pennsylvania Law Review 625; and the discussion in ch. 6 above.

best available settlement. It will be seen below that such co-ordination challenges have a dramatic effect on the potential of certain strategies for effecting turnarounds and rescues – such as the London Approach.  

The stages of informal rescue

Assessing the prospects

There are seldom clearly identifiable times in corporate life when rescue steps are required. As noted in chapter 4, the financial state of a company can be thought of as a portrait painted by accountants or company directors, a picture that may reflect a variety of ‘calculative technologies’, disciplinary perspectives and even sets of negotiations. Different actors, moreover, may play key roles in setting up rescues. As suggested, it is traditionally a firm’s bank that initiates turnaround steps. In the modern world of complex debt, however, the scenario may be quite different. The earliest signs of trouble may become apparent first to the hedge funds, investment banks and others who are swiftest to notice that a company’s high-yield debt has started to trade at below par; or that the rating agencies have downgraded the relevant paper; or that the credit insurers have tightened supply lines. The market may then develop its own momentum as the company’s own ‘relationship’ bank may start to sell its senior debt, the credit market loses confidence, and unfriendly buyers start to purchase controlling positions in the debt structure.

A firm’s own directors may also institute actions. They may call in firms of accountants to act as company doctors or specialist corporate

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26 See pp. 311–14 below.
28 R3’s Ninth Survey of Business Recovery in the UK reported in 2001 that when insolvency professionals were brought into a firm to carry out turnaround work such a step was instigated by a secured lender in 60 per cent of cases. See also R. Bingham, ‘Poacher Turned Gamekeeper’ (2003) Recovery (Winter) 27 (stating that it is usually the banks that call in interim turnaround executives).
30 On the difficulties that directors may encounter in dealing with the credit derivatives market see ibid.
troubleshooters may be consulted. Directors have been said to be responsible for appointing turnaround IPs in a fifth of cases. There are particular dangers to be borne in mind by directors when rescue measures are under consideration. They must look to their potential legal liabilities and must act consistently with their obligations. These are reviewed in chapter 16 but will be noted in outline here.

The first of four main areas of concern is the director’s potential liability for wrongful trading under section 214 of the Insolvency Act 1986, which requires directors to monitor the financial position of the company and when they conclude, or should conclude, that there is no reasonable prospect of their company avoiding insolvent liquidation they must take every step which a reasonably diligent person would take to minimise potential loss to the company’s creditors. If, after a company has entered insolvent liquidation, a court considers a director has failed to discharge such a duty, it may require the director to make such contributions to the company’s assets as it thinks fit. What matters for such purposes is not the actual knowledge of the director but the knowledge that might reasonably be expected of a person carrying out the director’s particular functions in the company. In the rescue context, directors must consider the prospects of avoiding insolvent liquidation and, if they are unsure of the position, must take heed of their duties to minimise potential losses to creditors and, when necessary, must cease trading and commence suitable insolvency procedures. A special concern of directors will, accordingly, be whether any agreed arrangement will allow debts to be paid as they fall due and whether projected cash flows and incomes will allow rescheduled loan payments to be met.

Under the Insolvency Act 1986, liability for wrongful trading (under section 214) applies not merely to directors but also to shadow directors, who are defined in section 251 as persons ‘in accordance with whose directions or instructions the directors of the company are accustomed

33 See Insolvency Act 1986 s. 214(1). Such jurisdiction was deemed to be primarily compensatory in Re Produce Marketing Consortium Ltd [1989] 5 BCC 569; compare the discussion in ch. 16 below.
to act’. A stakeholder may be treated as a shadow director if they exercise ‘real influence’ over the board and in the case of Becker emphasis was placed on proving that the de jure directors followed a consistent pattern of compliance with the instructions of the putative shadow.

When a bank exercises ‘intensive care’ over a distressed company it accordingly runs risks. It may be deemed a shadow director if, at a time of threatening insolvency, it gives ‘directions or instructions’ to the client company, as distinct from giving professional advice or merely imposing conditions for making or continuing a loan. There is evidence, however, that some judges may sympathise with the bank’s good intentions. Thus, in Re PFTZM Ltd, Jourdain v. Paul Judge Baker QC stated that a bank was unlikely to be treated as a shadow director, even where it exercised a considerable degree of control over the management of the company, when its actions were motivated by a desire to protect its position. Milman has cautioned, however, that such comments were obiter dicta and that ‘this is a questionable proposition in that it appears to confuse objective conduct with the subjective motivation behind such actions’.

Nor is the position of the independent consultant to a troubled company one that precludes uncertainty. A professional adviser acting strictly in that capacity is exempt from categorisation as a shadow

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34 Based on the definition in the Companies Act 2006 s. 251. Shadow directors will not merely be liable for wrongful trading, they could also be subject to a number of provisions, notably those requiring disclosure or controlling certain types of transaction: see Companies Act 2006 ss. 187(1)–(4), 188(7), 223(1), 230; Insolvency Act 1986 ss. 206 (3), 214(7). (This section builds on V. Finch, ‘The Recasting of Insolvency Law’ (2005) 68 MLR 713.) See also ch. 16 below.


director\textsuperscript{41} but it is clear from \textit{Re Tasbian Ltd (No. 3)}\textsuperscript{42} that a company doctor or management consultant may in certain circumstances be deemed a shadow director. In that decision, the Court of Appeal held that there was an arguable case sufficient to go to trial, that an accountant, brought in to advise a troubled company as a consultant and company doctor, was a shadow director, having allegedly gone further than merely acting as a watchdog or adviser.

Such legal questions, nevertheless, do not constitute insuperable impediments to a new focus on preventative measures. The courts have yet to hold a bank to be a shadow director for exercising ‘intensive care’. It would be a mistake, moreover, to confuse the timing of, say, a bank’s intervention in the management of a company with the intensity and breadth of that intervention. Provided that bank monitoring, scrutiny and advice do not constitute directions or instructions that the directors follow in a consistent pattern, the lenders will not be liable as shadow directors. It is arguable, furthermore, that the courts might well see themselves as having no especially strong reasons for holding banks to account as shadow directors when lenders exercise ‘intensive care’.\textsuperscript{43} The purpose of the Insolvency Act 1986 section 214 wrongful trading provision is primarily to stop directors from continuing to trade during troubled times so that unjustifiable risks are run at the creditors’ expense.\textsuperscript{44} There is, accordingly, little cause to hold the major lender to account if the funds at risk were largely their own and if there is evidence that rescue attempts were for the benefit of creditors as a whole. There is a case, perhaps, for holding banks liable under section 214 when there is evidence that the bank’s actions as a shadow director prejudiced the interests of other creditors – for example, unsecured creditors.\textsuperscript{45}

\textsuperscript{41} Companies Act 2006 s. 251(2); Insolvency Act 1986 s. 251: ‘a person is not deemed a shadow director by reason only that the directors act on advice given by him in a professional capacity’ (the wording is the same in both sections).


\textsuperscript{43} On reasons for deeming a party to be a shadow director and the link with mischiefs see \textit{Deverell} where Morritt LJ stated that the definition of a shadow director was to be construed in a normal way to give effect to the parliamentary intention ascertainable from the mischief to be dealt with and the words used: [2000] 2 BCLC 133, 144–5.


\textsuperscript{45} The bank may, for instance, be found to have brought undue pressure on the directors to cease certain operations where continuing those activities would have improved returns to unsecured creditors without significantly increasing risks to the bank. It is to be expected that the courts would not be quick to hold banks liable as shadow directors.
the courts endorse such reasoning, the legal constraints on *ex ante* approaches to insolvency risk management may not prove daunting in most cases since the bank will often be the main creditor and potential liabilities will be relatively small.

It should also be borne in mind that even if it does act as a shadow director, the bank will only be liable for wrongful trading under the Insolvency Act 1986 section 214(2)(b) if it continues to act as a shadow director after it knew, or ought to have concluded, that there was no reasonable prospect that the company would avoid going into insolvent liquidation. 46 Few banks, it is to be expected, will continue to put resources into intensive care after the point when liquidation has become inevitable.

A second area of directors’ concern will be their potential liability for fraudulent trading under section 213 of the Insolvency Act 1986. Directors, under this provision, may be liable to make contributions to the company’s assets where it appears, in the case of the winding up of the company, that any business has been carried on with intent to defraud creditors or for any fraudulent purpose. Criminal liability may also be involved. 47 Fraudulent trading will thus be engaged in when a director obtains credit for the company when he knows that there is no good reason for thinking that funds will be available for repayment when due or shortly thereafter. 48

A third area of relevant directorial worry relates to the general fiduciary duty of a director to act *bona fide* in the interests of the company, a duty that requires consideration of the interests of creditors as well as shareholders. 49 Where rescue arrangements are under discussion,
directors must remember that their fiduciary duty relates to all creditors’ interests, not merely those of the dominant creditors who may be those principally engaged in negotiating a rescue.

Finally, directors should consider whether a rescue arrangement may render them liable to disqualification from being a company director. A court must disqualify a director where it is satisfied that he or she was a director or shadow director of a company which has become insolvent and it is satisfied that his or her conduct as a director is such that he or she is unfit to be involved in the management of the company.\(^{50}\) When companies are in trouble, the real risks on this front tend to arise when directors hold creditors at bay while rescue options are reviewed or repay some debts rather than others for strategic reasons.\(^{51}\)

The alarm stage

First alarms are often sounded in companies when it is not possible to find the cash to pay immediate bills.\(^{52}\) The company directors may then raise the issue of rescue steps or a creditor may do this: as where a bank sees that overdraft limits are being exceeded unacceptably and expresses its concerns. A meeting will usually be called at this stage and major creditors will discuss issues with directors. At this point a Governor of the Bank of England has suggested that three things are often evident.\(^{53}\) The first is that no one, including the company, has a sufficiently complete and robust picture of the company’s financial position to make a soundly based decision on its future.\(^{54}\) Secondly, the amount of debt, including off-balance-sheet items and the number of creditors, is usually larger than anybody supposed and, thirdly, the creditors often find that they have divergent interests.

A further form of alarm may be voiced in the new world of credit derivatives – the directors of a company may start to receive calls and emails from aggressive lenders, with whom they probably have never had any prior contact. Those lenders will have been prompted by their


\(^{51}\) See Re Sevenoaks Stationers Retail Ltd [1990] BCC 765.

\(^{52}\) See Segal, ‘Rehabilitation and Approaches’, p. 147.

\(^{53}\) Ibid., quoting the Governor’s Special Report, 25 October 1990.

observations of the credit market to ask the directors a series of difficult questions about the company’s cash flows and its ability to make future payments to, and maintain covenants with, the holders of senior debt.55

The evaluation stage

When the company’s major creditors have become appraised of the company’s position there usually follows a period in which urgent attempts are made to identify the nature and extent of a firm’s problems and to assess the prospects of turnaround.56 At this time, deadlines for action vary from case to case but may be very tight and the main pressures on the company are likely to stem from cash flow problems and threats of actions by creditors. Attention will be paid to means of securing a breathing space that will allow the company to regroup and, accordingly, to sources of financing that will cover immediate needs and to gaining the co-operation of creditors. Here it should be emphasised that informal rescues require the unanimous consent of affected creditors57 and that this may often be difficult to obtain. Where, for example, a good deal of debt is owed to diverse sets of debt holders or to trade creditors who are heterogeneous and not amenable to (or capable of) negotiating rescue agreements, informal solutions will be difficult to achieve.58 Where, in contrast, debts are owed to small numbers of sophisticated lenders such as banks, the prospects of informal resolutions are brighter. To this end, it is commonly necessary to bring major creditors together and to seek to co-ordinate actions. Where appropriate, the creditors will agree to a period of grace in which existing credit lines are maintained and, if necessary, extra funds are provided for an interim period.

Analysis of the company’s state will proceed apace during this period and parties will explore such issues as the reasons for the company’s decline, the severity of the problems encountered, the extent of the viable core of the business, the human resources available to the company and the state of relevant markets and positions within these.59 Financial

59 Campbell and Underdown, Corporate Insolvency, p. 62.
reviews of the whole company will be undertaken, including an audit of each of the functions carried out by the company.

Such an evaluation will frequently be carried out by investigating accountants who will usually be nominated by the lead bank. The overall aim is to identify the company’s potential for survival and the steps that have to be taken to produce turnaround. Company directors at such a time will not, however, be inactive. They will continue to manage the company’s affairs and will usually have been asked to prepare business plans and sets of proposals for dealing with the company’s difficulties. The investigating accountants have a role in considering such business plans and both the investigators and creditors will focus on whether the critical ingredients for successful turnaround are to be encountered in the company. These parties will examine whether the managers are sufficiently able, motivated and decisive to effect a rescue, whether there is a core of business that is strong enough to found restoration of corporate fortunes and whether necessary changes can be made within the available timescales.\(^60\)

Towards the end of the evaluation stage, there will occur a review by the rescuing bank or banks.\(^61\) This review will consider the report of the investigating accountants together with the managers’ business plan. Discussions with investigators and managers will be conducted and the banks will attempt not only to assess the prospects for company turnaround but also to produce some consistency and co-ordination of approach between the various banks. They will thus come to terms with issues of priorities between creditors in relation to recoveries and also with the banks’ collective position. Key issues in relation to the latter are whether additional security should be taken, whether new financial facilities should be provided and whether equity interests should be exchanged for debt.\(^62\)

### Agreeing recovery plans

If action at the preceding stages suggests that the prospects of recovery are good, plans for recovery will be devised and agreement on these sought. If the senior creditors are banks, the company will be likely to

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60 Ibid., p. 61. See also J. Wilding, ‘Instructing Investigating Accountants’ (1994) 7 Insolvency Intelligence 3.
62 Ibid.
have agreed with them the terms on which finances will be made available during the support period and on which new securities will be offered. A support agreement will set out relevant provisions. The creditors will also have made settlements between themselves covering, for instance, the sharing of losses and recoveries and the interest rates appropriate.

When recovery objectives and strategies are drawn up by managers and advisers, they must be supported by creditors and also by other key players beyond the company. The assent of a major customer or supplier may, for example, have to be secured if a recovery is to have a prospect of success. Increasingly, in the modern era, it may be necessary to persuade the hedge funds or other holders of credit instruments to agree to a course of action – and the company may rely heavily on the services of a turnaround professional or other restructuring/corporate recovery specialist in seeking to secure such agreements.63

A particular response to multi-bank support for companies with liquidity problems was developed in London in the 1970s and became known as the ‘London Approach’.64 The Bank of England identified, at that time, a need to co-ordinate discussions among banks with loans outstanding to firms in difficulty. For broad economic reasons, the Bank wanted to avoid unnecessary receiverships and liquidations and to preserve viable jobs and productive capacity.65 The principles of the London Approach were established in 1990 and the process has operated entirely informally on the basis of a set of principles providing a framework for bank support.66 There is, by design, no formal code or

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65 Flood et al., Professional Restructuring, p. 27.

list of rules\textsuperscript{67} and the approach relies on consensus, persuasion and banking collegiality in order to reconcile the interests of different creditors to a company in difficulty.\textsuperscript{68} The process involves four phases. First comes a standstill covering all debt owed and all bank lenders must give support at this stage. Second, the bank sends in an investigating accountant (who will not be the company’s auditors). Third, the lead bank negotiates with the other banks in order to secure new facilities for the company (which are generally accorded priority) and, finally, where negotiations are successful, a new financing agreement for the company is put into effect and is monitored.

The London Approach has been said to have four main tenets:\textsuperscript{69} the banks are supportive and do not rush to appoint receivers; information is shared amongst all parties to the workout; banks and other creditors work in a co-ordinated fashion to reach a collective view on whether and how a company shall be given financial support; and pain is shared on an equal basis. London Approach proposals typically provide that the banks share the benefits of the rescue and the costs of the restructuring process \textit{pro rata} to their outstanding exposure at the time when the banks agree to desist from enforcement actions against the debtor company.

In favour of the London Approach, it can be said to provide an efficient means of rescue that avoids the delays and expense of formal actions. Central to the Approach has been the role of the Bank of England in facilitating the emergence of an agreed course of action by the banks. The Bank has acted as a neutral intermediary and chairman and has used its authority to push discussions through banks’ hierarchies. Informal pressures can also be exerted by the Bank of England where the banks are proving difficult. Most lending agreements contain covenants that require the unanimous agreement of creditor banks to the kind of changes of repayment practice that rescues usually demand. This means that one recalcitrant bank can threaten to vote against a rescue proposal and put the company at issue into receivership unless the other


banks repay its own loan. Such a stance would prejudice the rescue, but the Bank of England under the London Approach has been able to bring pressure on a rogue bank and encourage it to co-operate. If necessary, the Bank of England has been prepared to talk to a foreign bank’s national regulator in order to bring the creditor into line.

A number of factors may lead banks to co-operate in a London Approach rescue. A first consideration has been the threat of Bank of England regulatory sanctions, which may underpin the informal pressure applied by the Bank. This may well have been the case in the 1970s and 1980s but Bank interventions in workouts were reduced from the mid-1980s onwards in favour of the Bank’s encouraging the involved parties to organise workouts themselves. The Bank’s supervisory role as banking regulator was, moreover, transferred to the Financial Services Authority in June 1998. Other incentives to co-operate do exist, though. Individual banks may fear that if they act obstructively, the banking community will exclude them from further profitable deals or deny them future co-operation. This fear will also reduce ‘hold-out’ strategies – in which individual banks may attempt to extract better terms by threatening non-cooperation. Co-ordination is also encouraged by the practice whereby a ‘lead bank’ organises the gathering and distribution of the information relevant to the rescue. This cuts down the information asymmetries that would reduce trust and co-operation levels. It also rules out ‘free-riding’ in the information collection process, since costs are shared.

The value of the London Approach has, however, been largely confined to very large rescue attempts and extensive borrowings. One reason is that implementation costs have been high – up to £6 million – and the Bank of England has had to be selective in using its good offices.
The fees of the lawyers and accountants who act in such rescues have been criticised as extremely high and there may be other indirect costs that are not inconsiderable.\textsuperscript{76} One variety of indirect costs may arise from the loss of decision-making power that a rescue produces within a firm. With the London Approach, a firm may remain under bank control for up to ten years\textsuperscript{77} and the firm’s managers may lose the power to take decisions without approval. The market may also respond to rescue measures in a manner that acts to the detriment of the company. In response to these points, however, it is worth bearing in mind that inefficiencies and losses to firms and creditors would be considerably higher if formal processes were to be pursued. What may remain a concern is whether the cost-effectiveness of the London Approach is undermined by the fee levels of lawyers, accountants and other professional consultants. If the market for such services is not highly competitive it is to be expected that the gains of the London Approach will be materially captured not by the companies, shareholders or creditors but by the consulting professions.

A further factor that limits the utility of the London Approach is the lack of any formal moratorium and the need for unanimity of support from relevant creditors. A company that is the subject of such a workout will be exposed to creditors’ demands while the terms of the rescue are being negotiated. When a large number of banks are involved in such negotiations the complexities involved may make for extensive periods of discussion and, accordingly, exposure to demands. Whether banks will co-operate with a London Approach rescue will depend on their balancing the costs of negotiation with the prospects of disruption and unproductive outcomes, and high numbers of banks and other creditors will militate against a successful use of the London Approach.

Where large sums are owed to numbers of trade creditors, it is likely to be difficult to obtain informal agreements to a workout. The claims of trade creditors, assuming these creditors are included in deliberations, may also be highly divergent in their characteristics and this may impede negotiations. Trade creditors, moreover, may be less inclined to make


\textsuperscript{77} Flood et al., Professional Restructuring, p. ii.
informal arrangements than banks and they may be less well equipped to negotiate such deals.\textsuperscript{78}

As for secured creditors, they are likely to see their interests as concurrent with those of unsecured creditors where the troubled company’s collateral is small, but, if they are fully secured, their incentive to co-operate may be weak. In some conditions, moreover, a secured creditor may possess an incentive to move towards immediate enforcement – where, for example, delay will reduce the value of the relevant collateral\textsuperscript{79} – and here they may prefer insolvency to renegotiation.

Where, as in the UK, it is common practice for companies to raise significant sums by secured loans, this imposes limits on negotiated solutions. More optimistically, however, it can be argued that even where banks have secured loans in such circumstances, they may be induced to adopt a co-operative stance because they indulge in ‘mutual aid’ understandings and anticipate requiring a return favour from other banks in the future, or because they want to protect their reputations.\textsuperscript{80}

In cross-border cases, the domestic and international creditors involved may be of very many kinds. They are likely to be geographically dispersed and may have assets spread across a number of jurisdictions. They will have to work together against a background of different attitudes, procedures, expectations, regulatory regimes and laws. Languages, modes of interpretation, conceptual frameworks and insolvency law objectives may also vary.\textsuperscript{81} Relationships of trust may also be strained by suspicions that the domestic banks are too favourably disposed towards the domestic debtor (for reasons of longer-term domestic strategy). Co-operation between the banks may, as a result, be low.\textsuperscript{82} Such lack of trust may conduce to secrecy and this may impede the flow of accurate, relevant and timely information that is essential to the successful London Approach.\textsuperscript{83}

The development of the credit derivatives market and the involvement of a host of new actors in the credit-providing process are changes that

\textsuperscript{78} See Belcher, \textit{Corporate Rescue}, p. 116.

\textsuperscript{79} Armour and Deakin, ‘Norms in Private Insolvency Procedures’, p. 45 (JCLS version).

\textsuperscript{80} \textit{Ibid.} See also R. Sugden, \textit{The Economics of Rights, Cooperation and Welfare} (Blackwell, Oxford, 1986).

\textsuperscript{81} See Obank, ‘European Recovery’, p. 149.

\textsuperscript{82} \textit{Ibid.} The London Approach has been used as a model in other jurisdictions: see N. Segal, ‘Corporate Recovery and Rescue: Mastering the Key Strategies Necessary for Successful Cross Border Workouts – Part I and Part II’ (2000) 13 \textit{Insolvency Intelligence} 17, 25.

\textsuperscript{83} See Segal, ‘Corporate Recovery and Rescue – Part II’, p. 28.
place further strains on the London Approach. As financing has becoming more fragmented, creditor co-ordination has become more difficult as banks are increasingly joined, in the pool of parties with debt interests, by hedge funds, private equity groups, bond holders, secondary debt traders, joint venture partners, special creditor and supplier groups and intermediate investors. The London Approach was attuned to the 1980s when banking creditors dominated and institutional shareholders were passive, but with the modern era’s dispersion of stakeholder groups, the challenge of steering a rescue operation has changed in degree and kind. As Bird notes:

Today could not be more different. Bond holders, secondary debt traders, the US private placement market, joint venture partners, special creditor and supplier groups and intermediate investors have all discovered a voice and a willingness to interfere in one way or another … It pushes the process to the limit and sometimes beyond the sphere of influence of the Bank of England.

The situation nowadays, then, is that the Bank of England has a voice that is joined by others and it has retreated from its central role in influencing renegotiations for a number of reasons: as a matter of policy; through reallocation of regulatory functions, and because, as noted above in chapter 3, large UK companies are resorting less to bank loans and making more use of intermediated debt finance, notably bond issues, to raise funds. The emergence of markets for corporate debt has thus increased the strains on the London Approach not merely because stakeholder groupings are more fragmented, extensive in numbers, hard to track down and difficult to co-ordinate but because the

87 Richard Obank has, however, argued that transfer of banking supervision from the Bank of England to the Financial Services Authority under the Bank of England Act 1998 may not affect the London Approach significantly and ‘could actually strengthen the Bank’s role in work-outs by boosting its role as an independent mediator’: Obank, ‘European Recovery’, p. 151.
increasing complexity of financial structures produces new levels of opacity concerning the nature and extent of different parties’ interests, and, also, new potential for conflicts of interest between junior and senior creditors. The nature and fluidity of the debt market means not only that the costs of communicating with involved parties to a renegotiation are high (because the parties are changing and their interests are often uncertain) but there is an increase in risks of breaches of confidentiality and of unhelpful market responses to these breaches. It might be responded that players in the distressed debt market will tend to co-operate on rescues – for reasons mirroring the banks’ incentives – and there is evidence that market associations for distressed debt (as formed in London and New York) may encourage co-operation. Against this view, though, it can be argued, first, that the sheer involvement of a greater number and diversity of players is likely to militate against the rapid, informed and cheap negotiation of rescues, and, second, that, as pointed out above, the different parties in such markets may have very different aims, priorities and approaches when viewing rescue.

The markets in credit products are now global in nature and this further strains the London Approach. Where, as is increasingly the case, companies are bound up with overseas intermediate holding companies or subsidiaries, and where foreign banks, hedge funds and other types of organisation are involved as creditors through the holding of different credit products, the possibilities of gaining informal agreements on reconstruction, investment and short-term cash recovery diminish. Such scenarios tend to reduce the likelihood of repeated interactions between parties with claims against a distressed company. Parties buying bonds or distressed debt or parties operating from abroad

are less likely to have any expectation of repeat business with the banks in question:

This increases the likelihood that one or more such parties may incorrectly observe the conventions operating in the London Approach workouts and adopt strategies which precipitate insolvency. Simultaneously it reduces the efficiency of the sanctions which the ‘club’ of London banks can threaten to exert. They are unable to exclude buyers of bonds or distressed debt from participation in future loan syndication.\(^9\)

Should the London Approach be formalised and placed on a statutory footing? This would run counter to its existing philosophy of flexibility and informality, and a regime based on shared values, understandings, moral suasion and favours might be difficult to encapsulate in statutory language. Formalisation would, however, allow steps to be taken that would potentially facilitate the production of agreements between creditors. At present, if a creditor refuses to agree to a proposed arrangement, this may wreck the workout (a difficulty that has led the Bank of England to consider the possibility of replacing unanimity with a qualified majority voting system).\(^92\) Bankers, however, may be reluctant to appear uncooperative to their fellow bankers since they may be seeking cooperation from others in a future rescue. As debt trading becomes even more widespread rescue negotiations may be undermined since some smaller lenders may look to extricate themselves from a situation rather than to work towards solutions.\(^93\) Trading in the distressed market, moreover, remains a challenge to the London Approach since the banks have successfully resisted suggestions that a code of conduct should ban debt trading at ‘sensitive’ times. The banks are consequently left with their powers of influence and persuasion to deter others from spoiling rescues.\(^94\) A moratorium might, nevertheless, be provided for and the risks of creditors ‘defecting’ by selling their debt into the

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\(^93\) See Kent, ‘London Approach: Distressed Debt Trading’; Belcher, Corporate Rescue, p. 120.
secondary distressed debt market might be limited by statutory restrictions on such defection, at least for a stipulated period. As noted above, however, such a ban on debt trading has been opposed by British and foreign banks and legal restrictions of the kind mooted might prove too legalistic to have many supporters. What has proved more acceptable has been the use of a code of practice. In October 2000, INSOL International produced a ‘Statement of Principles for a Global Approach to Multi-Creditor Workouts’. This has been described as ‘a rare combination of clarity and flexibility’ and has been endorsed by bodies such as the World Bank, the Bank of England and the British Bankers’ Association. The Statement sets out eight principles which are of relevance to domestic multi-bank situations, and these provide for co-operation on such matters as a ‘standstill period’ during which creditors should refrain from enforcing claims.

One respect in which such a statement of principles may prove to be of real value is in providing a foundation for the resolution of disputes between creditors. To this end, more use might be made of arbitrators or mediators in the informal rescue process. Such persons would have the task of facilitating negotiations between different stakeholder groups and would seek to secure agreements more rapidly and cost-effectively than is otherwise possible.

As already indicated, the London Approach could be said to lead to some lowering of managerial expertise in so far as supervision arrangements by the bank will detract from decision-making powers. In reply, however, the potential effects on managers of formal alternatives should be compared, and it could be asserted that improvements of expertise are likely to be encountered when managers who have steered the company into financial troubles are led, by negotiations with bankers, to see the error of their ways and to arrive at more financially sound modes of

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95 For discussion see Chief Editor, ‘International Approach to Workouts’ (2001) 17 IL&P 59.
96 Ibid.
97 Reproduced verbatim at (2001) 17 IL&P 59, 60. Principle 2 does countenance the disposal of debts to third parties during the standstill period.
98 A Price Waterhouse survey conducted in 1996 revealed that 53 per cent of respondents favoured the use of such mediators: see J. Kelly, ‘Banks Back Plan for Rescuing Big Companies’, Financial Times, 2 December 1996. The Vice-Chairman of the INSOL Lenders Group has suggested that it would be useful, in international cases, to have an ‘honest broker’ in each jurisdiction to assist in the application of the INSOL International Principles, a role that could be filled by the appropriate regulator: see (2001) 17 IL&P 59.
conducting business. Another issue relevant to expertise is whether modern banks, subject to severe competitive pressures, have the capacity and will to devote significant resources and senior expertise to the management of a major inter-creditor rescue arrangement.99 Professional experts can be brought in but these, as noted, tend to be highly priced. If there is, or becomes, a shortage of the kind of banking expertise that is needed to work the London Approach, it is to be expected that the regime will decline in importance.

Moving to issues of accountability and accessibility, the London Approach can be criticised for its secrecy and exclusivity. Not all creditors will have access to negotiations in the London Approach and attempts may be made to conduct operations without, say, trade creditors gaining information on developments. This may be efficient but it would not appeal to excluded creditors on accessibility grounds.

As for those creditors who are involved in negotiations, much depends on the procedures followed by the lead bank. This is the bank that co-ordinates the rescue, appoints the investigators, puts the rescue team together and manages information flows. The London Rules state that the lead bank must have sufficient resources and the necessary expertise to ensure that information is made available to all lenders participating in the rescue on a timely basis. Performance on this front varies, however. In the view of the Bank of England: ‘One of the most frequent complaints we receive at the Bank of England is that a lead bank has failed to provide banks with information which they regard as essential for the decisions that they are being asked to make.’100

Lead banks, nevertheless, are subject to a number of pressures to release information. They will work closely with the steering committee, which is a body of three or five persons elected by the creditors and which will encourage the dissemination of information. Lead banks also have an incentive to keep the other banks informed and content, for if the latter are not satisfied with their position they may withdraw their co-operation or they may sell their debts in the secondary distressed debt market.

As for fairness, it might be contended that the London Approach workouts operate for the benefit of large lenders and tend to undervalue small, especially unsecured, creditors’ interests. Larger creditors might

respond that their efforts benefit the broad array of corporate stakeholders and that many small creditors, who do not contribute to the costs of the rescue, are to some extent free-riding on the efforts of the banks. This response might, however, overlook the ability of the banks, in certain instances, to compensate themselves for their efforts by improving their security or equity position in a rescue agreement. There is evidence that during periods of rescue, bank credit tends to contract but unsecured trade credit tends to expand, sometimes dramatically.  

In summary, then, the London Approach exemplifies a number of the virtues and vices of informal rescue activity. It tends to be practised in relation to large debtor companies only and gives grounds for concern on a number of fronts. If, however, it is placed alongside the available formal alternative procedures, its virtues appear more prominent.

**Implementing the rescue**

Once agreement is reached on a strategy for rescue, a number of measures will often be taken in an effort to achieve corporate turnaround. These steps may be put in train by pursuing formal insolvency procedures (as discussed in chapters 8–10 below) or informally, by agreement. The first of these steps may, indeed, have already commenced before any final agreement between creditors is arrived at.

**Managerial and organisational reforms**

A successful rescue will almost always involve the retention or institution of an appropriate workforce and managerial team. Once the future activities of the company are settled upon, it will be necessary to see that persons with the appropriate skills are employed and that those who will no longer contribute appropriately will part ways with the company. Replacements, recruitments, promotions and staff reductions may all

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101 See Franks and Sussman, ‘Cycle of Corporate Distress’, p. 2: trade credit expansions of up to 80 per cent are noted in cases that end in a formal insolvency procedure.

102 On turnaround techniques and their use, see Society of Practitioners of Insolvency, Eighth Survey, *Company Insolvency in the United Kingdom* (SPI, London, 1999) pp. 12–14. The survey revealed that turnaround efforts failed (and formal insolvency ensued) in 37 per cent of cases in the manufacturing, wholesale, distribution and construction sectors. R3’s Ninth Survey in 2001 revealed that respondent insolvency professionals considered that in 77 per cent of cases there were, by the time they were appointed, no possible actions that might realistically have averted company failure. Nearly one in five businesses did, however, survive insolvency and continued in one form or another.
have to be brought about and attempts made to reduce the attendant disruptions and confusions. Changes at the top of management will often be required in order to move a company in a significant new direction out of crisis and to signal to outsiders and markets that positive remedial steps are being taken. R3’s Ninth Survey of Business Recovery (2001) found that insolvency professionals considered that for companies with over £5 million turnover a change of management could have averted company failure in 10 per cent of cases. When the SPI asked its members, in 1998, what actions companies might have taken to avoid falling into ‘intensive care’ scenarios, a change of management (in 28 per cent of cases) came second only to earlier actions to stem losses.103 In more than half of SPI-studied cases inadequate management was noted as an obstacle or hindrance to obtaining a non-insolvency solution to corporate difficulties (but such difficulties were rarely so serious as to prevent turnaround).104 As for methods of company rescue, the R3 Ninth Survey revealed that turnaround practitioners used change of management as a primary tool of rehabilitation in 20 per cent of cases.

On the organisational front, a variety of steps can be taken. The corporate governance structure of the company can be reformed so as to improve checks and balances, but the organisation of operations can also be revised in ways that may improve performance: for example, by decentralising and devolving power so as to create lower-cost modes of supervision, greater senses of responsibility, increases in morale and tighter management. Such decentralisations of operations may also lead to greater flexibility by creating identifiable free-standing parts of a business and, accordingly, greater opportunities to sell off these units as elements in asset reduction strategies.105

**Asset reductions**

A strategy designed to secure profitability is the reduction of corporate activities to a healthy core by cutting away unprofitable products, branches, customers or divisions and disposing of assets that are poorly utilised or are not needed for core profitable business operations.106 Such

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103 SPI Eighth Survey, p. 13. R3’s Twelfth Survey (2004) suggested that poor management was responsible in 32 per cent of failure factors cited: see ch. 4 above.
104 SPI Eighth Survey.
105 See Campbell and Underdown, Corporate Insolvency, p. 67.
reductions may include sales of subsidiaries, equipment or surplus fixed assets, closure of branches or streamlining of stocking arrangements. Asset reductions may, however, involve considerable costs. Beyond the fees payable to lawyers, accountants and other professionals there may be redundancy expenses, prices attached to contract cancellations and other divestment costs.

**Cost reductions**

An essential element in most rescue packages is a programme of cost reductions.\(^{107}\) This will involve investigations into current costs and potential savings and will cover not merely raw materials and equipment but also workforce expenditure.

**Debt restructuring**

Troubled companies are often too highly geared or in possession of a pattern of borrowing that is inefficient. A number of steps can be taken to reorganise corporate debts but successful reorganisation depends on the ability of those managing the company to convince financiers and other interested parties that the appropriate rescue plan has been put into effect, that the prospects of recovery are sound, and that the proposed debt reorganisations offer a better prospect of returns to creditors than would be delivered by resort to formal insolvency procedures.

If the company’s main problems relate to cash flows, short-term difficulties or underinvestment, steps can be taken to inject new funds into the company. Creditors in such circumstances will usually demand additional levels of security and may act to improve the overall security of their positions: for example, by using floating charges over the

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\(^{107}\) The SPI Eighth Survey indicated that the most common primary turnaround techniques were cost reductions, debt restructurings, raising new equity and negotiating with banks. These steps were followed in (descending) frequency of use by improved financial controls, asset reductions, changes of management, product/market changes, organisational changes and improved marketing (SPI Eighth Survey, p. 13); the R3 Ninth Survey of 2001 indicated that the primary method of rehabilitation used most frequently by turnaround managers was debt restructuring, resorted to in 39 per cent of cases involving such practitioners. Cost reduction, however, was only used as a primary method in just over 11 per cent of cases. The R3 Twelfth Survey of 2004 did not return to this issue.
corporate assets. Co-operation from banks is most likely to be found where large reputable companies encounter such difficulties. Banks fear bad publicity and any association with conspicuous failure or large-scale unemployment. They will, accordingly, tend to be most helpful to large, high-profile and respectable firms with considerable numbers of employees.

Consolidation of funding is a step that can also be taken when banks are helpful. Substantial benefits can be obtained by reorganising a proliferation of funding agreements and bringing these together in a simple financial arrangement. This process may allow a firm to negotiate a reduction in the overall cost of borrowing or a conversion of short- to longer-term credit facilities. Other arrangements, such as sales and leasebacks of property and equipment, may additionally be employed.

Debts can also be rescheduled in order to ease immediate problems. This may be a useful course of action where the company’s credit is supplied by a small number of banks and the company’s financial problems are short term in nature. Rescheduling does not, however, remove balance sheet deficits or improve gearing ratios. It involves a contract between the debtor company with all or some creditors, and this may alter obligations by deferring payments, harmonising obligations between different creditors or granting security (or additional security) to creditors.

Rescheduling may appeal to banks because, as noted already, such informality avoids the adverse publicity involved in precipitating the liquidation of a company. It may also allow securities to be adjusted and, where a number of banks are involved, rescheduling may prove far less complex and expensive than receivership. Similarly, where creditors in a variety of jurisdictions are involved with a company, it may be quicker and cheaper to respond to difficulties by negotiating new contracts than by resorting to formal proceedings. Problems with rescheduling will tend to arise when many banks are involved but some of them feel uncommitted to the company involved, lack a close relationship to it and feel no loyalty to the enterprise. In these circumstances, the

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108 When new security is given to a creditor in a rescue operation it may be questioned whether this constitutes a preference under the Insolvency Act 1986 s. 239; see also Insolvency Act 1986 s. 245. See ch. 13 below.
110 See generally ibid.
111 Ibid., p. 40.
creditor agreement necessary to make rescheduling work will be difficult to secure.

**Debt/equity conversions**

A further mode of informal rescue, and one that can be implemented through a variety of procedures – following, for instance, a London Approach process or a hedge fund purchase – is the conversion of debt to equity.\(^{112}\) In this procedure, the creditor agrees to exchange a debt for an equity share in the company and hopes that, at some future date, this will produce a greater return than would have been obtained in a liquidation. Recent celebrated cases of such conversions have included Eurotunnel, which had been overwhelmed by huge debts since it was floated in 1987.\(^{113}\) The latest in a long line of restructuring deals was concluded in 2007 and saw the company taken over by a new holding company, Groupe Eurotunnel (GE), creditors left in control of about 87 per cent of the shares in GE, and Eurotunnel’s debts slashed from £6.2bn to £2.84bn. Similar debt for equity conversions have been associated with the names of Saatchi and Saatchi plc (£211 million of debt), Brent Walker Group plc (£250 million of bank debt), Signet (formerly Ratners Jewellers, £460 million of debt) and Queens Moat (£200 million of debt).

From a creditor’s point of view, a conversion may be attractive because it offers the prospect of a future return on investment that is potentially unlimited as the company’s fortunes upturn and potentially far more valuable than the returns available on liquidation. Where banks have loaned without security – as is often the case with lending to larger quoted groups that have borrowed from many banks – there is the prospect of low recovery rates in an insolvency and debt to equity conversion can be more desirable than resort to formal insolvency procedures. In contrast, the creditor that is fully or partially secured has a far weaker incentive to support a troubled company by taking an equity position. Where the creditors, companies and projects involved are high profile, a further advantage of the debt to equity conversion is that it brings public relations returns: the creditor is seen in the public eye


to be committed to industry and loyal to its customers in their hour of need.

From the company’s perspective, a conversion takes away the burden of interest repayment, it eases cash flow and working capital difficulties and it improves the appearance of the balance sheet because managerial workforce efforts will be seen as producing profits rather than as merely servicing interest burdens. The financial profile and gearing of the company will improve as debts and competitive disadvantages are removed. The company will then be better placed to seek new credit lines from creditors, to attract new business and to reassure its current customers. This, in turn, is likely to improve morale within the company and to increase the prospects of turning fortunes around. For directors, particular benefits will occur as the threat of liability for wrongful trading is reduced when debts are taken off the balance sheet in a conversion.

The DTI issued a Consultation Paper in 1996 which stressed the important contribution that debt/equity swaps can make in allowing troubled companies to reorganise their affairs. The DTI favoured encouraging such swaps but thought it inappropriate to require creditors by law to participate in compulsory swaps. Instead, the Department sought to raise the profile of swapping; to make involved parties more aware of the potential benefits of swaps; and to encourage the development of model debt/equity swap schemes that could be adapted to particular circumstances.

Debt to equity conversions do, however, involve a number of difficulties and disadvantages. They can be time-consuming and expensive to negotiate, not least because the consent of the company’s existing shareholders, as well as of the main creditors, will usually be required. The former will have to agree to the issue of new shares, and such shareholders may be inclined to hold out in order to improve their positions. Where there are divergences of approach or position on the part of the creditors, it may again be difficult to come to a prompt, agreed restructuring plan. These divergences may arise because exposure levels

114 DTI, Encouraging Debt/Equity Swaps.
vary, the banks may be based in different jurisdictions or they may work
subject to different regulatory constraints and within their own business
cultures. Where foreign banks are involved, it will be necessary to
consider, for instance, whether these are subject to regulatory restrictions
on the holding of equity.

For creditors, a negative aspect of a conversion is that there will be a
loss of priority on a subsequent liquidation in so far as they have
become shareholders and as such will be eligible to receive no return
until all creditors have been repaid. The financial flexibility of the
creditors’ operations will also be reduced by conversion since it will
be more difficult to realise their investment afterwards: sale of shares
after a conversion may prove difficult or unproductive. Ownership of
shares may, moreover, involve a culture shock for UK banks who,
unlike their German counterparts, are unused to owning material
portions of industry. They may be inclined to sell any accumulated
shares once the market becomes liquid but such liquidity may be a long
time coming.

For these reasons, there may be alternatives to either formal insolvency
proceedings or debt to equity conversions that may be more attractive to
creditors and debtors. Debt rescheduling may be appropriate where the
number of bank creditors is small and the company’s financial problems
can be overcome by changing the progressive interest or principal repay-
ments. What rescheduling will not do is remove balance sheet deficits or
improve gearing ratios.

Another alternative is to convert debt to limited recourse or subordi-
nate debt. In such a process, the creditors agree either that their debts will
be converted from a general corporate obligation into claims secured
against specific assets or that they will rank for repayment behind other
debts (but ahead of equity). This will give some protection to directors
with regard to wrongful trading liabilities but, again, it will not remove
balance sheet deficits or gearing problems.

In summary, debt to equity conversions can provide an effective and
efficient means of allowing troubled companies to continue operations
and of avoiding formal insolvency procedures. The main effectiveness
and efficiency concerns relate to the time and money that has to be

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116 See further Kemp and Harris, ‘Debt to Equity Conversions’, pp. 22–3.
117 Ibid., p. 25. The US Bank Holding Company Act 1956 with few exceptions generally
prohibits US banks from acquiring equity securities.
118 Kemp and Harris, ‘Debt to Equity Conversions’, p. 22.
expended in achieving the agreements of involved parties. Here much depends on the numbers and types of creditors involved.

The worry, in terms of expertise and the scope for exercising it, is that banks may not always be attuned to the assessment of equity risks. Some may be better placed than others. The Royal Bank of Scotland set up a unit called Specialised Lending Services in the early 1990s in order to help companies by taking equity share stakes. Banks, moreover, are able to buy in expertise from accountants and other consultants in order to make equity assessments. Whether banks can operate sufficiently astutely to make equity-holding activities profitable is another issue. The National Westminster Bank was forced in 1991 to acknowledge the failure of its Growth Options equity stakeholding venture, and has since conceded that it had not been able to make money out of small equity shareholdings.¹¹⁹

The accessibility and accountability of conversion processes tend to be high in relation to major creditors since their consent will be required for those processes to work. Similarly, the requirement of shareholder approval for new share issues will ensure that those stakeholders gain a voice in the rescue process. Minor creditors may not be offered easy access in a debt to equity conversion but their interests will not usually be affected detrimentally, and they may well benefit from the reductions of debt that follow a conversion and from the reductions in the length of the potential queue for insolvency payments that will follow a conversion that changes the status of certain creditors to shareholders. For these reasons, it is also difficult to criticise conversions on the grounds that they involve unfairness to any affected parties. A company’s shareholders may suffer when a conversion takes place: Eurotunnel shareholders were diluted to 13 per cent in the 2007 restructuring deal. Such shareholders, however, take risks openly and they suffer less in a conversion than they would in a liquidation.

Conclusions

Since the mid-1990s, a new emphasis has been placed on informal responses to corporate troubles and on the taking of remedial actions at the pre-insolvency stage. Sometimes these responses centre on the

monitoring of corporate performance, sometimes they focus on restructuring. New actors have come onto the scene to challenge both the former dominance of the banks and the approaches to corporate troubles that tend to be adopted by the banks. Whatever the approach to rescue – be it one that focuses on turnaround of the existing company or on restructuring the business – resort to informal action offers a number of potential gains. It avoids the constraints of formal insolvency procedures and it offers companies new opportunities to enjoy business success. Assessing the efficiency of informal rescue procedures, individually or as a group, is, however, fraught with a number of difficulties. Informal rescue ranges from crisis management and turnaround to the use of consultancy services to improve management. It is, accordingly, almost impossible to separate out rescue activity from routine negotiations with creditors and other business partners. The lack of any formal gateway rules out such identification. Nor will information on much turnaround work be readily available: publicity, after all, will often be highly counterproductive. What can be looked to is the success rate of forms of rescue work that involve certain parties. Thus, the figures of R3 reveal that in a small sample of cases where IPs were appointed, the ratio of turnaround projects that succeeded or were still in progress to turnaround projects that failed and resulted in a formal insolvency was 62:50.120

Informal action can be swifter and cheaper than formal procedures but this is not always the case and it can also be more partial and less well informed. We have seen that informality does give grounds for concern on some fronts. The expenses of informal actions may be high. The expertise being applied at key points in informal processes may not always be appropriate. The accessibility and accountability of some procedures may be low (secrecy may be treated as a virtue in some informal rescues) and whether all affected parties are dealt with fairly can be a matter of fortune.

The philosophy of rescuing companies, it should be emphasised, is very different in orientation from many aspects of formal insolvent liquidation procedures. It is less strictly guided by statutory rules and its main focus is not the maximisation of returns for the various creditors in strict order of priority. It looks towards ongoing commercial viability and involves the application of skills relevant to marketing, manufacturing, product development and general management as well as the legal

120 R3’s Ninth Survey.
issues. Those practising rescue have accordingly to exercise judgement and adopt a different stance from the insolvency practitioner engaged in liquidation who is content simply to collect assets for distribution. Experience, competence and powers of staff motivation are all called for in the ideal rescue professional. It is in the arena of rescue that insolvency moves furthest from the mechanical application of rules for the benefit of creditors.
Receivers and their role

A first legally structured insolvency procedure with some potential for rescue to be considered here is receivership. It follows from the earlier chapters that an appraisal of receivership should go further than offering an outline of powers and duties and should analyse the role and conception of receivership as it operates. This chapter, accordingly, will look at receivership as a process as well as an institution. The laws, procedures and actors involved in receivership will be examined and the benchmarks of efficiency, expertise, accountability and fairness will be employed in asking whether receivership plays an acceptable role in insolvency as a whole. The part played by receivers in rescues will be a focus here, but attention will also be paid to ongoing corporate operations and the impact of receivership on these.

At this stage it might be objected that administrative receivership has largely been abolished and so does not need to be examined here – that the Enterprise Act 2002 took away the floating charge holder’s right to appoint an administrative receiver and, in doing so, largely replaced receivership with administration. It is true that the 2002 Act restricted the use of administrative receivership but receivership is not dead yet. Creditors with ‘qualifying’ floating charges that were created

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before the 2002 Act, or those with charges which, though created after that date, fall within one of the specified exceptions may still appoint administrative receivers. ‘Ordinary’ receivers, moreover, can still be appointed by the courts and debenture holders. It is, accordingly, necessary to consider the operation of receivership and the reasons for its curtailment. This discussion is best commenced by outlining the development of receivership, the procedures that are adopted in receivership and the duties and obligations that form the legal framework for receivership.

The development of receivership

Receivership is a long-established method by which secured creditors can enforce their security. There have traditionally been two types of receiver in English law: the receiver appointed by the court and the receiver appointed by a debenture holder under the terms of the debenture deed. The ‘administrative receiver’ was an institution introduced by


4 See Enterprise Act 2002 s. 250 which inserts a new s. 72A into the Insolvency Act 1986 listing the exceptions.


6 I.e. all-assets receivers appointed by the court and receivers of only part of the company’s property. See further S. Fennell, ‘Court-appointed Receiverships: A Missed Opportunity?’ (1998) 14 IL&P 208. Although the appointment of court-appointed receivers is rare, the procedure can be used to good effect to gain control of assets held overseas ‘when all other avenues look doomed to fail’: see D. Wood, ‘Can a Court Appointed Receiver Secure Assets Held Overseas?’ (2008) Recovery (Spring) 30.
The receiver is thus a person appointed to take possession of property that is the subject of a charge and he or she is authorised to deal with it primarily for the benefit of the holder of the charge. The court has an inherent jurisdiction to appoint a receiver in order to take care of property until the rights of the interested parties can be determined. This jurisdiction includes, in the case of a business, the power to appoint a manager so that courts can appoint a receiver/manager even in the absence of any express power in the relevant debenture. After the Law of Property Act 1925 all mortgages by deed contain an implied power to appoint a receiver.

The modern term ‘administrative receiver’ refers to the individual who, under the Insolvency Act 1986, is the receiver and manager of the whole (or substantially the whole) of a company’s property, appointed by the holders of a debenture secured by a charge which was, as created, a floating charge. In the pre-Enterprise Act 2002 scenario, this individual was typically appointed by the secured creditor under the terms of the relevant floating charge at a time of crisis in the debtor firm’s affairs.

They have to be a qualified insolvency practitioner within the meaning of Part XIII of the Insolvency Act 1986.

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7 On the advantages of LPA receivers see L. Verrill, ‘The Use of LPA Receiverships’ (2007) 20 Insolvency Intelligence 160 (noting the virtues of speed, lender control, no court process, no statutory filings, no IP requirement, no capital gains tax, no business rates, no fee scrutiny and no dealing with creditors). See also R. Connell, ‘Enterprising Receivers’ (2003) Recovery (Spring) 20: ‘it is likely that, as an alternative to administration, the fixed charge receivership will continue to have most appeal in cases of single asset or special purpose companies’.

8 Insolvency Act 1986 s. 29(2).

9 Frisby’s study suggests that, from 2001 to 2004, the clearing banks continued to be the main users of administrative receivership but a fifth of all receivership appointments were made by independent firms engaged in factoring and/or invoice discounting: see S. Frisby, Report to the Insolvency Service: Insolvency Outcomes (Insolvency Service, London, June 2006) (hereafter ‘Insolvency Outcomes, 2006’). Franks and Sussman report that, in spite of dispersed security of lending, and with the main bank supplying only around 40 per cent of all debt and trade creditors supplying most of the remainder, ‘the liquidation rights are almost entirely concentrated in the hands of the main banks’: see J. Franks and O. Sussman, ‘Financial Distress and Bank Restructuring of Small to Medium Size UK Companies’ (2005) 9 Review of Finance 65–96.

10 It is an offence under the Insolvency Act 1986 ss. 388, 389 for a person to act as an IP without being properly qualified under the Insolvency Act 1986 s. 390. The IP must be a member of a recognised professional body or obtain authorisation to act under the Insolvency Act 1986 s. 393. See ch. 5 above.
This chapter focuses on administrative receivership, the roots of which are to be found in the Cork Report\(^\text{11}\) and the Insolvency Act 1986. The Cork Committee (Cork) saw the aims of insolvency law in terms of the dozen objectives set out in paragraph 198 of the Cork Report and discussed in chapter 2 above. Cork stressed that the public interest should be protected by corporate insolvency processes because groups in society beyond the insolvent company and creditors were affected by an insolvency. Cork also emphasised that means should be provided for preserving ‘viable commercial enterprises capable of making a useful contribution to the economic life of the country’. After the enactment of the Insolvency Act 1986, four different formal insolvency procedures were available to play a part in corporate rescues and reorganisations. These were: (1) administrative receivership; (2) administration under Part II of the Insolvency Act 1986; (3) company voluntary arrangements under Part I of the Insolvency Act 1986; and (4) creditor schemes of arrangement under the Companies Act 1985 (now the Companies Act 2006). These procedures establish regimes for the management of the affairs of a business and they are binding on the managers of the business as well as on the creditors. In this sense they are ‘formal’ procedures to be distinguished from the informal methods that can be adopted in response to corporate troubles. It should be emphasised that companies in financial difficulties do not have to resort to formal procedures. As was noted in chapter 7, if the involved parties (directors, shareholders and creditors) can come to (and sustain) an agreement on the steps to be taken to effect a rescue then informal processes are likely to offer a far speedier and cheaper way of reversing corporate fortunes than resort to formality. Research suggests that there is ‘an elaborate rescue process outside formal procedures’ with about 75 per cent of firms emerging from rescue and avoiding formal insolvency procedures altogether by either turning around their fortunes or repaying their debts.\(^\text{12}\)

When the Cork Committee looked at receivership, a receiver might be put in place by the traditional methods of appointment by the court or under the powers contained in an instrument such as a mortgage


debenture. Despite receiving numerous suggestions for the reform of receivership and numbers of complaints concerning the institution, Cork remained unpersuaded that radical legal changes were called for, advocating instead that receivership should be strengthened – an exhortation which resulted in the creation of ‘administrative receivership’ to which we now turn.  

Processes, powers and duties: the Insolvency Act 1986 onwards

The Insolvency Act 1986 established the ‘pre-Enterprise Act’ version of administrative receivership. The position after 1986 and before the Enterprise Act 2002 came into effect was that the administrative receiver (hereafter ‘receiver’) could be appointed by a creditor of a company who had taken security over the whole or substantially the whole of a company’s property by a package of security interests that must include a floating charge. This meant that a floating charge holder was entitled to appoint a receiver even if a series of fixed charges and preferential debts had priority over the floating charge. All that was necessary was that the floating charge covered a substantial part of the company’s property. Such a creditor would normally be present in the case of most troubled companies since it is usual practice for UK companies to rely to a considerable extent on finance from banks and for the latter to take out security packages that will render them eligible to appoint a receiver to protect their loan.

It is common for debentures to set out lists of the situations entitling the debenture holder to appoint a receiver. Typical events include: failures to meet demands to pay principal or interest; the presentation of a

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13 On which see pp. 346–7, 350–1, 356–60 below.
15 For cases when receivership could not be used, Cork recommended the creation of a new rescue procedure – administration: see ch. 9 below.
16 Insolvency Act 1986 s. 29(2). On the phrase ‘substantially the whole’ see Goode, Principles of Corporate Insolvency Law , p. 253.
17 Note that where the security is composed of fixed and floating charges the AR’s appointment is effected under the floating charge: see Meadrealm Ltd v. Transcontinental Golf Construction Ltd (1991, unreported).
winding-up petition or the passing of a resolution to liquidate the company voluntarily;\textsuperscript{19} the presentation of a petition for administration or the initiation of a CVA; the levying of distress or execution against the company; failure to meet any obligations, or to abide by any restrictions that are set out in the debenture;\textsuperscript{20} ceasing to trade; placing the assets in jeopardy; or being unable to pay debts. Frequently a bank would appoint a receiver suddenly and against the wishes of the directors.\textsuperscript{21}

A debenture holder who was able to appoint a receiver was also in a position to block the effective operation of other insolvency procedures. The party entitled to appoint a receiver had to be given notice of a petition for administration and could then put in the receiver – a course of action that would lead to the dismissal of the petition for administration.\textsuperscript{22} Similarly in the case of a CVA, the creditors’ meeting called to consider this may not approve a proposal affecting the enforcement rights of a secured creditor without the latter’s approval.\textsuperscript{23} Nor may a liquidator take possession of assets under the control of a previously appointed receiver.\textsuperscript{24}

Appointment of a receiver does not bring the company’s trading to a halt since company contracts will generally continue to be enforceable by and against it; its assets remain in its ownership and its directors remain in office.\textsuperscript{25} Legal control of the company, however, passes to the receiver even though factual control may seem, to an outsider, not to have changed. This legal control means that the receiver is entitled to direct the company as to the conduct of the firm’s management.\textsuperscript{26}

\textsuperscript{19} If the court has appointed a liquidator its leave is required before a receiver can be appointed, but such leave will normally be forthcoming: Insolvency Act 1986 s. 130(2); \textit{Henry Pound and Sons Ltd v. Hutchins} (1889) 42 Ch D 402.

\textsuperscript{20} An example would be a grant by the company of a new security interest in contravention of the terms of the debenture.

\textsuperscript{21} See Milman and Durrant, \textit{Corporate Insolvency}, p. 54, who noted also that the directors could occasionally welcome the appointment of a receiver who took the difficult decisions (and was blamed by employees for these). Receivers could also have a ‘better chance of persuading creditors to be patient than the directors who have been promising a cheque for months’.

\textsuperscript{22} Insolvency Act 1986 s. 9(2)(a); s. 9(3). Administrative receivers can still be appointed, even after the reforms of the \textit{Enterprise Act 2002}, although such appointment is much restricted: see further p. 360 below.

\textsuperscript{23} Insolvency Act 1986, s. 4(3).

\textsuperscript{24} See Armour and Frisby, ‘Rethinking Receivership’, p. 76; \textit{Re Crigglestone Coal Co.} [1906] 1 Ch 523.

contracts of employment of employees are generally unaffected by the appointment of a receiver out of court, but termination of contracts will be involved if certain events take place, such as sale of the business.27

The powers of the receiver will be stipulated in the relevant debenture and in any subsequent orders.28 A series of implied powers is also set out in Schedule 1 of the Insolvency Act 1986.29 Receivers are thus equipped to take a series of actions for the enforcement of the debenture holder’s rights: to manage the company’s business;30 to borrow using the company’s assets as security;31 and to take possession of the company’s assets.32 They may also institute legal proceedings,33 go to arbitration or settle disputes,34 and prove for debts owed to the company by insolvent debtors.35 Cheques can be issued and documents executed in the company’s name36 and necessary payments made.37 Once the assets are collected the receiver possesses power to sell these in order to create funds for repaying the debenture holder; subsidiary companies can be established and portions of the business transmitted to these as ongoing operations or for sale.38

A receiver may apply to the court for directions in relation to the performance of his or her functions and the court may give directions or make an order declaring the rights of persons (before the court or otherwise) as it thinks fit.39 Receivers can thus apply to the court for directions in order to resolve disputes about entitlement to the secured property.40 Receivers, furthermore, can dispose of property subject to a

27 Or if the receiver arranges for new inconsistent employment contracts and if the continued employment of an employee is incompatible with a receiver taking over the running of the company: see Milman and Durrant, Corporate Insolvency, pp. 61–4.
28 The receiver has powers in rem (relating to the company’s assets comprised in the security) and rights in personam (or agency powers) relating to everything else.
29 See Insolvency Act 1986 s. 42 which provides that the powers conferred on an administrative receiver by the appointing debentures shall be deemed to include the list of powers set out in Sch. 1 to the 1986 Act and these deemed powers operate ‘except in so far as they are inconsistent with any of the provisions of those debentures’. The list of powers includes, inter alia, the power to carry on the business of the company, to sell or otherwise dispose of the property of the company by public auction or private contract and to raise and borrow money and grant security over the property of the company.
31 Ibid., para. 3. 32 Ibid., para. 1. 33 Ibid. 34 Ibid., paras. 6 and 18.
38 Ibid., paras. 15 and 16. 39 Insolvency Act 1986 s. 35.
40 See, for example, Re Ellis, Son & Vidler Ltd [1994] BCC 532.
third-party’s security (which ranks in priority to the rights of the receiver’s appointee) on an order of the court.41

Receivers, however, possess powers not merely to act for the debenture holder, but to act for the company. These follow from the execution of the debenture.42 Receivers are thus placed in a strange position: they have two principals but are not subject to the control of either of them. They cannot be instructed or sacked by the company’s board43 and, as Fox LJ said in *Gomba Holdings*:44

The relationship set up by the debenture and the appointment of a receiver is tripartite and involves the mortgagor, receiver, and debenture holder. The receiver becomes the mortgagor’s agent whether the mortgagor likes it or not. The mortgagor has to pay the receiver’s fees as a matter of contract. The mortgagor cannot dismiss the receiver and cannot instruct him in the course of his receivership.

The debenture holder, in return, is largely protected from responsibility for the acts and omissions of the receiver.45

In summary, it has been said of the receiver: ‘He can best be described as an independent contractor whose primary responsibility is to protect the interests of his appointor, but who also owes a duty to his deemed principal, the company, to refrain from conduct which needlessly damages its business or goodwill, and a separate duty, by statute, to observe the priority given to preferential creditors over claims secured by a floating charge.’46

When receivers agree contracts, employment or otherwise, they act as agents of the company but they may incur personal liabilities (except in so far as the contract provides otherwise). An important issue here concerns the circumstances under which the receiver will be deemed to

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41 Insolvency Act 1986 s. 43. Note that this would not cover property subject to a ROT clause: see s. 43(7).
43 ARs can only be removed by an order of the court: Insolvency Act 1986 s. 45(1).
44 *Gomba Holdings UK Ltd and Others v. Homan and Bird* [1986] 1 WLR 1301.
45 See Insolvency Act 1986 s. 44(1)(a).
have adopted an employment contract for which he or she will be personally liable. The Insolvency Act 1986 governed such issues through section 44(1)(b), which made the receiver personally liable on contracts adopted by him in carrying out these functions. Receivers have a statutory indemnity covering such liabilities but until the mid-1990s receivers sought to avoid such liabilities by issuing a standardised letter informing each employee that the office holder was not adopting, and would not adopt, their contract of employment. The company, the letter went, would continue to be their employer for the time being (this became known as a Specialised Mouldings letter). The validity of Specialised Mouldings letters was, however, put to the test in the Paramount case. Lord Browne-Wilkinson, in the House of Lords, was forced to the view that such letters did not exclude adoption once the fourteen-day period of grace ran out and that contracts of employment were inevitably adopted if a receiver (or administrator) caused the employment to continue beyond the fourteen days. Paramount thus left receivers in an awkward position since it may be difficult to form a professional judgement on the feasibility of rescue within such a short time.

The deficiencies of the law in this area were partially addressed before the House of Lords decided Paramount, when the Insolvency Act 1994 was passed. This applied only to employment contracts adopted on or after 15 March 1994 (and thus left Paramount to address contracts adopted between the commencement of the Insolvency Act 1986

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48 See unreported ruling of Harman J in Re Specialised Mouldings (13 February 1987).

49 Paramount: the case that laid the foundation for this issue was Nicol v. Cutts [1985] 1 BCC 99.

50 Provided for in the Insolvency Act 1986 s. 44(2) which states that an AR is not taken to have adopted a contract of employment by reason of anything done or omitted within fourteen days of his/her appointment.

January 1987) and 15 March 1994). Under sections 44 (2A–D) of the Insolvency Act 1986 (as amended by the Insolvency Act 1994), where a contract of employment is adopted, a receiver will only become liable personally for ‘qualifying liabilities’, which are defined (for example, to include liabilities to pay wages or salary or pension contributions incurred when the receiver is in office) and which accrue and relate to services rendered only after the date when the contract was adopted. This means that where services are rendered partly before and partly after adoption of contracts, only such a sum as reflects services rendered after adoption will qualify under sections 44 (2A–D) and will be accorded the enhanced protection that flows from the receiver’s personal liability. With regard to payments referable to periods pre-adoption or before the receiver’s appointment, employees will thus stand as unsecured creditors with claims against the company alone.

Turning to the duties of the receiver, the primary obligation is to act bona fide to realise the assets of the company in the interests of the debenture holder. The receiver’s powers of management have been said to be ancillary to that duty. There is, as indicated, no duty to obey the firm or generally to provide the company with details and information concerning the conduct of the company’s affairs. At one time, however, the courts assumed that receivers owed a duty of care in tort to the company and subsequent encumbrancers and guarantors of the company’s debt. The duty was to use care to obtain the best possible price when selling company property. In the Downsview Nominees case the

52 In administration such employees would have ‘super-priority’ by virtue of the Insolvency Act 1986 s. 19(4) and (5) which gives such payments priority over any charges. In receivership there is personal liability of the receiver, who is entitled to indemnity out of the company’s assets: s. 44(1)(c). On the case for a ‘uniform approach which transcends the differences between the various forms of insolvency proceedings’ see H. Anderson, ‘Insolvent Insolvencies’ (2001) 17 IL&P 87.


55 Ibid.


57 Downsview Nominees Ltd v. First City Corporation [1993] AC 295.
Privy Council held that a receiver only owed equitable duties to non-appointing debenture holders and to the company to act in good faith. Specific equitable duties were owed to these parties to do such things as keep premises in repair and avoid waste. The Privy Council accepted that a receiver was subject to a specific equitable duty to take reasonable care to obtain a proper price for assets sold, but it denied the existence of a general duty of care in tort to subsequent encumbrances or the company with regard to dealing in the secured assets.\(^5^8\) The Court of Appeal, however, in *Medforth v. Blake*,\(^5^9\) reasserted that the duties of receivers are equitable rather than tortious but stated that a receiver owed a duty, if managing the mortgaged property, to do so with due diligence, which amounted to an equitable duty of care. In that case, Medforth, the owner–manager of a pig farm, owed sums to the Midland Bank that became unacceptable to the lender. The loan terms provided for the appointment of a receiver and a receiver was appointed with power to run the business. The business was run by the receiver for four years before new terms were agreed between Medforth and the bank. During that period, the receiver had not negotiated with the relevant pre-existing pig feed suppliers in order to obtain the 10 to 15 per cent discounts that Medforth had received and which Medforth had repeatedly advised the receiver to ask for. Around £200,000 of discounts had not been obtained during the receivership. The issue was whether the receiver owed Medforth a duty of care that had been breached or whether there had been a breach of good faith.

Sir Richard Scott VC delivered the sole judgment of the Court of Appeal and stated: ‘The proposition that in managing and carrying on the mortgaged business the receiver owed the mortgagor no duty other than of good faith offends in my opinion commercial sense … If [the


receiver] does decide to carry on the business why should he not be expected to do so with reasonable competence?\(^{60}\) It was argued for the receiver in *Medforth* that the cases of *Re B. Johnson & Co. (Builders) Ltd\(^{61}\) and *Downsview\(^{62}\) established that receivers owed no duty to exercise skill and care and that to go beyond the duty to perform with good faith would undermine receivership by doing away with the judicially sanctioned advantages that receivership as an institution offered.\(^{63}\) Scott VC’s response was that the authorities cited gave non-exhaustive lists of the obligations of receivers and that, since, on strong authority, receivers had to take reasonable steps to obtain proper prices on asset sales, it would be anomalous not to impose a corresponding duty in relation to the management of those assets. Scott VC went on to state that principle and authority supported the following seven propositions:

1. A receiver managing mortgaged property owes duties to the mortgagor and anyone else with an interest in the equity of redemption.
2. The duties include, but are not necessarily confined to, a duty of good faith.
3. The extent and scope of any duty additional to that of good faith will depend upon the facts and circumstances of the particular case.
4. In exercising his powers of management the primary duty of the receiver is to try and bring about a situation in which interest on the secured debt can be paid and the debt itself repaid.
5. Subject to that primary duty, the receiver owes a duty to manage the property with due diligence.
6. Due diligence does not oblige the receiver to carry on a business on the mortgaged premises previously carried on by the mortgagor.
7. If the receiver does carry on a business on the mortgaged premises, due diligence requires reasonable steps to be taken in order to try and do so profitably.\(^{64}\)

Whether the imposition of *Medforth* duties of competence on receivers will enhance the institution of receivership or detract from it will be considered below. Taking the issue of financial competence further, though, another case has considered the receiver’s duty to maximise value before the sale of secured assets. In *Silven Properties*,\(^{65}\) the Court

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\(^{60}\) [1999] 3 All ER 97 at 103.  
\(^{61}\) [1955] Ch 634.  
\(^{64}\) [1993] 3 All ER 97 at 111 G–J.  
\(^{65}\) *Silven Properties and Another v. The Royal Bank of Scotland plc* [2003] BCC 1002.
of Appeal stated that the obligations of a receiver did not extend to postponing the exercise of a power of sale until after the decision of a planning application where the outcome might have been to increase the market value of a mortgaged property. Nor was the receiver, as agent of the mortgagee, obliged to invest time or money in steps designed to increase the value of the mortgaged property. The limit of the receiver’s duty was to take reasonable care to obtain a price that reflected the added value offered by the potential granting of the planning application. The primary duty of the receiver was to secure repayment of the secured debt and the primary obligation was to the bank. In short, the duties of the receiver were the same as those of a mortgagee and there was no duty to delay by taking steps to increase the value of the property or by otherwise improving it.

In addition to the mixture of common law duties owed by a receiver is the set of statutory obligations imposed by the Insolvency Act 1986. Notable among these is the obligation of a receiver appointed to enforce a floating charge to ensure that the regime of statutory preferential claims is correctly applied and to retain for the benefit of the general creditors the prescribed part of the net property subject to a floating charge. Provisions on disclosure of information include duties to furnish annual accounts to the company’s registry, the company, the appointor and the creditors’ committee; a duty to prepare a report within three months of receiving a statement of affairs from the company officers; and an obligation to summon a meeting for unsecured

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66 Thus a receiver cannot remain passive if that would damage the interests of the mortgagor or mortgagor – he must preserve the value of property over which he is appointed. In Bell v. Long and Others [2008] EWHC 1273 (Ch) Patten J confirmed that the receivers were entitled to choose the time of sale even if it turned out to be disadvantageous to the mortgagor who could have recovered more had the properties been sold later. The receiver is not a trustee of his power of sale for the mortgagor.


69 Insolvency Act 1986 s. 40; IRC v. Goldblatt [1972] Ch 498; Woods v. Winskill [1913] 2 Ch 303; Insolvency Act 1986 s. 176A(2). It is the receiver who is obliged to see that preferential claims are settled when receivership and liquidation coincide: Re Pearl Maintenance Services Ltd [1995] 1 BCLC 449.

70 Insolvency Rules 1986 r. 3.32. 71 Insolvency Act 1986 ss. 47 and 48.
creditors to consider this report. As for the enforcement of the receiver’s duties, the statutory obligations are usually underpinned by criminal sanctions of fines and the common law duties can be backed up by enforcement actions taken in the ordinary courts. It is now clear that the company can bring a direct action against its receiver.

Finally, as far as termination of the receivership is concerned, this may result from the receiver’s death, removal by court order, or ceasing to be a qualified IP. The usual process, however, involves the completion of duties, notably realisation of all valuable assets and the making of all possible distributions to interested parties in the order of priority fixed by the law. Notification is then given to the company and the creditors’ committee and any surplus funds are passed to the company. Resignations of receivers require at least seven days’ notice of intention to be given to the appointor company, any liquidator and the creditors’ committee. The receiver will also have to vacate office if an administrator is appointed by the court. Removal of the receiver by the appointor is, after the Insolvency Act 1986 s. 45(1), only possible following a successful application to the court. The purpose of this reform was to make the receiver independent of the appointing debenture holder.

Efficiency and creditor considerations

In some regards the administrative receiver may be thought to be particularly well placed to secure the rescue of an ailing company. As noted, the receiver is not necessarily required to go to court in order to act and there is no need to secure the agreement of directors, shareholders or creditors before actions to protect the debenture holders’ interests are taken. The company’s assets can be disposed of free from security interests (apart from those of the appointor) if the court gives leave. Receivers owe obligations to report to other creditors but have no duties

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72 Ibid., s. 48(2); Insolvency Rules 1986 rr. 3.9–3.15; see Milman and Durrant, Corporate Insolvency, p. 73.
74 The replacing includes giving notice under Insolvency Rule 3.34.
75 Insolvency Act 1986 s. 45(1).
76 Ibid., ss. 45(2), 389, 390.
77 Insolvency Rules 1986 r. 3.33.
78 Insolvency Act 1986 ss. 45(2), 11(1)(b).
79 Milman and Durrant, Corporate Insolvency, p. 76.
80 Insolvency Act 1986 s. 43.
to accede to their wishes or even to listen to their views. After appointment they act in a highly independent fashion and, as noted, the debenture holder can only remove them from office by securing an order of the court.

It could be contended, however, that the independent and swiftly responsive model of receivership may now have been prejudiced by the *Medforth v. Blake* imposition of a duty of care on receivers. In *Medforth* it was argued on behalf of the receivers that imposing a duty of due diligence would undermine receivership. In response, though, it has been noted:

Scott VC was unimpressed by that submission and justifiably so. The advantages of receivership to the modern day financial institutions go far beyond the avoidance of wilful default liability. Statute has [conferred] an array of powers on administrative receivers, all of which will accrue to the benefit of the appointor, so much that escaping liability as mortgagee in possession will be little more than an afterthought to the contemporary debenture holder.

Receivership as an institution may have had powerful institutional supporters but *Medforth* could give rise to legal uncertainties that are liable to produce defensive attitudes on the part of receivers and which could decrease the efficiency of receivership as an institution. As already noted, Scott VC’s judgment left some doubt as to the scope of the equitable duty owed by the receiver. In suggesting that this might ‘depend on the facts and circumstances of the particular case’ Scott

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81 See E. Ferran, ‘The Duties of an Administrative Receiver to Unsecured Creditors’ (1988) 9 Co. Law. 58. Ferran suggested that the disclosure requirements could benefit unsecured creditors in an indirect way, namely by providing them with ammunition with which to persuade a liquidator that an action should be brought against the administrative receiver.

82 Insolvency Act 1986 s. 45. 83 [1999] 3 All ER 97.

84 For a review of the discussion see Frisby, ‘Making a Silk Purse’, pp. 420–2; Sealy, ‘Mortgagees and Receivers’.


87 For criticism of the *Medforth* reasoning on the equitable duty see Sealy, ‘Mortgagees and Receivers’.

88 [1999] 3 All ER 97 at 111: a point taken by Nicholas Warren QC in *Hadjipanayi v. Yeldon et al.* [2001] BPIR 487 at 492–5, when, in reviewing the duties of a mortgagee-appointed receiver, he deemed it arguable (but no more) that receivers may owe a duty to co-operate with the mortgagor in selling the mortgaged property with its attendant business as a going concern.
VC missed the opportunity to lay down a guiding rule. The facts in *Medforth* indicated a very high level of negligence in so far as the warnings concerning the pig feed discount were repeatedly not acted upon. The receiver’s behaviour could be construed as close to a breach of good faith and this leaves open a series of questions about receiver failure, notably whether the *Medforth* type of behaviour would have involved a breach of duty in the absence of the warnings that were given. A number of receivers will, as a result of such uncertainty, be exposed to litigation and, until the law is clarified, the institution of receivership will involve higher transaction costs than would be the case with a more legally definite rule.

Such a process of legal clarification may indeed take some time because Scott VC’s judgment in *Medforth* contained what has been dubbed some ‘fancy footwork’ in escaping the constraints of previous case law, in ‘applying an equitable label to a common law concept’ and by declining to arrive at the just result by reasoning in terms of wilful default and good faith. As one critic of the decision wrote: ‘*Medforth* is an attempt wholly to outmanoeuvre the *Downsview* analysis by rewriting the obligations in equity of the receiver by creating an equitable duty of care which can hardly be distinguished in practice from the common law tortious duty of care so comprehensively forsworn in *Downsview*.’

Whatever the doctrinal rights and wrongs here, the potential for litigation on these points should not be written off. That is the danger for receivers and for all parties who see legal certainty as serving their interests.

There is a response to such concerns, however, that may offer some reassurance to the parties just mentioned. It can be argued, first, that *Medforth* does not add significantly to uncertainties for the receiver.

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because the long-established obligation to secure a reasonable price⁹² is liable to overlap significantly with a Medforth obligation of competence: many instances of lack of competence will mean there is a failure to secure a reasonable price. They might also constitute instances of wilful default per Downsview.⁹³ Second, it can be added that receivers who are wary of Medforth should not find it beyond their capabilities to protect themselves from legal attack by establishing proper procedures that reflect the minimal levels of competence of a reasonable business person.⁹⁴

A second concern about Medforth might be the belief (consistent with the judgment in Downsview)⁹⁵ that imposing an equitable duty of care on receivers will compromise the receiver’s primary obligation to act in the interests of the debenture holder. This worry is perhaps readily responded to by stating that a duty to exercise skill and care should not impinge on such a primary obligation or place other interests on a par with those of the debenture holder in the considerations of the receiver: the requirement is merely that ‘decisions be competently taken’.⁹⁶ (As noted above, the Silven Properties decision, moreover, reaffirmed the primacy of the obligation to the mortgagee.)⁹⁷ As the Insolvency Service has commented: ‘Some respondents asserted that the effect of [Medforth] was to remind receivers of their wider duties and that, accordingly, this diluted the force of the criticisms that receivership was not a collective procedure. This is arguably an overstatement of the Medforth decision.’⁹⁸ Medforth does not change the balance of power so much as demand an absence of behaviour lacking in care. This response

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⁹² See also Silven Properties and Another v. The Royal Bank of Scotland plc [2003] BCC 1002.
⁹³ See also A. Walters, ‘Round Up: Corporate Finance and Receivership’ (1999) 20 Co. Law. 324, who argues, at p. 329, that: ‘Given the possible damage that an incompetent receiver could do to the equity of redemption, it is perhaps not surprising to see the Court of Appeal applying a modern form of equitable duty analogous in some respects to the old-fashioned concept of “wilful default” by a mortgagee in possession.’ Walters thus equates Medforth v. Blake [1999] 3 All ER 97 with Knight v. Lawrence [1991] BCC 411.
⁹⁶ Ibid. Frisby argues that what is being targeted is careless behaviour rather than a deliberate course of conduct that will benefit the mortgagee to the detriment of the mortgagor. Thus Medforth does not overturn the balance of power between the mortgagor and mortgagee (when properly analysed and applied): pp. 420–1.
also provides an answer to a further concern about Medforth – represented by Lord Templeman’s view in Downsview – that liability in negligence would lead receivers to sell assets ‘as speedily as possible’.\textsuperscript{99} If there is a clear duty to the appointor, an obligation to act competently should have, at worst, a neutral effect on speed of disposition, and in many cases it will favour a less precipitate, more deliberate, style of decision-making. Whether receivers’ duties to creditors should be broadened is a matter to be returned to below in considering issues of fairness.

Note should now be taken of a number of difficulties that constitute limitations on the collectivity of receivership. Receivership involves no moratorium on the enforcement of claims against the company. This means that a receiver is powerless to stop other creditors from acting to enforce their claim and, in doing so, throwing a spanner in the works of the rescue plan. Nor is there any power in the receiver’s hands to stop the company from entering into liquidation. Liquidation will not stop receivers from acting. They will continue in office, exercising powers in the interests of their appointor (acting as agent for the appointor, no longer for the company). But the chances of a successful rescue will be reduced by the advent of liquidation. Once that stage is reached there is no prospect of corporate survival, although the receiver may succeed in selling off some part of the business as a going concern.

Nor, as we have seen, is the receiver always obliged to attempt to rescue the business. The receiver is only obliged to pursue the rescue option if this course is in the interests of the appointing debenture holder. If the interest of the appointor is best served by a simple realisation of the assets, the administrative receiver is obliged not to attempt to rescue unless the full approval of the appointor is forthcoming. There are reasons for thinking, moreover, that receivers will tend to play safe and to favour simple realisations rather than rescues when in doubt. Receivers are private professionals not public officials and are dependent for their livelihood and appointment on a relatively small group of financial institutions, such as banks, taking floating charges. Although administrative receivers cannot be removed from office once appointed, except by order of the court, they would jeopardise future appointments if they disregarded their appointor’s wishes.\textsuperscript{100}

\textsuperscript{99} [1993] AC 295 at 316.
\textsuperscript{100} A. Clarke, ‘Corporate Rescues and Reorganisations in English Law after the Insolvency Act 1986’ (Mimeo, University College, London, 1993) p. 7.
The statistics of the nineties indicated that receivership resulted in rescue in fewer instances than other formal procedures: the DTI’s 1993 Consultative Document on Company Voluntary Arrangements reported that in 1993, 50 per cent of administrative receiverships terminated with a break-up sale of the company’s assets, but that 67 per cent of all administrations and 75 per cent of all CVAs achieved a complete or partial survival of the enterprise.\(^\text{101}\) When, indeed, the Royal Bank of Scotland (RBS) adopted a rescue culture, it immediately cut the number of receivers appointed.\(^\text{102}\) This is perhaps because, as has been pointed out, receivership can only be effectively used for rescue purposes if the company has a dominant creditor (perhaps a bank or consortium of banks); if that creditor is willing actively to support rescue; and if other parties refrain from spoiling actions. If such conditions exist, moreover, it may well be possible to forgo receivership and mount a rescue by means of informal agreements.

When the Insolvency Service consulted on rescue mechanisms for its 2000 Review\(^\text{103}\) it encountered very different appraisals of receivership. Most of its respondents were favourably disposed towards the institution of receivership, a situation that was not surprising given that most responses came from law firms and trade associations.\(^\text{104}\) These respondents stressed that administrative receivership was an integral part of the rescue culture in the UK that contributed to rescue and corporate survival. They emphasised the ability of receivers to take rapid and effective actions to prevent deterioration in the viability of businesses (particularly where fraud was evident or suspected); the sizeable number of businesses that go into receivership and then are sold as going concerns; and the relatively low costs of initiating the procedure (as seen by creditors and practitioners). The ‘larger professional service firms’ considered that the banks took a responsible attitude towards receivership and only appointed receivers as a last resort. They conceded, however,

\(^\text{101}\) R3’s Ninth Survey of Business Recovery in the UK (2001) indicated business preservation rates associated with appointments as follows: receiverships 59 per cent; administrators 79 per cent (up from 41 per cent in a small sample); CVAs 74 per cent. Receiverships were found in the SPI’s Eighth Survey, *Company Insolvency in the United Kingdom* (SPI, London, 1999), to save 31 per cent of jobs compared to 37 per cent for CVAs and 40 per cent for administrators (1997–8).

\(^\text{102}\) In 1992 the RBS appointed 418 receivers (11 per cent of the national total); in 1996 it appointed 48 (5 per cent of the national total): see M. Hunter, ‘The Nature and Functions of a Rescue Culture’ [1999] *JBL* 491 at 508, n. 66.

\(^\text{103}\) *IS* 2000, p. 53. \(^\text{104}\) Ibid., pp. 15, 48.
that non-bank floating charge holders were ‘more likely to act precipitately as they tended to be less focused on preserving a long term relationship with the debtor’. Research conducted by Franks and Sussman and discussed by the IS\textsuperscript{105} gives some support to the ‘last resort’ account. The IS noted the key research finding that: ‘It seems clear that banks rarely petition for the liquidation of a company and that, in recent years, they have tended to see administrative receivership as a last resort for a troubled company. Where an administrative receiver is appointed, going concern sales (of the whole of the business or of some part of it) are achieved in about 44 per cent of cases.’\textsuperscript{106} More recent empirical research has suggested that the displacement of receivers with administrators in the post-Enterprise Act 2002 regime has resulted in very little increase in the number of corporate rescues and no significant difference in outcomes between new style administrations and receiverships under the old law – both in terms of going-concern sales versus break-up sales and in terms of returns for creditors.\textsuperscript{107}

Many business people consulted by the Insolvency Service were, however, concerned about the power of the floating charge holder:

They were very sceptical about the banks’ contentions that receivers would only ever be appointed as a last resort and tended to be wary of their banks in times of difficulty. Some business people told us of personal experiences where the banks appeared to have acted very unreasonably. Many considered that banks were only adopting a more relationship driven style at the larger end of the market and that the banks did not have the same interest in the SME end of the market – with the result that in times of trouble, the banks would be looking to exit the relationship as quickly as possible, via receivership if necessary.\textsuperscript{108}

Respondents who voiced reservations about the effectiveness of administrative receivership as a rescue device emphasised three points.\textsuperscript{109} The first was that: ‘It can lead to unnecessary business failures and undermines the rescue culture, particularly when the relationship between the

\textsuperscript{105}Ibid., pp. 16–19; Franks and Sussman, ‘Cycle of Corporate Distress’.

\textsuperscript{106}IS 2000, p. 17.


\textsuperscript{108}IS 2000, p. 17. See also Carruthers and Halliday, \textit{Rescuing Business}, p. 286.

\textsuperscript{109}IS 2000, p. 15. Points relating to the consistency of administrative receivership with international and EU requirements have been left out of account here.
floating charge holder and the business breaks down; the floating charge holder may then decide to withdraw support from the business and appoint an administrative receiver when an alternative lender might have elected to continue such support.\(^{110}\) The second was that: ‘Because the purpose of the receivership is primarily to ensure repayment of the amount due to the secured creditor, there is no (or there is insufficient) incentive to maximise the value of the debtor company’s estate.’\(^{111}\) The third point was that the growth of asset-backed lending, factoring and invoice discounting as modes of corporate financing, together with a growing diversity of parties able to appoint administrative receivers, has made it more difficult to ensure that the appointment of an administrative receiver is effectively treated as a measure of last resort by lenders. Such diversity, in turn, makes it more difficult to rely on self-regulatory measures by creditors, such as the British Bankers’ Association’s Statement of Principles.\(^{112}\)

The pessimistic view of receivership, however, has to be contrasted with what has been called the ‘concentrated creditor governance’ theory of receivership.\(^{113}\) This theory urges that the law on receivership can generate significant and worthwhile efficiencies. Two propositions lie at the heart of this argument: first, that debt finance can act as a mechanism of corporate governance, especially in small and medium-sized enterprises (SMEs) where other governance mechanisms such as hostile takeovers are less important; and second, that concentrating a firm’s

\(^{110}\) See DTI/Insolvency Service, *Productivity and Enterprise: Insolvency – A Second Chance* (Cm 5234, 2001). Franks and Sussman (‘Financial Distress and Bank Restructuring’) argue that a bank’s typical response to distress is to attempt a rescue, while reducing credit, but suggest that evidence of banks’ tendencies to liquidate prematurely is ‘mixed’.

\(^{111}\) On the tendency of receivership to lead to premature closures and ‘inefficient liquidations’ of good firms, see DTI/Insolvency Service, *Insolvency – A Second Chance*. On returns to secured creditors, Frisby’s research for the Insolvency Service suggests that in pre-Enterprise Act receiverships, secured creditors recovered on average 29.3 per cent on debts owed, compared to 34.6 per cent for post-Enterprise Act administrations and 13.4 per cent for pre-Enterprise Act administrations: see S. Frisby, *Interim Report to the Insolvency Service on Returns to Creditors from Pre- and Post-Enterprise Act Insolvency Procedures* (Insolvency Service, London, July 2007) (hereafter ‘Returns to Creditors, 2007’).


\(^{113}\) See Armour and Frisby, ‘Rethinking Receivership’. 
debt finance in the hands of a relatively small number of creditors can reduce total monitoring and decision-making costs. The suggestion here is that giving control over enforcement to a ‘concentrated creditor’ allows that creditor to utilise the information it has gathered during the course of its deliberations on whether or not to continue to support the debtor, and that this both enhances the disciplining effect of credit and allows for quicker and cheaper enforcement than would take place with the collective insolvency procedure in which an outsider appointee takes over the firm. Consistent with this suggestion are studies published in 2006 suggesting that the direct costs of pre-Enterprise Act 2002 receivership cases are lower than those of post-Enterprise Act administrations. They also indicate that the average net recoveries to creditors in receiverships are no lower than in the new administrations.

The arguments for creditor concentration emphasise that a number of problems are faced in creditor collective actions. First, there is the issue of information. It will cost creditors money to gain information on whether to enforce the debt or renegotiate it, but the benefit of such information will be only a fraction of the total value at stake and so individual creditors will be notionally under-informed. They may, moreover, seek to free-ride on the monitoring of others and, overall, there will be collective underinvestment in monitoring. ‘Hold out’ problems may also affect collective action since collective renegotiation or decisions to sell the firm as a going concern may demand that all creditors agree the course of action. Individual creditors will thus have incentives to hold out against such agreements until their co-operation is bought. If such problems are severe, a race to enforce debts may result as collectivity breaks down.

The suggested solution to such problems is not to follow Jackson and argue for state-imposed collectivism: this, say Armour and Frisby, will reduce enforcement costs but it will do ‘nothing to ameliorate collective

114 Armour, Hsu and Walters, Report for the Insolvency Service, p. iv (who suggest that concentration allows repeat-playing banks to negotiate down the fees of IPs more effectively in a receivership than is possible for dispersed unsecured creditors in an administration).

115 Ibid., p. v. But see Frisby’s argument that administration as a procedure is likely to produce better outcomes for all creditors than receivership: Frisby, Returns to Creditors, 2007, p. 34.

action problems associated with information gathering beforehand'. A more comprehensive solution, in their view, is for the debtor to have one main creditor who will act as a whistle blower. This will produce savings because creditor concentration means that the main creditor has appropriate incentives to monitor the debtor for default and, also, can renegotiate swiftly and efficiently since there is only one significant creditor. It is argued that enforcement in this manner is better informed and quicker than if carried out by a state official. It is a low-cost strategy for the creditor bank and so this increases the effectiveness of debt as a disciplinary mechanism for underperforming managers. Receivership thus is a vehicle for facilitating the efficient disposal of assets by a concentrated creditor.

Empirical research was said to support the case for the creditor concentration approach. Professionals involved in receivership thought that, in the majority of cases, receivers were appointed by a bank that was the debtor firm’s principal lender. Statistics also indicated that receivership appointments were largely confined to SMEs with annual turnovers of less than £5 million and that the majority of appointments were made by banks. As for monitoring, there was evidence that clearing banks typically lend to SMEs through local business relationship managers, but that some routine monitoring of debtors is conducted and that risk evaluations are carried out. If performance dropped below a certain point, the debtor’s file would be transferred to a central ‘intensive care’ division of the bank and into the hands of specialist staff acting with the primary objective of turning corporate affairs around. Scrutiny by the bank would then become more intensive and, if the firm’s fortunes did not change, the bank might appoint an accountant to carry out an independent business review. The function of that review would be to build a bridge between the bank and the troubled company’s management in order to find a solution – which might or might not be a receivership. The whole process, in terms of creditor concentration theory, amounts to an information-gathering exercise initiated by the concentrated creditor that generates benefits for other creditors in terms of improved quality decision-making.

The creditor concentration theory is, however, subject to a number of objections. Leaving aside issues of fairness to non-appointing creditors, and focusing on economic efficiency considerations, the first problem is

118 Ibid., p. 92; SPI Eighth Survey, p. 11.
that concentration may produce inefficient and distorted decisions concerning the continuation of the business as a going concern. Proponents of concentration concede that (consistently with their legal obligations) receivers generally see their role as being to maximise recoveries for the main creditor (hereafter ‘the bank’). The danger, as summarised by one commentator, is:

The receivership system may lead to an equilibrium in which the company is prematurely and inefficiently liquidated. The problem stems from the feature of this system which allows creditors to act in individualistic self-interest. They have the right to recover the value of their claim without considering the overall value of the pool of assets upon which they draw. This may force the company to liquidate its assets even though on efficiency grounds it should continue business.\(^\text{119}\)

Proponents of the creditor concentration theory, however, might respond that there is little evidence that banks tend to act in a precipitate fashion. Franks and Sussman have concluded from a study of 542 financially distressed small and medium-sized companies that there are no clear indications of such a tendency.\(^\text{120}\)

A second defence of receivership might lie in the argument that banks will be unwilling to close marginal businesses since indirect costs will be involved where the closed firm’s customers, suppliers and employees are also bank customers and stand to be adversely affected by closures. It could be added that banks will not act precipitately for reputational reasons, since closing SMEs will not sit well alongside advertising campaigns stressing the banks’ caring and listening characteristics.\(^\text{121}\) This defence, however, has limited mileage. On the bank’s decision to institute a receivership, it may well be the case that some banks, in buoyant financial conditions, will act in an understanding manner, but it would be rash to design insolvency regimes by presupposing continuing general goodwill in banks. Such goodwill may be sketchily distributed and short lived in hard times when insolvencies will multiply. The incentive will be for banks to put receivers into post with an eye to their own selfish


\(^{120}\) Franks and Sussman, ‘Financial Distress and Bank Restructuring’, pp. 91–2.

\(^{121}\) British Bankers’ Association, Banks and Business Working Together (London, 1997) sets out a number of principles for dealing with SMEs, stating, *inter alia*, ‘Banks have long supported a rescue culture and thousands of customers are in business today because of the support of their bank through difficult times’: discussed in Hunter, ‘Nature and Functions of a Rescue Culture’.
interests. Some would argue, moreover, that the general UK trend is for banks to operate in an increasingly hard-nosed manner and to move away from ‘gentlemen’s club’ altruistic stances.\(^{122}\) Once the receiver is appointed, moreover, the bank is not running operations and the receiver has a legal obligation and, as seen above, an inclination to act in the bank’s interests rather than broader interests.

Empirical research, however, suggests that if receivership is compared to post-Enterprise Act administration procedure, concentrated and dispersed creditor governance regimes may prove functionally equivalent. This is because, although gross realisations may have increased with post-Enterprise Act administration’s collective regime, those increases have tended to be eaten up by the increased process costs associated with the collective regime.\(^{123}\)

The creditor concentration theory is also open to contest on its assumptions concerning the monitoring of corporate managers. A key assumption is that banks will possess strong incentives through concentration to monitor managerial performance. This will produce benefits to the general body of creditors. There are, however, reasons for thinking that this will not always be the case. In so far as credit is not 100 per cent concentrated in the secured loan from the bank, the bank will under-monitor since its incentive to oversee will relate to the extent of its secured loan and not the total sum owed to creditors and at risk through managerial activities. It is, moreover, the case that where the secured creditor is not first in the queue to be paid (e.g. where there are fixed charges and preferential creditors) any incentive to monitor will be reduced. Thus, if the prospect of recovery of the sum owed stands to be reduced to 25 per cent by the existence of prior

\(^{122}\) W. Hutton, *The State We’re In* (Vintage, London, 1996); Carruthers and Halliday, *Rescuing Business*, pp. 197–205. But see the argument that banks are now tending to favour administration rather than receivership (even when they have powers to appoint receivers) because of reputational concerns: Armour, Hsu and Walters, *Report for the Insolvency Service*.

\(^{123}\) See Armour, Hsu and Walters, *Report for the Insolvency Service*. Frisby’s study gives gross returns for pre-EA receiverships as 29.3 per cent for secured creditors and 1.9 per cent for unsecured creditors, and, for post-EA administrations, 34.6 per cent for secured creditors and 2.8 per cent for unsecured creditors: see Frisby, *Returns to Creditors*, 2007, p. 5. Note, however, Frisby’s caution (p. 4) on drawing such comparisons and her pointing to a series of complicating variables – including the abolition of the Crown’s preferential status by the EA 2002 which might be expected to have increased the body of unsecured creditors and, at the same time, swelled the mass of funds available for secured creditors.
claims, the inducement to monitor will be a quarter of the efficient incentive.

Attention must, in addition, be paid to the purposes to which such monitoring is put. It would be rash to assume that monitoring relates to the general health and well-being of the enterprise rather than the prospect of repayment of the loan.\(^{124}\) The more modest the loan is in relation to overall corporate turnover, the more likely it is that the bank will take its eye off overall business health. It may even be the case that a generally poorly performing company would, on receivership, be able to meet the sum owing to the bank on the floating charge.\(^{125}\)

The monitoring of management, moreover, can be seen as merely one of a number of ways in which a creditor can deal with the risks of lending. Taking increased security offers an alternative way of managing developing risks as do the processes of spreading risks and of adjusting interest rates and associated charges for credit. From the point of view of a creditor, the objective in lending will be to manage risks in the most efficient manner: that is, the one that allows the bank best to compete in the marketplace and best to maximise returns for its own shareholders. Such an objective is likely to be met by the bank adopting a mixture of strategies: perhaps combining some taking of security, some monitoring and some adjustment of interest rates. The problem for the creditor concentration theory is that, even if concentration is assumed, it cannot be taken for granted that the bank’s incentive will be to monitor managerial practice with an eye either to ongoing corporate health or to instituting receivership at the appropriate time. Many banks will often find it cheaper to deal with risks by increasing security and by increasing charge rates.

Nor should the virtues of monitoring be accepted unquestioningly in setting these up as a justification for any unfairness in underprotecting the interests of certain classes of creditor. The notion that monitoring protects creditors assumes that there is a linkage between this and improvements in the management of the firm. It may well be the case that underperforming managers fail to deliver the goods in many instances because of irrationalities, lack of ability, failures of strategy


and deficiencies of understanding. It takes a considerable leap of faith to believe that such poor performers will be highly responsive to the messages received from monitoring banks. If a typical unsecured creditor was to be offered the choice of a larger share of the insolvency estate or better monitoring of management he or she might well opt for the former. The point can also be made that even if creditor concentration is present, the bank may only possess partial control over the firm since finance may have been raised by quasi-security devices such as hire purchase or retention of title arrangements. The claims of such finance suppliers will take precedence over the floating charge and the bank will have reduced de facto control over the firm’s assets.

A final difficulty concerns creditor concentration itself and how this is to be ensured. If levels of concentration are left to the market, it may or may not be (or remain) the case that the typical SME has only one main (bank) secured creditor. There is considerable evidence, as discussed in chapter 3, that credit arrangements are increasingly fragmenting for a number of reasons.126 It would, accordingly, be risky to design a regime of insolvency law on the continuing assumption of concentration. If, on the other hand, insolvency law is set up to offer firms an incentive to resort to only one main secured creditor, this would not be consistent with the provision of the flexible financing opportunities that firms need in order to respond efficiently to market changes. There may also be problems of ‘reverse agency costs’ in so far as the main creditor bank may chill the firm’s investment decisions – leading to valuable opportunities being forgone in favour of lower-risk alternatives.127

Expertise

The Insolvency Act 1986, as noted, provides that all receivers must be qualified insolvency practitioners within the meaning of Part XIII of the Act. The Act, in turn, responded to Cork’s view that persons performing as IPs must possess some minimal professional qualifications and be subjected to control.128 General issues relating to the expertise of IPs have been discussed in chapter 5 and will not be rehearsed here, save to note that some commentators have questioned whether the training and

126 See Frisby, Insolvency Outcomes.
approach of IPs gives them a sufficient grounding in managerial skills and provides them with a proper orientation towards rescue rather than mere debt collection. Within the context of receivership it can be argued that there are particular institutional factors that militate unduly against rescue options, notably the ongoing relationship that most receivers have with the major lending banks and the primary legal obligations of receivers to act to protect the bank’s interests. Receivers, even if managerially trained, would find themselves ill-positioned to put such skills into good effect for the purposes of rescue. They may be proved to be highly expert at protecting the bank’s interests but this may constitute a narrower expertise than the overall public interest demands. Receivers, moreover, act with one hand tied behind their backs even if disposed to exercise their skills in favour of rescue. Receivership is not a collectivist approach proper and, accordingly, other parties cannot be bound in a manner that prevents interference with the receiver’s proposed route out of corporate troubles.

As far as particular or sectoral skills are concerned, problems may arise when receivers are appointed at an early stage of corporate troubles. If those troubles are mainly to do with financial management then the IPs acting as receivers may be able to assist the company by rationalising affairs. If, however, attention to corporate problems demands detailed knowledge of a particular industry, market or mode of organising the business, there may be a danger that the receiver is far less well equipped to effect a rescue or appropriate sale of assets than managers who are familiar with the scene. Receivers will accordingly have to rely heavily on management.

As was seen above, receivers are, at law, obliged to perform their functions with certain levels of skill. It is clear from the judgment of Scott VC in Medforth v. Blake\(^ {129}\) that a receiver, if managing the business, owes the mortgagor more than a duty to exercise good faith. Reasonable competence must also be displayed and an equitable duty of care is owed. As noted also, Medforth was adopting a policy line consistent with prior case law that demanded that a receiver must take reasonable steps to obtain a proper price from the sale of assets.

**Accountability and fairness**

The receiver operates at a low level of accountability. The appointing debenture holder, as noted, has no power to direct the receiver and the

\(^{129}\) [1999] 3 All ER 97.
receiver owes the troubled company neither a duty of obedience nor a
duty to provide information in relation to the management and conduct of its affairs. On selling assets, however, there is, as we have seen, legal accountability through the obligation to take reasonable steps to obtain a proper price and, during management, again, a duty of care is owed to the debtor company – though subject to a fiduciary duty to act in the interests of the debenture holder.

Just as the troubled company has little input into the receiver’s decision-making, so the array of junior creditors is distanced from such processes. Cork responded to complaints on this front with proposals designed to create ‘a relationship of accountability’ between the receiver and the unsecured creditor. It has been suggested, however, that the resultant legislative steps did little to ensure meaningful participation rights: the requirement that there be a creditors’ committee, for instance, is designed to assist the receiver in discharging his functions but it contains no power to direct the receiver in relation to the carrying out of these functions. This contrasts with the stronger powers possessed by liquidation committees and meetings of creditors in administration. In any event, the Insolvency Service noted that ‘very few such committees are appointed’ and concluded that the framework for administrative receivership does not ‘provide a basis for accountability or properly aligned incentives in relation to the bulk of cases’.

Turning to fairness, it can be argued that receivership operates in a manner that is procedurally and substantively unfair to non-appointing creditors and others. In substance it is a private procedure that allows enforcement of the appointor’s security rights to the potential detriment of other creditors, employees, the company and a range of stakeholders including suppliers and customers. Procedurally it is unfair because the interests of these parties may be affected by the receiver’s actions but

130 Gomba Holdings UK and Others v. Homan and Bird [1986] 3 All ER 94.
131 Armour and Frisby, ‘Rethinking Receivership’, p. 77.
132 Cork Report, para. 481. See Insolvency Act 1986 s. 48(2) and Insolvency Rules 1986 rr. 3.9–3.15 on the calling of a meeting of the creditors. See further Armour and Frisby, ‘Rethinking Receivership’, p. 79.
133 See Armour and Frisby, ‘Rethinking Receivership’; Ferran, ‘Duties of an Administrative Receiver’.
135 Insolvency Act 1986 Sch. B1, paras. 51–3. On administration see ch. 9 below.
there is no appropriate regime of access and input into decision-making for such potentially prejudiced parties. Indeed, in a climate of concern with corporate governance issues and stakeholder interests, the system of receivership could be said to raise serious governance considerations in that it allows a number of companies to be handed over and dealt with by one interested party with little or no concern for other claimants.

It is clear, moreover, that there was particular concern about such unfairness in the lead up to the Enterprise Act 2002. The Insolvency Service noted in 2000 that a number of the respondents to its consultation were worried that the floating charge and administrative receivership placed too much power in the hands of one creditor and caused unfairness in so far as there was no incentive for the floating charge holder to consider the interests of any other party; the floating charge holder could take decisions having a significant impact on returns to other creditors without there being any requirement for their consent; the administrative receiver owed a duty of care to the floating charge holder and not to creditors in general; and, unlike in other procedures, the cost of administrative receivership would fall on unsecured and preferential creditors if there were surplus funds over and above those needed to discharge the secured creditor’s debt. On the last point, research by Franks and Sussman for the IS noted that the costs of receivership are significant and tend to be borne by the bank ‘only in the minority of cases in which they recover less than 100 per cent’, and that when the bank is paid in full ‘the junior creditors are effectively paying the cost of realising the bank’s security’. As for the quantum of such costs, the White Paper of 2001 noted that ‘unsecured creditors have no right to challenge the level of costs in a receivership, even though they have an identifiable financial interest where there are sufficient funds to pay the secured creditor in full’.

See, for example, the Company Law Review Steering Group’s Consultation Documents: Modern Company Law for a Competitive Economy: The Strategic Framework, URN 99/654 (February 1999) and Developing the Framework, URN 00/656 (March 2000).

Milman and Mond, Security and Corporate Rescue, p. 48.

See IS 2000, p. 15. See also Davies, ‘Employee Claims in Insolvency’, p. 150: ‘The promotion of rescues as distinct from the promotion of banks’ interests in rescues, requires the decision as to the best way of realising the company’s assets to be taken in the general interests of the company’s creditors and not by the agent of one particular type of creditor.’

IS 2000, pp. 16–19.

suggests that the costs of receivership tend to be lower than those of the ‘new’ administration to the extent that this compensates for any lower levels of recovery for creditors.  

Floating charge holders might argue that receivership is fair because they have paid for their right to appoint a receiver in so far as they have lowered interest rates in reflection of the easy enforcement and risk control that such a right gives them. The banks, furthermore, may suggest that they charge very low margins on secured loans while trade creditors’ gross profit margins may be anything up to 50 per cent, ‘so the latter’s losses will be offset by the higher profits they made when the company was trading profitably and paying its debts’. It may be responded, however, that many unsecured creditors are simply in no position to negotiate security arrangements, that typically they lack the bank’s knowledge of the company’s financial position, that markets often do not allow high profit margins, that the institution of receivership offers a ready means for the better placed banks to exploit their positions, and that the interest rates charged by the floating charge holders are excessively profitable because risks are loaded onto unsecured creditors.

The concerns of trade and expense creditors are reinforced by the work of Franks and Sussman which has found that bank rescues often lead to a rise in debts due to such creditors while the indebtedness to the bank decreases. Their 2000 research for the IS suggested that, during bank intensive care periods, the debt owed to the bank tends to contract (by averages, for the three banks involved in the study, of 34 per cent, 19 per cent and 45 per cent respectively where the ‘rescue’ is successful and the company returns to the branch, and by averages of 15 per cent and 8 per cent for Banks 1 and 2 where the company moves to a debt recovery unit) whilst trade credit expands modestly. Later figures, published in 2005, indicate that bank lending in periods of intensive bank support tends to contract by between 30.8 and 43.3 per cent while trade credit tends to grow by between 11.1 and 32.6 per cent.

142 See Frisby, Insolvency Outcomes; Armour, Hsu and Walters, Report for the Insolvency Service. Frisby argues that unsecured creditors are not prejudiced by the receiver’s prioritisation of his appointor’s welfare in the majority of cases: see Frisby, Returns to Creditors, 2007, p. 30.
143 IS 2000, p. 18.
144 IS 2000, p. 17. ‘If formal insolvency ensues the bank will recover anything between 60–80 per cent of its indebtedness whilst trade creditors will recover nothing’: ibid.
Society as a whole may also complain about the unfairness of receivership since this is a regime that does not aim to maximise overall social benefit: its purpose is merely to secure a return to the debenture holder. This would be an empty complaint if it could be argued with conviction that receivership brings overall benefits to society because, for example, debenture holder monitoring is generally effective in protecting interests across the range of corporate creditors and stakeholders. As we have seen, however, it is difficult to make out the case that such benefits are achieved. The Insolvency Service made the point in 2000 that a number of problems bedevil consumers of different insolvency regimes, notably the difficulty of assessing the impact of different insolvency procedures while making allowance for other factors such as the selection that takes place before a company enters a particular procedure and the stage in corporate decline at which resort is made to a procedure.\footnote{IS 2000, p. 18. For studies comparing the performance of different regimes see Armour, Hsu and Walters, Report for the Insolvency Service; Frisby, Insolvency Outcomes; Franks and Sussman, ‘Financial Distress and Bank Restructuring’.

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Revising receivership

As far back as the Cork Committee’s deliberations, the institution of receivership was the focus of complaints: ‘mainly from or on behalf of ordinary unsecured creditors who are highly critical of the apparent lack of concern for their interest when the receiver has been appointed.’\footnote{Cork Report, para. 436.} Cork noted such, and other, concerns\footnote{Ibid., paras. 437–9.} but was unconvinced of the need for radical reform.\footnote{For a personal account of the benefits of receivership see K. Cork, Cork on Cork: Sir Kenneth Cork Takes Stock (Macmillan, London, 1988). On Cork’s ‘exaggerated representation of the virtues of receivership’ see McCormack, ‘Receiverships and the Rescue Culture’, p. 236.} The Committee took the view that it would be wrong to make the receiver specifically accountable to anyone, even the debenture holder, if that would involve a requirement to take instructions.\footnote{Cork Report, para. 444.} The receiver, said Cork, owes fiduciary duties to the debenture holder and duties to the charge holder and company to exercise reasonable care to obtain proper prices for property and to preserve the goodwill of the business. Statutory obligations were also owed to preferential creditors. Cork’s overall view was that incidences of damage to third parties in receivership were few in number and it would be ‘wrong and
unhelpful’ to treat receivers as merely the nominees of appointors.\textsuperscript{151} Cork cautioned that if receivers had to have regard to a statutory list of matters and interests, ‘the effectiveness of the floating charge would be seriously weakened’\textsuperscript{152} since creditors would be driven to early enforcement of fixed securities, to greater use of hybrid forms of security (e.g. fixed charges on future book debts)\textsuperscript{153} and to direct enforcement of the security without the appointment of a receiver. None of these steps, the Committee urged, would advance the conduct of trade generally or the interests of unsecured creditors. Such a list of matters and interests to be considered might also increase opportunities for ‘expensive and delaying litigation’ without benefit to unsecured creditors.

As to the idea that statute law should make receivers accountable to all the creditors, secured and unsecured, Cork responded that this again would drive prospective lenders away from floating charges into other alternatives.\textsuperscript{154} If such difficulties were anticipated and receivers were bound to have regard to priorities \textit{inter se} when looking to protected interests, this again would lead to unhelpful legal challenges, delays and expenses. Cork, accordingly, was unwilling to introduce any fundamental reform of the law to change receivers’ accountability and summarised:

\begin{quote}
It is an undoubted virtue in the eyes of those who appoint them, that receivers can act economically, swiftly and with little danger of successful challenge before the event. A statutory provision of the kind now under consideration offers potential detriment to the holders of floating charges without, it seems to us, any real advantage to anyone else.\textsuperscript{155}
\end{quote}

In the new millennium, however, matters were viewed differently and a consensus had developed that administrative receivership was questionable as a way to maximise economic value and was also inconsistent with those notions of collectivism that ought to operate when a company entered insolvency. In 2001 the Blair Government announced that, on grounds of both efficiency and equity, the time had come ‘to make changes which tip the balance firmly in favour of collective insolvency proceedings – proceedings in which all creditors participate, under

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\textsuperscript{151} Ibid., para. 446. \textsuperscript{152} Ibid., para. 447. \textsuperscript{153} Ibid., para. 449. \textsuperscript{154} For arguments that the Enterprise Act 2002 has produced such a shift towards more complex and fragmented forms of credit see Armour, ‘Should We Redistribute in Insolvency?‘; Armour, Hsu and Walters, \textit{Report for the Insolvency Service}, p. iii; Frisby, \textit{Insolvency Outcomes}. \textsuperscript{155} Cork Report, para. 451.
\end{flushleft}
which a duty is owed to all creditors and in which all creditors may look to an office holder for an account of his dealings with a company’s assets.\textsuperscript{156} The lack of fit between the collective approaches of international law and administrative receivership was also noted\textsuperscript{157} and the Government stated that it believed ‘that administrative receivership should cease to be a major insolvency procedure’.\textsuperscript{158}

The Insolvency Service had proposed restricting the use of receivership and developing a more effective and flexible administration procedure and the Enterprise Act 2002 (EA) made the necessary changes. That Act made administration, rather than administrative receivership, the governmentally preferred procedure for attempting to rescue troubled companies. The EA prohibits (subject to stated exceptions) the use of administrative receivership by the holders of floating charges.\textsuperscript{159} Instead, the EA provides for the general enforcement of floating charges to be carried out through use of the administration process – a process in which the administrator differs from the traditional receiver in so far as he is charged to pursue his functions ‘in the interests of the company’s creditors as a whole’.\textsuperscript{160} The exceptions to the prohibition are not, however, trivial. Secured creditors holding charges created before 15 September 2003 retain, as noted, the right to appoint an administrative receiver and, in addition, a large range of specialist financing arrangements allow the possibility of administrative receivership.\textsuperscript{161}

\begin{itemize}
\item \textsuperscript{158} DTI/Insolvency Service, \textit{Insolvency – A Second Chance}, p. 10. See also R3 Ninth Survey which noted the declining use of receivership over the years surveyed. Receivership accounted for 6.6 per cent of all insolvency proceedings in the Ninth Survey, 8.8 per cent in the Eighth (SPI) Survey and 14.4 per cent in the Seventh (SPI) Survey.
\item \textsuperscript{159} Insolvency Act 1986, s. 72A.
\item \textsuperscript{160} Ibid., Sch. B1, para. 3(2).
\item \textsuperscript{161} These are itemised in ss. 72B–72G of Insolvency Act 1986, as supplemented by the Insolvency Act 1986 (Amendment) (Administrative Receivership and Capital Markets) Order 2003 (SI 2003/1468) and the Insolvency Act 1986 (Amendment) (Administrative Receivership and Urban Regeneration etc.) Order 2003 (SI 2003/1832). The six exceptions relate to capital market arrangements, public/private partnerships, utilities projects, project finance, certain financial market contracts and registered social landlords/housing authorities. The aim of these exceptions, however, is arguably to deliver the same outcome as was sought to be
\end{itemize}
The wisdom of moving away from receivership perhaps remains to be seen as the performance of the administration procedure becomes assessable over time. Cork’s fears perhaps hang in the air: that weakening floating charge holders’ powers and widening obligations to creditors will cause increased delays and expenses and will drive lenders to the early enforcement of fixed securities, to greater use of hybrid forms of securities and to direct enforcement of their security.\footnote{162}

Conclusions

Receivership has proved to be a contentious process and one that has largely given way to the post-Enterprise Act 2002 administration procedure.\footnote{163} This is not to say that the positions of the banks and other traditional floating charge holders have been entirely weakened. Under the 2002 Act the holders of ‘qualifying’ floating charges are ‘fast tracked’ into administration in so far as they can apply out of court for an administration order\footnote{164} without the need for a Rule 2.2 report.\footnote{165} The achieved through the Enterprise Act changes. Thus ‘the purpose of appointing an administrative receiver in capital market arrangements, public–private partnership projects, utility projects and financed project companies is to ensure the continuation of the income stream, protecting the provision of the public service or completion of the project. This results in the company continuing to trade and thereby the interests of the secured creditors and the ordinary unsecured creditors are catered for in a mutually beneficial way’: S. Leinster, ‘Policy Aims of the Enterprise Act’ (2003) Recovery (Autumn) 27 at 28. See also \textit{Feetum and Others v. Levy and Others} [2005] BCC 484 regarding an (unsuccessful) attempt to uphold the appointment of an administrative receiver under the ‘project exception’ of s. 72E of the Insolvency Act 1986 as amended: see further G. Stewart, ‘Legal Update’ (2005) Recovery (Summer) 6, p. 7. Cork Report, paras. 449–50. It has been argued that the Enterprise Act 2002’s new scheme and virtual abolition of receivership effectively heralds the demise of the floating charge: see R. Mokal, ‘The Floating Charge – An Elegy’ in S. Worthington (ed.), \textit{Commercial Law and Commercial Practice} (Hart, Oxford, 2003). For a contrary view arguing, \textit{inter alia}, that the floating charge still facilitates ‘concentrated creditor control even without receivership’ see Armour, ‘Should We Redistribute in Insolvency?’, p. 215.

\footnote{162}{In 2006 there were ‘barely’ 500 cases of receivership recorded: see D. Milman, ‘Corporate Insolvency Law: An End of Term Report’ (2007) \textit{Sweet & Maxwell’s Company Law Newsletter} (August).}

\footnote{163}{See Insolvency Act 1986 Sch. B1, paras. 14–21.}

\footnote{164}{See Insolvency Rules 1986 r. 2.2. Under the ‘old’ administration procedures an application to the court for administration was invariably accompanied by an independent report from the proposed administrator: r. 2.2. These reports were not mandatory but tended to be viewed as carrying considerable weight: see \textit{Re Newport County Association Football Club Ltd} [1987] BCC 635. See also Practice Note (Administration Order Applications: Independent Reports) [1994] 1 WLR 160 which attempted to cut the length and application (and thus the costs) of these reports.}
banks, which routinely use floating charge security, have, moreover, been offered a sweetener for giving up receivership in so far as the 2002 Act abolishes the Crown’s status as preferential creditor. Banks may, nevertheless, be expected to object that the effect of the Enterprise Act 2002 changes is to force them to secure their investments increasingly on fixed assets, which will raise the cost of capital and reduce the flexibility of financing arrangements.

Receivership, it should be emphasised, is a process that can still operate for some time because of exemptions and pre-2003 floating charges. It is nevertheless viewable now as something of an anachronism and out of tune with modern, and international, endorsements of collectivism. Receivership was criticisable on a number of fronts, notably on grounds of fairness and accountability, but whether its replacement with administration will produce the efficiency losses that Cork associated with dispersed creditor obligations will, as noted, remain to be seen. It is, indeed, to the virtues and vices of the new administration procedure that we now turn.

166 Enterprise Act 2002 s. 251. On preferential creditors see ch. 14 below.
Administration

The Cork Committee, as we have seen, placed emphasis on the value of insolvency processes that provide ways of rescuing troubled companies, as well as help realise corporate assets. Its recommendations led to the procedures governing administration orders and company voluntary arrangements (CVAs) that are set out in the Insolvency Act 1986. This chapter examines the administration regime, as now revised by the Enterprise Act 2002, considers how this regime tends to satisfy the values set out in chapter 2 and reviews the philosophy underpinning modern administration.

The rise of administration

The roots of administration can be seen in the Cork Committee’s belief that corporate rescue could often be furthered by allowing an independent expert to take over the management of a distressed company. Cork noted that one particular advantage flowed from the floating charge holder’s power to appoint a receiver and manager over a company’s undertaking: receivers were given extensive powers to manage and, in some cases, had been able to restore troubled companies to profitability and return them to their former owners. In others, the receivers had been able to dispose of all or part of the business as a going concern and, in either case, the preservation of the profitable parts of the enterprise had

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been ‘of advantage to the employees, the commercial community and the general public’.²

In the absence of a floating charge there was, however, no possibility of such an appointment and the choice lay between an informal moratorium and a formal scheme of arrangement under the Companies Act 1948. Neither procedure was, however, wholly satisfactory. Formal schemes of arrangement were expensive and time-consuming and informal procedures were not binding on non-assenting creditors and were difficult to sustain in practice. When neither course of action was possible, the directors had no option but to cease trading and the results were bleak: ‘We are satisfied that in a significant number of cases, companies have been forced into liquidation and potentially viable businesses capable of being rescued have been closed down, for want of a floating charge under which a receiver and manager could have been appointed.’³

Cork, accordingly, proposed the institution of the administrator who would be appointed in order to consider: reorganisations with a view to restoring profitability or maintaining employment; ascertaining the chances of restoring a company of dubious solvency to profitability; developing proposals for realising assets for creditors and stockholders; and carrying on business when this would be in the public interest but where it was unlikely that the business could be continued under the existing management.⁴

Three key notions underpinned Cork’s vision of the administrator: that rescue opportunities should be taken sufficiently early in corporate troubles to stand a chance of success; that companies should be given a breathing space from the pressure of claims; and that consideration should be given to the interests, not merely of creditors and shareholders, but of the widest group of parties potentially affected by the insolvency. As Sir Kenneth Cork wrote in his autobiography:⁵

> We saw that if a company was to be saved, action should be initiated a long time before the time when a bank normally appointed a receiver … [Companies] needed a period when the dogs were called off and they were able to recover a degree of equilibrium. They needed, in other words, a moratorium for which existing law made no provision … The appointment of an administrator, we suggested, would not constitute an ‘act of

insolvency’. None of the things would happen which happened when a company became officially insolvent. For an administrator should be brought in before a company was declared insolvent, where for instance, the directors were obviously incompetent or dishonest and the ordinary processes could not remove them, or where in the national interest the government should take a hand … He would have all the powers and more of a receiver, and he would have to realise the assets for the general good … He would be responsible to all parties who were interested in the particular debtor company.

From the Insolvency Act 1986 to the Enterprise Act 2002

The Insolvency Act 1986 provided a mechanism for appointing an administrator by applying for an order of the court that directed that the affairs, business and property of the company should be managed by the administrator.\(^6\) The effect of presenting a petition for an administration order was that a moratorium was triggered and a stop imposed on the enforcement of most types of claim, secured and unsecured, against the company. The company could not be wound up and the leave of the court was required for such actions as enforcing a security against the company, repossessing goods in the company’s possession under a hire purchase agreement, or the commencement or continuation of any other legal proceedings or levying distress against the company or its property.\(^7\) Protection also extended to property owned by the company but in the possession of third parties such as lessees.\(^8\) Before the Enterprise Act 2002, such a moratorium did not, however, stop a debenture holder from appointing an administrative receiver, nor did the presentation of a petition stop the directors from calling a meeting of members to consider voluntary liquidation or stop a creditor from presenting a winding-up petition.\(^9\) Managerial powers were unaffected by the petition\(^10\) and the company could create secured interests.\(^11\)

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6 Insolvency Act 1986 s. 8(2). 7 Ibid., s. 10(1). See further pp. 375–8 below. 8 Re Atlantic Computer Systems plc (No. 1) [1992] Ch 505, [1992] 2 WLR 367, [1990] BCC 859. 9 Entry into liquidation was not permitted, however, until the petition was heard: Insolvency Act 1986 s. 10(1)(a). 10 Though the court on hearing the petition could make an interim order appointing an interim manager: see D. McKenzie Skene and Y. Enoch, ‘Petitions for Administration Orders – Where there is a Need for Interim Measures: A Comparative Study of the Approach of the Courts in Scotland and England’ [2000] JBL 103; Insolvency Act 1986 s. 9(4). 11 Bristol Airport plc v. Powdrill [1990] Ch 744, 768.
The pre-Enterprise Act position was that when an administration order was made, any winding-up petition had to be dismissed. An administrative receiver had to vacate office, and during the operation of the administration order there was a stronger freeze on the enforcements of right against the company than operated on presentation of the petition. After the order was made, an administrative receiver could not be appointed and no winding-up petition might be presented without the consent of the administrator or the leave of the court. Powers of the company and its officers were not exercisable without the administrator’s consent and this effectively divested the directors of their powers. The directors, moreover, were given obligations to co-operate with the administrator.

Administration did not provide for a permanent restructuring of creditors’ interests or for a distribution to unsecured creditors. The process operated as a temporary freeze during which proposals for a permanent solution to the company’s problems could be devised. These solutions then had to be put into effect through the institution of another insolvency regime such as a CVA or liquidation or a compromise arrangement (under the then s. 425 of the Companies Act 1985), to operate either during the currency of the administration order or after it had been brought to an end.

The evidence suggests that, before the enactment of the Enterprise Act 2002, administration had been ‘less efficacious’ as a rescue device than

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12 Insolvency Act 1986 s. 11. 13 Ibid. 14 Ibid., s. 11(3)(d). 15 Ibid., s. 14(4).
16 Ibid., s. 235. Breach of this duty renders the directors liable to disqualification: see CDDA 1986 s. 9, Sch. 1, Part II, para. 10(g).
17 Contrast with the US Chapter 11 procedure: see ch. 6 above.
19 Insolvency Act 1986 s. 14(5). Unlike a normal agent the administrator was not subject to control and direction by the company, his principal: section 14(4). Section 14 aimed to ensure that an administrator normally incurred no personal liability on any contract or other obligation he could enter into on the company’s behalf.
20 Insolvency Act 1986 s. 14, Sch. 1.
The insolvency regime, as envisaged by Cork, was thought to offer company directors a set of incentives to opt for administration in times of trouble. It provided them, in the first instance, with protection from disqualification and wrongful trading actions: punitive prospects that Cork hoped would lead directors to seek outside help at early stages of trouble. Administration also offered directors some continuing role in the management of the business and the chance of persuading creditors, within the protection of the moratorium, to accept something less than full-blown insolvency. They would, furthermore, be able to nominate a friendly Insolvency Practitioner (IP) who would sympathise with their positions. Such incentives, thought Cork, would produce effective rescue mechanisms. The Committee’s view was that if insolvency practitioners could become involved with companies at an early stage of their decline they stood a good chance of saving the business and ‘four out of five never needed to have become insolvent’. Not only that, but lack of legal rescue provisions at such an early stage had led, according to Cork, to a series of evils. It had encouraged directors to keep trading, delayed the introduction of expert reviews and given rogue creditors incentives to break ranks on informal moratorium debt collection, all of which factors militated against successful corporate rescues.

The DTI’s 1993 consultative document revealed that from 1990 to 1993 there were 88,000 corporate insolvencies in England. Of these, 21,500 had entered receivership, over 40,000 had gone into creditors’ voluntary liquidation, and over 26,000 into compulsory liquidation. Only 296 CVAs and 447 administration orders were encountered. By the time the DTI Insolvency Service published the 1999 figures for corporate proceedings under the Insolvency Act 1986, the ratio of administration appointments to liquidations (voluntary and

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23 Quoted in *ibid.*, p. 286. In R3’s Ninth Survey of Business Recovery in the UK (2001) rescue professional respondents indicated their belief that in 77 per cent of cases by the time they were appointed there were no possible actions that could realistically have averted company failure. In younger companies (under one year) in 90 per cent of cases there was thought to be no such rescue action possible.
25 Rajak, ‘Challenges of Commercial Reorganisation’, p. 202 reported that in 1990 there were 211 administrations compared to 15,051 liquidations and 4,318 receiverships.
The business preservation rate in administrations in 1998–9 was given by R3 (formerly the SPI) in 2001 as 79 per cent and the job preservation rate was put at 40 per cent by the SPI in its Eighth Survey.

Why then did administration not operate as the popular rescue option that Cork had hoped to establish? It is possible to identify a number of factors that weakened the effectiveness of administration as a rescue device and tended to discourage its use. First, administration was a procedure that could be blocked by a floating charge holder who chose to appoint an administrative receiver as a means of protecting his or her own interest. If, indeed, a petition for administration did not contain what amounted to the consent of any person entitled to appoint an AR, the petition would be dismissed. Administration, accordingly, was a process that could only be used if the firm had no creditor with a floating charge (a rare occurrence given the proliferation of secured lending in standard British financing arrangements and banking practice) or if the floating charge holder was happy to see the company’s troubles dealt with by administration rather than administrative receivership. In some circumstances the latter situation might have obtained and some considerations might have led the floating charge holder to accept administration as preferable to the insertion of a receiver. Factors favouring this approach included the attractiveness of the moratorium which might have been seen to outweigh the disadvantages of administration: for example, where protection was needed against suppliers of goods who had retained title or where a large firm had a complex structure and considerable time and effort had to be put in before a way forward was arrived at. Administration might also have been attractive if: criticisms from creditors would have been directed towards the administrator.

26 IS 2000, p. 14; as the Insolvency Service’s 1999 Review points out, such figures do not give the whole picture of insolvency because they do not take on board all the companies that are struck off the register but do not enter any formal process.
28 SPI Eighth Survey (1999): the figure had dropped from 65 per cent in the Seventh Survey.
30 IS 2000, p. 12, para. 36.
32 Ibid., p. 206: ROT holders were blocked by the wide definition of hire purchase agreements in the Insolvency Act 1986 s. 10(4).
rather than the debenture holder or their receiver; the size of the sum due did not justify the appointment of a receiver; the debenture holder thought that his or her charge was vulnerable; or the debenture holder had been given the right to nominate the administrator. Additional considerations favouring administration rather than administrative receivership may have been that a court-appointed insolvency officer might have been better placed than a receiver to recover assets from foreign jurisdictions and an administrator, but not an AR, could apply to have suspect pre-insolvency transactions set aside.

Surveys, nevertheless, suggested that in 60 per cent of cases where administration orders were made, the floating charge holder would appoint a receiver. In most cases of corporate decline the floating charge holder would have been very aware that administrative receivers acted in the interests of the appointing floating charge holder, whereas administrators acted for all creditors. It is unlikely, accordingly, that the floating charge holder would, in normal cases, have allowed administrations to run unhindered. Floating charge holders, moreover, lost control if they allowed administration to occur rather than put in a receiver. Once the administrator was appointed, even fixed-charge security holders could not enforce without leave and the general creditors enjoyed the income generated by the property subject to such charges. Floating charge holders faced with an administration also stood to see a diminution of the value of the assets covered by the floating charge, since their debt would have been satisfied after the expenses and remuneration of the administrator had been met, as well as after there had been payment of all debts and liabilities (including certain taxes) that had been incurred by the administrator as a result of contracts he or she had entered into. Administration also brought temporal uncertainty to the floating charge holder since the administrator had no power to make distributions and considerable time might elapse before payments were made on debts.

The procedural costs of administration were also very considerable. This was largely due to the high level of judicial supervision involved in

35 Ibid. See Insolvency Act 1986 ss. 238, 239, 244.
37 DTI 1993, p. 29.
administration. The court was involved in appointing the administrator and would usually be involved when the administrator was given power to interfere with private rights. Nor was the judicial role confined to checking to see that the administrator had acted in good faith and *intra vires*: the court would often have to examine the issue in depth and make its own judgement. Such a process would frequently involve the use of expert evidence, and decision-making, as a result, would be slow as well as costly. The expenses of obtaining the administration order itself could be very considerable. Figures as high as £20,000 were cited as minimum starting costs, with the money having to be provided in advance in order to secure the services of the necessary IPs. The Rule 2.2 (of the Insolvency Rules) report, which became in practice a prerequisite to the making of an order, was almost always written by an accountant and often involved the practitioner’s solicitors. This tended to increase the obligations of the IP, the company and the court and so raised costs considerably and placed applications beyond the reach of smaller firms. Banks who instigated formal insolvency procedures may, moreover, have possessed undesirably low incentives to control the costs of these procedures (about half of which comprise fees to IPs). This is because such costs would be borne disproportionately by unsecured creditors in a regime that distributed assets by priority. Administration, accordingly, was too expensive a process to be used for the rescue of small or even medium-sized businesses.

A further reason for the low uptake of administration was the administrator’s lack of any obligation to consult creditors before taking

38 See Insolvency Act 1986 s. 15, but note s. 15(1), (3) and (4) where the court’s consent is not needed.
39 DTI 1993, p. 29. But see C. Morris and M. Kirschner, ‘Cross-border Rescues and Asset Recovery: Problems and Solutions’ (1994) 10 IL&P 42–3, suggesting that in smaller cases the expense could be only £1,500–£2,000. See also n. 131 below.
40 The DTI’s 1993 Consultative Document described the report as ‘almost mandatory’, DTI 1993, p. 29. These reports were not, in fact, mandatory but tended to be viewed as carrying considerable weight: see *Re Newport County Association Football Club* [1987] BCC 635. See also Practice Note (Administration Order Applications: Independent Reports) [1994] 1 WLR 160, which attempted to cut the length and application (and thus the costs) of these reports.
action. This meant that he or she could sell the company’s property before holding a creditors’ meeting. Such a lack of involvement could make creditors reluctant to instigate or (in the case of floating charge holders) accede to administration. When the administration process was employed it achieved rescue in about 40 per cent of cases and liquidation occurred in around 50 per cent of instances.

Yet another reason for the inefficiency of administration as a rescue device – and a factor tending to reduce the incidence of resort to administration – was that administration orders could only be applied for at the latest stages of corporate decline, when chances of rescue had severely diminished. As noted, the court, under section 8(1)(a) of the Insolvency Act 1986, had to be satisfied that the company ‘is or is likely to become unable to pay its debts’ within the meaning of the Insolvency Act 1986 s. 123. This requirement of near-insolvency was starkly at odds with the Cork vision, which demanded that an administrator should be appointed at an earlier stage in corporate decline. This was, as noted, a point of great disappointment to Sir Kenneth Cork, who commented on the Government’s Insolvency Act 1986 approach:

They said [an administrator] could only be appointed when a company was insolvent or was in the process of becoming insolvent which missed the whole point … To them insolvency was insolvency; for them it was essential that a company went broke before anyone took action. Behind it lay the absurd theory that shareholders could always remove incompetent directors.

Sir Kenneth’s view of section 8(1)(a) was perhaps more pessimistic than it needed to be. It was open to the court to operate administration as a pre-insolvency rather than an insolvency procedure. There was no case law, however, that offered guidance on the restrictiveness with which ‘likely to become unable to pay its debts’ (section 8(1)(a)) would be interpreted. Some commentators suggested that the subsection did not require insolvency to be likely in the immediate future but only ‘fairly soon’. If administration had been seen in a pre-insolvency sense by the

45 For a review see DTI 1993, ch. 5.
46 Cork, Cork on Cork, p. 197.
courts then it might have served rescue purposes if used for such objectives as: protecting the company from creditors during a period of cash flow difficulties; overcoming short-term problems more serious than cash flow difficulties but which could be survived by using CVAs or schemes of arrangements to reschedule debts; or reorganising the firm and selling unsustainable parts of the business so as to leave the company with the profitable parts under the protection of the moratorium. There might, however, have been difficulties in convincing courts to endorse administration at early stages in decline. This was a procedure that involved curtailment of the rights of at least some of the creditors of the company and it might have proved difficult to persuade the court that such interference was merited unless insolvency was imminent.

A judicial willingness to grant administration orders on a pre-insolvency basis would not, however, have ensured that parties would come forward with applications. There may have been numerous reasons why such early applications tended to be few in number. Company directors often lack knowledge of the applicable insolvency procedures. They may, in addition, possess poor internal accounting and information systems and may not know that the business is approaching insolvency. They may, furthermore, be unwilling to put the company into an insolvency procedure which they see as ceding control of the business to an outside accountant. The administrator had power to remove and appoint directors, and directors will tend to opt for courses of action that leave them with an assured role in the company’s immediate future. Other suggested reasons for directorial slowness to resort to administration in times of trouble were put to the DTI in its 1999–2000 consultations and included: mistrust of IPs; unrealistic optimism; fear of failure; fear of the bank withdrawing support; and concern over the cost of advice. Directorial fears for their own reputations and future job prospects must also have constituted a reason for inaction.

Nor have the courts always decided cases in a manner that enhances the effectiveness of administration as a rescue device. In the case of Powdrill v. Watson, for instance, the Court of Appeal held that administrators who kept employees in post after the administration came into effect (and after the fourteen-day period of grace provided for in section 48 See M. Phillips, The Administration Procedure and Creditors’ Voluntary Arrangements (Centre for Commercial Law Studies, QMW, London, 1996) p. 21.
19(5) of the Insolvency Act 1986)\(^{52}\) had adopted the relevant employment contracts. The administrators were, accordingly, liable to pay not only the wages, pension contributions and holiday pay referable to the post-administration order period, but were also obliged to pay liabilities under the adopted employment contracts out of the company assets in priority to most creditors. The effect, critics noted,\(^{53}\) was to force administrators (and administrative receivers) to dismiss employees within the fourteen-day period. This contrasted with the established practice of retaining employees but making it clear to them that their contracts were not being adopted.\(^{54}\)

The Court of Appeal’s decision in *Powdrill* prompted a strong adverse reaction from the insolvency profession and others. Following energetic lobbying of the President of the Board of Trade, legislation designed to redress the effects of *Powdrill* was rushed through Parliament and became the Insolvency Act 1994. This Act had the effect on administrators of introducing a new subsection, 19(6), to the Insolvency Act 1986, to provide that sums payable in respect of liabilities incurred while the administrator was in office under contracts of employment that had been adopted by him or by any predecessor were to be paid out of the assets covered by a floating charge created as such and were to have the same priority as sums covered by section 19(5) – namely sums owed under contracts entered into by the administrator or a predecessor – but only to the extent that they constituted ‘qualifying liabilities’ as defined in the new subsections 19(7)–(9) of the Insolvency Act.\(^{55}\) The effects of the 1994 Act were, however, limited. It applied only to contracts of employment entered into on, or after, 15 March 1994, and this left

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\(^{54}\) Brown, *Corporate Rescue*, p. 660; *Re Specialised Mouldings Ltd* (unreported) 13 February 1987 (Harman J).

\(^{55}\) A qualifying liability per s. 19(7)–(9) was one to pay a sum by way of wages or salary or contributions to an occupational pension, which was in respect of services rendered wholly or partially after the adoption of the contract but disregarding payment for services rendered before the adoption of the contract. This included wages or salary payable in respect of holiday, absence through sickness or other good cause. Sums payable in lieu of holiday were deemed wages or salary in respect of services rendered in the period by reference to which the holiday entitlement arose (Insolvency Act 1986 s. 19(9) and (10); Insolvency Act 1994 s. 1(6)). See *In re FJL Realisations Ltd* [2001] ICR 424 (also reported as *Inland Revenue Commissioners v. Lawrence* [2001] BCC 663) in
considerable potential for post-*Powdrill* claims; it did not affect the concept of ‘adoption’ or the issue of contracting out (though it did take away the most undesirable consequences of the 1986 provisions as interpreted in *Powdrill*). It left a number of questions open – such as when liabilities are incurred and whether it is possible to dismiss and re-employ workers in a manner not amounting to a sham – and it was unclear on the consequences of voluntary payments by administrators.

When the House of Lords decided consolidated appeals on the meaning of ‘adopt’ within sections 19 and 44 of the Insolvency Act 1986, the liabilities under employment contracts of both administrators and administrative receivers were at issue. Focusing here on administration, their Lordships were concerned with the rights of parties affected by the 1,200 or so administrations commencing between 29 December 1986 (the commencement date of the Insolvency Act 1986) and 15 March 1994 (the commencement date of the Insolvency Act 1994). The House of Lords decided unanimously that the contracts of employment in question had been adopted by the administrators. This ruling was greeted with ‘shock and disappointment’ by the insolvency and banking community. It meant that cases involving adoption of employment contracts by administrators after 15 March 1994 would be dealt with under the Insolvency Act 1994 but that cases on adoption between 1986 and 1994 would be dealt with on the basis set out by the House of Lords in *Powdrill*. Further complications were to follow when the Enterprise Act 2002 replaced section 19 of the Insolvency Act with paragraph 99 of the new Schedule B1 and, in doing so, introduced new levels of confusion in defining administrators’ liabilities regarding ‘wages and salary’. These complications, and the general rescue implications of transferring employee contracts and protecting employees’ acquired rights in the

which the Court of Appeal held that, as the administrator’s liability under contracts of employment was to pay the employee the full salary *including* the statutory amounts in respect of PAYE and national insurance contributions, it was not possible for the administrator to split the contractual liability in two. Accordingly, the sums deducted to the Inland Revenue were a liability of ‘any sums payable in respect of debts or liabilities incurred’ for the purposes of s. 19(5) and (6) and as such enjoyed special priority over any charges arising under s. 19(4) of the Insolvency Act 1986. See now Sch. B1, para. 99 (introduced by the Enterprise Act 2002) and ch. 17 below.

56 See Brown, *Corporate Rescue*, p. 481.
57 *Powdrill v. Watson* (also known as *Re Paramount Airways Ltd No. 3*) [1995] 2 WLR 312, [1995] 2 All ER 65 (House of Lords).
insolvency context, will, however, be considered below in outlining the post-Enterprise Act administration regime and, in chapter 17, when discussing the positions of employees at times of corporate distress.

The role of the judiciary was always important in relation to the moratorium accompanying administration. The effectiveness of the moratorium stood to be reduced by the court’s exercise of a ready discretion to allow enforcement actions against the company during the moratorium, or if the courts interpreted the coverage of the moratorium restrictively.

On issues of scope and coverage, the indications are that all relevant actions and claims against the company were seen as within the moratorium’s area of protection. Sir Nicholas Browne-Wilkinson VC emphasised in Bristol Airport plc v. Powdrill that it was the essence of administration that businesses would be carried on by administrators who had acquired the right ‘to use the property of the company free from interference by creditors and others’. The courts, however, were not content to allow the administrator to judge whether to allow a creditor to enforce a claim or to balance the interests of a single creditor against those of the company and its creditors as a whole. The judiciary, accordingly, rejected the view that they should desist from interfering with the administrator’s decision if the claimant failed to show that something in the administrator’s conduct merited adverse criticism. Dangers of excessive litigation expense and court involvement were met by the courts making it clear, first, that they expected administrators themselves to consent to the enforcement of claims where there would be no attendant adverse effect on the conduct of the administration and, second, that administrators who unjustifiably refused consent would be penalised in costs. As to the criteria that were to govern decisions whether or not to permit enforcement of a particular claim, the courts tended to balance the interests of the petitioning creditor against those of


other corporate creditors.\textsuperscript{64} They avoided taking into account the wider public, employee or trade-dependent interests that might be affected by the potential rescue of the business. Nicolls LJ stated in \textit{Re Atlantic Computer Systems plc}:\textsuperscript{65}

In carrying out the balancing exercise, great importance or weight is normally to be given to … proprietary interests … [T]he administration procedure is not to be used to prejudice those who were secured creditors when the administration order was made in lieu of a winding up order … The underlying principle here is that an administration for the benefit of unsecured creditors should not be conducted at the expense of those who have proprietary rights which they are seeking to exercise, save to the extent that this may be unavoidable and even then this will usually be acceptable only to a strictly limited extent.

In \textit{Re Olympia & York Canary Wharf Ltd},\textsuperscript{66} moreover, Millett J was of the opinion that, to the extent that the moratorium represents an interference with private rights, it should go no further than is required to support the ability of the administrator to carry out his functions.\textsuperscript{67} Such an approach might have been of value to the court in imposing limits on the interests that have to be taken into account when deciding enforcement issues, but it was hardly consistent with Cork’s vision of administration as a process that takes on board the broad array of interests affected by the potential insolvency.

As for the statutory extent of the moratorium, section 11(3) of the \textit{Insolvency Act 1986} provided that on the making of an administration order: ‘No other steps may be taken to enforce any security over the company’s property, or to repossess goods in the company’s possession under any hire purchase agreement, except with the consent of the administrator or the leave of the court and subject (where the court gives leave) to such terms as the court may impose; and ‘no other proceedings and no execution or other legal process may be commenced or continued, and no distress may be levied, against the company or its property except with the consent of the administrator or the leave of the court and subject (where the court gives leave) to such terms as aforesaid’.

\textsuperscript{65} [1990] BCC 859 at 880. \textsuperscript{66} [1993] BCLC 453.
What constituted ‘a security’ for such purposes was defined in section 248(b)(i) as ‘any mortgage, charge, lien or other security’. This reference to ‘other security’ both gave the court considerable discretion to determine whether certain enforcement actions were ruled out by section 11(3) and created some uncertainty. In Bristol Airport v. Powdrill the court took a wide view of the moratorium and the airport was prevented by section 11 from asserting a statutory lien for unpaid airport charges with respect to an aircraft leased by a third party to the company. In Re Atlantic Computer Systems plc items of computer equipment were leased or let under hire purchase agreements to a company which sublet them to third parties. The company went into administration and the Court of Appeal ruled that the owners of the equipment were not entitled during the administration period to receive from the administrators, as expenses of the administration, the payments due under the head leases and hire purchase agreement. The equipment was held to be within the possession of the company for section 11(3) purposes and so leave was required to take steps to terminate the head agreements, repossess the equipment and enforce any security in relation to it – though leave would be granted in the circumstances.

A particular concern was whether the landlord of the company in administration could exercise a right of peaceable re-entry to the corporate premises or whether this was ruled out as ‘enforcement of security’ under section 11(3). The importance of this point to a troubled company is difficult to exaggerate: the protection offered by the moratorium would have assisted rescue efforts very little if the company had been liable to lose access to its work premises. Peaceable re-entry, moreover, was a procedure allowing a landlord to forfeit a lease without having to obtain a court order and could be instigated on non-payment of rent or breaches of covenant by the tenant. All the landlord normally had to do

68 The Court of Appeal refused to invoke an ‘expenses of the administration’ principle (similar to liquidation: see ch. 13 below) because administration was a novel regime and solutions to problems it posed were not to be found in settled areas of insolvency law. See further Bridge, ‘Company Administrators’, p. 395.

69 See Bridge, ‘Company Administrators’.

in practice was to change the locks and exclude the tenant from the premises.

Over the years preceding the Enterprise Act 2002 it had became clear that the courts were unlikely to extend the protection of the section 11 moratorium so as to stop peaceable re-entry. The case of Exchange Travel Agency v. Triton plc.71 had suggested that peaceable re-entry would be covered by the moratorium as it involved enforcement of the security interest. But matters changed with Razzaq v. Pala,72 a decision which put forward a more recent and dominant view that the moratorium would not cover peaceable re-entry. The DTI review group was of the view in 2000 that the law should be changed to bring landlords within the ambit of the statutory moratorium.73 This change was effected in the Insolvency Act 2000 and the same position then obtained in relation to moratoria in administration and within the CVA procedure set out in the Insolvency Act 2000.74

Turning to the issues of information and expertise, a criticism of the pre-Enterprise Act administration procedure was that expert judgements tended to be too narrowly channelled through the Rule 2.2 report, which both increased costs and detracted from other means of informing judgements such as consulting a wide range of parties affected by the insolvency. Rule 2.2 reports, on this view, tended to become excessively elaborate and expensive without always adding a great deal to decision-making. A simpler, cheaper, more accessible regime, the criticism ran, would be likely to improve rescue decisions as well as make them more acceptable to a wide range of affected parties.75

As for the accountability and fairness of pre-Enterprise Act administration, a first problem was that the administrator was not obliged or entitled to consider the public interest or the interests of all parties materially affected by the potential insolvency. This meant that

72 [1997] 1 WLR 1336 (dealing with security interests per s. 383(2) of the Insolvency Act 1986); Razzaq dealt with bankruptcy but it was likely that the courts would take the same view in relation to corporate insolvency: see Ezekiel v. Orakpo [1976] 3 All ER 659; Clarence Coffey v. Corchester Finance (unreported) 3 November 1998; Re Lomax Leisure Ltd [1999] EGCS 61; Christopher Moran Holdings Ltd v. Bairstow [1999] All ER 673.
73 IS 2000, p. 37.
75 See Phillips, Administration Procedure, p. 5.
customers, suppliers and employees of the company – all of whom might have considerable stakes in its future – had no voice in administration if they did not constitute creditors of the firm. The company’s unsecured creditors had a voice through the creditors’ meeting and approval mechanism in determining the course of action taken by the administrator, but such creditors voted according to the value of their debts and not according to the extent of their dependence on the company’s fortunes. An employee, accordingly, would only have a vote that reflected any money owed to him or her and account was not taken of their future role within the company. When, moreover, the court scrutinised, at various points, the administrator’s actions, it would look to the financial interests of creditors and members rather than broader concerns.\footnote{See, for example, Insolvency Act 1986 s. 27(1)(a).} Such an approach, again, was at odds with the Cork Committee’s argument that the court should appoint an administrator, \textit{inter alia}, to restore profitability or maintain employment; or to carry on a business ‘where this is in the public interest’.\footnote{Cork Report, para. 498.} Sir Kenneth Cork himself spoke of his committee’s intention that an administrator would have a role to play ‘[w]here, in the national interest, the government should take a hand – as happened in the case of Rolls Royce’\footnote{Cork, \textit{Cork on Cork}, p. 195.}.\footnote{Cork Report, para. 193.}

Shareholders as members of the company could apply to the court under section 27 of the Insolvency Act 1986 if they had a complaint that the administrator’s proposal, if implemented, would prejudice some part of them or them generally. Such shareholders, however, were not involved in approval of the administrator’s proposals, which under section 24 was a function given to the creditors alone. On this point it might be argued that there was some consistency with Cork’s suggestion that society’s interest lies not in the preservation or rehabilitation of a company as such but in the commercial enterprise.\footnote{Cork Report, para. 193.} Such an argument, however, can be taken too far: even if it is accepted that society’s interest lies in the enterprise and not the company, this does not in itself mean that the interest of shareholders should be ignored by granting shareholders no procedural rights. If there is a prospect of rescue can shareholders be said wholly to have given over their interests in the company to the creditors? Shareholders clearly did have an interest in the administrator’s actions. There was, indeed, no basis for stating that
Parliament established administration in pursuit of the survival of the enterprise and that the company’s survival was not a legitimate objective in view. Section 8(3)(a) of the 1986 Act stated explicitly that an administration order could be made for the purpose, *inter alia*, of ‘the survival of the company and the whole or any part of its undertaking as a going concern’. It seems, accordingly, hard to deny the legitimacy of shareholder interest in administration.

To summarise the discussion thus far, administration (between the Insolvency Act 1986 and the Enterprise Act 2002) was a procedure that was oriented towards rescue as well as asset realisation but it underperformed in a number of respects when assessed on efficiency, expertise, accountability and fairness counts. Whether the 2002 reforms corrected such underperformance and whether administration has been reformulated in an improved guise are matters to which we now turn.

The Enterprise Act reforms and the new administration

By 2000, the Insolvency Service Review Group had come firmly to the view that reform of administration was necessary – principally to remove its vulnerability to the actions of floating charge holders: ‘Our firmest recommendation is that the law should be changed to remove the right enjoyed by the holder of the floating charge to veto the making of an administration order, thus bringing the position in administration in line with that proposed for the moratorium in a CVA.’

By July 2001, the Government had endorsed this proposal in its White Paper on *Productivity and Enterprise* and legislative steps followed when the Enterprise Act was passed in 2002. This Act came into force on 15 September 2003 and substituted the original Part II of the 1986 Act with a new Part II, the provisions of which are set out in a new Schedule B1 to the 1986 Act. The effect was to make administration

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80 IS 2000, p. 21.
82 Hereafter references to Sch. B1 will be referred to as ‘para. …’. Note, however, that the ‘old’ administration procedure survives in relation to a number of categories of public utility company and to building societies: EA 2002 s. 249. It also survives where an administration order petition was presented to the court before 15 September 2003 (SI 2003/2039, art. 3(2)).
rather than administrative receivership the governmentally preferred procedure for attempting to rescue troubled companies.\textsuperscript{83} The new law prohibits (subject to stated exceptions) the use of administrative receivership by the holder of a qualifying floating charge (QFC).\textsuperscript{84} Instead, the EA provides for the general enforcement of floating charges to be carried out through use of the administration process. The EA streamlines administration by introducing an out-of-court appointment procedure\textsuperscript{85} and by abolishing the need for the administrator’s Rule 2.2 report.\textsuperscript{86} After the EA 2002 there are, accordingly, three methods by which an administrator can be appointed: \textit{by the court} on the application of the company, its directors, one or more of the company’s creditors or a combination of these parties;\textsuperscript{87} \textit{out of court} on the application of the holder of a qualifying floating charge;\textsuperscript{88} and \textit{out of court} on the

\textsuperscript{83} For HM Treasury proposals for a special insolvency regime for UK banks (made in the wake of the Northern Rock crisis) see: HM Treasury, \textit{Banking Reform – Protecting Depositors: A Discussion Paper} (HM Treasury, London, 2007). See now the Banking (Special Provisions) Act 2008 (to be replaced: see Banking (No. 2) Bill (HL, 4 December 2008).

\textsuperscript{84} Insolvency Act 1986 s. 72A. The general prohibition applicable to holders of ‘qualifying floating charges’ is subject to six exceptions relating to capital markets: see ss. 72B–72G of the IA 1986 and ch. 8 above. Transactions that predate the implementation of the EA 2002 will still allow holders of qualifying floating charges both to appoint administrative receivers and to block the appointment of an administrator.

\textsuperscript{85} I.e. on the application of the holder of a qualifying floating charge (IA 1986 Sch. B1, paras. 14–21) and on the application of a company or a company’s directors (IA 1986 Sch. B1, paras. 22–34).

\textsuperscript{86} See p. 370 above. Under the ‘old’ administration procedures an application to the court for administration was invariably accompanied by an independent report from the proposed administrator: Insolvency Rule 2.2. Note, however, that even though there is no longer a requirement to prepare a Rule 2.2 report, IPs are still under an obligation to make a statement that it is reasonably likely that ‘the purpose of the administration’ will be achieved (Sch. B1, paras. 18(3), 29(3), r. 2.33(2)(m), as applicable). See r. 2.33 for the list of matters the administrator is required to include regarding his proposals for the administration, some of which could be said to be ‘unrealistic’: H. Sims and N. Briggs, ‘Enterprise Act 2002 – Corporate Wrinkles’ (2004) 17 \textit{Insolvency Intelligence} 49 at 50.

\textsuperscript{87} IA 1986 Sch. B1, paras. 11–13. If the directors, company or secured creditor want to ensure that the administrator’s appointment will have extraterritorial effect under the EC Regulation on Insolvency Proceedings 2000 (1346/2000), they should use the court-application route: see G. Moss, ‘On the Edge of Non-Recognition? Appointment of Administrators under the Enterprise Act and the EC Regulation’ (2004) 17 \textit{Insolvency Intelligence} 13.

\textsuperscript{88} IA 1986 Sch. B1, paras. 14–21.
application of a company or a company’s directors.\textsuperscript{89} The court may only make an order (under paragraph 11) if it is satisfied that the company is or is likely to become unable to pay its debts (paragraph 11(a)) but this requirement does \textit{not} apply in the case of applications to court or out-of-court applications by holders of qualifying floating charges.\textsuperscript{90} Inability, or likely inability, to pay debts \textit{is} a prerequisite for out-of-court appointments by the company or by directors (under paragraph 22).\textsuperscript{91}

The EA lays down the objectives to be pursued and the purpose of administration in paragraph 3 of the new Schedule B1 of the Insolvency Act 1986.\textsuperscript{92} Paragraph 3(1) states that the administrator of a company must perform his functions with the objective of (a) rescuing the company as a going concern, or (b) achieving a better result for the company’s creditors as a whole than would be likely if the company were wound up (without first going into administration) or (c) realising property in order to make a distribution to one or more secured or preferential creditors. The first stated objective is to rescue the company as a going concern.\textsuperscript{93} The administrator must act to pursue objective (a) unless he thinks either that it is not reasonably practicable to achieve that objective or that the objective set out in (b) would achieve a better result for the company’s creditors as a whole.\textsuperscript{94} The

\textsuperscript{89} Ibid., paras. 22–34. Note that with regard to FSA-authorised companies the FSA’s written consent is needed. On IPs’ responsibilities under the Financial Services and Markets Act (FSMA) 2000 see further C. Rafferty and O. Gayle, ‘Financial Services and Markets Act 2000: Considerations for the IP’ (2007) \textit{Recovery} (Summer) 35.

\textsuperscript{90} IA 1986 Sch. B1, paras. 35(1)(a); 35(2)(a).

\textsuperscript{91} See para. 27(2)(a) involving a statutory declaration as to the company’s inability to pay debts.

\textsuperscript{92} I.e. EA 2002 s. 248 ‘substitutes’ the four statutory purposes for which an ‘old’ administration order could be obtained under the IA 1986 s. 8(3) with paragraph 3 of Sch. B1. The decision of \textit{DKLL Solicitors v. HMRC} [2007] BCC 908 shows that the purpose of the administration is a self-standing test rather than a function of the wish of creditors, even if they control the voting at the creditors’ meeting at which the administrator’s proposals might come to be considered: see S. Frisby, ‘Judicial Sanction of Insolvency Pre-Packs? \textit{DKLL Solicitors v. HMRC} Considered’ (2008) 27 \textit{Company Law Newsletter} 1; S. Frieze, ‘Round-up of Some Recent Cases on Administration’ (2008) 21 \textit{Insolvency Intelligence} 14.


\textsuperscript{94} The administrator, in the absence of some special relationship, owes no general common law duty of care to (individual) unsecured creditors regarding the conduct of the administration: see Kyrris \textit{v. Oldham} [2004] BCC 111, [2004] 1 BCLC 305. See further pp. 444–6 below.
objective set out in (c) is only to be pursued if he thinks that it is not reasonably practicable to achieve either (a) or (b) and the administrator does not unnecessarily harm the interests of the creditors of the company as a whole. Subject to the provisions governing the pursuit of (c), the administrator is to pursue his functions ‘in the interests of the company’s creditors as a whole’ (paragraph 3(2)). The effect of the above is that the administrator is not obliged to rescue the company at all costs.95 The tension between protecting the company and protecting the business is managed by paragraph 3(3) and notably by 3(3)(b), which stipulates that rescuing the company gives way to arrangements that would give a better result for the creditors as a whole. This gives primacy to saving the business where this gives the better result for creditors.96

The administrator acts as the company’s agent and has an impressive range of powers to assist him in doing ‘anything necessary or expedient for the management of the affairs, business and property of the company’.97 These powers are listed in Schedule 1 and in paragraphs 61–3 and 70–3 of Schedule B1 of the Insolvency Act 1986 and the administrator must use these statutory powers to aid his management of the company in accordance with any proposals which have been approved by a meeting of creditors or in accordance with any directions given by the court.98 As an officer of the court, the administrator is under a duty to act in good faith, with independence, impartiality and loyalty, and not to

95 Compare with 'the hierarchy of objectives' found in para. 3 of Sch. B1 of the Enterprise Bill under which it 'was clear that administration was first and foremost about rescuing the corporate entity': see Phillips and Goldring, 'Rescue and Reconstruction', p. 76.

96 As noted above, the Explanatory Notes to the Enterprise Act 2002 state that 'rescuing the company as a going concern' is intended to mean 'the company and as much of its business as possible' (para. 647). Rescuing the company alone/simply allowing the survival of the corporate shell will thus not satisfy this objective: see further Phillips and Goldring, 'Rescue and Reconstruction'; S. Frisby, 'In Search of a Rescue Regime: The Enterprise Act 2002' (2004) 67 MLR 247, 262–3.

97 See Sch. B1, para. 69; para. 59(1).

98 See Sch. B1, para. 68. Administrators are under no obligation to dispose of assets in a particular manner but there is a duty to maximise realisations. Assets should therefore be the subject of a professional independent valuation and the prudent administrator would seek the views of the creditors’ committee, if there is one, where practicable to do so. See Coyne and Hardy v. DRC Distribution Ltd and Foster [2008] BCC 612 where the Court of Appeal, inter alia, comprehensively analysed the actions of the administrators and set out guidelines as to what is expected of office holders when undertaking their work. According to Rimmer LJ, the administrators’ conduct ‘had the potential for disaster written all over it; and disaster is what happened. As the judge said, they “did not act expeditiously and with the robustness of purpose that one would have hoped for and which [one] is entitled to expect”’. 
act dishonourably or unfairly.\(^\text{99}\) Also, as discussed below,\(^\text{100}\) the administrator must act rationally and thus, in exercising a discretion or discharging a duty, must act in the way that a reasonable administrator would act.\(^\text{101}\)

The EA may shift English law in the direction of US Chapter 11 but it does not go the whole way. Administration involves handing control of the company to an outsider – the insolvency practitioner (IP) – and is thus not a debtor in possession (‘DIP’) system. Furthermore, unlike the US position, secured creditors cannot be ‘crammed down’ and compelled to accept a reorganisation plan against their wishes.\(^\text{102}\) Nor does the EA provide a US-style mechanism for financing companies in financial difficulties – a matter to be returned to below. As for timings, the EA limits the duration of the administration to twelve months.\(^\text{103}\)

An important aspect of administration is that there is a moratorium, which frees the company temporarily from harassment by creditors.\(^\text{104}\) The moratorium available under the ‘new’ administration\(^\text{105}\) is established in much the same form as found in the earlier provisions of the IA 1986\(^\text{106}\) and the pre-EA case law is thus relevant to the construction of the new provisions.\(^\text{107}\) In the post-EA administration process there are two types of moratoria – a moratorium for the period the company is in administration\(^\text{108}\) and an interim moratorium pending

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100 See pp. 446–51 below. The administrator is both a statutory office holder and an agent of the company owing fiduciary obligations to it: see further Lightman and Moss, Law of Administrators, pp. 246–59.


103 Subject to agreed extensions: see para. 76.


105 Sch. B1, paras. 42 and 43.

106 IA 1986 ss. 10 and 11.

107 See Lightman and Moss, Law of Administrators, p. 581. See also pp. 376–8 above.

108 Para. 43.
the disposal of an administration order application or the coming into
effect of an out-of-court appointment of an administrator.\textsuperscript{109}

The interim moratorium becomes effective, if applying to court for admin-
istration, as soon as the application is made. When a floating charge holder
applies under paragraph 14, the moratorium takes effect from the date a copy
of the notice of intention is filed at the court, as that is when the company or
directors are seeking to appoint. The provisions of paragraphs 42 and 43 of
Schedule B1 generally apply during the period of the interim moratorium.\textsuperscript{110}

When an administrator has been appointed there is a general moratorium
on the enforcement of remedies without the consent of the administrator
or the permission of the court.\textsuperscript{111} As noted previously, the moratorium is
procedural in nature, suspending the power to enforce rights but not
destroying such rights. The company cannot then be wound up\textsuperscript{112} and the
consent of the administrator or the leave of the court is required for such
actions as enforcing a security against the company, repossessing goods
in the company’s possession under a hire purchase agreement, exercising a
right of forfeiture by re-entry,\textsuperscript{113} or the commencement or continuation of
any other legal proceedings or levying distress against the company or its
property.\textsuperscript{114} Protection also extends to property owned by the company but
in the possession of third parties such as lessees.\textsuperscript{115} An administrative
receiver cannot be appointed when the company is in administration
and an administrative receiver already in office must vacate.\textsuperscript{116}

Financial collateral arrangements

At this point consideration must be given to the insolvency effects of the
Financial Collateral Regulations 2003\textsuperscript{117} and their implementation of the

\textsuperscript{109} Para. 44.
\textsuperscript{110} Except that winding-up petitions on public interest grounds under IA 1986 s. 124A or
Financial Services and Markets Act 2000 s. 367 are not prevented: see further V. Finch,
‘Public Interest Liquidation: PIL or Placebo?’ [2002] Ins. Law. 157 and ch. 13 below. The
appointment of administrators by qualifying floating charge holders (QFCs) (under
para. 14) is similarly not prevented under the interim moratorium, nor is the appoint-
ment of administrative receivers.
\textsuperscript{111} Paras. 42, 43 — applicable whether the administration is out of court or via a court order.
\textsuperscript{112} Para. 42(2)(3).
\textsuperscript{113} See Metro Nominees (Wandsworth) (No. 1) v. Rayment [2008] BCC 40.
\textsuperscript{114} Para. 43.
859.
\textsuperscript{116} Paras. 43(6A), 41(1).
\textsuperscript{117} Financial Collateral Arrangements (No. 2) Regulations 2003 (SI 2003/3226).
EU Directive on Financial Collateral Arrangements. The purpose of the Directive was to enhance the effective use of financial collateral across the EU and its implementation involves streamlining arrangements for creating collateral and providing for easier realisation of collateral through enforcement. For insolvency lawyers, the significance of the 2003 Regulations lies in their neutralising certain insolvency provisions so as to benefit particular lenders. The Regulations go beyond the Directive and apply to all banks and companies taking financial collateral. Such collateral includes cash and financial instruments (government securities, shares, bonds and other financial instruments such as units in collective investment schemes). Collected book debts and other sums credited to bank accounts will be covered but not uncollected book debts or other types of collateral, such as commercial property, plant and machinery. The Regulations apply to security interests such as mortgages and fixed charges and to floating charges provided that the collateral is ‘in the possession or control of the collateral taker’.

In the case of such collateral, Regulation 8 disapplies various insolvency provisions relating to administration and winding-up, notably: the Schedule B1 paragraph 43(2) veto on enforcing a security when the company is in administration without the consent of the administrator or the court’s permission; the Schedule B1 paragraph 44 interim moratorium on enforcing a security that operates as soon as an application for administration is made; the Schedule B1 paragraph 41(2) rule that any receiver shall vacate of office if required to do so by the administrator; and the Schedule B1 paragraphs 70–1 power of the administrator to dispose of property subject to certain types of charge. The effect of the Regulations is to assure lenders of easy enforcement in the case of insolvency. Such provisions, however, can be seen as reducing the availability of company cash deposits to fund administrations and to

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118 Directive on Financial Collateral Arrangements 2002/47/EC.
120 Lawson, ‘New Financial Collateral Regulations’.
122 The 2003 Regulations also disapply the automatic avoidance provisions of the Insolvency Act 1986 s. 245 (floating charges), s. 127 (property dispositions) and s. 88 (share transfers after a winding-up resolution): see Sharp, ‘Collateral Directive’, pp. 147–8.
fly in the face of the Enterprise Act’s conception of administration as a rescue mechanism.\textsuperscript{123}

**Preferential creditors, the prescribed part and the banks**

Other important provisions of the Enterprise Act 2002 concern priorities and the protection of vulnerable creditors. The Crown’s status as preferential creditor was abolished by section 251 of the EA.\textsuperscript{124} It is estimated that this will result in some £70 million per annum flowing to other creditors.\textsuperscript{125} The EA also introduced ‘ring-fencing’ of a prescribed proportion of the company’s net floating charge proceeds. These proceeds are to be made available to the company’s unsecured creditors and only surpluses of funds following such use will be available for distribution to the floating charge holders.\textsuperscript{126} The ‘prescribed part’ of funds for ring-fencing is stipulated by Statutory Instrument.\textsuperscript{127}

\begin{footnotesize}
\textsuperscript{123} See the comments of practitioners: Sharp, ‘Collateral Directive’; Lawson, ‘New Financial Collateral Regulations’: ‘Secured lenders will have increased leverage over cash assets which may otherwise be used to fund the administration … [They] may be able to avoid the new prescribed part provisions altogether either by taking certain floating charge assets for themselves or relying on the Regulations to disapply the prescribed part provisions once the charge has crystallised.’

\textsuperscript{124} Paras. 1, 2, 3–5C, 6, 7 of the IA 1986 Sch. 6 are deleted. Preferential debts that remain are: unpaid contributions for occupational pensions; four months of unpaid employee wages and holiday entitlements; and unpaid levies in respect of coal and steel production. See further ch. 14 below.

\textsuperscript{125} See IS, *Regulatory Impact Assessment for Insolvency Provisions in the Enterprise Act 2002 (IS, London, 2002)* (hereafter ‘EA 2002 RIA’) para. 5.29 – this is based on the Crown recovering £90 million per annum preferentially in all insolvencies and the estimate that this would drop to some £20 million per annum when the Crown became unsecured.


\textsuperscript{127} See Insolvency Act 1986 (Prescribed Part) Order 2003, SI 2003/2097 – 50 per cent of net property where that net property is less than £10,000; above £10,000, then 50 per cent of the first £10,000 in value and 20 per cent of the excess, up to an overall limit of £600,000. See also ch. 3 above.
\end{footnotesize}
For the banks, as holders of post-EA (or ‘qualifying’) floating charges, the EA produces a significant alteration in substantive rights. Whereas a receiver owes a duty to look only to the interests of the floating charge holder, the administrator has a duty to act in the interests of the creditors as a whole and in pursuance of the ‘tiered’ objectives set out now in Schedule B1, paragraph 3(1)(a), (b) and (c). Under paragraph 3(3) of Schedule B1 the administrator, as noted, is only to realise property to distribute to one or more secured or preferential creditors if (a) he thinks that it is not reasonably practicable to achieve either of the objectives in 3(1)(a) or (b) (i.e. rescuing the company as a going concern or achieving a better result for creditors as a whole than would be likely in a winding up) and (b) he does not unnecessarily harm the interests of the creditors of the company as a whole. The reforms do not change priorities in an insolvency but may have a substantive effect on the floating charge holder. This is because a floating charge holder who appoints an administrator rather than an administrative receiver is dealing with a regime in which the administrator has to take into account interests other than the floating charge holder’s and in which rescuing the company has a degree of primacy in relation to satisfying the secured creditors’ interests.

Lobbying by powerful lenders in the period leading up to the EA produced a set of impressive procedural rights for the banks.128 The British Bankers’ Association (BBA) argued forcefully during 2001 that administrative receivership had been a very successful ‘engine for reconstruction and enterprise in the UK’.129 Receivership, said the BBA, had allowed secured creditors to ‘appoint somebody who is able to act quickly and manage the restructuring process in a way which has saved businesses and jobs in a cost effective manner’.130 The thrust of this argument was that any new administration procedure that was to be rescue-friendly had to be streamlined and fast. The Enterprise Act 2002 moved towards such streamlining by removing the need for a Rule 2.2 report and limiting the number of circumstances requiring a court

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130 Ibid., p. 3; on receivership as a rescue procedure, see ch. 8 above.
procedure.\textsuperscript{131} Now a lender (bank) files a notice of appointment declaring that: they are the holders of a qualifying floating charge in respect of a company’s property; the charge is enforceable; and the appointment is in accordance with Schedule B1 to the Insolvency Act 1986.\textsuperscript{132} For the secured lender, appointing an administrator will differ little from the current process for appointing a receiver. Banks are able to use the streamlined appointment procedure in all cases, not merely situations of urgency, and they are able to determine who should be appointed to the post of administrator.\textsuperscript{133} This gives the banks the power to insert their chosen administrator with speed and without regard to the other creditors or the courts. As has been observed: ‘Even if the company or its directors choose an administrator, effectively the holder of the floating charge can choose an alternative administrator.’\textsuperscript{134} The overall effect, then, is that floating charge holder concerns have largely been sought to be met in the Enterprise Act – to the extent that one group of practitioners has argued: ‘It may be better to describe the reforms as a “transformation” or “merger” of administrative receivership and administration

\textsuperscript{131} The Association of Business Recovery Professionals (R3) estimated a standard r. 2.2 report to be between £4,000 and £8,000 (based on £1 million turnover, £500,000 book value of assets expected to realise £200,000): see EA 2002 RIA, para. 5.27.

\textsuperscript{132} If there is a prior qualifying charge (per Sch. B1, para. 14(2)) to that held by the lender (the bank), then the bank may not appoint an administrator unless it has given at least two business days’ written notice to the prior charge holder (enabling the prior qualified floating charge holder to consider appointing an administrator itself): see Sch. B1, para. 15.

\textsuperscript{133} See Sch. B1, paras. 14(1), 18(3). On how the court resolves competing proposals regarding the identity of the administrators where there is no QFC see R. Tett and F. Paterson ‘World Class Administrators’ (2005) Recovery (Summer) 24; Re World Class [2005] 2 BCLC 1. See also The Oracle (North West) Ltd v. Pinnacle Services (UK) Ltd [2008] EWHC 1920 – where significant creditors have a clear preference for one administrator over another and the secured creditor and other creditors are neutral, the court should decide in favour of the wishes of those creditors, particularly given that administration is intended for their benefit.

\textsuperscript{134} See M. Stevenson, ‘The Enterprise Bill 2002 – A Move Towards a Rescue Culture?’ (2002) 18 IL&P 155, 157. Mond argues: ‘I don’t like the fact the bank can appoint an administrator of its own choice without reference to the court. That is very, very dangerous. It feels like a back door way of receivership’ (quoted in Willcock, ‘How the Banks Won the Battle’, p. 26). See also p. 428 below on the effect this may have to incentivise administrators to keep the banks happy. If an administration application is made by a party other than the floating charge holder (e.g. by a company or directors) and the floating charge holder applies to have its chosen administrator appointed instead, the court shall allow this unless it thinks it right to refuse ‘because of the particular circumstances of the case’ (Sch. B1, para. 36(2)).
procedures rather than as being the end of the administrative receivership procedure.\footnote{S. Davies, \textit{Insolvency and the Enterprise Act 2002} (Jordans, Bristol, 2003) pp. 40–1; ‘the new deal is merely ‘son of receivership’”: see Willcock, ‘How the Banks Won the Battle’, R3 commented on the White Paper proposals, \textit{Insolvency – A Second Chance}, that the \textit{status quo} was being upheld and that banks would have the same real powers in case of administration as they did with receivership: \textit{Financial Times}, 1 August 2001.}

\textit{Exiting from administration}

A number of routes out of administration are possible.\footnote{See G. Todd, ‘Administration Post-Enterprise Act – What Are the Options for Exits?’ (2006) 19 \textit{Insolvency Intelligence} 17.} An administrator will automatically vacate office one year from the date the administration commenced, unless this term has been extended by the court (for such period as the court deems necessary) or extended with the consent of the creditors for up to six months.\footnote{Sch. B1, paras. 76–9. This automatic termination of administration after twelve months is a feature introduced by the EA 2002 reforms and evidences the clear aim of the legislature to make administration a short-lived, transitory process to be dealt with ‘quickly and efficiently’: see also para. 4. For a pragmatic interpretation of the exit routes available under para. 79 see \textit{Re TM Kingdom Ltd} [2007] BCC 480 (Norris J).} Furthermore, the new-style administration can be converted to a Creditors’ Voluntary Liquidation (CVL) by filing documents at Companies House if the administrator thinks that there will be a distribution to unsecured creditors.\footnote{Sch. B1, para. 83. Preconditions are laid down in para. 83(1) and (2), namely that provision must have been made to ensure that all secured creditors will be paid off and, after that, there must be something remaining available for the unsecured creditors. The procedure is available for court-appointed or out-of-court-appointed administrators and with the former it is not necessary to seek a court order: see \textit{Re Ballast plc (in administration) and Others} [2005] BCC 96. See \textit{Re GHE Realisations (formerly Gatehouse Estates Ltd)} [2006] BCC 139 regarding exit modes in paras. 83 and 84.} This process obviates the needs for advertising the office holder’s appointment or for holding a creditors’ meeting. In the alternative, the administrator can now make a distribution to the company’s creditors, generally the secured and preferential creditors,\footnote{Sch. B1, para. 65. If a distribution is sought to any other type of creditor the court’s permission must be obtained. The Financial Markets Law Committee has raised concerns that these new rules to make distributions to unsecured creditors (which include set-off provisions – \textit{Insolvency Rules 1986} r. 2.85 – and administration expenses – IA 1986 Sch. B1, para. 99 and IR 1986 r. 2.67) could give rise to potential legal uncertainties} and can then move to put the company into CVL under Schedule B1, paragraph 83, as noted above.
Alternatively the administrator can institute a process to dissolve the company. Such a direct move into dissolution is possible where the administrator thinks that there is no property left which might permit a distribution to creditors.\textsuperscript{140} The administrator will achieve this result by sending a notice to the registrar of companies and, at the end of three months, the company will be dissolved automatically.

Where an administrator has been appointed out of court and there has been a rescue and a return of the company to the directors, the administrator may end the process of administration by giving notice that the purpose of the administration has been achieved.\textsuperscript{141}

A court order may also end the administration.\textsuperscript{142} This may happen when the administrator applies for such an order (for instance when he feels the objective cannot be achieved, or that the company should not have entered administration or if a creditors’ meeting so directs him to apply). If the administrator has been appointed by the court then he may apply to the court to end the administration if he thinks the purpose has been achieved. When the administrator reports to the court that there is a stalemate regarding the administrator’s proposals, the court may also end the administration.\textsuperscript{143} A creditor may apply for an order to end the administration on the basis that there has been an ‘improper motive’ behind the appointment,\textsuperscript{144} and where a creditor or member wishes to challenge the conduct of the administrator on grounds of unfairness or harm to the interests of the applicant, the court can provide for the administrator’s appointment to cease to have effect.\textsuperscript{145} Finally, the Secretary of State may apply to the court to have the company

which could, in turn, discourage counterparties from dealing with companies in administration, thereby harming any rescue attempt: see FMLC discussion paper, ‘Administration – Set-off and Expenses’ (Issue 108, 17 January 2008), available on the FMLC website (www.fmlc.org). (On set-off see ch. 14 below.) The administrator can also make payments other than through para. 65 ‘if he thinks it likely to assist achievement of the purpose of administration’ (para. 66). This could allow the administrator to pay off arrears owed to a creditor who made such a payment a condition of making further essential supplies, e.g. fuel or raw materials: see L. S. Sealy and D. Milman, Annotated Guide to the Insolvency Legislation 2007/2008 (10th edn, Thomson/Sweet & Maxwell, London, 2007) p. 550.

\textsuperscript{140} Sch. B1, para. 84. See Re GHE Realisations Ltd [2006] BCC 139, which indicated that an administrator was only required to think \textit{at that time} that there was no further property to distribute (and prior distributions were immaterial). This decision departed, in this regard, from \textit{obiter} comments in Re Ballast plc [2005] BCC 96.

\textsuperscript{141} Sch. B1, para. 80. \textsuperscript{142} Ibid., para. 79. \textsuperscript{143} Ibid., para. 55.

\textsuperscript{144} Ibid., para. 81. \textsuperscript{145} Ibid., para. 74(4)(d).
wound up on grounds of public interest during the course of an administration.\textsuperscript{146}

\textbf{Evaluating administration}

The introduction of a new administration procedure raises a host of questions concerning its value as a rescue process and its cost-effectiveness, as well as its amenability to the exercise of expertise, its accountability and its fairness. It is now time to turn to these matters and, \textit{inter alia}, to consider the findings of the valuable research that the Insolvency Service has undertaken or commissioned regarding different aspects of these matters.\textsuperscript{147}

\textit{Administration and rescue: efficiency issues}

Use, cost-effectiveness and returns to creditors

An aim of the EA was to promote the use of administration rather than receivership\textsuperscript{148} and this objective has been achieved. The number of annual administrations rose from 649 in 2002–3 to 2,661 in 2005–6 at a time when total numbers of corporate insolvencies dropped slightly (from 17,810 to 16,907) and this represented a rise in administration as the procedure employed in instances of insolvency from 3.6 per cent to 15.7 per cent.\textsuperscript{149} Receiverships, in the same period, fell from 1,310 to 565.\textsuperscript{150} One reason for the popularity of the new procedure may have been the new streamlined out-of-court route of entry into

\textsuperscript{146} Ibid., para. 82(1)(a).
\textsuperscript{148} The EA was not retrospective and holders of qualifying floating charges (QFCs) created before 15 September 2003 can still appoint administrative receivers.
\textsuperscript{149} And to 17.2 per cent in the first quarter of 2007: \textit{Insolvency Service Evaluation}, 2008, p. 23.
\textsuperscript{150} Ibid., p. 11. These figures are consistent with the findings of Katz and Mumford, 2006.
administration. This proved immediately attractive, especially in relation to smaller enterprises,\footnote{See N. Hood, ‘How the Enterprise Act is Helping to Preserve Businesses’ (2005) Recovery (Spring) 14 at 15: ‘the advisors of most cash-strapped SMEs shied away from going to court to get protection’.} so that, in 2003–4, 65.5 per cent of entries into administration were by this route compared to 29.8 per cent by court order.\footnote{Frisby, Report, 2006. The instituting actions in 70.6 per cent of these cases were taken by directors, 10.6 per cent were taken by the company and 18.1 per cent by a charge holder.} The EA also sought to speed up administrations by introducing a time limit of one year, creating defined exit routes\footnote{See Sch. B1, paras. 79, 80, 81, 82.} and demanding that administrators complete their functions as quickly and efficiently as is reasonably practicable.\footnote{Sch. B1, para. 4.} Again, the objective seems to have been achieved, with average durations of administration dropping from 438 days for pre-EA cases to 348 for post-EA cases.\footnote{Frisby, Report, 2006; Insolvency Service Evaluation, 2008, p. 55.}

On whether the new procedure conduces to rescue, the Insolvency Service’s conclusion is that the overall outcomes of administrations, in terms of corporate and business rescue, appear to be largely unchanged from those associated with administrative receivership and there appear to be proportionately fewer ‘rescues’ than under the previous administration regime – though more in absolute numbers.\footnote{Insolvency Service Evaluation, 2008, Section 3.9.}

As for the costs of administration, direct entry expenses may have been lowered but the overall average costs of the more collective processes of administration appear to be higher than for administrative receivership.\footnote{Armour, Hsu and Walters, 2006.}

The realisations in post-EA administrations have been found to be significantly higher than in pre-EA receivership cases – especially in instances where the corporate assets were worth more than the secured creditor was owed.\footnote{Armour, Hsu and Walters, 2006.} This supports the view that the duty of the administrator to act in the interests of all the creditors is impacting on total realisations.\footnote{Ibid.} The beneficial effects of such increases may, however, be enjoyed more by professionals than by creditors. Armour, Hsu and Walters found that the direct costs of administrations (primarily IP
and legal fees) were significantly higher in post-EA administrations than in pre-EA receiverships and that this generally occurred when the senior charge holders were over-secured (and, it seems, lacking incentives to monitor professional costs).\(^{160}\) Such were these costs that the impact of increased recoveries in administrations had been negated by increased costs and fees so that there had been no resultant increase in returns to creditors.\(^{161}\) Frisby has issued updated research suggesting that returns to secured and preferential creditors have improved in post-EA administrations but ‘unsecured creditors do not yet appear to be benefiting from the Act’.\(^{162}\) Her figures show that, comparing post-EA administrations with pre-EA receiverships, average returns to secured creditors rose from 29.3 per cent to 34.6 per cent and unsecured creditors rose from 1.9 per cent to 2.8 per cent. Unsecured creditors’ returns from pre- and post-EA administrations, however, fell from 6.7 per cent to 2.8 per cent.\(^{163}\)

The Insolvency Service responded to issues of process costs in late 2007 by issuing a consultation paper setting out proposals for streamlining insolvency procedures.\(^{164}\) Of the eight proposals involved, two may have a bearing on administration processes: first, to modernise and make more flexible the means of communication and the exchange of information between office holders and creditors\(^{165}\) and, second, to remove the

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160 Ibid.
161 Ibid. Katz and Mumford, 2006, state at p. 49: ‘there appears at this stage to be no strong grounds for either celebrating or regretting the substitution of administration for administrative receivership’.
163 Ibid., noted in the Insolvency Service Evaluation, 2008, p. 155. Frisby suggests that this drop may be due to ‘receivership substitution’ (use of administration in circumstances formerly using receivership), ‘liquidation substitution’ and the rise of pre-packaged administrations – where the price for a business is discounted.
165 By, for example: introducing a provision requiring creditors to ‘opt in’ if they wish to receive information issued by the insolvency office holder during the conduct of the proceedings; updating insolvency legislation to make it explicit that communication can be effected electronically where the legislation requires it to be ‘in writing’; enabling insolvency office holders to provide information by sending a link to a website on which information is posted; and providing a legislative framework that will allow insolvency office holders to hold meetings which are required to be held as part of their conduct of insolvency cases through media other than meetings held at a physical venue. It is noteworthy here that, in Re Sporting Options plc [2005] BCC 88, the administrators were not allowed to serve notice of appointment and proposals to creditors by email: see further ‘Administrators: Electronic Communication with Creditors’ (2006) 19
requirement for any document in insolvency proceedings to be sworn by affidavit and to replace it with a less burdensome requirement. It remains to be seen whether, post-consultation, the above steps will be introduced in a form that significantly reduces the costs of administration.

Will administration continue as a popular insolvency process or will its expense and complexity prompt a revival of other procedures such as the Law of Property Act 1925 (LPA) receivership (which allows holders of charges over particular assets to appoint receivers)?\textsuperscript{166} For a large lender, administration involves not merely intricate procedural burdens (including notification requirements and the pressure imposed by a year’s deadline for completion) but also a duty on the administrator to act in the interests of creditors as a whole.\textsuperscript{167} There are, however, advantages of using the qualifying floating charge (QFC) and administrator route, and these include: a right to receive five days’ notice of any directors’ or company’s application to court for an administration order or out-of-court appointment; a right to at least two days’ notice of an intended appointment of an administrator by a junior holder of a QFC; and a right to apply for the appointment of their own nominee that will prevail over the nominating rights of non-QFC holders (for example, the company, its directors or its creditors). The administrator route also allows the QFC holder to apply for the appointment of an administrator when a winding-up order has been made and to benefit from the administrator’s significant legal powers as well as the statutory moratorium.

If resort is made to fixed security and the LPA route, the lender will be aware that, if an LPA receiver is appointed, they can be required to vacate office by a subsequently appointed administrator – and, on such appointment, the lender will not be able to act further to enforce their security

\textit{Insolvency Intelligence} 15. The present terms of reference to the Insolvency Rules Committee include a direction to review and, if thought appropriate, recommend the modernisation of the Insolvency Rules to allow for the greater use of electronic disclosure. The Insolvency Service is undertaking a general restructuring of the Insolvency Rules 1986 and substantive changes are being made. The final implementation of the consolidation of insolvency secondary legislation and the restructuring of the Rules has been subject to delay and, at the time of writing, is expected on 1 October 2009. See G. Davis, ‘The Role of the Insolvency Rules Committee’ (2007) 20 Insolvency Intelligence 65; P. Bailey, ‘The Insolvency (Amendment) Rules 2005 – Yet More Changes for Insolvency Folk’ (2006) 19 Insolvency Intelligence 24.


\textsuperscript{167} On the confusions arising from the terms of the new administration see S. Gale, ‘Insolvency Law Post Enterprise Act: Does It Do What It Says on the Tin?’ (2007) Recovery (Autumn) 34.
without the consent of the administrator or the consent of the court. A receiver will lack the investigative powers of an administrator and will not have the protection of the moratorium against forfeiture, execution or legal proceedings. The LPA receiver, moreover, will become personally liable regarding contracts entered into (subject to the right of indemnity). A fixed, rather than floating, charge is needed to trigger the LPA route and this may involve difficulties, notably the risk that the charge may be deemed floating\textsuperscript{168} and the commercial reality that using a fixed charge may impede the company’s commercial responsiveness.

An attractive aspect of administration has been said to be its potential as a substitute for liquidation.\textsuperscript{169} When a company is put into administration and then into liquidation, the once customary creditors’ meeting is bypassed. This is because companies can now appoint an administrator without the need for a court order and then, instead of creditors appointing a liquidator, the company makes the appointment. In liquidation, the identity of the office bearer rests primarily with the general body of creditors but, in administration, the company can make the appointment and unsecured creditors will have little input into selection of the office holder. This difference in control is likely to be to the advantage of directors and IPs rather than unsecured creditors.\textsuperscript{170} On the incidence of ‘liquidation substitution’, research by Katz and Mumford, published in 2006,\textsuperscript{171} found that in 14 per cent of post-EA

\textsuperscript{168} See the discussion of Spectrum Plus at pp. 411–15 below.

\textsuperscript{169} See L. Linklater, ‘New Style Administration: A Substitute for Liquidation?’ (2005) 26 Co. Law. 129; A. Keay, ‘What Future for Liquidation in Light of the Enterprise Act Reforms?’ [2005] JBL 143. The Lords’ decision in Buchler v. Talbot [2004] 2 AC 298 held that, in contrast with administration, the expenses of liquidation were not recoverable from property subject to a floating charge. This ensured the popularity of administration until the Companies Act 2006 s. 1282 reversed Buchler and inserted a new s. 176ZA into the Insolvency Act 1986, providing that if the company’s assets available to meet the claims of unsecured creditors are not sufficient to meet the expenses of winding up, those expenses have priority to and are to be paid out of any property subject to a floating charge created by the company.

\textsuperscript{170} In El-Ajou v. Dollar Land (Manhattan) Ltd [2007] BCC 953, however, it was stated that, in the absence of economic advantage through using the administration procedure, the court favoured liquidation over administration due to the visible independence of the liquidators from those concerned with the company. In Re Lafayette Electronics Europe Ltd [2007] BCC 890 the court, in deciding to appoint joint administrators as joint provisional liquidators, was influenced by the fact that the administrators were effectively in office, were up to speed with the affairs of the company and did not need paying for reading into the company’s plight. The Insolvency Service has warned practitioners of its expectation that liquidation will be the usual exit route where rescue is not possible.

\textsuperscript{171} Katz and Mumford, 2006, p. 5.
administrations (and 3 per cent by value) administration had been the procedure selected solely to provide a convenient method of sale of a business or package of assets when this result appeared to have been equally achievable in liquidation. The ‘disenfranchising’ of unsecured creditors in administration will be returned to below in considering accountability within the administration process.

Responsiveness

Turning from banks’ incentives to use administration to the need for rescue actions to be taken decisively and rapidly, there may be concerns that the move from administrative receivership to the new administration may reduce the ability of key players to behave in this manner. As noted above, the British Bankers’ Association (BBA) has for some time argued that receivership operated as an effective way of saving businesses (not necessarily companies) because receivers, acting for the banks, could operate very dynamically.\(^\text{172}\) The BBA’s fear about the new administration is that it will involve more parties, delays and uncertainties and will accordingly make rescues more difficult than under receivership. ‘Concentrated creditor’ theory\(^\text{173}\) holds that a multiplicity of creditors increases negotiating frictions whereas the concentration of the old receivership system reduced these. Similarly it can be contended that the inclusiveness of the post-EA regime, and the enfranchising of parties other than floating charge holders, increases negotiation costs relative to receivership\(^\text{174}\) and reduces the chances of rapid and effective responses to corporate troubles. It is further arguable that, in the past, the existence of receivership, and its potential use, served a useful purpose in concentrating the minds of all the classes of creditor involved with the potential rescue of a troubled company – that it was this prospect that gave urgent life to many a general agreement on reorganisation and rescue.\(^\text{175}\) In contrast, the post-EA regime involves no such draconian fall-back position and in other ways it also increases the incentives of the broader band of creditors to contest strategies and actions – for instance by ring-fencing provisions to increase the prospects of unsecured creditors.


\(^{173}\) See Armour and Frisby, ‘Rethinking Receivership’.

\(^{174}\) See the discussion at pp. 429–35 below.

\(^{175}\) See Armour and Frisby, ‘Rethinking Receivership’.
This could be said to be a statutory trading-off of efficient rescue in favour of more fairness to unsecured creditors.

As a counterbalance to such fears, however, it can be pointed out that in many recovery scenarios there is little point in making rescue-related decisions quickly (for example to seek to ensure that requisite funds are available) if the conditions that underpin continued trading are not sustained – and one thing that the EA does do is to increase the incentives to support rescue of those business partners who are unsecured creditors. Those incentives will be encouraged not merely by the administrator’s duty to consider their interests (as compared to the receiver’s duty to act in the interests of the floating charge holder) but also by the abolition of Crown preference and the ring-fencing provisions set out in sections 251 and 252 of EA 2002. Both of these reforms increase the anticipated returns to unsecured creditors in a potential liquidation. This, in turn, may reduce the risks faced by unsecured creditors in supporting the rescue – though it will not always do so on a dramatic scale.

Decisive action in pursuit of rescue demands that administrators act to further their statutory rescue objectives in a purposive way. They have, as noted, a statutory duty to perform their functions ‘as quickly and efficiently as is reasonably practicable’ but, as far as rescue is concerned, the administrator’s statutory objectives, as established by Schedule B1, paragraph 3(1), do not even give absolute priority to rescue. The administrator must act with the aim of rescuing the company as a going concern unless he thinks that it is either not ‘reasonably practicable’

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176 See Insolvency Act 1986 s. 176A.
177 See H. Rajak, ‘The Enterprise Act and Insolvency Law Reform’ (2003) Co. Law. 3. Under the ‘ring-fencing’ or ‘prescribed part’ provisions the quantum of the ‘prescribed part’ of funds reserved for unsecured creditors out of property otherwise available for distribution to the holders of a floating charge is established by Statutory Instrument: see Insolvency Act 1986 (Prescribed Part) Order 2003 SI 2003/2097 (see p. 387 above). Without such a ‘ring-fencing’ measure the consequence of the abolition of the major part of the Crown’s preferential status as a creditor would be a windfall for the charge holder. John Armour argues that unsecured creditors may in fact be worse off in that they will receive only a trivially small increase in their expected payout on insolvency through the prescribed part while facing the risk that, if fragmented capital structures make it more difficult for banks to orchestrate workouts, the probability of default may increase: ‘Should We Redistribute in Insolvency?’ in J. Getzler and J. Payne (eds.), Company Charges: Spectrum and Beyond (Oxford University Press, Oxford, 2006) p. 223. See also ch. 3 above.
to achieve it or that other actions will produce a better result than winding up for the creditors and that this would be a better result for the creditors as a whole than seeking to rescue the company.\textsuperscript{180} Only if he thinks that neither of these objectives can reasonably practicably be achieved can property be realised in order to make a distribution to one or more secured or preferential creditors.\textsuperscript{181} As has been pointed out above, the terms of the EA mean that it is arguable that an administrator is obliged to pursue a going concern sale where he thinks this will serve creditors better than efforts made to rescue the company – even where it might be possible to rescue the company.\textsuperscript{182} Primacy is accordingly given to maximising overall returns to creditors, rather than to rescue \textit{per se}.

The courts have made it clear that they are inclined to encourage the development of administration as a streamlined and cost-effective regime. In the cases of \textit{Re Transbus International Ltd}\textsuperscript{183} and \textit{Re Ballast plc}\textsuperscript{184} the courts indicated that para. 68(1) – which provided that the administrator shall manage the company’s affairs in accordance with the proposals approved by the creditors’ meeting and any directions given by the court – meant neither that the administrator had to await the creditors’ meeting before acting, nor that he or she could not act without court directions. The two cases suggest, additionally, that the courts are keen to defer to the administrator’s commercial judgement and to allow a considerable margin to such judgements.\textsuperscript{185} Such judicial approaches are designed to allow the administrator to act in decisive ways without fear of delays or second-guessing from the judicial oversight process.

Decisiveness is also called for on the part of company directors. Ever since the Cork Report commentators have urged that the purposes of rescue and the maximising of returns to creditors will be served best where the directors of troubled companies do not delay unduly in calling in rescue professionals.\textsuperscript{186} It is, after all, the directors of a company who,
in the main, must be relied upon to trigger rescue-oriented proceedings. These are the parties who have the requisite hands-on knowledge of a company’s immediate state of affairs rather than the creditors or shareholders. What the EA 2002 does do to expedite rescues is to move from the old regime – in which an administrator could only be appointed by an order of the court on a petition by the company or its directors or creditors\textsuperscript{187} – to the new process, which allows a company to enter administration out of court on application by the company, its directors or the holder of a qualifying floating charge.\textsuperscript{188}

Statutory procedures are one thing, incentives to resort to these another, and, from the directors’ point of view, the nature of the regime being entered may, as noted, be highly material. A difficulty with an insolvency practitioner or practitioner in possession (PIP) regime is that it demands that the directors give up control of the company and so offers directors only limited encouragement to seek early help. For a start, the practitioner in possession, the administrator, is likely to be a person of the bank’s choice rather than their own. If the company or its directors wish to appoint an administrator out of court they must give the holder of a qualifying floating charge five days’ notice\textsuperscript{189} and that holder may then appoint their own administrator in the interim period.\textsuperscript{190} The qualifying floating charge holder’s appointment prevails – as would also be the case where the application to court procedure is followed. The danger is that if the company’s managers anticipate that any formal procedure will involve their giving up the reins of office they will tend to delay commencement of entry into such a procedure beyond the point when the situation calls for external help and involvement. During such a troubled period, moreover, the company directors are likely to take unjustifiably large business risks in the hope, not merely of rescuing the company from its troubles, but of clinging onto their offices. Further dangers are that the directors will dissipate the going concern value of the company’s assets and, in doing so, will prejudice any rescue operations and force the company into liquidation. Such delays will

\textsuperscript{187} (Pre-15 September 2003) Insolvency Act 1986 s. 9(1).
\textsuperscript{188} See paras. 22 and 14. As noted above, however, the company’s inability (or likely inability) to pay its debts is a prerequisite for court appointments of administrators at the behest of the company, its directors or its (non-QFC) creditors (para. 11) and for out-of-court appointments by the company or by directors under paragraph 22 (see para. 27(2)(a)). On valid appointment of administrators out of court see Flitpex Ltd v. Hogg [2004] BCC 870.
\textsuperscript{189} Para. 26. \textsuperscript{190} Para. 14.
accordingly be likely to diminish the value of the assets available for
distribution to creditors.191

The disincentives to seek help that flow from PIP might be sought to be
countered by legal liabilities for directors who wrongfully trade192 or by
disqualification provisions.193 The effectiveness and desirability of such
responses to problems of overtrading have, however, been questioned194
on the grounds of their limited deterrent value and because the imposition
of such liabilities may chill healthy entrepreneurship. Here debtor in pos-
session (DIP) systems offer a contrast in so far as they leave the directors in
charge of the company and this removes at least one disincentive to seeking
help. As Hahn argues: ‘Given the shortcomings of the stick, handing
management a carrot may prove more effective. To accomplish this …
some “tax” needs to be paid to those decision makers. Leaving management
in control of the debtor corporation while the reorganisation is pending is
precisely that tax.”195

The danger of DIP, however, is that this may distort the choice of
procedure entered into.196 In a DIP system, managers who opt for
liquidation face immediate replacement by an appointed trustee in
liquidation. If they opt for reorganisation they may remain in office.
They will, accordingly, tend to file for reorganisation 197 even in circum-
stances where liquidation would be judged the better course of action for
the creditors and the corporation as a whole. Such an inclination will be
encouraged where, as will often be the case, the managers expect that
they will be able to use their control in reorganisation proceedings to
obtain value for themselves in the reorganised corporation198 or they

4 JCLS 117; J. Day and P. Taylor, ‘The Role of Debt Contracts in UK Corporate
192 Insolvency Act 1986 s. 214. See ch. 16 below.
193 Company Directors’ Disqualification Act 1986. See ch. 16 below.
Bhandari and L. Weiss (eds.), Corporate Bankruptcy: Economic and Legal Perspectives
196 See e.g. D. Bogart, ‘Unexpected Gifts of Chapter 11: The Breach of a Director’s Duty of
Loyalty Following Plan Confirmation and the Postconfirmation Jurisdiction of
197 P. Aghion, O. Hart and J. Moore, ‘The Economics of Bankruptcy Reform’ (1992) 8
198 See M. Bradley and M. Rosenzweig, ‘The Untenable Case for Chapter 11’ (1992) 101
Yale LJ 1043. On DIP financiers filling the ‘governance vacuum’ in Chapter 11 see D.
Cardozo LR 101.
may anticipate being able to use their period of control in order to serve their ongoing career opportunities. Such a bias in favour of reorganisation means that managers will not consider choices of insolvency proceedings in undistorted ways and they will not make judgements in a detached, expert manner with an eye to efficient rescue.

The advantage of PIP is that it involves a lower risk of bias or delay in decisions to liquidate since control under all the procedural options will move from directors to independent professionals.\(^{199}\)

To return to PIP as established in the new administration: if a problem is that the new process fails to encourage directors to seek help, can the banks be relied upon to institute rescue processes in a timely fashion? The answer to this question turns on the impact of the EA reforms on banks’ rights, incentives and attitudes. Here one relevant consideration, as already indicated, is the array of legal uncertainties that the EA reforms may involve. This is a statute that provides a complex set of objectives and which may make the administrator’s actions seem highly vulnerable to challenge.\(^{200}\) It also involves uncertainties with respect to the administrator’s allocation of realisations to fixed and floating charges for the purpose of identifying the funds covered by ring-fencing under the Insolvency Act 1986 section 176A.

Such uncertainties may sow the seeds of doubt about rescue in the minds of the banks. The banks may expect procedural and legal costs to be high in post-EA rescues and this may lead them to avoid lending with floating charge security and to move, as noted, towards greater use of secured, asset-based financing and more personal security. The effect of the post-EA regime may, as a result, be the production of a fragmentation of security that will not prove rescue-enhancing. As Prentice has pointed out, the Act does not affect the right of banks to characterise charges as they see fit, to insert the terms and conditions that they consider appropriate and to control the timing of any enforcement action.\(^{201}\) The banks,

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199 Hahn, ‘Concentrated Ownership’.
200 See Sch. B1, para. 3(1). The reality may be that the judges prove reluctant to interfere with the judgements of administrators (at least where aims are phrased subjectively): see notes 361–5 below and accompanying text. There is, as yet, a ‘conspicuous’ absence of case law where administrators have been sued for breach of duty: see Keay and Walton, Insolvency Law, p. 116. The authors comment, however, that this is likely to change as administration begins to take over from administrative receivership ‘as the most common non-terminal corporate insolvency procedure’ and actions under para. 75 for breach of equitable or common law duties become more frequent.
when lending in the shadow of the EA 2002 reforms, will be free to determine the property that is subject to the charge and the type of charge securing the debt. If they are induced by the uncertainties of the EA regime to be selective about the company’s assets that are subject to a charge this will affect the collectivity and coverage of post-EA rescue processes. An advantage of the former regime was that an administrative receiver managed the whole of the corporate property and that the banks were induced to opt for charges that were as comprehensive as possible. This may not be the case with the post-EA processes and fragmentation of the secured assets may ensue. A bank may, accordingly, take a fixed charge over certain corporate assets that are sheltered via the creation of a special purpose vehicle (SPV) that is a subsidiary of the parent company. The overall effect will detract from efficient rescue in so far as the administrator is likely to face more serious problems of asset co-ordination than was the case for administrative receivers. Rapid, decisive, rescue-orientated action will be the more difficult in the face of such fragmentation.

The inclination of the banks to lend by means of secured asset-based financing may, moreover, be strengthened by the EA’s ring-fencing, for the benefit of unsecured creditors, a prescribed part of the funds otherwise available to floating charge holders. Even when banks do lend under floating charge security they will tend to ask for higher rates of interest in reflection of the post-EA uncertainties that, from their point of view, compare badly with the attractions of the old administrative receivership system. The need to demand such raised rates may, in turn, produce a shift towards raising company financing through other routes such as factoring, discounting, leasing or hire purchase arrangements.

There are implications here for the role of the banks in acting to institute rescue proceedings at the optimal time. Proponents of the

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202 Ibid.
203 Ibid., p. 7. A fixed charge can be taken over the parent company’s shares in the SPV. See also Insolvency Act 1986 Sch. B1, paras. 70 and 71, but, as Prentice notes, these provisions need the appointment of an administrator and, in the case of a fixed charge, a court order. See also ch. 3 above.
204 See also ch. 7 above. On the comparative efficiency of debtor-oriented (as opposed to creditor-oriented) insolvency regimes where debt is not concentrated, see S. Franken, ‘Creditor and Debtor Oriented Corporate Bankruptcy Regimes Revisited’ (2004) 5 EBOR 645.
205 Insolvency Act 1986 s. 176A; see pp. 387, 398 above.
‘concentrated creditor’ theory stress the benefits of concentration in encouraging the efficient monitoring of corporate affairs and the summoning of help at the right time during troubles. The uncertainties of the EA reforms may, however, diminish creditor concentration as resort is made to wider ranges of financing and this may mean that the banks are less committed to the role of judging the best point for precipitating changes in a company’s management.

A worrying effect of such changes, from the perspective of rescue, is that as banks become more uncertain about their role in rescue proceedings and if they have doubts about the potential of rescue processes to serve banks’ interests quickly and efficiently, they may be increasingly inclined to be impatient with troubled companies and to take direct enforcement action at an earlier stage in corporate decline than was the case before the EA. This opens up the prospect of potentially precipitate bank action which would detract from efficient rescue. Other aspects of post-EA administration – such as the vulnerability of inclusive procedures to delaying tactics by reluctant directors – may also produce limited bank patience with post-EA procedures.

Super-priority funding

A further aspect of timely rescue is the availability of funds for the purposes of recovery. On this front, a problem with the EA is that it did not provide for a regime of ‘super-priority’ funding for administration. For banks, accordingly, the new arrangements are less conducive to rescue funding than was receivership, which gave them a power of veto over administration. Such a power, in practice, allowed the banks to use the threat of appointing receivers to negotiate administration strategies that were designed to protect against dissipations of their security during the period of the administration. The banks’ power in such respects has been weakened by the EA reforms and this may reduce incentives to fund rescue attempts.

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207 See Armour and Frisby, ‘Rethinking Receivership’; J. Franks and O. Sussman, ‘Financial Distress and Bank Restructuring of Small to Medium Size UK Companies’ (2005) 9 Review of Finance 65, suggest that there is evidence that bank domination may make banks ‘lazy’ in monitoring receivers’ costs but not with regard to the replacement of management. On limitations of the concentrated creditor theory, see ch. 8 above.

208 See BBA, Response to White Paper.

209 This was proposed in the House of Lords but the Government rejected the proposal: see HL Debates, 21 October 2002. See further pp. 408–9 below.

210 See IA 1986 s. 9(3).
Companies involved in any potential rehabilitation process face the central problem that funds must be obtained in order to allow a turn-around to be effected.211

Continued trading is essential for some form of going concern to emerge at the end of the process and for a company to continue trading through an insolvency procedure, it will routinely require access to some form of external finance. Unless that finance is available, the rescue will fail, the assets will have to be sold piecemeal and the company will be forced into liquidation.212

When a company enters a formal insolvency process, the difficulties of obtaining financing may increase considerably. At such times creditors will view lending to the company on an unsecured or undersecured basis as a very risky activity in which repayment depends on the success of the proposed rescue. Few lenders, as a result, may come forward under these conditions.

A super-priority regime seeks to address these difficulties by providing that the suppliers of funds during a moratorium are to be given priority over all existing creditors.213 This concept is found in the US Chapter 11 provisions and, in 1993, the DTI invited comments on its suitability in the UK. Such super-priority, the DTI said, might be financed either from cash flow or (in England and Wales) by a lien over specific uncharged assets. Such funds would have to be used only in the ordinary course of business (e.g. to pay employees during the moratorium) and any extraordinary items would have to be authorised by the lender. One advantage of super-priority, suggested the DTI, was that where funds were provided by the main secured lender on such a basis, there would be reassurance to the lender that their security was not being dissipated during the

211 R3’s Ninth Survey of 2001 indicated that in one in five cases of failed companies with in excess of £5m turnover, the main factor preventing a positive outcome was lack of funding.

212 IS 2000, p. 33. In 1999 the Insolvency Service cited the SPI’s Eighth Survey, indicating that lack of security for extra funding was cited in 51 per cent of cases as a barrier to turnaround and lack of appropriate finance in 43 per cent of cases.

213 On super-priority financing generally see McCormack, ‘Super-priority New Financing’ (looking at the UK, USA and Canada); D. Milman and D. Mond, Security and Corporate Rescue (Hodgsons, Manchester, 1999). The INSOL International Statement of Principles for a Global Approach to Multi-Creditor Workouts (October 2000) is endorsed by the Bank of England. Principle 8 states that where additional funding is provided in a standstill period, the repayment of this should ‘so far as practicable, be accorded priority status’.
moratorium. It had to be faced, however, that, should the company fail, the super-priority funding would operate at the expense of other creditors.

The idea of super-priority has, however, been subject to ebbs and flows of favour at the DTI.\textsuperscript{214} In 1995 the DTI looked at CVA procedures and rejected super-priority on the grounds that the comfort of super-priority might militate against a lender’s giving proper consideration to the viability of a business. As for the earlier suggestion that super-priority loans might be repaid earlier from cash flow, or secured by a lien over specific uncharged assets, the DTI was concerned that a company contemplating a CVA would not have sufficient cash flows or uncharged assets during a moratorium. Given such worries, the DTI proposed that nominees should be required to consider the availability of funding as part of the initial assessment of the CVA’s prospects of success. If the assessment was favourable, said the DTI, there was no substantial reason why funders would not support the company. In 1999, the Insolvency Service was more favourably disposed and announced that its Review of Company Rescue and Business Reconstruction Mechanisms would reconsider super-priority. Note was taken of London Business School research by Maria Carapeto which showed that of 326 firms that had filed for \textit{Chapter 11} protection in the USA, some 135 had raised super-priority (or ‘debtor in possession’) financing which had comprised around 19 per cent of the total debt of the company. About half of the new finance was advanced by pre-petition lenders and high levels of such lending were associated with positive effects on recovery rates.\textsuperscript{215}

In 2000 the Insolvency Service Review Group Report noted that for most CVAs additional funding tended to be provided by owners/directors or by existing lenders, often with the benefit of existing or increased security and/or personal guarantees. New secured finance was available only to the extent that existing secured creditors agreed to this or if the company had uncharged assets or charged assets with surplus value that

\textsuperscript{214} The DTI became the Department for Business, Enterprise and Regulatory Reform (BERR) on 28 June 2007.

\textsuperscript{215} The IS 1999 makes no reference, however, to the interest rates in \textit{Chapter 11} lending. These rates are frequently at a premium. As Gregory notes, ‘Some argue that the total volume of \textit{Chapter 11} financing (19 per cent of total company debt) is more of a comment on the cost of \textit{Chapter 11} procedures than a reflection of the commercial needs of the company … Statistical comparisons here are actually misleading because like is not being compared with like’: R. Gregory, \textit{Review of Company Rescue and Business Reconstruction Mechanisms: Rescue Culture or Avoidance Culture?} (CCH, Bicester, December 1999) p. 21. On \textit{Chapter 11} procedures see ch. 6 above.
could be offered as security. The prevalence of the floating charge meant, however, that uncharged assets were rare in corporate insolvencies.

The Review Group had considered in detail the options for post-petition funding under Chapter 11 of the US Bankruptcy Code\textsuperscript{216} but did not think it appropriate to attempt to replicate Chapter 11 in the different business cultural and economic environment of the UK. The basic principles underlying US practice were nevertheless deemed relevant. These principles were summarised\textsuperscript{217} as holding that:

- Making additional finance available to a business in distress could be ‘value enhancing’ for the business, provided that it was part of a properly considered plan for financial recovery.
- If it was value enhancing for the business in the short, medium or long term, it would also be value enhancing for creditors or it would at least not worsen their position.
- The partiality of their outlook might prevent individual creditors from seeing this potential for value creation or giving it the same value as one would in relation to the business as a whole.
- The specialist insolvency judges and courts could take a broader view and they have the power to grant security to new finance during Chapter 11 even if this displaces the security held by an existing creditor; but displacement must not diminish the expected return to that creditor. The principle is that additional finance should only be provided where it is genuinely value enhancing for all.
- There is no automatic approval for post-petition financing but practice has evolved so that in the early stages of Chapter 11 some form of such financing ‘necessary to avoid immediate and irreparable harm to the company’s estate’ is usually approved without difficulty.

The Review Group floated the idea that the law might allow the authorities supervising an insolvency procedure to have regard to similar considerations to those in the USA when assessing proposals for super-priority finance. In practice this approach would allow super-priority financing to be approved by the courts (or a subordinate tribunal) if several criteria were met. The principal criteria suggested\textsuperscript{218} were:

- The super-priority finance could reasonably be expected to enhance the value of the enterprise as a whole and, thus, returns to all creditors.

\textsuperscript{216} IS 2000, pp. 33–5. \textsuperscript{217} Ibid., pp. 33–4. \textsuperscript{218} Ibid., p. 35.
The position of each individual creditor would be protected and their expected return would be at least the same as if the finance were not provided.

The courts would need to be given significant discretion and the criteria to be satisfied before super-priority finance was granted would need to be demanding. Practice would no doubt evolve over time regarding the operation of such provisions.

Secured creditors would need to be given appropriate influence over the selection or confirmation of the insolvency practitioner.219

In such a regime there is an attempt to ensure that a proper judgement is made about the prospects of viability.220 Concerns that super-priority funders will not assess viability on a proper basis are addressed by making the court or tribunal the arbiter on such matters. It is essential, accordingly, that a properly resourced and skilled system of courts or tribunals be established and that these incorporate appropriate insolvency expertise.221 It might be objected that such judgements will not be located in a commercial or market context but, in response, the Insolvency Service’s suggestion is that an option might be to have ‘a system of expert tribunals with a strong commercial flavour dealing with cases on a day to day basis and to focus on the role of the higher courts as resolving disputes as to the application of the law and reviewing the procedures followed by the expert tribunal’.222

Despite the Insolvency Service considering that there was a case for such an approach to super-priority funding in 2000, the Government declined, two years later, to accept an amendment to the Enterprise Bill that would have created a statutory framework for super-priority financing during administration and which its proponent suggested was essential if administration was to operate as an effective rescue tool.223 The Government took the view that the decision to lend in times of trouble was best left to the commercial judgement of the market and that it would be wrong to offer a guaranteed return to a super-priority investor whether or not the rescue proposals had satisfied

219 Ibid., p. 35.
220 On the US position see e.g. M. White, ‘Does Chapter 11 Save Economically Inefficient Firms?’ (1994) 72 Wash. ULQ 1319.
221 A point made in IS 2000, p. 35, para. 137. 222 Ibid.
the market. Such views were taken against a background of confidence that the market would meet the financing requirements of troubled companies on appropriate terms. Here consideration was given to the growth of asset financing, factoring and discounting and the increasing orientation of these financing systems towards rescue.

A potential route to super-priority funding is, however, provided by the Insolvency Act 1986 section 19(5) and Schedule B1, paragraph 99. These provisions cover debts incurred under contracts entered into by the administrator, in the carrying out of his functions. Such debts are given a priority ranking above that of the administrator’s statutory charge for his own remuneration and expenses (which, in turn, rank above a floating charge in priority of payment from the corporate estate). McCormack has argued that the words of paragraph 99 ‘seem sufficiently broad to encompass liabilities under loan contracts entered into by the administrator on behalf of the company’. The High Court has also considered the matter. In Bibby Trade Finance Ltd v. McKay a financier had provided funds to administrators in order

224 For a comment on the ‘regrettable’ failure to provide for super-priority funding see A. McKnight, ‘The Reform of Corporate Insolvency Law in Great Britain – the Enterprise Bill 2002’ (2002) 17 JIBL 324 at 333.


226 Ibid. See also the discussion concerning IA 1986 s. 19 at pp. 373–5 above.

227 Contracts entered into before the administration will not enjoy the priority of those entered into by the administrator in carrying out his functions: see Freakley v. Centre Reinsurance International Co. [2006] BCC 971.

228 See Sch. B1, para. 99(3), which provides for payment of a ‘former administrator’s remuneration and expenses’ out of assets in the custody or control of the administrator in priority to any charge which, as created, was a floating charge. Para. 99(4)–(6) gives ‘super-priority’ to debts or liabilities arising out of contracts entered into by the administrators and (regarding ‘qualifying liabilities’) to debts and liabilities under adopted employment contracts. In Re Trident Fashions plc [2006] All ER 140 the Court of Appeal accepted that an expense payable pursuant to rule 2.67 (introduced by the Insolvency (Amendment) Rules 2005 (SI 2005/527)) was actionable by the expense creditor against administrators who had drawn remuneration in priority to such an expense. See further Lightman and Moss, Law of Administrators, pp. 134–45; and p. 417 below.


230 [2006] All ER 266. See A. Bacon, ‘Administration Costs: Some Welcome News’ (2007) 20 Insolvency Intelligence 1. In Freakley v Centre Reinsurance International Co. [2006] BCC 971 the House of Lords stated that the power to decide what expenditure was necessary for the purposes of the administration, and which should therefore receive priority, rested with the administrator (subject to the supervision of the court). Lord Hoffmann indicated that it would be unusual for the courts to interfere with the business judgement of the administrator on such matters.
to allow the completion of a single profitable order. On completion of the order the administrators deducted the advances prior to accounting for the proceeds – on the basis that the liabilities from the administrators to the financier were expenses of the administration. The directors of the company (who had guaranteed the company’s indebtedness to the financier) challenged these deductions, arguing that the sums paid to the financier by the administrators were paid on behalf of the company and should reduce their liabilities to the financier. The court rejected the directors’ contentions, saying that their proposed course would give them a windfall at the expense of unsecured creditors. What was accepted, though, was that the administrators’ liability to the financier was a legitimate administration expense.231

The significance of the Bibby case lies in its demonstrating that the English courts are capable of authorising super-priority funding without there being any need for new legislation.232 If Bibby is followed, this may herald the arrival of a system in which new funds can be raised as an administration expense under super-priority arrangements. It remains to be seen whether, in the future, the courts will further develop such a regime so as to require that administrators seek the consent of different creditors to such arrangements.

Rethinking charges on book debts

In continuing the discussion of funding arrangements as the underpinnings of effective rescue procedures, it is necessary to deal with the issue of book debts. Book debts are sums outstanding and owed to the troubled company and, during a rescue procedure, book debts are often the only funds that are available for the purposes of financing continuing operations through the rescue period. Between 1978 and 2005 many lenders

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231 In the case of Re Huddersfield Fine Worsted Ltd [2005] 4 All ER 886 the Court of Appeal stated that protective awards under the Trade Unions Labour Relations (Consolidation) Act 1992 and payments in lieu of notice did not enjoy super-priority since they did not fall within Sch. B1, para. 99(5) and (6). A similar decision regarding claims for wrongful dismissal subsequent to the adoption of a contract of employment by the administrator was made in Re Leeds United Association Football Club Ltd (in administration) [2008] BCC 11. See pp. 415–16 and ch. 17 below.

232 As Bacon observes, the decision shows ‘a continued commitment by the courts to the rescue culture and a realistic attitude to striving to ensure that professionals involved in corporate recovery are dealt with even-handedly’: ‘Administration Costs’, p. 4. See, however, D. Fletcher, ‘Time for a DIP?’ (2007) Recovery (Summer) 30, who cautions (at p. 30) that it cannot be assumed that the courts will follow the Bibby judgment in cases where the primary issue is whether DIP funding can be classed as an administration expense. (In Bibby the judgment focused on interpretation of the wording contained in a Tomlin Order.)
sought to secure their loans by way of fixed charges over the borrowing company’s book debts. The decision of the House of Lords in the *Spectrum Plus* case, however, changed matters. *Spectrum Plus* overruled the decision in *Siebe Gorman* and held that the company charges over present and future book debts that were modelled on the form used in *Siebe Gorman* were floating in spite of their being designated on their face as fixed. In *Spectrum Plus* there was a charge describing itself as fixed; a covenant by the company to pay into its account with the bank all

233 If a bank is deemed to possess a floating charge over the book debt proceeds, it will rank behind preferential creditors; if the charge is deemed fixed, the charge holder will precede the preferential creditors in the queue for repayment – the distinction between fixed and floating charges is thus of practical importance.


235 *Siebe Gorman & Co. Ltd v. Barclays Bank Ltd* [1979] 2 Lloyd’s Reports 142. After *Siebe* a fixed charge could cover future assets in a manner that, until the decision, had been considered the exclusive domain of the floating charge. According to *Siebe*, the creditor had to be able to prevent withdrawals from the account into which the proceeds of the book debts were paid but the cash flow implications of this position were not fully explored. In the wake of *Siebe* an extensive case law had sought to delineate the conditions under which fixed charges could be held over book debts and their proceeds and judges and commentators struggled to make clear the basis for designating book debt charges as fixed or floating; see, for example, *Re Brightlife Ltd* [1987] Ch 200; *Re Keenan Bros. Ltd* [1986] BCLC 242; *Re New Bullas Trading Ltd* [1993] BCC 251. For discussion see E. Ferran, *Company Law and Corporate Finance* (Oxford University Press, Oxford, 1999) pp. 518–33; Armstrong, “Return to First Principles”; Gregory and Walton, ‘Book Debt Charges: Following *Yorkshire Woolcombers*’; Gregory and Walton, ‘Book Debt Charges: The Saga Goes On’. The Cork Report had urged statutory reversal of *Siebe* in 1982: paras. 1585–6.

moneys that it might receive in respect of the charged book debts; an agreement not to sell, factor, charge or assign the charged debts without the bank’s written permission; and an undertaking, if called upon by the bank, to assign the charged book debts to the bank. The House of Lords had to decide whether the charge was a floating charge per section 175(2)(b) of the IA 1986 and ruled that the unrestricted right to draw on the account into which Spectrum was obliged to pay the proceeds of the book debts was inconsistent with there being a fixed charge over those debts. The debenture left the company free to use the proceeds of the book debts in the ordinary course of its business and that was the essence of a floating charge.237

What their lordships did not do was offer a clear set of details on the nature and degree of control that a chargee must possess over the charged assets in order for the charge to be categorised as a fixed charge. The hanging question is how, in the absence of practical guidance from the judges, it is now possible to create a fixed charge over book debts by setting up an arrangement in which the proceeds of book debts are not made available for use in the course of business – for example by providing that all such proceeds are to be paid into a ‘blocked’ account.238 The Lords did, however, take the view that what is of relevance in deciding whether a charge is fixed or floating is the substance and reality of the situation rather than the form of the transaction. Berg suggests that: ‘This is unsurprising since whether the chargee has control over the charged assets is a question of commercial reality not legal technicalities.’239 A residual problem is that there are considerable costs to certainty in commercial transactions if matters are decided with reference to the substance of the particular transactional

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237 Spectrum Plus, paras. 112, 138–40. The immediate practical result of the Spectrum decision was that IPs were able to distribute the book debt proceeds in an estimated 550 or more insolvency cases which had been held up in the system as a result of uncertainty following the earlier decision in Brumark [2001] All ER 21. HM Revenue and Customs and the Insolvency Service issued a joint statement in 2005 explaining their expectations regarding such distribution of book debt proceeds post-Spectrum.

238 As Marshall notes, it will be interesting to see whether the Spectrum decision adds anything to the debate, post-Brumark, regarding particular collection account arrangements in structured finance, project finance and securitisation transactions: J. Marshall, ‘Spectrum Plus: A Wasted Opportunity?’ (2005) Recovery (Summer) 30.

239 Berg, ‘Cuckoo in the Nest’, p. 32.
arrangement. On this matter, the Lords agreed with Lord Millett’s statement, in *Brumark*, that it was not enough to provide for blocking in the debenture if it was not in fact operated as a blocked account.

A more recent trend in English cases had, however, moved away from *Siebe Gorman* before *Spectrum Plus* was decided. The decision in *Re Atlantic Computer Systems plc* concerned a clause dealing with the assignment of leases. This provided for the assignee to have the benefit of all rentals and moneys under certain subleases but no provision was made concerning the application of the individual rent payments made under these subleases. The Court of Appeal ruled that there might have been an intention for Atlantic Computer Systems to be free to use the rent instalments until the assignee intervened, but this did not mean that the charge was floating rather than fixed. Nicholls LJ distinguished, however, between a charge on existing income-producing property (such as a lease) and a charge on present and future property (for example, a typical charge on present and future book debts). The decision has thus been criticised as an old-fashioned approach inconsistent with the modern view that what distinguishes fixed and floating charges is not the nature of the asset but the location of the power to manage and control its use. In the wake of *Spectrum Plus*, it can be argued that *Atlantic Computers* is no longer good law and that the arrangement in *Atlantic Computers* would now be likely to be viewed as one involving a floating charge as per *Spectrum Plus*. This view is reinforced by the first application of *Spectrum Plus* principles to assets other than book debts. In *Re Beam Tube Products* in 2006 a

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240 See Capper, ‘*Spectrum Plus* in the House of Lords’, p. 458 (speaking of ‘a dangerously schizophrenic approach to the categorisation of security interests’).


244 Ferran, *Company Law and Corporate Finance*, p. 525.


247 [2006] BCC 615.
debenture created purported fixed charges over (*inter alia*) all plant and machinery and all book and other debts and a floating charge over all assets not covered by fixed charges. With regard to the charge over the plant and machinery, the company was left free to deal with many of these items in the ordinary course of business. The court, accordingly, held that, in spite of the description of the charge as fixed, it was floating in nature. It, moreover, took an ‘all or nothing’ approach in saying that the fixed or floating nature of the charge related to all of the assets that it covered and that it could not be treated as fixed regarding some assets and floating regarding others.  

What is likely to be the effect of *Spectrum Plus*? In combination with the EA 2002 reforms, the effect on bank lenders is likely to be significant. The EA 2002 renders the floating charge less attractive since it removes the right of the holder to appoint a receiver and it reserves a prescribed part of funds for the benefit of unsecured creditors.  

*Spectrum*, in addition, reduces the availability of the fixed charge. It seems unlikely, therefore, that banks will react to *Spectrum* by taking floating charges to secure receivables financing or by imposing day-to-day controls over customers’ accounts so as to render charges ‘fixed’ within the terms of *Spectrum*. Reducing the availability of fixed charges over book debts may have the effect of increasing the fragmentation of credit as

248 See R3, *Technical Bulletin*, Issue 76, October 2006, para. 76.1. With regard to the charge over book debts, the court in *Beam* noted that recent authority had held that where the security documentation envisages a fixed charge over those debts and a floating charge over the proceeds of those debts, the fixed charge will be treated as a floating charge: consequently the present charge over the book and other debts was a floating one.

249 A fund in which floating charge holders cannot participate for any shortfall: see *Permacell Finesses Ltd (in liquidation)* [2008] BCC 208 and further Offord, ‘Case Digest’. See also *Re Airbase (UK) Ltd, Thorniley v. Revenue and Customs Commissioner* [2008] BCC 213 (Ch) and further Walters, ‘Statutory Redistribution of Floating Charge Assets’.

250 The *Spectrum* judgment does not rule out a lender’s being able to take a fixed charge over book debts. Their Lordships agreed that it was conceptually possible and gave examples of ways in which this could be achieved: by assigning the book debts to the security holder; by preventing all dealings with the debts other than their collection and requiring the proceeds to be paid to the chargee in reduction of the chargor’s debts; by preventing all dealings with the debts other than their collection and requiring the proceeds to be paid into an account with a third party over which the chargee takes a fixed charge; and by preventing all dealings with the debts other than their collection and requiring the proceeds to be paid into a blocked account with the chargee bank.

251 See Armour, ‘Should We Redistribute in Insolvency?’. As Armour notes, the effect of the decision is to make it far more difficult for banks to take fixed security over receivables without ‘micro-managing the debtor company’s dealings’ in those assets – a process which would be ‘likely to be uneconomic for banks’ (pp. 202, 203).
companies look to an increasingly wide variety of lenders and methods of raising money – and, notably, to asset-based finance arrangements such as invoice discounting or factoring.\(^\text{252}\) In terms of rescue, the fear (as noted in chapters 3 and 6) is that such arrangements do not lend themselves to turnarounds because creditor co-ordination costs and difficulties are increased and more obstacles are placed in the way of a successful rescue.\(^\text{253}\) Alternatively, lenders may take charges that are not QFCs but are fixed charges over certain of the company’s assets. The holder of such a charge is then placed to appoint a receiver should the need arise. Similarly, complex arrangements can be devised whereby lending is carried out through numbers of subsidiaries, each of which has a fixed charge over part of the company’s property but none of which has security over the whole or substantially the whole.\(^\text{254}\) The EA 2002, by encouraging these strategies, however, may be said not to further rescue objectives since it incentivises the selling off of parts of the company and may lead to piecemeal disintegration of the business.

Administrators’ expenses and rescue

The successful pursuit of a rescue requires that the administrator decides that it is appropriate to continue trading so as to produce a better return for creditors than would be likely in an immediate liquidation.\(^\text{255}\) This decision may turn in no little part, however, on how the law deals with debts owed to employees by virtue of employment legislation\(^\text{256}\) and on how priority is attached to the expenses of the administration.\(^\text{257}\)

The Insolvency Act 1986 Schedule B1 paragraph 99(4) and (5) provides that where the administrator adopts employees’ contracts, the

\(^{252}\) On techniques for lenders to avoid the controls of the EA 2002 see R. Stevens, ‘Security after the Enterprise Act’ in Getzler and Payne, Company Charges, at pp. 166–7.

\(^{253}\) See IS 1999. Lack of ‘creditor consensus’ may thus be an increasing problem: see Armstrong, “Return to First Principles”, p. 110. Armstrong argues, however, that he has seen ‘no empirical evidence to prove that increasing fragmentation of the small companies finance market frustrates rescue’: p. 111.

\(^{254}\) See Stevens, ‘Security After the Enterprise Act’.

\(^{255}\) IA 1986 Sch. B1, para. 3(1).

\(^{256}\) See pp. 372–5 above. For further discussion of employees in insolvency see ch. 17 below.

wages and salaries involved have ‘super-priority’ and are payable in advance of not merely the claims of floating charge holders and preferential creditors but also the expenses of the administration and even the administrator’s own remuneration. The rescue issue is, however, that if ‘wages and salary’ is interpreted broadly, this places the administrator in a very difficult position. The broad interpretation reduces the prospects of turnaround considerably by reducing the assets available to fund a rescue and, in order to limit such liabilities, the administrator may have to lay-off the very staff that are needed for realistic prospects of continued trading. The courts have considered these matters and sought to further rescue objectives. In *Re Allders Department Stores Ltd* the court held that redundancy or unfair dismissals payments were not ‘wages and salary’ enjoying priority under paragraph 99 since they arose from statute, not the contract of employment. Similarly in *Re Huddersfield Fine Worsted Ltd* it was held that protective payments under the Trade Union Labour Relations (Consolidation) Act 1992 were not payable in priority to administration expenses.

258 Administration expenses, as noted, are payable ahead of floating charge holders: IA 1986 Sch. B1, para. 99(3)(b). See the House of Lords’ decision in *Freakley v. Centre Reinsurance International Co.* [2006] BCC 971 – handling expenses incurred by insurers (who under the policy were entitled to handle insurance claims of the company in administration) did not have priority over administration expenses under the then s. 19(5) of the Insolvency Act 1986. Note that after the Enterprise Act 2002 there are new rules governing the fixing of the administrator’s remuneration. Insolvency Rule 2.106 provides for the fixing of the administrator’s remuneration on a percentage or time-spent basis by the creditors’ committee, by a meeting of creditors or by the court: see further Sims and Briggs, ‘Enterprise Act 2002 – Corporate Wrinkles’, p. 52. Note also that after the Enterprise Act 2002 removed Crown preference the Treasury changed the rules so that when a company goes into administration, its existing accounting period comes to an end and a new one starts. Consequently any corporation tax chargeable on the profits earned in the administration becomes an expense of the administration as opposed to an unsecured claim: see generally B. Walsh and S. Martins, ‘Tax in Enterprise Act Administrations: Some Practical Issues’ (2008) 21 *Insolvency Intelligence* 103.


261 [2005] 4 All ER 886, [2005] BCC 915. See similarly *Leeds United AFC Ltd* [2008] BCC 11: damages for wrongful dismissal would not be covered by para. 99 and would not be payable ahead of the other expenses of the administration. Pumfrey J further deemed that liabilities for wrongful dismissal would not count as necessary disbursements for the purpose of r. 2.67(1)(f) of the Insolvency Rules 1986 so as to rank in priority to the ordinary creditors.
Less conducive to rescue, however, is the effect of the new version of rule 2.67 that is set out in the Insolvency (Amendment) Rules 2005.\(^{262}\) In the *Exeter City (Trident)* case\(^ {263}\) it was held that non-domestic rates were necessary disbursements within rule 2.67(1)(f) and paragraph 99(3). This ruling followed the liquidation expenses rule set out by the House of Lords in *Toshoku*\(^ {264}\) but *Exeter City (Trident)* is not rescue friendly since, by giving priority to non-domestic rates for the period of the administration, funds available for continued trading are reduced. Gabriel Moss QC has dubbed *Exeter City (Trident)* ‘a potential disaster’ and commented: ‘This could make an administration insolvent from day one if there are a large number of leasehold retail premises incurring new liabilities for rates.’\(^ {265}\) David Richards J said in *Exeter City (Trident)* that his conclusion was arrived at in spite of the overall policy of promoting a rescue culture and stood in the face of evidence that the effect of the decision would be detrimental to successful administrations. He suggested that the legislators had subordinated the policy of rescue to the desire to give priority to the payment of rates.\(^ {266}\)

Some relief from the effects of *Exeter City (Trident)* was offered in 2008 when the Department for Communities and Local Government promulgated new regulations to exempt companies in administration from liability for unoccupied property rates.\(^ {267}\) This followed lobbying from R3 who argued that, in view of *Exeter City (Trident)*, companies in administration should have the same exemption from empty property rates as companies in liquidation. This reform, accordingly, renders empty property rates neutral regarding decisions about whether to enter administration or liquidation.

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\(^ {265}\) See Moss, ‘Rescue Culture Speared by *Trident*’, p. 75.  
\(^ {266}\) *Exeter City Council v. Bairstow and Others, Re Trident Fashions plc* [2007] BCC 236, para. 8.  
The case for cram-down and supervised restructuring

At this point it is relevant to consider an argument that the new administration procedure is, in reality, old hat: that it addresses an outdated set of challenges; that it does not provide the rescue procedure that modern restructurings really require; and that there is a need to move to a regime of cram-down and court supervision. This argument has been put forward strongly by the European High Yield Association (EHYA), an association representing participants in the European high yield bond markets. The EHYA contends that, against a background of huge growth in the leveraged lending market, most restructurings occur outside formal procedures and administrations will have only limited use in coming years because use of a formal procedure is seen as reflecting corporate failure; the ability of suppliers and customers to abandon contracts frustrates purposes and destroys value; and funding difficulties often impair trading through the proceedings. The EHYA suggests, furthermore, that the out-of-court debt restructuring processes that can now be used will face increasing challenges due to the growing complexities of capital structures, the dispersion of debt and the multiplicity of parties generally involved with troubled companies:

Stakeholders approach each restructuring with their own agenda and strategy, often looking for positions of control and influence to gain leverage, not always seeking common ground and consensus. The absence of a predictable, supervised restructuring process creates a considerable layer of uncertainty, increases costs and can alter the economics of a deal.

What is needed, the EHYA argues, is a court-supervised restructuring process that includes a stay on enforcement actions, including a ban on the exercise of contract termination provisions by suppliers and customers (as found in the USA and France); judicial resolution of valuation disputes; and a system of cram-down to prevent those without an


269 The EHYA acknowledged that the informality of such actions means that statistics on numbers of restructurings are not available.

270 On such tensions in informal rescues and reconstructions see ch. 7 above.

economic interest (the ‘out of the money’ parties) from frustrating the proceedings. The effect would, *inter alia*, be that when a company is in administration, the power of customers and suppliers would be curbed and there would be no vetoing of a restructuring plan by those shareholders and creditors who no longer have economic interests in the company (because available company funds do not allow them a return). The EHYA’s stated intention is to streamline the claims of ‘financial stakeholders’ (i.e. ‘structural investor debt’ and shareholder claims) as opposed to ‘trade’ creditors ‘whose claims arise out of the day to day operations of the business’. There is no advocacy of a cram-down applicable to trade creditors.

Excluding the ‘out of the money’ parties from the restructuring process is a contentious point but one on which the EHYA takes a firm line: ‘As a policy matter, we do not consider that creditors or shareholders with no economic interest in the enterprise (on a proper valuation basis) should be in a position where their “veto” forces full insolvency proceedings.’ The *quid pro quo* for removing the veto of the ‘out of the money’ parties is the proposed system of judicial supervision.

In support of the proposal, it can be said that the 1986 Insolvency Act, as amended, already allows the administrator to avoid calling a creditors’ meeting if there is no prospect of a return to unsecured creditors. The administrator, moreover, has a general duty to act in the interests of all creditors of the company. As for shareholders, it can be said that the dispersion of equity which the ‘new capitalism’ involves means that, for practical purposes, many holders of equity interests will be unable to participate in a restructuring to rescue-essential, tight timescales in any

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272 Note that the Insolvency Act 1986 s. 233 already prohibits utility suppliers (for gas, electricity, water and communication services) from cutting off connections unless, for example, arrears are paid. The supplier may require the administrator (or ‘office holder’) to undertake personal responsibility for payment for any new supply but may not make the provision of a new supply conditional on receiving payment or security for the old.


274 Ibid., p. 5. No weakening of protections for employees is envisioned by the EHYA: see p. 6.

275 Under Sch. B1, para. 52(1)(b) the administrator is not obliged to call an initial creditors’ meeting (under para. 51(1)) if he thinks that the company lacks the property to make a distribution to unsecured creditors other than the prescribed part under IA 1986 s. 176A(2)(a). Creditors holding over 10 per cent of total debts can, nevertheless, call for a creditors’ meeting under Sch. B1, para. 52(2)(a).

276 See ch. 3 above, pp. 133–40.
event. If, moreover, their holdings have no economic value, the EHYA argument that they have no economic interest carries some weight.

The difficulties with the proposals, however, are not trivial. The EHYA anticipates that the suggested court-supervised restructurings would be effected by either a scheme of arrangement or a Company Voluntary Arrangement (CVA) procedure and would involve a court-appointed ‘monitor’ to prevent improper use of the stay and reporting back to the court. Some observers, however, fear that resort to a court-run procedure would see the UK rescue regime descend into bitter litigation and delays: ‘[B]y pushing so much of the UK’s insolvency and restructuring process into the courts these proposals could lead us into the mire of expensive litigation that US companies are now so keen to escape. Insolvencies will change from being relatively quick and pragmatic into huge set piece multi-party litigation of the kind that exists in the US.’

A central worry about the EHYA proposals is that the cram-down rules would turn on drawing a distinction between ‘in the money’ and ‘out of the money’ parties. This distinction might well raise difficult issues and precipitate the complex and economically technical litigation that would undermine the speedy route to rescue that the EHYA desires. In a world of highly structured, complex debt – in which creditors increasingly hold bundles of debts of quite different kinds – it might prove more and more difficult to identify the parties that are ‘out of the money’ and much might depend on debatable assumptions and contentious modes of calculation. All of this could fuel litigation.

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277 See V. Finch, ‘Corporate Rescue in a World of Debt’ [2008] 8 JBL 756, 773–6. See also the concerns expressed by the Insolvency Service in concluding that there was not sufficient evidence to show that the UK needed the EHYA proposed procedure (IS letter to the Managing Director, EHYA, 8 May 2008, reproduced on IS website: www.insolvency.gov.uk). The IS expressed particular concerns about: retaining managers in place when there might have been mismanagement or fraud; dangers that shareholder challenges and ‘legal wrangles’ would delay restructurings; the likelihood that, where potential overridings of rights were anticipated, this would distort commercial arrangements; the possibility that the EHYA regime would stimulate a move towards more use of fixed charges and/or higher interest rates, with possible shorter call periods – all of which could deter investment in UK enterprises. A further IS worry was that an automatic stay outside insolvency would give an unfair advantage to a company in temporary difficulty compared to its competitors. The IS suggested that the proposed EHYA regime did not offer much that was unavailable under administration.

As for shareholders, it could be argued that they would often be inclined to contest both their being condemned to the ranks of the ‘out of the money’ and the company’s grounds for going to court because it (in the EHYA phrase) ‘believes there is a real prospect of it becoming unable to pay its financial debts’. The EHYA put forward its reforms as a way to cut down on the uncertainties associated with the current judicial position on shareholder approvals but many may fear that, given the issues involved in judicial supervision, significant uncertainties may be generated within their own proposed regime.

The EHYA’s critics, moreover, may fear that the proposed scheme will operate as a procedure that allows the hedge funds and other economically powerful operators to secure court approval for essentially pre-packaged deals and approaches to valuation that favour their own interests and make it difficult for less well-positioned, less well-resourced and less fleet-footed creditors to challenge the settlements put to the court. The critics might contrast the proposed regime with the post-Enterprise Act administration procedure and its emphasis on the administrator’s duty to act in the interests of all creditors. The big difference, they might say, would be that less powerful creditors will find it far more difficult to secure protection of their own interests in a court-driven procedure than in one that relies on the administrator to produce a set of proposals that reflects the interests of all of the company’s creditors.

As for the proposal to apply a stay so as to prevent customers and suppliers from enforcing contractual terminations triggered by insolvency, the likely objection is that this element of the EHYA system involves shifting risks to unsecured creditors by removing their ability to adjust their positions in the light of the company’s troubles – that more risk is being loaded onto those parties who are least able to evaluate or handle that risk and most vulnerable to financial shocks. There may be concerns that this is not only unfair but that it undermines the

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279 See the cases of Marconi, British Energy and My Travel as discussed in EHYA, Submission on Insolvency Law Reform (2007), p. 5.

280 In the EHYA scheme, the company would submit its own valuation evidence with the draft scheme documents to support any proposed cram-down, debt to equity swap or other division of the value of the company.

281 In administration procedure it is the administrator, not the court, who will exclude the ‘out of the money’ parties within the terms of Sch. B1, para. 52(1)(b) – by not calling a creditors’ meeting where he believes that funds will not allow a distribution to unsecured creditors.
value of contracts and may impede the general efficiency of business operations by making suppliers and customers less confident in dealing with possibly troubled companies.\textsuperscript{282} In the EHYA world, it could be cautioned, customers and suppliers will face higher business costs since they will feel the need to expend more resources than at present on checking the viability of companies that they enter into business relationships with.

Equity conversions

A more radical and ‘market’ approach to the design of a cost-effective rescue regime is the proposal put forward by Aghion, Hart and Moore.\textsuperscript{283} In the suggested procedure, the administrator would convert the company into an all-equity firm and allocate rights to this equity among the former claim holders in exchange for their former claims. Senior creditors would be given equity, junior creditors and former shareholders would be given options to buy equity; the IP would invite bids for all or part of the ‘new’ firm. Non-cash bids might include proposals to reorganise the firm as a going concern and to take on new debts. These two tasks would be completed within a specified time, say within three months, and then junior creditors and former shareholders would decide whether to exercise their options. Following this stage, the new shareholders would vote on which bid to select and the firm would exit from insolvency. Junior creditors would thus be required to buy out senior creditors before they receive anything.

Aghion, Hart and Moore aim to offer a regime that is quick, cheap and leaves minimal discretion in the hands of the judiciary and experts. Their main goal is the Jacksonian one of maximising the total value of the proceeds (measured in money terms) that are received by existing claimants. The main perceived evils countered are, first, the danger that senior creditors will vote for liquidation when this serves their interests

\textsuperscript{282} See the concerns expressed by the Insolvency Service in concluding that there was not ‘sufficient evidence to show that the UK needs [the EHYA] procedure’: IS letter of 8 May 2008 to the Managing Director of the EHYA (reproduced on the IS website, www.insolvency.gov.uk). The IS expressed particular concerns which have been noted above: see p. 420, n. 277. In the autumn of 2008 discussions between the IS and the EHYA were still ongoing, however.

but is not in the general interest of affected parties and, second, the
tendency of the administrator when exercising discretion to be involved
in inefficient and time-consuming bargaining in an attempt both to
secure agreement on taking a firm forward and to decide how to dis-
tribute the resulting cash or securities.\textsuperscript{284}

The regime’s proponents point to a number of its supposed
strengths.\textsuperscript{285} First, conversion to equity gives the main creditor (‘the
bank’) a stake in the recovery of its debt (assumed to be secured by a
floating charge) but also an interest in equity value increases beyond that
point. This reduces the bank’s incentive to enforce its debt prematurely
when it is probable that waiting would increase returns or rescue pro-
spects. The bank also has an incentive to sell the company for as much as
possible, rather than for merely enough to satisfy its security. Second, the
banks in general may end up holding equity more often than at present
and this may have a desirable effect on their propensity to appraise and
monitor corporate debtor performance. Third, the system overcomes the
fast-increasing problems that administrators face in attempting to
negotiate resolutions of problems when different creditor groups have
divergent interests. Fourth, the regime avoids the voting distortions that
present administration arrangements may produce when junior cred-
itors are placed in a position where they can, without justification, block
plans and extract more money than they are allowed under priority.
Finally, the system reduces the need for a moratorium because it allows
the companies with good prospects to be saved within either adminis-
tration or receivership.

A number of objections to the scheme and a number of potential
difficulties can, however, be identified.\textsuperscript{286} In the first instance, some
confusion surrounds the issue of entitlement to instigate the equity
conversion, with critics noting that a single unsecured creditor might
be able to trigger the process irrespective of the amount owed and
questioning whether a small unsecured creditor would have the right to

\textsuperscript{284} The Enterprise Act’s removal of the floating charge holder’s right to appoint an
administrative receiver to some extent reduces dangers of precipitate and self-interested
actions by floating charge holders but the administrator’s duty to act in the interest of all
creditors does not remove the \textit{practical} power of the large creditor: see pp. 428–9 below.

\textsuperscript{285} See P. Aghion, O. Hart and J. Moore, ‘Insolvency Reform in the UK: A Revised
Proposal’, Special Paper No. 65 (LSE Financial Markets Group, January 1995) and in

\textsuperscript{286} For criticism see Brown, \textit{Corporate Rescue}, pp. 680–4.
displace an administrative receiver or an administrator appointed by the court.²⁸⁷

It can also be objected that if the procedure is not made compulsory it will add little to present procedures. In many schemes of arrangement, formal and informal, there is an element of debt/equity conversion and shareholders or junior creditors can always ‘buy out’ senior creditors: for example, by managerial buyouts of the business.²⁸⁸ The position of the unsecured creditor in the scheme also gives ground for concern. Such creditors will only retain the right to claim outstanding debts if they exercise options to buy shares in the company by a specified date. All the equity in the scheme is, after all, given to the holder of the floating charge and unsecured creditors have to purchase their equity. This has been called a ‘fundamental injustice’ as it requires a group of creditors who have lost money to put up further funds to keep their debt alive.²⁸⁹ Junior creditors may also be placed in a difficult position if they find it difficult to sell their options and, if these lapse, the effect will be to leave the senior creditors with all the equity.²⁹⁰ The conversion proposal can indeed be seen as allowing floating charge holders to exploit their superior resourcing, information and bargaining positions in a manner that worsens the predicament of unsecured creditors. This is liable to be the case since the very factors that lead to the granting of unsecured loans will produce poor positioning to effect purchases of equity options, notably: informal modes of business operation; lack of familiarity with legal structuring in commercial relations; modest levels of staffing operations; and modes of business operation involving large numbers of small, fast-moving transactions and players. Of all creditors, the unsecured creditors are least likely to be able to put their hands on cash at short notice in order to purchase equity shares. As a result of their poor positioning, unsecured creditors will tend to be worse off within an equity conversion scheme than under many alternative arrangements. As is to be expected with proposals based on economic efficiency-seeking, there is a neglect of

²⁸⁸ Brown, Corporate Rescue, p. 680, who concedes that Aghion, Hart and Moore acknowledge this point in ‘Insolvency Reform in the UK’, at p. 70. On schemes of arrangement see ch 12 below.
²⁹⁰ Brown, Corporate Rescue, p. 680.
distributional justice issues and an inbuilt bias in favour of giving more to those who already have. Those who already have tend, after all, to be the parties who are best placed to make use of the opportunities on the table.

The deadlines involved in the conversion proposal only exacerbate the position of the unsecured creditor. Tight time limits are involved and options have to be exercised before the IP’s plan is placed before the shareholders’ meeting. As has been commented: ‘At this stage it is unlikely that such creditors would have sufficient information to make an informed decision about the survival prospects of the company and exercising options could amount to throwing good money after bad.’

From the point of view of the strongest players – the banks with the floating charges – the position is, in contrast, rosy. The conversion process allows the bank to commence formal proceedings, trigger the conversion procedure and force the unsecured creditors to buy them out or else give up all their claims.

As for the hope that an equity conversion scheme will keep transaction costs, and particularly legal costs, low, this may not be achievable in practice. There is the potential for much litigation and the need for a good deal of court supervision within the scheme in relation to issues of asset valuation, protections against abuse, control of the process and bias; the acceptability of the decisions of the IP; whether ‘urgency procedures’ can be used to meet deadlines; and the discretion exercised by the IPs. Administrators, in particular, may be placed in a difficult position if they are seeking bids for the company and, at the same time, assisting junior creditors to dispose of their options. As one commentator has cautioned: ‘Widespread adoption of this procedure will generate new forms of potential duties and liabilities as administrators.’

The difficulty, in short, is that without legal oversight and controls, the very considerable discretions exercisable by IPs are open to abuse and liable to prompt many disputes in court. If, on the other hand, a high level of court supervision is involved, the scheme loses one of its heralded virtues. On the question of asset valuation, there are particular difficulties. The scheme’s proponents suggest that disputes can be avoided by incorporating (in relation to fixed charges at least) ‘forced sale’ valuations by professional firms. Here there is a huge potential for fee paying, expense, litigation and delay. It is by no means the case, moreover, that

293 Brown, Corporate Rescue, p. 680.
a company’s assets and liabilities can be ascertained quickly and easily.\textsuperscript{294} Such calculations may be lengthy, fraught and highly contentious. Nor can such uncertainties be dealt with easily by Aghion, Hart and Moore’s suggestion that disputes can be set aside and dealt with once the company has come out of insolvency. The existence of a body of contested claims will constitute, apart from anything else, a cloud of uncertainty that will hang over unsecured creditors’ decisions on whether to exercise options and, as has been pointed out, such creditors may ‘invest money to keep claims alive only to discover later that their equity holding is worth far less than they had calculated because of the existence of deferred claims’.\textsuperscript{295} In sum, the equity conversion scheme has as its major probable effect the improvement of the position of banks at the expense of unsecured creditors. Nor is the deterioration of the unsecured creditors’ position unconnected with the public interest in general. Commercial life depends to a large extent on the efficient giving of unsecured credit. In so far as unsecured creditors face large risks due to uncertain processes they will tend to resort to quasi-security devices and withdrawals of credit (demanding payment on the spot). Such a tendency will hinder rather than lubricate the wheels of commerce.

\textit{Expertise}

Can the new administration procedure be said to constitute a regime that allows expert judgements to be brought to bear on turnaround? A first issue on these fronts is whether the procedure conduces to the generation and use of the information that is needed to make expert and well-founded judgements.\textsuperscript{296} From the administrator’s point of view, the need for information is urgent. He must present proposals to creditors within eight weeks of his appointment.\textsuperscript{297} He must also commence a creditors’ meeting within ten weeks of the administration’s start.\textsuperscript{298}

\textsuperscript{295} Campbell, ‘Equity for Debt Proposal’, p. 17.
\textsuperscript{296} This section builds on V. Finch, ‘Control and Co-ordination in Corporate Rescue’ (2005) 25 Legal Studies 374.
\textsuperscript{297} Para. 49(5)(b).
\textsuperscript{298} Para. 51(2). (Unless the administrator thinks (a) creditors will be paid in full; (b) there is insufficient property to make a distribution to unsecured creditors; or (c) the company cannot be rescued as a going concern or a better result for the company’s creditors as a whole than would be likely on a winding up cannot be achieved: para. 52(1).)
Administrators will have considerable knowledge of the laws and processes relevant to rescue but they are unlikely to have detailed understandings of the company and its operations. On such matters, the existing management constitutes the major reservoir of relevant information and the administrator will need to use the resources that are represented by existing directors and employees.\(^{299}\)

Co-ordination between directors and the IP is essential if information is to flow and, at this point, it is useful to consider the various factors that are likely to affect the degree to which the participants in administration will co-ordinate on the generation and use of information. A first issue is commitment to the rescue enterprise and the incentives of different actors to co-operate in the pursuit of rescue. This is likely to be affected, in turn, by perceptions of personal, corporate or other gains but also by perceptions of, and confidence concerning, other actors’ incentives. Where interests are seen as divergent, this will undermine co-operation but so will uncertainty about motives and the alignment of interests. Directors, moreover, may possess personal incentives to control the flow of information into the rescue process. Directors who want to prolong their employment at a company – for example while they seek new job opportunities – will be disinclined to precipitate action by the administrator by laying all their informational cards on the table. Instead they may seek to preserve uncertainty about the company’s position and future prospects so that the decision-maker is induced to delay taking decisions.\(^{300}\)

It is arguable that the EA 2002 reforms will increase directorial incentives to stay on during the rescue process because the directors will recognise that IPs have rescue, and the interests of all creditors, in mind, rather than a predisposition simply to act rapidly to realise returns for the floating charge holder – as in the ‘old’ system of administrative receivership. Directors here may be conscious of the IP’s Schedule B1,

\(^{299}\) See Phillips and Goldring, ‘Rescue and Reconstruction’, pp. 75, 78.

\(^{300}\) See D. Baird and E. Morrison, ‘Bankruptcy Decision Making’ (2001) Journal of Law, Economics and Organization 356, 369. It may be, of course, that if directors are considering appointing an administrator, they might also consider, and discuss with an IP, whether the IP would consent to their continued management of aspects of the business under Sch. B1, para. 64. (The administrator may leave some functions in the directors’ hands but, in doing so, cannot absolve himself from his own responsibilities.) The appointment of an administrator has the effect of making the directors’ powers exercisable only with the administrator’s consent in so far as they might ‘interfere with the exercise of the administrator’s powers’ (para. 64(2)(a)) and the administrator has the power to appoint or remove directors under para. 61.
paragraph 3(1)(a) primary obligation to rescue the company as a going concern. Against such arguments, however, it might be contended that the process established by the EA may prove unpalatable to directors and that the EA’s emphasis on recognising the voices and interests of all creditors ‘may result in battle-weary key management figures who resign’.\(^{301}\) It is also the case that in many instances of corporate distress the incumbent directors are ousted as a result of pressure from banks or shareholders and so they are removed from the scene and do not constitute providers of ongoing information.\(^{302}\)

It might also be contended that directors will often be highly uncertain about the motivations of the administrator in the post-EA regime. Directors may think that the main incentive for an administrator will, in reality, be to keep the banks happy rather than to pursue rescue. Such perceptions will be encouraged on reflecting that IPs are repeat players in insolvency work, that they will depend on banks for most of their current and future business, and that the banks’ powers to appoint administrators of choice\(^{303}\) will lead to ongoing relationships between IPs and the banks. As has been commented, moreover, administrators will rely on the provision of funds when negotiating rescue and the secured lenders, the banks, will be the usual providers of funds. These banks will be very concerned that the administrator’s proposals meet their approval: ‘there is no legislation that can address the economic facts of life: he who pays the piper will call the tune’.\(^{304}\) As discussed above, the EA did not

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\(^{302}\) In Gilson’s study of US firms only 46 per cent of incumbent directors were in place when the firms emerged from bankruptcy or settled privately with creditors two years later and in 8 per cent of cases the whole board was replaced: see S. Gilson, ‘Bankruptcy, Boards, Banks and Blockholders’ (1990) \textit{27 Journal of Financial Economics} 355. It may well be, of course, that in DIP regimes a higher turnover of directors is to be expected than in PIP regimes since the banks will be more concerned about directorial quality in regimes that leave directors in power rather than give control to a professional. On reasons for directorial departure in US firms see S. Gilson, ‘Management Turnover and Financial Distress’ (1989) \textit{25 Journal of Financial Economics} 241, 271–81 (suggesting that bank-lenders frequently institute managerial changes). For a discussion of poor performance as a driver of board change see J. Warner, R. Watts, K. Wruck \textit{et al.}, ‘Stock Prices and Top Management Changes’ (1988) \textit{Journal of Financial Economics} 461. See also ch. 6 above.

\(^{303}\) Holders of qualifying floating charges (QFCs) can appoint administrators out of court. If other eligible parties intend to make such appointments they must give notice to qualifying floating charge holders (QFCHs) (para. 26(2)) which allows QFCHs to appoint their own choice of administrator: see further Davies, \textit{Insolvency and the Enterprise Act 2002}, pp. 164–5.

introduce super-priority funding for any rescue initiative and, in the absence of super-priority, banks advancing rescue funds are liable to prove extremely highly motivated to negotiate the rescue plans that protect their own interests. If directors are conscious of such potential biases, they may be restrained in their commitments to assist the administrator.

A second factor that may affect co-ordination on the generation and use of information is the size and urgency of the challenge faced. This will be greater where participants in a potential rescue are large in number, divergent in character, outlook and interest and are widely dispersed. Further co-ordination difficulties arise when business challenges have to be responded to according to tight schedules.

A third, and related, issue is communication. In order to derive assurance about other actors’ intentions, each participant in a rescue operation will have to trust disclosures made about those intentions and will also have to understand these. Here there may be a set of communications difficulties that flow from the various systems within which the different actors attribute meanings to communications. Directors, banks and administrators, for instance, see the world differently from each other and are engaged in very different endeavours. Some directors, for instance, may see rescues in terms of protecting employment whereas banks may tend to see protection of corporate assets as a priority and administrators will focus strongly on their statutory objective to protect the interests of creditors as a whole. These actors possess different value frameworks and, accordingly, it is to be expected that frictions and distortions will infect communications. This means that insolvency regimes that involve multi-party systems of collecting information, devising strategies or implementing those strategies run serious risks that confusions, delays and uncertainties will arise during these processes – that is the downside of the inclusive processes set up by the EA 2002. Such communication difficulties, moreover, will affect not


306 For a discussion of the problems of dual decision-making (where authority in insolvency is shared) see Hahn, ‘Concentrated Ownership’, pp. 152–4.
merely the propensities of different parties to commit to co-operation but also their *ability* to co-operate where they share a desire to co-operate – even the best-motivated choir sounds poor if its members read their song sheets in different ways.

Other factors may aggravate communication difficulties, notably increases in numbers of participants and differences of outlook and character. Here the EA creates potential gains as well as difficulties. It calls on the administrator to pursue his/her functions ‘in the interest of the company’s creditors as a whole’.\(^\text{307}\) It gives the banks considerable procedural rights,\(^\text{308}\) obliges the administrator to disclose proposals,\(^\text{309}\) and gives any creditor or member of the company a power to challenge the administrator’s conduct.\(^\text{310}\) Such provisions seek to implement the White Paper vision of a more inclusive insolvency regime.\(^\text{311}\) On the one hand, this expands inputs and access into the regime and might be said to encourage the flow of information into the rescue process from a variety of sources. On the other, it might be cautioned that such multiple inputting is likely to lead to confusions and contests as different perspectives underpin the pursuit of various interests. The overall effect may be to reduce co-operation and free flows of information. Such a situation may be exacerbated by legal provisions, such as those in paragraph 3 of Schedule B1, which create a complex hierarchy of objectives in laying down the administrator’s obligations to serve a wide variety of creditors’ interests.\(^\text{312}\)

Will the dominant banks operate as ready suppliers of rescue-relevant information to administrators?\(^\text{313}\) It is arguable that the EA institutionalises the position of the floating charge holding bank as the primary source of information to the administrator about the company’s affairs and prospects. This is because all three routes into administration demand that the administrator makes a statement of the objectives intended to be pursued and formulates proposals within eight weeks of

\(^{307}\) Para. 3(2).


\(^{309}\) A statement of the proposals has to be sent to creditors within eight weeks of appointment of the administrator (IA 1986 Sch. B1, para. 49(5) and (6)) and an initial creditors’ meeting to consider them convened within ten weeks (para. 51(2)(b)).

\(^{310}\) See para. 74.

\(^{311}\) See Insolvency Service, *Insolvency – A Second Chance*.

\(^{312}\) See Frisby, ‘In Search of a Rescue Regime’.

\(^{313}\) On the governance role of banks at times of corporate distress see Gilson, ‘Bankruptcy, Boards, Banks and Blockholders’; Franken, ‘Creditor and Debtor Oriented Corporate Bankruptcy Regimes’. 
his or her appointment. The effect of these requirements will be that prospective administrators will have to be in possession of detailed information on nearly all aspects of the company and its business before they agree to act. They are likely, accordingly, to make it clear to the banks that they expect to be provided with such data on being approached and, thus advised, institutional lenders will routinely carry out independent business reviews whenever any of their debtor companies seems to be nearing financial difficulties. The banks will facilitate such reviews by making their loans conditional on the debtor company agreeing to supply information on request and to cooperate with any business review processes instituted by the bank.\[314] The banks are likely to possess a stock of valuable financial and operational information about many of their debtors\[315] but their inclination to use this for rescue purposes cannot be taken for granted. Here again the central issue is whether post-EA administration will operate as a reconstituted form of receivership or a genuinely rescue-orientated process.\[316] If banks use their strong positions with an eye to turning administration into receivership and the pursuit of bank rather than general creditor interests, it is to be expected that they will be little concerned to feed rescue-relevant information into the administration process.\[317] Administration, however, is not receivership and the interests of all creditors have to be taken into account.\[318] Where it is clear from the administrator’s proposals that rescue is being considered, the banks may well be concerned to inject


\[316\] See e.g. Willcock, ‘How the Banks Won the Battle’; but cf. Lord McIntosh of Haringey, HL Debates, 21 October 2002: col. 1101. The banks may even use the process as a route to winding up; see pp. 396–7 above and generally Keay, ‘What Future for Liquidation’; Linklater, ‘New Style Administration’; Insolvency Act 1986 Sch. B1, para. 83. Where banks are engaged in such use of the procedure they will seldom be inclined to supply rescue-relevant information.

\[317\] On whether events post-EA will be driven by ideas, interests or legally allocated rights see Finch, ‘Re-invigorating Corporate Rescue’.

\[318\] See para. 3(2).
information into the administration process – even if this is done in an effort to demonstrate the non-viability of a rescue option. The banks’ commitment to inform should not, however, be exaggerated. Banks may consider that post-EA they are not so strongly positioned as formerly to influence the IP’s actions and this may make them reserved participants in the rescue process. They may be happy to stay with entrenched and modest ways of monitoring their investments. They may, indeed, protect their investments by resorting to asset-based fixed securities rather than relying on gaining and deploying information.\textsuperscript{319} The EA, moreover, in ‘abolishing’ administrative receivership and curtailing the bank’s ability to deploy a rapid, self-interested enforcement tool may have reduced both the bank’s ability and its inclination to insist on very extensive ongoing supplies of information from the debtor company.\textsuperscript{320}

As for unsecured creditors, these are parties who might be expected to possess useful information about a company in some circumstances – for example when they are established trading partners of the enterprise. The hoped-for effect of the EA reforms was to encourage informational input (and corporate monitoring) by unsecured creditors since it promises them more receptivity for their views than was the case with receivership.\textsuperscript{321} Instances where unsecured creditors will be well informed about companies, well placed to participate in rescue processes and highly committed to such participation (for example, through extent of interest) may, however, be few and far between.\textsuperscript{322} Frisby’s research, moreover, suggests that there is ‘a lack of participation in the insolvency process by unsecured creditors’ with creditors’ meetings generally being very poorly attended.\textsuperscript{323}

Thus far the discussion has focused on information flows to the administrator but attention should also be paid to the information


\textsuperscript{321} See the administrator’s duty to consider the interests of creditors as a whole: para. 3(2). On the reception of creditors’ input in receivership see ch. 8 above; E. Ferran, ‘The Duties of an Administrative Receiver to Unsecured Creditors’ (1988) 9 Co. Law. 58.

\textsuperscript{322} Average returns to unsecured creditors may be so low post-administration that this may not conduce to high commitment: an R3 Survey of July 2004 revealed that unsecured creditors, on average, gained returns from ‘old’ administrations of 6.3 pence in the pound (5.4 pence from administrative receiverships).

\textsuperscript{323} Insolvency Service Evaluation, 2008, p. 115.
flows that involve other participants in rescue processes. The courts, for instance, have a role to play in the post-EA regime – one that may prove highly significant given the terms of the EA. It has been contended that if receivers were to owe duties to a wide range of parties, the judges would be liable to face considerable informational difficulties:

the information available to them about the specific facts of the decision is almost always likely to be less than that available to the decision-maker in question. Furthermore their decision must be made with hindsight. Actions which at the time of taking were known to be risky but justifiable in terms of expected benefits, can be seen [to be] unjustifiable with hindsight when a ‘bad’ outcome has materialised … [they] are likely to give receivers incentives to behave in too risk-averse a fashion, thus reducing the expected returns to all parties.324

The same points can be made about judicial scrutiny of the administrator’s actions in the post-EA regime. Overall, then, does the post-EA system contribute as well as might be desired to the supply and use of the information needed for expert judgements? The answer is that it leaves a large number of issues up in the air. The banks, for instance, may feel the need to secure good information flows from debtors in order to be able to brief administrators well and early but they may have doubts about their abilities to insist on this information and the use that the administrator will make of it. What, perhaps, can be said at this stage is that information use is unlikely to be enhanced by uncertainties within the system – for example, regarding the rigour with which the courts will oversee the administrator’s duty to serve all creditors’ interests.

Good information flows are essential to the application of expertise but attention should also be paid to the sources of expertise. On this point, it should be borne in mind that a given corporate rescue may involve a number of areas of specialisation or expertise. A distinction has already been drawn between expertise in insolvency procedures (the expected province of the IP) and expertise in business affairs. The latter expertise can, in turn, be disaggregated into expertise regarding such matters as: reorganisation strategies; finances; operations; marketing; product development and human resources. On such disaggregation it can be seen that across such areas there will be variations in the balance of expertise between the administrator, the directors of the troubled company and the major creditors (the banks). Within the post-EA regime expertise in reorganisation strategies and finances

324 Armour and Frisby, ‘Rethinking Receivership’, p. 100.
may be offered by the IP and the banks, who may not need to rely a
great deal on the input of directors regarding such matters. On human
resource or operational issues, however, it is likely that the existing
directors possess far greater firm-specific knowledge than the IP or the
banks. Herein lies a potential problem with the post-EA regime. It
relies on inclusive procedures and it attributes competences generally.
It gives final authority to the IP on all rescue-relevant issues rather than
allocating competences (or sharing these) according to anticipated
areas of expertise.

The inclusive processes established by the EA produce a further
danger: that expertise may be stifled. On this point it may be useful to
distinguish between three different scenarios for exercising expertise:
single authority; multiple authority; and inclusive. In single authority
systems there is a single dominant decision maker – as in pre-EA
receivership. This allows a judgement to be made with one voice – as
where one coach picks the team. In multiple authority decision or policy-
making, responsibility is shared and a process of exchanging views is
encouraged. This brings the gains of discussion but the dangers of
potential deadlock. With inclusive decision-making, as in the post-EA
regime, there may be a single formal authority who makes policies or
decisions, but the dominance of that actor is reduced by arrangements
for consultation, negotiation and discussion. This produces potential
gains in openness and accountability and it may improve fairness but,
like multiple authority, it brings dangers – of confusion, delay, compro-
mise and deadlock.325 These problems may detract from both the appli-
cation of expertise and the efficient formulation of strategies for rescue.
As indicated in the previous section, it involves negotiations between
parties who differ not merely in interests but in cultural frameworks and
ways of conceptualising the purposes of rescue. It is to be expected that
communications between such parties will be delayed and distorted as a
result of such differences.

A further danger inherent in the post-EA administration process is
that the price paid for inclusiveness may be too high in that expert judg-
ments and strategies are over-constrained and over-contested. Timescales,
as noted, may also be relevant and here there are tensions. Tight scheduling
is desirable in so far as it protects against indecision and tardiness on the

325 See e.g. O. Brupbacher, ‘Functional Analysis of Corporate Rescue Procedures: A
Proposal from an Anglo-Swiss Perspective’ [2005] 5 JCLS 105; Frisby, ‘In Search of a
Rescue Regime’.
part of the administrator. If, however, proposals have to be presented to creditors within eight weeks of appointment – even in the case of complex corporate scenarios – this may militate in favour of those strategies that are the least contentious rather than the most expert – that are sub-optimal because they are devised at speed and with an eye to minimising contest from any of the creditors with powers to take legal issue. In practice this may mean that the banks will exert strong pressure on investment decisions in an attempt to ensure that strategies carrying very low risks to bank interests are the ones that are chosen. These may not always be the strategies that are most conducive to rescue (or the most fair to creditors other than the bank) and they are likely to be implemented by administrators of the bank’s choosing. A further danger is that in the newly inclusive post-EA regime, parties other than the floating charge holding banks – such as unsecured creditors – will contest the pro-bank policies and if agreement cannot be reached within statutory timescales, they will resort to court challenge. The result may be a loss not only of expertise in choices of strategy but also of efficiency in that rescue-necessary schedules cannot be adhered to. As already indicated, the EA sets up objectives for administrators that offer numerous pegs upon which disgruntled creditors may hang lawsuits and this legal setting creates further difficulty for those administrators who would make judgements and strategies on best appraisal of their merits.

The post-EA system is not trouble free on the above fronts but it might be argued that it deserves approval for other characteristics that conduce to the expert and efficient making of high-quality rescue judgements. It might be said, for instance, that in times of corporate difficulty there is a case for taking the strategic function away from existing managers and for practitioner in possession (PIP) rather than debtor in possession (DIP) arrangements. The strength of this case turns a good deal on the model of the company director that underpins the analysis. English insolvency law has traditionally been built on the assumption that

326 The administrator, as noted, has a duty to perform his functions as quickly and efficiently as is reasonably practicable (para. 4) which creditors or members can enforce by means of an application to court under para. 74(2).
327 Para. 49(5).
329 As noted above, qualifying floating charge holders (QFCHs) can appoint administrators out of court; other parties who intend to make such appointments have to give notice (para. 26(1)) to QFCHs which then allows QFCHs to appoint their own choice of administrator.
where a company becomes insolvent this is usually due to a failure of management and that the last people to delegate judgements to, or to leave in control, are those who are responsible for the company’s plight in the first place. Numerous analyses of the causes of corporate failure put poor management at the top of the list of factors inducing decline. This may not always be the case, however, and external pressures may sometimes place a company in acute difficulty in spite of faultless management. The English model of the director of the troubled company, moreover, contrasts with that implicit in the US regime, which is more inclined both to trust the skill and judgement of the existing managers and to treat corporate difficulties as problems that merit attention rather than blame.

One response to the English view of the (often failing) corporate manager is, of course, to take steps to improve directorial skills. It could be argued that business people ought to be required to possess some sort of elementary qualification before they are allowed to act as company directors. Such qualifications would indicate that the individual has a basic understanding of company law and finance as well as the legal obligations going with directorship. (They might also certify that the person possessed a basic knowledge of insolvency procedures and obligations.) The IS noted that a number of business people opposed a requirement to hold qualifications on the ground that this could operate as a brake on enterprise. The directors consulted, however, said that they would be willing to undertake some sort of instruction provided that it was not expensive or time consuming and, overall, there was moderate support for the idea. Mandatory basic training for directors could,

330 See discussion in ch. 6 above. Sir Kenneth Cork has written that insolvency provides an occasion for a change 'from incompetent hands to people who not only have the wherewithal but also hopefully the competence, the imagination and the energy to save the business': Cork on Cork, pp. 202–3. On the UK insolvency system’s development as a 'manager-displacing' regime see J. Armour, B. Cheffins and D. Skeel, ‘Corporate Ownership Structure and the Evolution of Bankruptcy Law: Lessons from the United Kingdom’ (2002) 55 Vand. L Rev. 1699, 1734–50.
331 See ch. 4 above; R3, Twelfth Survey, Corporate Insolvency in the UK (2004).
332 See ch. 4 above.
335 IS 2000, para. 58. 336 Ibid.
furthermore, be advocated on the grounds that the Companies Act 2006 spells out directors’ duties and creates new insolvency regimes but that such provisions will only have limited effect if steps are not taken to bring those duties and regimes to the attention of directors. Some firms and directors will voluntarily acquaint themselves with such legal matters but these more responsible firms and directors are less likely to breach legal obligations or to meet financial troubles than more maverick operators. It is the latter who are disproportionately in need of training and higher standards. As for placing a brake on enterprise, it can be responded that ill-informed and irresponsible directorial behaviour may itself hinder enterprise. A world in which traders act defensively because of fears about their solvency or financial responsibilities is not a dynamic, responsive, low-transaction-cost world. It might be conceded that directors of firms with a level of turnover below a certain figure should be exempted from the qualification requirement – this concession may be justifiable in order to encourage new business – but above that level the qualification could be mandatory. Those who object to the expense and difficulty of testing thousands of directors may be reminded, first, that each year huge numbers of would-be drivers of vehicles are tested in theory as well as in practice, and, second, that the actions of ill-informed directors may wreck businesses and lives, and, third, that a minimum competence may be a reasonable quid pro quo for the privilege of limited liability.

Knowledge of directorial obligations and of insolvency procedures does not in itself ensure that directors will input more effectively into rescue processes or be inclined to seek help at an earlier stage of corporate decline than occurs now. What is needed, according to some commentators, is a cultural change in attitudes to insolvency. This change can be encouraged on a number of fronts. First, the notion that seeking help evidences managerial failure can be countered by public rejection of the condemnatory approach to insolvency. The speeches of Peter Mandelson when Trade Secretary exemplified such a rejection. Second, as indicated already, directors, where possible, can be involved

337 See Companies Act 2006, Part 10 and, for example, ss. 171–7.
338 See ch. 16 below.
339 See the extract in Hunter, ‘Nature and Functions of a Rescue Culture’, p. 519; The Times, 14 October 1998; White Paper, Our Competitive Future: Building the Knowledge Driven Economy (Cm 4176, December 1998), section entitled ‘Fear of Failure’, paras. 212–14, which Hunter argues evidences the endorsement of this approach by Peter Mandelson’s successor, Stephen Byers. See also White Paper on Enterprise, Skill and Innovation
in rescue operations (under supervision arrangements) rather than excluded on the basis that they are inevitably culpable incompetents. Third, investors and large creditors can move to assure directors that taking early steps to secure help involves, in itself, no greater blot on the *curriculum vitae* than a decision to hire management consultants. Finally, such changes might be reinforced by tougher attitudes to those who indulge in wrongful and reckless trading, with greater use of the CDDA 1986 and stronger penalties imposed on errant directors.\(^{340}\) Such measures may go some way towards encouraging the view that failure to seek help is a more serious matter than being at the helm of a company that encounters difficulties.

Note should also be taken of the potential role of unsecured creditors in providing special expertise to rescue processes. Many unsecured creditors will know little of their business partners’ activities but some will have a detailed knowledge of the troubled company’s affairs – perhaps because of an established trading relationship in a specialised marketplace. What the collectivity of the EA processes and the duty to all creditors offers to such creditors is the chance to voice an opinion on rescue options. The unsecured creditor, accordingly, has an opportunity to attempt to persuade the administrator that there is a solution to corporate problems that allows rescue and a better than winding-up return to creditors.\(^{341}\) This contrasts with the prior position in receivership where the receiver had no obligation to listen to such voices and in which speedy action on behalf of the floating charge holder tended to be accorded precedence over sustained consideration of various creditors’ views.\(^{342}\)

So will the new administration process as set up by the EA produce more expert rescue judgements more efficiently than other systems such as DIP? Much will depend on the particular company and particular management team involved in a given corporate decline. The virtue of


\(^{341}\) As per para. 3(1)(a) or (b). The EA does, however, allow creditors’ meetings to be bypassed in certain circumstances: see Sch. B1, para. 52. On the ‘capture’ of creditors’ meetings generally see S. Wheeler, ‘Empty Rhetoric and Empty Promises: The Creditors’ Meeting’ (1994) 21 *Journal of Law and Society* 350.

\(^{342}\) See Ferran, ‘Duties of an Administrative Receiver’.

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(2001), ch. 5, paras. 5.9–5.15: ‘An entrepreneurial economy needs to support responsible risk taking. Insolvency law must be updated so that it strikes the right balance. It must deal proportionately with financial failure, whilst assuring creditors that it is handled efficiently and effectively’ (para. 5.10).
the PIP system is that greater or lesser roles can be given to directors according to assessments of their powers of judgement and expertise that are carried out by an independent generalist familiar with insolvency situations.

**Fairness and accountability**

If expert judgements concerning responses to corporate distress are to merit approval, they have to be made fairly and accountably. Here the post-EA regime might be expected to score high marks as it places an independent officer of the court in control. It also sets up open procedures that are designed to allow reasonable input to creditors and which hold administrators to account through creditors’ meetings as well as through the imposition of a series of legal duties. Such creditors’ meetings allow unsecured creditors to hold administrators to account in a way that was not possible in administrative receivership. It should be noted, however, that accountability to the creditors’ meeting is avoided where the administrator acts without reference to such a meeting in accordance with the terms of Schedule B1, paragraph 52(1) or acts in advance of such a meeting – subject to any court directions given under paragraph 68(2) of Schedule B1. In the former instances (which would occur when the administrator thinks, for example, that there are insufficient funds for a distribution to unsecured creditors) there would be no requirement of court approval and aggrieved creditors would only be able to hold that administrator to account by commencing proceedings in court. Some practitioners have, as noted, voiced particular

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343 The administrator, as noted, is an officer of the court and thus subject to the ethical requirements of the rule in Ex parte James (1874) 9 Ch App 609: see D. Milman, ‘The Administration Order Procedure’ (2002) 17 Company Law Newsletter 1, 3.

344 See Hahn, ‘Concentrated Ownership’.


347 Under which, as noted, an administrator is not obliged to call a creditors’ meeting if he thinks that creditors can be paid in full; there is insufficient property for a distribution to unsecured creditors; or that it will not be possible to rescue the company as a going concern or achieve a better result for the company’s creditors as a whole than would be likely if the company were wound up.

348 Sch. B1, para. 74 governs challenges to the administrator’s conduct of the company by creditors or members. Para. 75 allows misfeasance actions against administrators by, *inter alia*, a creditor and the company does not have to be in liquidation for such an action to be commenced.
worries about the process in which a company can be put into administration out of court and then be converted into a creditors’ voluntary liquidation.349 As one expressed the concern: ‘Companies are put into administration for no other reason than to take advantage of the opportunity to put them into liquidation later without holding a creditors’ meeting.’350 In such scenarios another worry is that only a liquidator has a complete set of powers for dealing with wrongful and fraudulent trading and that use of the administration route may inhibit investigation of directorial actions because the directors may appoint an administrator out of court to realise and distribute assets and exit administration – all without the need to hold a meeting of creditors.351

In the modern distressed debt market, moreover, it can be argued that there are numbers of actors who are not so much interested in rescue as a fast return. As John Verrill, former president of R3, has stated:

> The modus operandi of the new-style entrants into the distressed debt market is that they fund the administrator and provide the stock. Normally under the old regime the administrator would have to show the court that he had the financial backing or funding to achieve the purpose for which he was seeking the order … Now if a floating charge holder wants to appoint an administrator, he can do so without the old checks and balances and no independent verification by the court. A company can now buy the debenture off a creditor who would otherwise be whistling for the money and then say to the administrator: ‘Do you want the job or not?’352

A system of practitioner in possession, as found in administration, could, however, be supported as avoiding the danger of unfairness or bias that comes from shareholder manipulation and which has been said to be

349 A mechanism for converting new-style administration to a CVL is found in Sch. B1, para. 83. Alternatively, in less complex cases, the IP may wish to take advantage of the ability to pay all creditors whilst the company is in ‘new’ administration rather than moving to liquidation: see further Todd, ‘Administration Post-Enterprise Act’. See pp. 396–7 above.

350 Nick Hood of Begbies Traynor, quoted in Accountancy Age, 18 December 2003, p. 11. See also Linklater, ‘New Style Administration’. See pp. 396–7 above.

351 At which meeting creditors would have had the opportunity to question the directors on the company’s demise. Administrators are entitled, however, to institute proceedings to have transactions at undervalue and preferences adjusted: IA 1986 ss. 238–9. The administration–liquidation route could, moreover, reduce costs and time and allow directors to have more input during the process: see further Keay, ‘What Future for Liquidation?’, pp. 152–5.

associated with DIP regimes – the risk that, where ownership is concentrated, shareholders will tend to encourage the management to engage in risky projects during troubled times since they are gambling with creditors’ money.\footnote{Ibid.; Scott, ‘Relational Theory’, p. 909.} Here there is a trade-off to be considered. A DIP regime might be expected to place rescue in the hands of directors – who are the parties with best knowledge of the business and its prospects – but it brings dangers of shareholder manipulation. A PIP system would be expected to involve lower levels of business-specific knowledge but greater resistance to such shareholder pressure.

In deciding whether DIP or PIP brings the preferable trade-off a number of considerations may be relevant. A first is the severity of the risks of bias through potential shareholder manipulation. On this point Hahn argues that concentration of ownership conduces to such manipulation but that, in the UK, the shareholding of listed corporations tends to be widely dispersed.\footnote{Hahn, ‘Concentrated Ownership’, p. 134. It should be emphasised, of course, that Hahn’s argument relates to listed corporations. Private companies would not offer the same dispersion of shareholding and, accordingly, risks of shareholder manipulation would be higher, and the attractions of DIP lower.} If risks of manipulation tend to be low, this militates, according to Hahn, in favour of DIP rather than PIP as the fairer regime. Such an analysis, however, focuses on the relationship between manager-directors and shareholders and may understate the dangers of manipulation by other interests. In the case of many troubled UK companies there will be a degree of creditor concentration and creditor power (as where the company is in debt to a bank that holds a floating charge). This, as already indicated, may lead the bank to press those in charge of the company to develop and apply strategies that principally protect bank interests. On this count, it is arguable that, although administrator-IPs may not be immune to such pressures (a point made above), they are likely to be more resistant than the company’s directors, who will not only be predisposed to keeping their major creditors happy,\footnote{Directors’ tendency to align their decision-making to the bank’s interests is likely to be the greater if the directors have also given the bank personal guarantees.} but may well be conditioned by their troubled experiences to give way to bank pressure.

Even within PIP, however, it should be emphasised that the importance of eleventh-hour funding in rescue operations may enhance the banks’ already strong positions to manipulate. In times of corporate distress it is common for the banks to supply rescue funds under terms
that give them very considerable powers to influence strategy.\textsuperscript{356} Covenants in restructured lending agreements will frequently impose restrictions on such matters as: operating activities (e.g. maximum outlays on administration); new investments (e.g. on levels and kinds of investment); dispositions of assets; payouts to shareholders; and financial activities (e.g. levels of borrowing; levels of working capital).\textsuperscript{357}

When banks supply new rescue funds they may increase their equity share in the corporation and accordingly may exercise considerable power as shareholders as well as creditors. They may also negotiate representation on the board which allows them, for example, to put turnaround specialists in place and gives \textit{de facto}, if not formal, influence over the strategy formulation process.\textsuperscript{358} The effect of such bank power is that, within the post-EA regime, the administrator is supposed to advert to the interests of creditors as a whole (a contrast with receivership) but, in doing so, will have to co-ordinate closely with the bank. There are dangers of both friction and manipulation (and hence of unfairness to some creditors) in such arrangements.

Turning to accountability through judicial oversight, this can be assessed by considering the courts’ role in shaping the administration regime. That shaping may involve the judges in influencing interactions between a variety of different actors by, for example, adjusting incentives to resort to law and detailing areas of expertise within which certain actors’ judgements will be deferred to. In order to explore the potential judicial role it is necessary, first, to outline the main ways in which the EA 2002 reforms allow the judges to impact on the new administration process and, second, to indicate how the judiciary might make best use of their potential impact in accordance with a co-ordination perspective that focuses on key rescue tasks.

The EA revises the involvement of the judiciary in the process of administration in a number of ways.\textsuperscript{359} In some respects, judicial supervision is weakened – as over the appointment process, where Schedule

\textsuperscript{357} See e.g. Gilson, ‘Bankruptcy, Boards, Banks and Blockholders’, p. 367. 
\textsuperscript{359} On the role of the judiciary in relation to the ‘new’ administration see also Armour and Mokal, ‘Reforming the Governance of Corporate Rescue’; Finch, ‘Re-invigorating Rescue’ and ‘Control and Co-ordination in Corporate Rescue’.
B1, paragraphs 14 and 22 involve a dramatic shift to out-of-court activity. Holders of qualifying floating charges as well as the company and its directors are able to appoint an administrator without going to court by filing a notice of appointment accompanied by a statement from the identified administrator that he consents to the appointment and that, in his opinion, the purpose of the administration is reasonably likely to be achieved. The route to appointment of an administrator via court order is retained by paragraph 10 of Schedule B1 which requires an administration application to court by either the company, its directors or one or more creditors.

On some issues, however, the courts are given new areas of judgement by the EA. Paragraph 13(1)(e) of Schedule B1 now empowers the court to treat an application for administration as a winding-up petition, carrying associated winding-up powers. The court is thus given a wide discretion to make the order it thinks most appropriate and it is likely to treat the application as a winding-up petition if the company is revealed to be hopelessly insolvent and the interests of creditors as a whole require an immediate investigation of its affairs by a liquidator and if this consideration outweighs any likely advantage to be achieved by realisation of assets in administration.

Another area in which there is at least the potential for considerable judicial input is in reviewing the exercise of the administrator’s powers as deployed in pursuit of the Schedule B1 paragraph 3 objectives. As noted above, a central issue here is whether the administrator should act to rescue the company as a going concern (paragraph 3(1)(a)); to achieve a better result than on winding up for creditors as a whole (paragraph 3(1)(b)); or to realise property in order to make a distribution to one or more secured or preferential creditors (paragraph 3(1)(c)). Selecting between these objectives is governed by paragraph 3(3), which is phrased in subjective terms and, to repeat, states that the administrator must act to rescue the company as a going concern unless he thinks either that this

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360 The company or its directors will also need to declare that the company is or is likely to become unable to pay its debts as a precondition to the appointment of an administrator. This contrasts with the holder of the qualifying floating charge who is not required to demonstrate this inability or likely inability: see pp. 381–2 above. On inability to pay debts and definitions of insolvency see ch. 4 above.

361 The company has to be or be likely to become unable to pay its debts and the court must be satisfied that the administration order is reasonably likely to achieve the purpose of administration: Sch. B1, para. 11(b).

362 The court may also make an interim order to restrict the exercise of directorial powers or to make these subject to supervision by an IP or the court (paras. 13(3)(a) and (b)).
course is not reasonably practicable or that a better result for creditors as a whole can be achieved by pursuing the second of the listed objectives.  

Paragraph 3(2) overlays a general duty on the administrator to perform his functions in the interests of the company’s creditors as a whole. The administrator, moreover, is subject to a duty, under paragraph 4, to perform his functions as quickly and efficiently as is reasonably practicable. Under paragraph 74(1) a creditor or member can challenge the administrator by claiming that he is acting or has acted or proposes to act so as to harm their interests unfairly. Paragraph 74(2) allows the same parties to mount a challenge on the grounds that the administrator is not performing his functions as quickly or as efficiently as is reasonably practicable.

Do these provisions offer the judges an opportunity to render administrators accountable through the exercise of energetic supervision? It would appear that the subjective phrasing of paragraph 3(3) (which was inserted late in the passage of the Enterprise Bill through Parliament) evidences a Government intention that administrators’ business judgments should not be interfered with lightly by the courts and not without evidence of irrationality. Both Lord Hoffmann and Sir Gavin Lightman have stated extrajudicially that such subjective phrasing

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364 For arguments that this means that administrators should act to maximise ‘total expected net recoveries’ see Armour and Mokal, ‘Reforming the Governance of Corporate Rescue’, pp. 46–7.

365 As has been noted, misfeasance actions (by, inter alia, a creditor) can be brought against administrators (or purported administrators) under para. 75 and the company does not have to be in liquidation for such an action to be commenced. On administrators owing no general common law duty of care in relation to their conduct of the administration to unsecured creditors see Kyrris v. Oldham [2004] BCC 111 (CA) and on duties of care to the company see Re Charnley Davies Ltd (No. 2) [1990] BCLC 760 where Millett J noted that the distinction between ‘misconduct’ and ‘unfairly prejudicial management’ does not lie in the particular acts or omissions of which the complaint is made but in the nature of the complaint and the remedy necessary to meet it: p. 783. As noted above, there is, to date, a ‘conspicuous’ absence of case law where administrators have been sued for breach of duty: see Keay and Walton, Insolvency Law, p. 118. This situation is unlikely to pertain as administration takes over from administrative receivership and actions under para. 75 for breach of equitable or common law duties become more frequent.

makes it virtually impossible for a court to interfere with the administrators’ commercial judgements provided that they are made in good faith, and, as noted above, the cases of Re Transbus International Ltd and Re Ballast plc support the view that the courts are content to defer to the judgements of administrators.

It should be noted, however, that the paragraph 3(2) duty to act in the interests of the company’s creditors as a whole is not similarly phrased in subjective terms – the obligation is to act objectively in pursuit of such interests, not in a manner that the administrator thinks is in the interests of creditors as a whole. The resultant tension between the subjectivity of paragraph 3(3) and the objectivity of paragraph 3(2) may open the way for judicial intervention. Thus a party challenging an administrator’s decision to act in pursuit of a better than winding-up result for creditors (under paragraph 3(1)(b)) rather than a going-concern rescue (paragraph 3(1)(a)) not only would be able to contest the administrator’s subjective estimation of what was reasonably practicable or in the interests of creditors as a whole but would be able to take issue on the grounds that the course chosen was not in fact in the interests of creditors as a whole. There is a similar combination of subjective and objective elements in paragraph 3(4) which empowers the administrator to realise property for distribution to secured or preferential creditors (paragraph 3(1)(c)) if he thinks it is not reasonably practicable to achieve either of the paragraph 3(1)(a) or 3(1)(b) objectives and ‘he does not unnecessarily harm the interests of the creditors of the company as a whole’ (paragraph 3(4)(b)). These provisions are liable to come into play when an administrator might have a choice of ways to realise assets, one of which involves a quick break-up sale, payment of the floating charge...
holder’s debt and a low return to unsecured creditors, and the other of which involves greater delay, more considered marketing and a higher return to unsecured creditors after the debt secured by the floating charge has been paid.

The status of the administrator as an officer of the court means that, in addition to being expected to act fairly and honourably, the courts may potentially treat administrators’ activities as reviewable on the usual public law grounds of illegality, irrationality and procedural impropriety. As an alternative to judicial review on public law grounds, it has been argued that ‘the courts will draw on the case law providing substance to the rationality test in the context of other fiduciary relationships’.

Even, accordingly, where the subjective phrasing of paragraph 3(3) is used, the administrator may be open to attack on ‘irrationality’ grounds where he fails to take a relevant consideration into account in making a decision or takes into account an irrelevant consideration. The potential role for the courts is, accordingly, to rule on whether, in considering different possible courses of action (for example, to aim for rescue as a going concern or to achieve a better than winding-up outcome; or to realise property and distribute to secured or preferential creditors), the administrator has taken relevant factors into account, has avoided reference to irrelevant factors and has avoided taking actions that are so unreasonable that no reasonable administrator would take them. For an administrator subject to such potential review, this means that care should be taken to make it clear on the record that all creditors’ interests


374 See Mokal and Armour, ‘New UK Corporate Rescue Procedure’, pp. 137–8. The duty to act rationally has its roots in the law governing fiduciaries and can be seen as analogous to the public law concept of reasonableness: see Lightman and Moss, Law of Administrators, p. 246. Here the tests applied to trustees, according to the rule in Re Hasting-Bass [1975] Ch 25, are similar to those applied to public bodies according to Associated Provincial Picture Houses Ltd v. Wednesbury Corporation [1948] 1 KB 223. On the rule in Hasting-Bass see Stannard v. Fisons Pensions Trust Ltd [1992] IRLR 27 (trustees were bound to give properly informed consideration to the value of a trust fund in calculating the just and equitable level of funds required to be transferred).

have been taken into account in assessing the array of possible actions on the basis of the information that is reasonably to be expected to be assessed. This will be central to the administrators showing that they have acted in accordance with their duty and have identified the relevant considerations and used all proper care and diligence in obtaining advice. The administrator, moreover, is obliged (when making a statement setting out proposals for achieving the purposes of administration) to explain why he thinks the objective mentioned in paragraph 3(1)(a) or 3(1)(b) cannot be achieved. Administrators, accordingly, should be prepared to disclose their proposals and reasons for action.

The above considerations suggest that the judges, if inclined, could boost the accountability of administrators by exercising intensive review over administrators’ activities. Whether they will be so inclined is a moot point. On one view, the judges are likely to prove reluctant to engage in interventions that amount to second-guessing the commercial judgements of administrators or, when thinking in public law terms, to do other than defer to the judgements of those actors to whom Parliament has entrusted specialised functions.

In support of this view, it might be argued that the judges have shown themselves to be slow to second-guess directors on issues involved in wrongful trading (which involves objective and subjective elements) and that consistency should produce a similar judicial reluctance regarding administrators. There are, however, a number of differences to bear in mind between the parties and roles involved in the comparison. Administrators are quasi-public officials. Directors inhabit the realms of private law. The consequences of intervention are also different. Reviewing an administrator’s action under paragraph 74 is most likely to result in the court making an order to regulate the administrator’s

377 Para. 49(2)(b).
378 I.e. at creditors’ meetings, if under a duty to call them (see para. 52(1) and (2)).
381 See Insolvency Act 1986 s. 214(4)(a) and (b); see also ch. 16 below.
exercise of his functions or to vary procedures adopted. This can be seen as less dramatic than making a finding of wrongful trading which may involve a director in substantial personal liability and arguably a degree of stigma. For both these reasons, it might be contended that the courts will be more inclined to interfere with administrators’ actions under paragraph 74 challenges than they would be to second-guess directorial behaviour for the purposes of wrongful trading.

If, however, it is assumed, for the moment, that the courts will exert a degree of control over administrators, how might they best use that control to serve the interests of rescue? One way to do this would be to exercise their powers so as to enhance expertly and efficiently co-ordinated actions between the various actors involved in a rescue process – while, of course, protecting the legal interests of those actors and holding the ring fairly between them. When seeking to enhance such co-ordination, furthermore, the judges might have in mind the need for key rescue decisions and actions to be based on good information, to incorporate sound judgements and to be implemented in a timely fashion.

On the generation of a good information base, the judicial role is likely to come into play when the administrator’s duty to garner and consider information from different parties is placed at issue. That administrator will be obliged, inter alia, to take all relevant considerations into account when devising a policy or making a decision. The stance of the pro-rescue judiciary might be to insist that administrators make all reasonable attempts to secure inputs from all of those actors who are well placed to contribute information relevant to the pursuit of the administrator’s statutory objectives. The administrator, accordingly, would be obliged to consult with, and take into account, the representations of such parties as directors, banks, unsecured creditors and any others who can provide relevant information. Such a judicial stance might demand of administrators that they do more than provide an opportunity for various actors to participate in the administration process – it might call for administrators actively to take all reasonable steps to seek out relevant information and to consider this.

It has, however, been stressed above that inclusive processes involve considerable dangers of inefficiency and losses of expertise through stultification, delay and confusion. Bearing this in mind, the judges

382 See ch. 16 below.
might make it clear in their decisions that administrators only have to seek out information and process it in so far as this is reasonable within the practical constraints of time and resourcing that they are faced with. In subjecting administrators to reasonableness-testing, accordingly, the judges should take the view that challenges to administrators’ decisions will only be successful where they have been shown clearly to have gone beyond the bounds of reasonableness (for example by refusing to receive inputs from parties where patently relevant information is involved). The general stance of the judiciary should be to ensure accountability and fairness through protecting the procedural rights of the various parties but, above all else, to further efficiency and expertise by shielding administrators from legal delays and second-guessing and to do so sufficiently to allow them to pursue their statutory objectives expeditiously. If this is not done the danger is that the administration process will prove generally too slow-moving and indecisive ever to serve the interests of rescue. The stance described may demand that the judges show a degree of deference to the administrators’ judgements on such matters as whether the need for action means that they should not carry out further investigations and consultations.

On the encouragement of sound judgements, this will, to a degree, be served by judicial actions to encourage expertise by ensuring that relevant information is considered and irrelevant matters are not taken into account. Closely related to the exclusion of irrelevancies is, moreover, protection against unfairness through bias and here it might be suggested that the judiciary should be ready to counter a number of predictable risks.

A first such risk is, as noted above, that banks holding qualifying floating charges and acting as potential suppliers of rescue funds will use their legal and financial muscle to induce administrators to act in their favour rather than in the interests of the body of creditors as a whole. Manipulation of this kind may occur through open negotiations between bank and administrator but a second risk may be that such influence, or ‘capture’, may occur in less visible ways – as where administrators adopt strategies that are excessively low risk and do so for fear of offending powerful actors, such as banks, who might contest their actions.

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384 See the references to reasonableness in the para. 4 duty to perform functions as quickly and efficiently as is reasonably practicable.
385 That is on ‘he who pays the piper calls the tune’ principles: see Swain, ‘Move Towards a Stakeholder Society’.
The judiciary, however, may face a difficult task in exercising review so as to control the above kinds of manipulation or bias. It is one thing to ensure that administrators adopt the fair and correct procedures, and consider the relevant matters and exclude irrelevant factors, it is another to assess whether the substantive strategies or actions effected by administrators are calculated, or likely, to involve a favouring of a certain creditor or class of creditors. It is true that the paragraph 3(2) duty to act in the interests of the company’s creditors is, as noted, objectively phrased, but ruling against an administrator under this paragraph demands, first, that the court is prepared to make a judgement on business risks and, second, that the court is willing to substitute its own judgement for that of the administrator.

What, then, would a rescue-friendly judicial stance look like when faced with this dilemma – whether to pursue fairness by protecting weaker creditor interests or to promote efficiency by leaving administrators free enough in their judgements to be able to act expeditiously? The analysis here suggests that the role of the judge should be to exercise their review powers so as to maximise the extent to which administrators are induced to serve the interests of all creditors, and to do so by counter-balancing those risks of bias that are likely within the post-EA regime. That regime places an IP in power and so the dangers of shareholder manipulation that are encountered in DIP systems are, as noted above, replaced by risks of bank manipulation. The aim of the judiciary, accordingly, can be envisaged as ensuring that the administrator performs on a level playing field – and they can do so by offering a counter-balance to the administrator’s natural inclination to err in favour of the banks. That counter-balance can be seen in the shape of the prospect of judicial interference where a bias is sufficiently grave to take the administrator out of his ‘protected’ area of judgement and to constitute a patent breach of paragraph 3(2).

Turning to the judges’ role in ensuring that actions and decisions are taken in a timely fashion, a first contribution, as indicated, is judicial action to ensure that the administrator’s ability to act quickly is not prejudiced by excessive legal attack and second-guessing. A second judicial task is to do what can be done to ensure that directors do not delay the instigation of insolvency processes unduly. It was noted above that disincentives to delay, through wrongful trading or disqualification provisions,\(^\text{386}\) may be of dubious value and, accordingly, the courts might

\(^{386}\) See IA 1986 s. 214; CDDA 1986; see also ch. 16 below.
do all that they can to reassure directors that entering administration under a PIP regime will not necessarily rule out their inputting into decisions about the future of the company or business. This can be done, as suggested above, by ensuring that administrators gather and consider all information relevant to the company’s future when making decisions and strategies or taking actions.

**Conclusions**

The Enterprise Act 2002 succeeded in placing administration at the heart of efforts to deal with companies in distress. There is work to be done, however, to make this process the finished product with regard to cost-effectiveness, accountability, fairness and conduciveness to the exercise of informed and expert judgements. There is scope, for instance, for further procedural streamlining in order to lower costs.

Current arrangements and approaches leave a number of questions to be resolved. It remains to be seen whether the judgements of administrators will be enhanced by the inclusiveness of the administration process or whether that inclusiveness will operate within tight scheduling so as to stifle expertise. Further residual issues are whether lenders will retreat from the use of administration and increasingly secure loans in ways that revive other procedures such as the LPA receivership; whether the use of administration as a substitute for liquidation needs to be controlled further; and whether the EA reforms will lead to a fragmentation of credit arrangements that makes rescues excessively difficult.

On this last issue, a central question is whether a point will be arrived at when it is necessary, as suggested by the EHYA, to restrict the rights of certain parties in a more radical fashion so as to render administration more responsive to corporate crises. A related question is whether there is, or will soon come, a need for a new approach to super-priority funding in order to incentivise the supply of rescue funds appropriately.

Co-ordination between administrators, directors and others will remain an issue within administration and attention may have to be paid to the propensity of the regime to encourage directors both to seek appropriate and timely help from outsiders and to assist the administrators in carrying out the latter’s functions. Whether the complexities of the paragraph 3 statement of administrators’ objectives will unduly inhibit co-operation and information supplies is a matter for continued monitoring and much may depend here on the way that the courts
oversee the administrator’s duty to pursue those objectives and to serve the interests of all creditors.

As for the judges, the indications are that they are sympathetic to the development of administration as a streamlined tool of rescue. They have sown the seeds for a version of super-priority lending and have shown that they are inclined to defer to the business judgements of administrators. In other respects, though, the implications of the judges’ decisions are less certain. The *Spectrum Plus* case left issues hanging concerning the control that is necessary if charges over book debts are to be deemed fixed rather than floating. It also remains to be seen whether *Spectrum Plus* (together with the prescribed part provisions of the EA 2002) will increase the fragmentation of credit to a degree that significantly impedes rescue. A further worry may be whether giving priority to non-domestic rates during the administration – as in *Exeter City/Trident* – will prove a ‘disaster’ for rescue in spite of recent legislative responses. The judges, as well as the variety of other actors involved with administration, will have to rise to a number of challenges if administration is to realise its full potential as a rescue and reorganisation process.
In chapter 6 it was argued that, over recent years, responses to corporate troubles have increasingly tended to be made before any final crisis precipitates formal action. One form of anticipatory action is the pre-packaged administration. This is a device that has been encountered on the UK insolvency scene since the mid-1980s but which has grown in use more recently. It is a device that some commentators herald as a freshly effective mechanism for furthering rescue objectives and others see as a means by which powerful players can bypass carefully constructed statutory protections.

The ‘pre-pack’ is a process in which a troubled company and its creditors conclude an agreement in advance of statutory administration procedures. This has the effect of establishing a deal in advance of the appointment of an administrator and it allows statutory procedures to be implemented at maximum speed. The danger most commonly pointed to is that such speedy implementations of faits accomplis will tend to ride roughshod over the procedural and substantive interests of less powerful creditors.

This chapter looks at the development of the pre-pack, identifies the issues raised by this device, and considers how insolvency law might respond to the burgeoning popularity of such agreements. A particular

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2 Pre-packs have historically been used in relation to receiverships but are increasingly employed in conjunction with administrations. This chapter focuses on administration-related pre-packs.
concern will be whether the advent of the pre-pack calls for a rethinking of current approaches to the protection of those interests that are affected by corporate troubles.

The rise of the pre-pack

In the United States, pre-packaged bankruptcy filings first emerged in the mid-1980s and rapidly grew in popularity in the early 1990s, so that by 1993 over 20 per cent of all public bankruptcies were pre-packaged.³ A common arrangement involves a troubled company seeking to trade debt for equity in order to shed the burdens of onerous interest payments. In order to make a pre-pack work the debtor will require the agreement to an arrangement of a significant majority of creditors (often around 90 per cent). The company then makes a Chapter 11 filing. The advantage gained is that, in a pre-pack plan, negotiations, distributions of disclosure statements and voting all take place before the bankruptcy case is filed in court.⁴ The debtor typically files not only a petition but also a plan and a disclosure statement. Such ex ante approval from creditors often allows the court to hold a single hearing to determine the adequacy of pre-petition disclosure and whether the plan should be confirmed. As a result, the company will frequently emerge from statutory proceedings quickly (sometimes in thirty to thirty-five days rather than years, as is common in conventional Chapter 11 proceedings).⁵

³ See Managing Credit, Receivables and Collections, (2003) March issue, p. 1. In 1995 a quarter of all Chapter 11 cases of public corporations involved a pre-pack: see V. Vilaplana, ‘A Pre-pack Bankruptcy Primer’ (1998) 44 The Practical Lawyer 33. The pre-pack has been said to be the single most important development in US corporate bankruptcy practice in recent years, so that it has now become routine and the strategy of choice for corporations with complicated financial structures: see D. A. Skeel, Debt’s Dominion (Princeton University Press, Princeton, 2001), quoted in P. Cranston (Eversheds LLP), ‘Pre-packaged Business Disposals: White Knight or Thief in the Night?’, presentation to ILA Annual Conference, Bath, 18 March 2006.


⁵ The US Bankruptcy Code Chapter 11 is a reorganisation procedure whose policy objective is strongly oriented to the avoidance of the social costs of liquidation and the retention of the corporate operation as a going concern. On Chapter 11 generally see ch. 6 above; R. Broude, ‘How the Rescue Culture Came to the United States and the Myths that Surround Chapter 11’ (2001) 16 IL&P 194. Note, however, that the Bankruptcy Abuse Prevention and Consumer Protection Act 2005 (BAPCPA) has tightened up timescales regarding Chapter 11 plans: see revised s. 1121(d) of the Bankruptcy Code (capping the debtor’s exclusive right to file a plan at eighteen months and the exclusive
Adverse and lengthy negotiations with creditors are often avoided and professional fees are far less than would be the case without the pre-pack. In many instances, argue advocates of pre-packs, employees’ jobs will be protected and trade creditors will be paid in full. Pre-packs, moreover, can be agreed long before financial difficulties are encountered. This means that the company has the resources to continue operating in an effective manner.

In the UK, pre-packaging will typically involve a pre-agreed restructuring deal and the appointment of an office holder – either an administrator or an administrative receiver. This individual will then execute the restructuring transaction on behalf of the troubled company. A corporate restructuring director at Ernst & Young LLP has summarised the appeal of the pre-pack: ‘In a pre-pack the restructuring process is condensed and offers the secured creditors a high level of control and certainty, making it a very attractive alternative to any protracted formal insolvency process.’

The pre-pack has grown in popularity in the UK in parallel with the growth in ‘live side’ or ‘pre-insolvency’ approaches to corporate troubles. It has come to serve an important role in contingency and recovery planning as ‘the divide between informal and formal [insolvency] continues to blur’. The process has accelerated in use, most

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6 See e.g. Harris, ‘Decision to Pre-pack’. The Enterprise Act 2002 reforms prohibit (subject to stated exceptions) the use of administrative receivership by the holders of qualifying floating charges: see now ss. 72B–72G of the Insolvency Act 1986. Transactions that predate the implementation of EA 2002 still allow holders of qualifying floating charges both to appoint administrative receivers and to block the appointment of an administrator: see ch. 8 above.

7 The pre-pack may be instituted and driven by a variety of parties: senior debt providers; Insolvency Practitioners (IPs) and advisers to distressed companies; specialist funds; bargain hunters; MBO teams; or groups/companies themselves: see Cranston, ‘Pre-packaged Business Disposals’.

8 Harris, ‘Decision to Pre-pack’, p. 27.

9 See chs. 6 and 7 above. Katz and Mumford found that in 2004, a pre-pack was involved in 44 per cent of cases in which rescue was an objective of proposals for an administration: see A. Katz and M. Mumford, Report to the Insolvency Service: Study of Administration Cases (Insolvency Service, London, 2006). Orbis, the council house cleaner listed on AIM, is an example of a recent pre-packaged administration: see P. Davies, H. Sender and C. Hughes, ‘Management Rescue Orbis in “Pre-pack” Sale’, Financial Times, 5 February 2008.

notably in relation to post-Enterprise Act administrations.\(^\text{11}\) It was estimated in 2006–7 that at least a third and perhaps half of all going concern sales during an administration involved a pre-pack.\(^\text{12}\)

**Advantages and concerns**

**Efficiency**

As indicated above, the proponents of pre-packs would point to a number of advantages produced by the device.\(^\text{13}\) As far as efficiency is concerned, pre-packs are said to be rescue-efficient in so far as they offer low-cost and speedy routes to recovery, they often involve repaying trade creditors in full, they keep legal and other professional costs low\(^\text{14}\) and they allow firms to implement recovery plans before they lose the funding that allows turnarounds to be executed. It might also be claimed that pre-packs are associated with better records of job preservation than business sales without pre-packs.\(^\text{15}\) The pre-pack offers support to incumbent management and provides a way to retain key employees who might leave the company if not confident that a sale can be agreed in the short to medium term – a step that is often essential if value is to be maximised.\(^\text{16}\) A pre-pack may prove particularly useful if the

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\(^{12}\) See S. Davies QC, 'Pre-pack – He Who Pays the Piper Calls the Tune' (2006) *Recovery* (Summer) 16 at 17. Frisby, *R3 Analysis* (p. 15), suggests a figure of 35.5 per cent, but Frisby quotes estimates elicited in interview at from 50 per cent to 80 per cent.

\(^{13}\) See e.g. Vilaplana, 'Pre-pack Bankruptcy Primer', pp. 34–5.

\(^{14}\) Vilaplana cites an example in which Anglo Energy filed twice for Chapter 11 protection. The cost with a pre-pack was $1 million, without $12 million: see ibid., p. 34. See also Walton, 'Trick or Treat?'; J. Ayer, M. Bernstein and J. Friedland, 'Chapter 11 – “101”: Out of Court Workouts, Pre-packs and Pre-arranged Cases: A Primer' (2005) 24 *American Bankruptcy Institute Journal* (April).

\(^{15}\) The Frisby *R3 Analysis* suggests that business sales involve 100 per cent transfers of staff in 65 per cent of all cases but that pre-packs save all staff in 92 per cent of cases. Whether this superior performance is due to the process used or because pre-packs tend to be used where prospects of rescue are brightest is a separate issue. It can be argued that there are not the opportunities for opportunistic lay-offs of workers in a pre-pack that exist in a straight administration (which will give more scope for dismissals that will not be deemed legally unfair): see Frisby, *R3 Analysis*, p. 72. The relative success of the pre-pack in preserving jobs in the short term may, however, have to be set against the higher subsequent failure rates of pre-packs as compared to business sales (39 per cent failure compared to 35 per cent).

\(^{16}\) Cranston, 'Pre-packaged Business Disposals'; D. Flynn, 'Pre-pack Administrations – A Regulatory Perspective' (2006) *Recovery* (Summer) 3; Frisby, *R3 Analysis* notes (p. 32) that staff retention figured strongly in reasons for using a pre-pack. Other cited reasons included: protecting book debt collections; ensuring continuity of insurance cover or a contract; and preserving goodwill.
volume of creditors makes negotiations impractical or if a significant minority of these are liable to hold the majority to ransom in the hope of extracting an improved return for themselves. The High Court has, moreover, upheld a pre-packed sale of a solicitors’ business entering administration, in the face of opposition from the major creditor, on the grounds that the pre-packaged sale minimised disruption to clients and was the best way to protect jobs.\textsuperscript{17}

It has also been argued that pre-packs usefully help to counter the holdout problems associated with the growth of ‘vulture funds’.\textsuperscript{18} Holders of such funds are prone to engage in holdouts in the hope of a better deal since they purchased their claims at a deep discount. A pre-pack in the USA allows such holdouts to be defeated since US law provides that a plan of reorganisation will bind dissidents so long as two-thirds in amount and more than half in number of those voting have approved the plan.\textsuperscript{19}

The speed of the pre-pack process may be particularly valuable in sectors or businesses where a protracted, public restructuring would dramatically affect corporate value – as, for instance, in a regulated sector (where possibilities of retaining licences, franchises and other valued positions may be affected) or where a business is built on human rather than physical assets (where there are dangers that the best staff will be lost to competitors), or where a brand or portfolio would be damaged by adverse publicity or public uncertainty.\textsuperscript{20} The pre-pack offers the prospect of a seamless transition to turnaround that minimises disruption and reduces the risks of declines in markets, reputations, assets or business partner relationships.\textsuperscript{21} It has also been suggested that the

\textsuperscript{17} DKLL Solicitors v. HM Revenue & Customs [2007] BCC 908.
\textsuperscript{19} See US Bankruptcy Code s. 1126: in the USA pre-packs are voted on, while in the UK the pre-pack involves no formal voting arrangement.
\textsuperscript{20} Harris, ‘Decision to Pre-pack’, p. 27; Davies, ‘Pre-pack – He Who Pays the Piper Calls the Tune’, p. 16. The very announcement of insolvency proceedings usually provokes a precipitous decline in goodwill: see G. Meeks and J. G. Meeks, ‘A Gouldian View of Corporate Failure in the Process of Economic Natural Selection’ (Mimeo, Centre for Business Research, University of Cambridge, 2002).
\textsuperscript{21} Cranston, ‘Pre-packaged Business Disposals’. On survival rates a comparison of administration business sales and administration pre-packs reveals that the latter are slightly more likely to fail – but it is said to be difficult to draw a certain conclusion that survival rates differ significantly: see Frisby, R3 Analysis, pp. 76–7.
Enterprise Act 2002 significantly encouraged the use of pre-packs by introducing the streamlined system of out-of-court routes into administration and simpler means of exiting administration. Martin Ellis, a partner at Grant Thornton, has argued that five reasons underpin the steady growth in popularity of pre-packs:

- The increased incidence of consignment stocks and valid reservations of ownership claims.
- The impact of TUPE and the risk that a sale may not ultimately be achievable.
- Demands for ransom payments by monopoly suppliers.
- Increased professional costs.
- The inherent risks of trading.

Sceptics, however, may worry that pre-packs will not always deliver the above goods and may prove less cost-effective than proponents would suggest. A concern that has been voiced in the USA relates to cost-effectiveness and is that, from the debtor’s point of view, the pre-pack may involve considerable legal risks. A bankruptcy court, for instance, may find a disclosure statement inadequate. If this happens, the statement will have to be amended or redistributed. The debtor will then have to re-solicit acceptances and this may produce lengthy delays in confirmation. An opportunity to vote will have to be offered or else such claimants may be well placed to mount a legal challenge to the pre-pack. In either case, delays, uncertainties and additional expenses will be generated. Where objectors delay or derail the proposed plan, the anticipated benefits of the pre-pack are liable to be lost.

Such worries are reinforced by evidence from other sources. In LoPucki and Doherty’s study of 1991–6 reorganisations in, inter alia, Delaware and New York (covering ninety-eight reorganisations), the

22 See Flynn, ‘Pre-pack Administrations’. See also ch. 9 above.
23 Ellis, ‘Thin Line in the Sand’.
27 See Plevin, Ebert and Epley, ‘Pre-packaged Asbestos Bankruptcies’, who cite the instance of two asbestos industry pre-packs that failed to include the insurers whose policy proceeds were to fund the trust under the plan. The resulting litigation deprived the debtors of the benefits of the pre-pack (p. 889).
authors found that debtors who reorganised by way of pre-packs had lower post-bankruptcy earnings than those who reorganised without pre-packs. 28 By this measure, they suggested, ‘pre-packaged organisations are more likely to fail than non pre-packaged organisations’. 29 The speed of pre-packs could also be exaggerated, argued LoPucki and Doherty. The evidence suggested that pre-packs were, at an average of 21.6 months, only 25 per cent shorter than traditional Chapter 11 cases (at 28.5 months). 30 Speed, moreover, inversely correlated with success in the LoPucki and Doherty study, which concluded: ‘Faster reorganisations are significantly more likely to fail than slower ones’. 31

As to the reasons for the higher failure rates of speedy or pre-packaged bankruptcies, LoPucki and Doherty admit that they can only guess – but they do surmise that this may be because such processes can stand in the way of parties coming to grips with the challenges that corporate troubles present:

We speculate that at the core of this market failure is the parties’ desire to appear to reorganise without in fact doing so. Effective reorganisation is unpleasant. Managers must at least acknowledge their past failures and perhaps also resign their positions. Creditors must accept substantial reductions in the amounts owed to them. The interests of shareholders must be finally and permanently extinguished … But no party wants the firm to actually face up to its problems. 32

**Fairness and expertise**

If the pre-pack procedure is compared to a normal Chapter 11 filing, it is more likely in a pre-pack that there will have been a failure to solicit relevant parties and to provide a voting opportunity to all persons asserting claims. 33 If there is an absence of such a chance of voting, this

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29 Ibid.; Vilaplana, ‘Pre-pack Bankruptcy Primer’, p. 41, argues that pre-packs ‘are not useful for companies that have fundamental problems such as major contractual disputes, asbestos problems or pension fund issues’. The usual pre-pack involves a basically healthy company that is over-leveraged.
33 All persons whose claims are ‘impaired’ by the plan are entitled to vote on it: see Plevin, Ebert and Epley, ‘Pre-packaged Asbestos Bankruptcies’, p. 889.
raises concerns not only about the costs and uncertainties associated with potential challenges but also regarding procedural and substantive fairness. Plevin, Ebert and Epley, a trio of Washington, D.C. practitioners in bankruptcy, have written that the pre-pack bankruptcy is seen by many troubled companies as a panacea in the asbestos litigation world, but: ‘Such bankruptcies have drawn rigorous objections by persons claiming that pre-packaged asbestos bankruptcies, as currently practiced, violate the Bankruptcy Code and Rules, improperly treat some claimants more favourably than others, and disregard the contractual rights of the insurers expected to fund the payment under the plan’.

In the UK also there have been similar worries about pre-packs. One practitioner has argued that the rapid growth of pre-packs has given rise to ‘unpleasant practices’ in which directors and shareholders of troubled companies are offered ways to shed their creditors and buy back their businesses at very modest cost. The danger, according to this argument, is one of unfairness in so far as administrators, banks and directors have strong incentives that may not serve all creditors well:

The organising administrator has a clear conflict of interest as typically he wants to get the appointment and the management can influence that – such a pre-pack is a good idea for practice development for him and for advising lawyers. It may suit a bank as it can allow it to participate in the equity going forward in a controlled way or provide it with an assured return potentially at the expense of other creditors. Administrators generally like helping banks.

Stephen Davies QC has raised issues of expertise alongside that of fairness in arguing that a small number of ‘professional bad apples’ who operate via pre-packs facilitate phoenix trading: ‘not withstanding the considerable antipathy of both the profession and the courts towards phoenix operations, insolvency sales to unscrupulous

34 Ibid., p. 923. 35 See Frisby, R3 Analysis, pp. 8–9.
37 On fears of lack of objectivity on the part of those organising pre-packs see Davies, ‘Pre-pack – He Who Pays the Piper Calls the Tune’, p. 16; Moulton, ‘Uncomfortable Edge of Propriety’.
38 Davies, ‘Pre-pack – He Who Pays the Piper Calls the Tune’.
management still occur and the pre-pack is the jemmy in the burglar’s jacket.\textsuperscript{39}

As for the incidence of Newco being owned and controlled by the same people as Oldco, Frisby’s 2007 study suggests that administration pre-packs involve a slightly higher proportion of sales to connected parties (59 per cent) than is the case with all business sales (52 per cent). The trend also seems to be towards more connected sales after the Enterprise Act. The figures for sales to connected parties in pre- and post-Enterprise Act administration pre-packs are 53 per cent and 62 per cent respectively.\textsuperscript{40} These compare with a figure of 51 per cent in post-Enterprise Act administration business sales.\textsuperscript{41} The post-transfer survival rates of businesses transferred to connected parties appear also to be lower than is the case in transfers to unconnected parties. The respective rates, in the case of sales, are 58 per cent to 71.9 per cent and, in the case of pre-packs, 51.4 per cent to 71.5 per cent.\textsuperscript{42}

Critics who are concerned about the fairness of pre-packs are liable also to argue that, with such arrangements, the market will rarely have been properly tested,\textsuperscript{43} some interested parties may not have been made

\textsuperscript{39} Ibid., p. 17. See Insolvency Act 1986 s. 216: this section is aimed at countering the ‘phoenix syndrome’ – a term used to describe an abuse of the privilege of limited liability whereby a company would be put into receivership or voluntary liquidation at a time when it owed large sums to its unsecured creditors. The receiver (frequently appointed by a controlling shareholder who had himself taken a floating charge over the whole of the company’s undertaking) would sell the entire business as a going concern at a knock-down price to a new company incorporated by the former directors of the defunct company. Thus, what was essentially the same company would rise phoenix-like from the ashes of the old and the business would be carried on by the same people in disregard of the claims of the first company’s creditors, who effectively subsidised the ‘birth’ of the new company debt-free: see L.S. Sealy and D. Milman, Annotated Guide to the Insolvency Legislation (10th edn, Thomson/Sweet & Maxwell, London, 2007) vol. I. See ch. 16 below.

\textsuperscript{40} Frisby, R3 Analysis, pp. 42–5.

\textsuperscript{41} Frisby suggests that the movement towards sales to connected parties via pre-packs may be due to Enterprise Act changes in entry into administration and that director-led entry may be a driver: ibid.; see also ch. 9 above.

\textsuperscript{42} Frisby, R3 Analysis, p. 79.

\textsuperscript{43} On failure to market as a central worry see Flynn, ‘Pre-pack Administrations’, p. 3. Frisby’s R3 Analysis (p. 49) states that in only 7.9 per cent of pre-packs was the company marketed, in comparison with a figure of 55.6 per cent for business sales without pre-packs. She argues (p. 38) that if the business has not been exposed to market forces ‘the complete lack of control rights and an inadequate provision of information on the part of the practitioner to unsecured creditors effectively disables them from calling upon the practitioner to demonstrate that he has paid due regard to the statutory scheme for protecting their interests’.
aware of the sale\textsuperscript{44} and the business may have been undersold.\textsuperscript{45} Further objections are that certain creditors may have been left out of consultation processes so that they feel ‘frustrated and impotent’ when informed about events,\textsuperscript{46} and the advisers may have been too aligned with certain interests – which may be those of well-placed creditors or involved managers.

What may make the position worse regarding fairness is that in the period before a pre-pack the directors may seek to build up stock at the expense of trade creditors – perhaps in anticipation of purchasing the business at an advantageous price from the administrator.\textsuperscript{47} Often, it is alleged, the ‘victims’ of pre-packs are the general creditors who see assets sold at undervalue but have difficulty in proving this. Such victims, moreover, face a difficult choice: do they sue the company (with its empty pockets), the directors (who may have concealed their transactions) or the administrator (who is a well-informed repeat player)?\textsuperscript{48}

As for fairness and substantive returns to creditors, the figures available indicate that returns to all creditors\textsuperscript{49} are no less in pre-pack

\begin{itemize}
\item \textsuperscript{44} See Davies, ‘Pre-pack – He Who Pays the Piper Calls the Tune’; S. Mason, ‘Pre-packs from the Valuer’s Perspective’ (2006) Recovery (Summer) 19: Mason notes the role, in pre-packs, of specialist independent valuers of property, equipment and stock.
\item \textsuperscript{45} See G. Rustling, ‘Pre-packaged Sales via Insolvency Processes’, Barclays Bank Protocol (Barclays, London, 10 November 2005), arguing that last-minute approaches to support a pre-pack are ‘unlikely to demonstrate that best commercial value of a business is being achieved’.\textsuperscript{46}
\item \textsuperscript{46} See Davies, ‘Pre-pack – He Who Pays the Piper Calls the Tune’, p. 16. On disenfranchisement being an issue that is not confined to pre-packs see Frisby, R3 Analysis, p. 35, who argues that considerations of speed and business continuity lead to considerable disenfranchisement in non-pre-pack business sales in administration. In Te\&D Industries plc [2000] 1 WLR 646, [2000] BCC 956 it was held (pre-Enterprise Act 2002) that an administrator had the power to sell the assets of a company prior to obtaining creditor approval – though the court stressed the importance of placing the proposals before creditors as soon as reasonably possible. See also Re Transbus International Ltd [2004] BCC 401 which also recognised that sometimes substantial actions have to be taken in administration without prior creditor approval: see S. Frisby, ‘Judicial Sanction of Insolvency Pre-packs? DKLL Solicitors v. HMRC Considered’ (2008) 27 Company Law Newsletter 1.
\item \textsuperscript{47} See Flynn, ‘Pre-pack Administrations’, p. 3.
\item \textsuperscript{48} Moulton, ‘Uncomfortable Edge of Propriety’, p. 3. On IPs and repeat player control of processes see e.g. S. Wheeler, ‘Capital Fractionalised: The Role of Insolvency Practitioners in Asset Distribution’ in M. Cain and C. B. Harrington (eds.), Lawyers in a Post Modern World: Translation and Transgression (Open University Press, Buckingham, 1994).
\item \textsuperscript{49} Frisby, R3 Analysis, p. 50, puts pre-pack administration returns to all creditors at 22.7 per cent on average compared to 22.8 per cent for business sales without pre-packs.
\end{itemize}
administration cases than in administration business sales without pre-packs, but that average returns to secured creditors are considerably higher in administration pre-packs than in administration business sales (59.1 per cent to 27.5 per cent) and that unsecured creditors do twice as badly in administration pre-packs as in administration business sales (2 per cent to 4 per cent). In post-Enterprise Act administration pre-packs the average return for unsecured creditors was only an eleventh of the return from post-Enterprise Act administration business sales. Such results, it seems, support the contention that administration pre-packs favour secured creditors at the expense of unsecured creditors.

Accountability and transparency

On the transparency of pre-packs, Frisby’s 2007 study considered whether practitioners’ reports on pre-packs disclosed sufficient information to creditors to allow them to determine whether their interests had been adequately protected. The quality of such reports varied greatly but their most common omission was the identity of the purchaser. Most gave details of the consideration but the overall informative value was rated, disturbingly, as ‘haphazard’, with significant gaps in a number of cases such as ‘to provoke suspicion and mistrust among creditors and unsecured creditors in particular’. That said, Frisby found that disclosures in non-pre-pack business sales were no better and concluded that disclosure deficiencies were not an exclusively pre-pack problem.

Statutory insolvency procedures offer a number of procedural and substantive protections for the creditors in a troubled company. Focusing on the post-Enterprise Act 2002 administration procedure, it was seen in chapter 9 that administrators must perform their functions in the interests of the company’s creditors as a whole and as quickly and efficiently as is reasonably practical. Administrators are officers of the court, they must act as agents of the company, and they have to operate within a framework of detailed rules on such matters as appointments,
statements of purposes and proposals, notifications and notices, moratoria, creditors’ meetings, and reports to the court and to creditors.

The use of pre-packs does not do away with the need for such statutory procedures. The pre-pack does, however, create at least the risk that the administration procedure will be reduced to a formal or presentational process rather than one offering real protections. This, the critics of pre-packs would argue, is liable to happen, first, when the pre-pack closes the effective options for the company and establishes a single way forward without reference to the full array of creditors. Second, it may happen when the administrator fails to act in a manner that is consistent with his obligations to act in the interests of the company’s creditors as a whole. This failure, it may be contended, is liable to occur when administrators are excessively inclined to treat the pre-pack deal as a fait accompli or are too heavily influenced by the banks.57 Walton argues, for example, that if a deal to sell a company’s business has been made in a pre-pack without leave of the court, and prior to a creditors’ meeting, it is difficult to see how the administrator who proceeds with their mind very much on the sale can be said to be complying with the statutory duty to consider rescue.58

Given that pre-packs are not prohibited by law59 it is clear that the pre-pack raises new questions about the role of the administrator and the place of regulatory or other controls in ensuring that there is accountability within procedures based on pre-packaging arrangements. A key focus for attention here is whether such changes demand a corresponding movement away from legal control and towards more managerial or professional approaches. How such control systems might govern pre-packs so as to increase efficiency, accountability, fairness and expertise is accordingly a matter for our consideration, and managerial and professional ethics and regulatory strategies will be looked at.60

57 See Moulton, ‘Uncomfortable Edge of Propriety’. On challenging administrators’ conduct see IA 1986 Sch. B1, paras. 74 and 75 and ch. 9 above. On administrators’ duties (under the old regime) see Re Charnley Davies Ltd [1990] BCC 605.
58 See Walton, ‘Trick or Treat?’, p. 116: ‘ironically, in this type of administration, the secured creditor may control the whole process … more than in the old-style administrative receivership’.
Controlling the pre-pack

The ‘managerial’ solution: a matter of expertise

One strand of thought sees the pre-pack as giving rise to a set of challenges that can at least partially be seen in managerial terms. Thus, it might be said that potential difficulties of holdouts and legal challenges can be dealt with by taking active steps to negotiate pre-packs in a manner that persuades potentially dissatisfied parties to accept that their interests could not be better protected. The key to success lies in expertise: in astute management of the proposed arrangement and the involved parties. This might entail the concluding of deals in which equity stakes are given in return for co-operation. As has been argued:

The risks of nuisance reaction around valuation and value break can be reduced, if necessary, by offering ‘out of the money’ stakeholders a minority participation in the restructured entity. But there are often technical hurdles here, particularly given the limitations on the extent of cram down in the UK … In the end, the ability to approach and effect a pre-pack confidently turns on the quality of the steps and debate that occur during the live side process.

Ellis has argued that: ‘What we need is [for] responsible IPs to be bold, to have the courage of their convictions and to state publicly and transparently why the business was sold through a pre-pack without advertising or market testing.’ In order to encourage such transparency, Ellis has advocated not regulation but a simple requirement for IPs to explain publicly how the return to creditors was optimised.

Such explanations will deal with the reasons why particular approaches were taken on such matters as marketing the proposed arrangement. What is clear is that a considerable amount of judgement is involved in, for example, balancing the need to market a sale properly and the need to limit disclosure in order to prevent losses of reputations, business positions and consumer confidence. As one experienced practitioner has stated: ‘Open marketing is about identifying the market and making it aware of the opportunities – it is not about exposing the proposal to the whole world.’

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61 See Harris, ‘Decision to Pre-pack’, p. 27; Ellis, ‘Thin Line in the Sand’.
62 Harris, ‘Decision to Pre-pack’, p. 27.
63 Ellis, ‘Thin Line in the Sand’.
64 Cranston, ‘Pre-packaged Business Disposals’.
will be able to explain why a particular level of market exposure effected a reasonable balance between such factors.

The market, moreover, may demand that IPs operate to certain standards in setting up pre-pack proposals. Barclays Bank, for instance, produced a protocol on pre-packs in 2005. This set down the issues that the bank expected to be addressed in letters of recommendation where a pre-pack was being proposed. Such issues included: details of the value being obtained and the marketing activities that have been undertaken and by whom; any third-party valuations; the identities of purchasers and their funding mechanisms; outcome statements comparing expectations from a traditional insolvency with those from the pre-pack (to include the position for the bank, other stakeholders and unsecured creditors); the risks to trading the business or to maintaining asset values; and whether it will be possible to trade the business profitably. The effect of such protocols will be to flesh out what market participants expect of a well-managed pre-pack and to develop common understandings regarding the information disclosures involved in well-managed pre-packs. It can be argued that reputational considerations will induce IPs to negotiate pre-packs in a manner that accords with such expectations and understandings.65

Astute management of the pre-pack may prove helpful in ensuring that enough creditors approve of the deal on the table. It may, accordingly, reduce problems of holdouts and legal challenges. This may, in turn, involve the conducting of rigorous consultations and (on the Ellis model) a degree of *ex post facto* transparency. It would be rash, however, to equate astute management of the pre-pack with the conducting of procedures that are fair across the board to all creditor interests. ‘Managing’ the deal efficiently may, in the eyes of sceptics, involve good public relations and leadership rather than efforts to protect vulnerable interests and wholehearted attempts to identify the solution that is the fairest to all of the company’s creditors.

*The professional ethics solution: expertise and fairness combined*

A variation on the above approach to protecting creditor interests is to rely on the expertise of the administrator but to emphasise the need for that expertise to be informed by a system of professional ethics. Such an approach accepts the highly discretionary nature of the administrator’s

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65 Ibid.
task and puts a high premium on arriving at the ‘right’ judgement. As one practitioner has put it: ‘A pre-pack must “feel right” and IPs must be careful. It is not just about getting an agent’s valuation – you need to carefully assess all the options available and balance the interests of secured creditors with other stakeholders. This can often come down to experience and a gut feeling of what is right.’

A director in corporate restructuring from a ‘Big Four’ firm has similarly emphasised the issue of ethical judgement: ‘For office holders, lenders and other stakeholders there are equally important ethical and reputational matters to assess. Fundamentally, the decision to pre-pack – to adjust the rights of stakeholders against their will or without reference to them – must “feel right” in all circumstances and must be conducted with a sense of fair play.’

For IPs the relevant code of ethics is the BERR ‘Guidance to Professional Conduct and Ethics for Persons Authorised by the Secretary of State as Insolvency Practitioners’. This has relevance on such matters as the duty to ‘strive for objectivity in all professional judgements’ and relates to such questions as whether an IP who has been involved in negotiating a pre-pack has a ‘material professional relationship’ (with, for example, the company’s directors) that prejudices their objectivity. What is clear is that the pre-pack process raises highly acute issues regarding objectivity and conflicts of interest. As Walton argues: ‘Insolvency Practitioners who operate pre-packs have seemingly insuperable conflict of [interest] duty problems.’

The regulatory answer

Commentators who are concerned about the above modes of controlling pre-packs are liable to assert that regulation of the administrator (and the pre-pack process) is needed if the more vulnerable creditor interests are to be protected. Thus Jon Moulton, the managing partner of Alchemy Partners, has argued: ‘This whole area of pre-packs needs regulation

67 Harris, ‘Decision to Pre-pack’, p. 27.
68 In this situation, argues Walton: ‘The administrator’s objectivity would appear to be impaired by a potential and actual conflict of duties.’ See Walton, ‘Trick or Treat?’, p. 117 and passim for a discussion of conflicts of interest and duty in pre-packs.
69 Ibid., p. 120.
(I generally despise regulation!) or the image of the profession will suffer deservedly from the very dubious actions of a few BMW owners.70

Moulton has suggested that pre-packs might be controlled from beyond the profession by requiring them to be blessed by a judge before they are implemented. At the least, he argues, practitioners who use them extensively should be scrutinised closely by their professional bodies. The head of regulation at the Insolvency Service has also expressed some concerns.71

Mike Chapman has argued that regulators need to be alert to the advent of pre-packs and should adapt their monitoring procedures so that action can be taken on the abuses that organising administrators may be party to before taking up appointments as office holders.72 Similarly it has been contended by insolvency consultants Wilson Pitts that scrutiny of pre-packs is a matter of professional regulation so that: ‘It is the responsibility of the insolvency profession’s authorising bodies to root out early sales where creditors are dissatisfied as to how those sales have been conducted whilst supporting well orientated pre-pack sales which can be shown to be in the general interest of all creditors.73

R3 has now issued guidance on pre-packs but some commentators have argued for rigorous complaints mechanisms to control ‘the professional bad apples’.74

A further possibility is to extend statutory controls so that these cover the solicitation of approvals for pre-packs.75 In the USA, it is to be noted, a network of legal rules governs such solicitations in the period

70 Moulton, ‘Uncomfortable Edge of Propriety’, p. 3 – whose example of an unethical organiser of pre-packs has him driving a ‘very nice BMW’.

71 M. Chapman, ‘The Insolvency Service’s View of Regulation’ (2005) Recovery (Winter) 24. In 2008 the Chief Executive of the Insolvency Service, Stephen Speed, emphasised that IPs need to think ‘very carefully in the pre-administration stage about the relation-ship they have with the company and how transparent what they are doing is to the creditors’: see (2008) Recovery (Autumn) 59.

72 See also Flynn, ‘Pre-pack Administrations’, who discusses the Statement of Insolvency Practice (SIP) 13 obligations on IPs not to assist clients in conduct that will ‘undermine public confidence in insolvency procedures or assist directors in any conduct which amounts to misfeasance’ (see SIP 13 paras. 4.1.1–2).


74 In January 2009 the R3’s Statement of Insolvency Practice 16 – Pre-Packaged Sales in Administrations took effect. This guidance note was approved by the RPBs and covers disclosures and processes relevant to pre-packs. See also Davies, ‘Pre-pack – He Who Pays the Piper Calls the Tune’; Flynn, ‘Pre-pack Administrations’.

75 Walton, ‘Trick or Treat?’, p. 120 argues that some provision for creditors to vote (perhaps by post) on a pre-pack deal prior to appointment of the administrator ‘may be the answer’.
before the commencement of a Chapter 11 case. Thus, the Bankruptcy Code, section 1126(b) states that a party is deemed to have accepted or rejected a plan in the pre-Chapter 11 period if the relevant solicitation was in compliance with the applicable non-bankruptcy rule or regulation, or, if there is no such relevant rule or regulation, the solicitation followed disclosure of ‘adequate information’ as defined in section 1125 of the Code. In addition, rules 3017 and 3018 of the Federal Rules of Bankruptcy Procedure require, inter alia, that plans and disclosure statements be distributed to all affected creditors and equity interest holders; that plans be sent to beneficial owners of securities; and that solicitation periods be reasonable. Securities laws in the USA will, moreover, treat pre-pack solicitations as ‘sales’ of securities and liable to regulation unless the nature of the steps being taken comes within an exemption as set out in the terms of the Bankruptcy Code or the securities laws (e.g. on the grounds that the offering is not ‘public’). Where the Bankruptcy Code applies to a pre-pack, dissatisfied parties may file objections within the time limits indicated in the bankruptcy court’s ‘scheduling order’. In the UK Stephen Davies QC has argued that it should be mandatory for advisers to file a statement at court (or possibly with the Registrar of Companies) giving details of the pre-pack, including: the date of first instruction; the reasons for the pre-pack; the period of marketing; all valuations received; the terms of sale; and the total fees by the adviser’s firm and the source of those fees. Desmond Flynn, Agency chief executive of the Insolvency Service, has furthermore suggested that it might be provided that administrators should only be allowed to take expenses incurred prior to formal appointment once these have been expressly authorised by the creditors within the administration proceedings. This proposal is designed to ensure not only transparency but also more effective creditor scrutiny of the administrator’s actions.

76 See Vilaplana, ‘Pre-pack Bankruptcy Primer’, pp. 35–42. The BAPCPA 2005 amends s. 1125 of the Bankruptcy Code to the effect that, notwithstanding the prohibition on post- (bankruptcy filing) petition solicitation of pre-packaged plan votes in the absence of a court-approved disclosure statement, votes may be solicited if the pre- and post-petition solicitation complies with applicable non-bankruptcy law (i.e. securities laws): see Kornberg, ‘Bankruptcy Abuse Prevention and Consumer Protection Act’, p. 35.
78 Davies, ‘Pre-pack – He Who Pays the Piper Calls the Tune’, p. 18.
79 Flynn, ‘Pre-pack Administrations’, p. 3. In 2007 the IS carried out a consultation exercise on draft amendments to the Insolvency Rules 1986 which would allow pre-pack administrators to claim the costs of their pre-appointment work as an administration expense subject to the approval of the creditors of the company: see further P. Walton, ‘Pre-appointment Administration Fees – Papering Over the Crack in Pre-packs?’ (2008) 21 Insolvency Intelligence 72.
Evaluating control strategies

A first point in evaluating systems for controlling pre-packs is to identify the potential mischief at issue. Critics of pre-packs would raise questions of fairness and accountability and argue that the key mischief the device presents is the undermining of those protections for creditors that are offered by (increasingly collective) statutory procedures. What, then, is the protection that administration procedures offer to creditors? If such protections, themselves, amount to little, then the pre-pack arguably involves no significant loss of protection.

As indicated above, the post-EA 2002 administration procedure offers a number of statutory consultation rights – notably by establishing creditors’ meetings and requirements that proposals be approved by these meetings. In substantive terms the administrator must act in the interests of all creditors of the company. These rules are underpinned by the requirement that the administrator must be an insolvency practitioner (IP) and by the existence of a regime of professional regulation for IPs.

Do these requirements offer effective protections for creditors? Are accountability and fairness ensured? As noted in chapter 9, critics of the new administration procedure might caution that under paragraph 52 of Schedule B1 of the Insolvency Act 1986, no initial creditors’ meeting needs to be called if the administrator thinks either that the company cannot be rescued as a going concern or that administration cannot achieve a better result for the company’s creditors as a whole than will be likely on a winding up without first being in administration. Cynics might argue that an administrator who is excessively inclined to keep the banks happy will, accordingly, be well placed to produce proposals for a quick sell off in pursuance of bank interests without going through the creditors’ meeting. As noted above, the legal phrasing of paragraph 3 of Schedule B1 gives administrators a considerable breadth of discretion that makes their judgements extremely difficult to challenge and judicial oversight of the administration process may be the weaker because of the potential for out-of-court appointments of administrators without the need for a Rule 2.2 Report.

In spite of these concerns about administration procedure, critics of pre-packs might argue that matters are worse in a pre-pack. Under

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80 Insolvency Act 1986 Sch. B1, para. 3(2). 81 See ch. 5 above.
normal Schedule B1 procedures, administrators will take a disinterested view of options in the light of their obligation to act in the interests of all creditors. This position might be contrasted by the critics with that found in pre-packs, in which administrators may be involved in pre-negotiations, they may be committed to a course of action before entering administration, and they may have an incentive to push proposals through statutory procedures as quickly as possible. In reply, the advocates of pre-packs might respond that the post-EA 2002 administration procedure itself demands that a good deal of work has to be done before the administrator is appointed. When, for instance, there is a direct appointment of an administrator under paragraph 14 of Schedule B1, the qualifying floating charge holder must, as noted, file a notice of appointment with the court, together with other documents, including a statement by the administrator that he is, *inter alia*, of the opinion that the purpose of administration is reasonably likely to be achieved.\(^8^2\) In practice this will mean that when a major creditor, for example a bank, seeks to appoint an IP as administrator, the bank will have to brief that person on the proposed turnaround package. This will inevitably involve a certain degree of pre-packaging. Proponents of pre-packs would thus argue that there is a continuum of scenarios ranging from appointments of administrators that involve very little homework to those involving much more considerable research and negotiation. A pre-pack, they would say, is merely a highly developed arrangement that does all the work that an administrator would want to have been carried out before he or she agrees to take up a position.

Such arguments, however, may go too far. The most serious concerns about pre-packs may arise not because a good deal of homework and research has been carried out in advance of court applications but because agreements on the company’s way forward have been concluded informally in advance of the statutory process – and that such agreements foreclose alternative courses of action in a manner that may prejudice less powerful creditors. The danger is that when powerful creditors agree to a pre-pack such an agreement creates a momentum that is difficult for the administrator to upset. The proposals on the table will constitute something close to a *fait accompli* in so far as many administrators, when surveying possible options for the company, will have a strong bias towards the pre-pack. This may arise because all non-pre-pack options are likely to carry the prospect of greater uncertainties

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\(^{8^2}\) IA 1986 Sch. B1, para. 18(3)(a) and (b). See ch. 9 above.
and more protracted negotiations. Unlike the pre-pack, they involve the opening of new cans of worms. If this is the case, the pre-pack commits the administrator to a course of action that is agreed outside statutory procedures and it is extremely difficult for less powerful creditors to scrutinise the pre-pack and to renegotiate terms. The administrator’s duty to act in the interest of all creditors has been bypassed and it is no answer to this to say that the IP can take an unbiased view of the pre-pack to assess whether it serves all interests fairly – the IP will have to compare the pre-pack proposals with other realistic options but the latter will have been weakened by the development of the pre-pack. The playing field is already tilted in favour of the pre-packaged agreement.

If such concerns point to a need to control pre-packs, what potential is offered by managerial or professional ethics or regulatory strategies? The problem with managerial strategies is that the cost-effective management of a pre-packaged rescue is not necessarily the same thing as the fair management of the rescue. As noted above, the lowest-cost way to manage turnaround may involve a narrow focusing of consultations on major creditors and the construction of a deal that is offered to other stakeholders on what may be close to a take it or leave it basis. This may differ quite markedly from a procedure in which an administrator holds the ring to see that proposals are developed on the basis of inputs from all relevant creditors. Such dangers of unfairness militate in favour of tempering ‘pure’ managerial approaches with provisions on transparency as suggested by Katz and Mumford – who say that where a sale completes a pre-packed agreement, creditors should be provided with such documentation as would allow them to understand the rationale for the sale. Other disclosure proposals have not been slow to emerge. Desmond Flynn has made proposals regarding creditor approval of pre-pack expenses, Stephen Davies QC has argued for the filing in court of a pre-pack statement and Martin Ellis has suggested that IPs should, in law, have to make public an explanation of why and how the return to

83 Katz and Mumford, *Study of Administration Cases*. As noted above, a new SIP on pre-packs was promulgated in January 2009. The SIP is concerned with transparency, not commerciality, and seeks to set out minimum levels of information to be provided to creditors so that they are properly informed and can form a view as to whether the pre-pack was in their interests. See also R. Heis, ‘Pre-packs – A New SIP’ (*2008*) *Recovery* (Spring) 14.

84 Flynn, ‘Pre-pack Administrations’.

85 Davies, ‘Pre-pack – He Who Pays the Piper Calls the Tune’. 
creditors was optimised. Even when such transparency requirements are in operation, however, it may be protested that explaining why the *fait accompli* was the best available option for the IP does not remove the inevitable bias towards the pre-pack solution.

Using professional ethics to control pre-packs offers, on its face, considerable potential for encouraging fairness. The notion here is that professional IPs only construct pre-packs in a manner that satisfies reasonable expectations of fairness across all creditors. These expectations would be established within the framework of ethics promulgated by systems of selection, training and guidance within the profession. The problems with this solution may be, firstly, those of adverse selection and incentives. A danger here is that the major creditors, the banks, would possess considerable incentives to use IPs with low ethical sensitivities and ‘more practical’ approaches to the pursuit of bank-friendly turnaround proposals. The market, accordingly, might punish ethical practitioners and reward those of a more ‘practical’ disposition.

From this viewpoint there is little reassurance in the contention that reputational concerns will lead IPs to operate even-handedly and openly – the market may reward IPs with reputations for amenability to bank rather than broad creditor interests. A further difficulty with the ‘professional ethics’ solution is that many stakeholders, and the public more generally, may be disinclined to place trust in the ethical judgements of professionals. This is a general problem with self-regulatory systems but it is all the more acute a difficulty in circumstances where the relevant professionals have clear incentives to favour the interests of powerful players – as, for instance, when the IPs who act as administrators are seen to be dependent on the goodwill of the banks in developing their practices. An additional problem may be that

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86 Ellis, ‘Thin Line in the Sand’. Lockerbie and Godfrey, ‘Pre-packaged Administration’ (p. 22) suggest that the factors that an administrator may cite as justifying use of a pre-pack may include: preservation of business relationships; protection of assets; retention of employees; funding requirements; and regulatory factors such as the retention of essential licences.


88 On bank power Davies has written: ‘the power of the clearing banks in the market is such that there is barely a major firm of accountants or solicitors prepared publicly to criticise their conduct or practice, no matter how professionally objectionable’. On incentives and interests of ‘actors’ in administration see ch. 9 above; V. Finch, ‘Re-invigorating Corporate Rescue’ [2003] JBL 527.
pre-packs may not always be set up by IPs – they may be negotiated in-house by the major creditors or they may be set up by independent, non-professional, unregulated specialists (Moulton’s ‘men in BMWs’). Such a pre-pack organiser may operate free from the constraints of any system of professional ethics whatsoever. The real worry is that if such an ‘ethically free’ person constructs a pre-pack that is self-fulfilling (in the sense that it is de facto not feasible to re-open the agreement within realistic timeframes) no amount of ethical shepherding of the deal on the part of the administrating IP will rectify the situation.

Such arguments point to the possible case for regulating pre-packs. On this front a number of strategies may be considered: professional regulation, external oversight mechanisms and legislative reforms.

A system of professional regulation of pre-packs might be furthered by tightening the monitoring regimes relating to pre-packs.89 The Insolvency Practices Council argued in 2006 that the IS and recognised professional bodies should require IPs acting as administrators to: report promptly to creditors when they have executed a pre-packaged sale; explain any decision not to advertise the business on the open market; bear in mind potential conflicts of interest where they have advised the managers of the relevant company on a pre-pack; and disclose potential conflicts of interest to creditors. To this end, R3 issued an SIP on pre-packs to cover such matters.90 It might, however, be required that when IPs process a pre-pack through an administration, they file a report to their professional body for scrutiny. A complaints processing regime could also be established so that dissatisfied creditors’ views might be taken on board. Such a system of control, of course, would not solve the problem of ‘mavericks’ and the difficulties that might arise from pre-packs that are arranged by parties other than qualified IPs. This is a matter to be returned to below.

What of the role of external oversight mechanisms? Some commentators, as noted, have argued that judges should perhaps bless pre-packs before they are implemented.91 Such judicial oversight would correspond to the scrutiny that is involved when the pre-pack proposals are

89 See Flynn, ‘Pre-pack Administrations’. On the monitoring and regulation of IPs see ch. 5 above.
91 See Moulton, ‘Uncomfortable Edge of Propriety’, p. 3.
implemented by means of an application to court for an administration order. It is to be noted, however, that paragraphs 14 and 22 of Schedule B1 of the Insolvency Act 1986 allow qualifying floating charge holders, the company or directors to commence administrations without the need for a court order. It could, accordingly, be argued that, having gone this far to create out-of-court routes into administration, Parliament might be reluctant to institute a judicial approvals mechanism in relation to pre-packs. Such an approvals process would undermine the speed and flexibility of the process and, moreover, would be difficult to set up in a way falling short of abolishing the paragraphs 14 and 22 routes into administration. It might be provided in law that the entry into administration would have to be by court order whenever there is a pre-pack but this would present two real problems. First, it would be necessary to define the precise circumstances, understandings or agreements that constitute a ‘pre-pack’ (which would create much work for lawyers and a good deal of uncertainty). Second, parties wishing to avail themselves of the out-of-court route into administration might find it relatively easy to circumvent any stipulations regarding the judicial approval of pre-packs by keeping their negotiations at a sufficient level of informality to escape the definition of pre-pack – at least until the point at which they have appointed an administrator.

Nor can it be expected that any system of judicial oversight (whether involving pre-packs or not) will involve a significant judicial willingness to interfere with the judgements of administrators. As noted above, the courts have shown themselves to be reluctant to second-guess commercial decisions that are made in difficult corporate circumstances even when the administration process is sought to be instituted by court order. In *DKLL Solicitors v. HM Revenue & Customs* a firm was insolvent (to the tune of about £2.4 million) and owed HMRC £1.7 million. Two of the equity partners of DKLL made an administration application to the court with a view to effecting a pre-pack sale for £400,000. HMRC opposed the application, arguing that it would have opposed the sale (because the price was too low) had it been given the opportunity to do so at a creditors’ meeting. Acting judge Andrew

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92 See Flynn, ‘Pre-pack Administrations’.  
93 See IA 1986 Sch. B1, paras. 11–13. It is arguable that the judicial oversight role is restricted by Parliament’s allocation of extensive discretion to the administrator.  
94 *DKLL Solicitors v. HM Revenue & Customs* [2007] BCC 908; see Frisby, ‘Judicial Sanction of Insolvency Pre-packs?’. See also Re Structures and Computers Ltd [1988] BCC 348.
Simmonds QC, however, granted the administration order, holding that the court had a discretion to grant such an order even where the majority creditor opposed it. (The legality of a pre-pack *per se* was treated as uncontentious.) He stated that in applications for the granting of an administration order the court would ‘give weight to the expertise and experience of impartial insolvency practitioners’. This statement indicates that a ‘business judgement’ approach may be forthcoming from the judges when they are faced with future pre-packaged administrations.

Ellis has, furthermore, cast doubt on the capacity of the judiciary to deliver rigorous and fair oversight: ‘Judges aren’t in a position to make commercial decisions, and, even if they were, who would represent the interests of the divergent stakeholders? Where would they source their information?’

Would legislative reform usefully control pre-packs? A first proposal might be to restrict the negotiation of pre-packs to IPs in order to increase the impact of professional and ethical systems of control and deal with the maverick problem. There may be issues of borderline to be dealt with here. How, for instance, might one stop a bank or another stakeholder from using their good offices to construct turnaround agreements? One way to do this would be to ensure that all pre-packs that underpin applications to court for administration orders are scrutinised or audited by IPs and certified as fair to all creditors. Such a procedure would address the ‘borderline’ and ‘maverick’ issues and would involve oversight not by the judiciary but by professionals specialising in the conduct of such negotiations and capable of making judgements about the feasibility, fairness and reasonableness of business proposals. A system of monitoring by the IPs’ professional body might be combined with such a legislative change. Further legislative reforms might, if necessary, be introduced to place the IPs’ pre-pack auditing function on a statutory basis. A statutory provision might, accordingly, impose an obligation on the IP to ensure, before approving a pre-pack, that the

95 *DKLL Solicitors v. HM Revenue & Customs* [2007] BCC 908 at 913, para. 10.
96 In the USA the so-called ‘business judgement rule’ is a principle that makes company directors and officers immune from liability to the company for loss incurred in corporate transactions that were within their authority and power to make when sufficient evidence demonstrates the transactions were made in good faith and with reasonable skill and prudence: see further D. Branson, ‘The Rule that isn’t a Rule – The Business Judgment Rule’ (2002) 36 Valparaiso Univ. LR 631; V. Finch, ‘Company Directors: Who Cares About Skill and Care?’ (1992) 55 MLR 179, 202.
procedural and substantive interests of all creditors have been reasonably dealt with. This could involve (as Ellis and Davies have both urged) a requirement that the IP is required to explain publicly why the proposed outcome is fair to all creditors.

A step further would be involved if the US regime were to be used as a model so that solicitations of agreements to pre-pack were to be governed by statutory requirements designed to ensure that any information is adequate or timescales involved are reasonable and that proposals are distributed to substantially all affected creditors and equity interest holders.

Such provisions would arguably offer a response to the feared mischiefs involved in pre-packs but there may be a downside involved in extending statutory regulation into the currently pre-formal area of commercial life. First, this would be likely to increase the complexity of turnaround procedures as well as the cost. Second, this might undermine the advantages of pre-packs and reduce their value as ways of effecting turnarounds before reputations and market positions are lost. If those running the pre-pack process were to have to operate procedures that would give them confidence of compliance with the law, this would involve very considerable risks to continuity of trading, business relationships and rescue objectives. Third, such an extended system of control might prove only partially successful in providing control over pre-formal deal-making. The effect might be to produce not only a series of new legal uncertainties (as parties contest such issues as whether a discussion constitutes a solicitation) but also more resort to ‘pre-solicitation’ deals of a highly secretive nature. Critics would caution that such ‘over-regulation’ is liable to lead to less transparency in turnaround negotiations, not more, and to less efficiency in rescue.

Conclusions

If pre-packs are a significant problem, it does seem possible to devise responses. Why, though, should yet more regulation be introduced into business life? Are levels of potential prejudice to creditors great enough to justify new monitoring systems and rules? To recap: the case for action rests on the prejudice to unsecured creditor interests caused by the use of pre-packs and the difficulties that vulnerable creditors have in challenging unsatisfactory pre-packs through the procedures established by the Insolvency Act 1986. Where pre-packs are used cynically it may well be the case that it is extremely difficult to mount challenges: first, because
the informational hurdles are high; second, because the administrator’s discretion is wide and difficult to challenge; and third, because pre-packs have a self-fulfilling effect in so far as, once agreed, they genuinely do make other rescue options less feasible.

The issue of pre-packs points again to the need for insolvency lawyers to come to grips with the issue of displacement and the propensity of corporate control systems to shift across from traditional insolvency processes and scenarios and into the pre-insolvency stages of governance. A clear message is that statutory processes such as the post-EA administration procedure can never be seen as complete or lasting solutions. Negotiations will always be conducted in the new shadows of the latest legislative procedures. The constant challenge may be to assess how statutory regimes sit alongside informal negotiations so that fresh light can be cast into the developing shadows.
Company arrangements

This chapter looks at the statutory arrangements that companies may voluntarily enter into so as to deal with troubles or adapt to changes in market conditions. The two main procedures for effecting voluntary arrangements either within or outside administration or liquidation are schemes of arrangement under section 895 of the Companies Act 2006 and Company Voluntary Arrangements (CVAs), as provided for in Part I and Schedule A1 of the Insolvency Act 1986.

Before looking at these two methods, it should be emphasised that informal arrangements made contractually can, as noted in chapter 7, provide very useful ways of attempting rescues before there is need to resort to the formalities of section 895 or CVA provisions. Informal steps, moreover, may be taken confidentially and, in the international context, may provide a useful way of negotiating between different insolvency systems. Such contractual steps, however, possess a number of weaknesses. They are only binding on contracting parties and cannot tie dissenting parties to an agreement. They offer no form of moratorium to shield the company from its creditors and, even if approved by meetings of creditors and members, offer no protection from the enforcement of claims. Informal procedures may also lend themselves to domination by large secured creditors in a way unmatched by CVAs and section 895 processes.

Schemes of arrangement under the Companies Act 2006
sections 895–901

The roots of the scheme of arrangement lie in Victorian legislation but, as set out in the Companies Act 2006, the process allows a ‘compromise or arrangement’ to be agreed between a company and ‘its creditors, or any

1 See ch. 7 above; D. Brown, Corporate Rescue: Insolvency Law in Practice (J. Wiley & Sons, Chichester, 1996) p. 647.
2 Joint Stock Companies Act 1870.
class of them. An arrangement here may include a reorganisation of share capital by the consolidation of shares of different classes or by the division of shares into different classes. Such schemes are commonly used to effect compromises and moratoria with creditors and schemes with policy holder creditors of insurance companies have also been common. They are also used in takeover and merger transactions and in reorganisations of rights allocated to classes of shares or debt, often where the articles or instruments constituting the capital are inadequate.

The relevant procedure for a scheme involves an initial approach to the court by the company or any creditor, member, liquidator or administrator of the company, or else the summoning (with court approval) of meetings of the company’s members and creditors. On such approval being obtained, the scheme must be approved by the court, which will consider


4 Companies Act 2006 s. 895(2). A proposal under s. 895 has to involve an ‘arrangement’ or ‘reconstruction’: see further Re My Travel Group plc [2005] 1 WLR 2365, [2005] BCC 457 (where Mann J agreed with subordinate bondholders that the scheme as initially proposed was not a ‘reconstruction’ for the purposes of the statute because only 4 per cent in value of the shares in the new company were held by the shareholders in the old company, with the bulk of the new company’s shares going to the old company creditors. Mann J also indicated, however, that the subordinated bondholders had ‘no economic interest’ in the company. This recital was set aside on appeal: Re My Travel Group plc [2005] 2 BCLC 123.) See N. Segal, ‘Schemes of Arrangement and Junior Creditors – Does the US Approach to Valuations Provide the Answer?’ (2007) 20 Insolvency Intelligence 49; Re T & N Ltd and Others [2006] 3 All ER 697 – per David Richards J – a mere expropriation of rights does not qualify as an arrangement; D. Milman, ‘Arrangements and Reconstructions: Recent Developments in UK Company Law’ (2006) 21/22 Sweet & Maxwell’s Company Law Newsletter 1.

5 See CLRSG, Modern Company Law for a Competitive Economy: Completing the Structure (November 2000) p. 206. A scheme of arrangement can also be put in place after the principal terms of an informal restructuring have been agreed, thus binding dissentient creditors: see further the discussion on informal rescue in ch. 7 above.

6 Ibid.

7 The Notes to Part 26 of the Companies Act 2006 state that one of the (two) changes of substance in the 2006 provisions is that ‘S. 899(2) makes clear that the persons who may apply
issues of procedural fairness, hear objections from dissenters and decide whether the scheme is ‘fair and reasonable’\(^8\) and would have been supported by any intelligent and reasonable bystander.\(^9\) The court will, \textit{inter alia}, consider whether each common interest group (for which there must be a separate meeting) is fairly constituted and whether the class’s decision to approve the scheme was one that could reasonably have been made.\(^10\)

One advantageous feature of the scheme of arrangement is that, if the arrangement is approved, it may modify the rights of shareholders and creditors and may do so without their consent. It is binding on all affected parties,\(^11\) not just those who, in accordance with the rules, were entitled to vote at the meeting approving the arrangement (as with a CVA under the Insolvency Act 1986 sections 1–7). Schemes, moreover, may be tailored to corporate needs. They are very flexible and there are no statutory prescribed contents for such schemes.\(^12\) They can be used in conjunction with liquidation (in order to reach a particular compromise for a court order sanctioning a compromise or arrangement are the same as those who may apply to the court for an order for a meeting (under s. 896(2))’ (para. 1166). The other substantive change is that ‘S. 901 requires a company to deliver to the registrar a court order that alters the company’s constitution. It also requires that every copy of the company’s articles subsequently issued must be accompanied by a copy of the order unless the effect of the order has been incorporated into the articles by amendment’ (para. 1167).


\(^9\) See \textit{Re Abbey National plc} [2005] 2 BCLC 15. On the issue of whether junior creditors have any residual economic interest in the debtor and the courts’ ability to deal with this issue when deciding whether the scheme is reasonable see Segal, ‘Schemes of Arrangement and Junior Creditors’; \textit{My Travel Group plc} [2005] 1 WLR 2365 (Mann J); \textit{My Travel Group plc} [2005] 2 BCLC 123 (CA).

\(^10\) The court must be satisfied that the scheme does not operate unfairly between groups and will ask whether an intelligent and honest member of the class could reasonably have approved the proposal: see \textit{Re Linton Park plc} [2008] BCC 17; \textit{RAC Motoring Services Ltd} [2000] 1 BCLC 307; D. Milman, ‘Schemes of Arrangement’ [2001] 6 Palmer’s In Company 1.

\(^11\) A majority in number representing three-quarters in value of the creditors, or class of creditors, or members, or class of members, is binding on all creditors, or the class of creditors, or the members, or class of members, where the arrangement is sanctioned by the court: Companies Act 2006 s. 899(1). The court has complete discretion, when approving a scheme, to make consequential directions. This may be useful where the proposal put to the court differs from the proposal considered by the shareholders: \textit{Re Allied Domecq plc} [2000] BCC 582.

\(^12\) Schemes must, however, be within the corporate powers of the company – \textit{Re Ocean Steam Navigation Co. Ltd} [1939] Ch 41 – and must comply with the Companies Act requirements on reductions of capital or issues of redeemable shares – \textit{Re St James Court Estate Ltd} [1944] Ch 6.
with creditors) or as an alternative to liquidation or as one of the purposes for which administration can be entered into. Section 895 schemes can also be embarked upon with regard to solvent companies. Securities may be removed or rights to enforce securities may be curtailed and creditors’ payment rights can be modified if the majority of secured creditors agree. (The court’s powers under the Companies Act 2006 section 900 are more extensive here than in relation to administration orders.)

A second advantage, of relevance to rescue scenarios, is that schemes may be formulated and approved without any requirement that there be an impending insolvency. Early attention to corporate difficulties and timely responses to problems may, accordingly, be instituted. (This may be a considerable advantage over some of the entry routes into the ‘new’ administration.) A third favourable factor is that schemes of arrangement are in essence agreements between companies and their creditors and, accordingly, there is no need to involve an insolvency practitioner in formulating or in implementing the scheme. This allows the existing directors to stay in control of the company and the process does not deter them from taking remedial action by holding out the real prospect of a ceding of control to an outside IP. Schemes, moreover, can be applied to companies not registered in the UK, and, if the company has assets in the UK, the scheme can prevent enforcement against these. This overcomes jurisdictional problems. A final attraction of the scheme of arrangement is that it can be used to reorganise corporate groups: debt can be exchanged for equity and schemes can provide for the transfer of shares or assets between companies or even the amalgamation of a number of companies.

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13 See e.g. the broadly defined purposes of para. 3 in Sch. B1 of IA 1986; see ch. 9 above.
15 See, for example, IA 1986 Sch. B1, paras. 11(a), 27(2) – an appointment of an administrator by the court (unless on the application of a QFCH), or out of court by the company or its directors, can only be made if the company is insolvent or nearly so: see ch. 9 above.
In spite of such advantageous characteristics, schemes of arrangement have been used on relatively few occasions. This infrequency of resort is understandable once the disadvantages of the scheme of arrangement are considered. A major constraint on use has been that such schemes have been so rigorously protective of minority interests that, in practice, schemes have not been approved unless they have happened to satisfy the interests of all parties affected by them. This protective stance is seen in the complexity of the approval arrangements. It is necessary to ensure that separate meetings are held for each different class of member or creditor affected by the proposed scheme. It is often difficult, however, to know what constitutes a class for these purposes, and the court will not offer guidance on such matters at the application stage. Different types of shareholding clearly produce different classes, and preferential, secured and unsecured creditors will also be separately grouped. Other interest groups within these classes may also, however, have to be organised into different classes, and if such classes are not established properly from the start, the whole scheme will be nullified. There have, however, been recent signs of a less protective stance by the judiciary – a change of approach that has prompted some concern. When the Company Law Review Steering Group (CLRSG) looked at these issues, it considered that, in an important case, the Court of Appeal had not given sufficient protection to minority creditors and members. The decision in *Re Hawk Insurance Co. Ltd* was seen as worrying in so far as a scheme of arrangement under (the then) section 425 was approved where a single meeting of all the creditors had been held,

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47 – are implemented by Part 27 of the Companies Act 2006, and s. 903 provides that, in the case of mergers or divisions within the scope of Part 27, ss. 895–901 are to have effect subject to the provision of Part 27: see Boyle and Birds’ *Company Law* (6th edn, Jordans, Bristol, 2007) p. 826.

18 The CLRSG favoured the idea that the court should have discretion to decide class issues at the application stage: see CLRSG, *Modern Company Law for a Competitive Economy: Final Report* (July 2001) para. 13.8.

19 A petition for approval of a scheme will be nullified: Practice Note [1934] WN 142.

20 [2001] EWCA Civ 241. Chadwick LJ stated that: ‘those whose rights are sufficiently similar to the rights of others that they can properly consult together should be required to do so, lest by ordering separate meetings the court gives a veto to a minority group. The safeguard against majority oppression … is that the court is not bound by the decision of the meeting’; see further R3, ‘Legal Update’ (2001) *Recovery* (September) 8. See also CLRSG, *Completing the Structure*, p. 215. The *Report of the Review Committee on Insolvency Law and Practice* (Cmnd 8558, 1982) (‘Cork Report’) noted the difficulties of class definition (paras. 405–18), and CVA procedures avoid separations of classes in favour of remedial procedures for those who consider they have been unfairly prejudiced: see Insolvency Act 1986 s. 6.
notwithstanding that the creditors appeared to have had different rights. The courts have taken varying approaches to class definition and the CLRSG looked favourably on legislating to define classes so as to restore the pre-*Hawk Insurance* position and state that the only persons entitled to attend and vote at a (then) section 425 meeting would be ‘persons whose rights are not so dissimilar as to make it impossible for them to consult together with a view to acting in their common interest’. The CLRSG also suggested that the courts should be able to sanction a scheme even if classes had been wrongly constituted or, in appropriate circumstances, where separate meetings had not been held. Neither of these suggestions found their way into the Companies Act 2006 but recent cases suggest that the judges are adopting constructive approaches both to procedural issues and to the sanctioning of schemes.

On top of complications relating to definitions of classes, there are elaborate provisions relating to schemes of arrangement that are designed to ensure that all members and creditors will be notified of

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21 On approaches to the definition of a class see, *inter alia*, the ‘tour de force’ judgement that will become a benchmark for the future (Milman, ‘Arrangements and Reconstructions’, p. 3) – *Re British Aviation Insurance Co. Ltd* [2006] BCC 14. See also *Re BTR plc* [1999] 2 BCLC 675: ‘those persons whose rights are not so dissimilar as to make it impossible for them to consult together with a view to acting in their common interest’; *Re Sovereign Marine & General Insurance Co. Ltd* [2006] BCC 774 (on which see T. McMahon, J. Wardrop and A. Wood, ‘Solvent and Insolvent Schemes of Arrangement ...WFUM: The Story So Far’ (2006) 19 Sweet & Maxwell’s Company Law Newsletter 1: ‘This highly detailed judgement demonstrates the careful and balanced view that the court will take when reviewing proposed schemes and will have a huge impact on the structuring of solvent schemes in the future’). See also *Re Telewest Communications plc (No. 1)* [2004] BCC 342 (the rights of sterling and dollar bondholders were not identical but they were sufficiently similar to be treated as a single class); *Re Osiris Insurance Ltd* [1999] 1 BCLC 182 (Neuberger J indicated that a single class might contain members whose interests were not exactly the same).


24 See for example *Re Abbey National plc* [2005] 2 BCLC 15, cited in Milman, ‘Arrangements and Reconstructions’, p. 4. Such pragmatism, however, does not go so far as to endorse a class ‘meeting’ as valid when attended by a single person where there was no evidence that there was only one person in that particular class: *Re Altitude Scaffolding Ltd* [2006] BCC 904.

25 See *In re Cape plc* [2006] EWHC 1316, [2007] Bus LR 109 where David Richards J confirmed that three different types of asbestos claimant could be combined in a single class and that arrangements containing provision for future amendment could be sanctioned by the court, albeit in exceptional cases. On *In re Cape* see further J. Townsend, ‘Schemes of Arrangement and Asbestos Litigation: *In re Cape plc*’ (2007) 70 MLR 837.
the meetings and fully informed of the issues. A very extensive explanatory statement must be sent out with notices of meetings, and this statement will be both scrutinised in its terms and subjected to a power of approval by the court. The court is thus involved in the procedure in at least two stages, first, on convening the necessary meetings of creditors and members and, second, on the petition to sanction the scheme as approved by the appropriate majorities of the meetings. On a petition for approval, moreover, a substantial review of information has to be provided to the court on such matters as the capital, business and financial history of the company, the terms of the scheme and the effects of the scheme on each relevant class of creditor or contributory. Dealings with the court on these matters involve substantial formality, routine and complexity as well as numerous attendances at court or chambers. Variations in schemes are also overseen by the court. When a scheme is approved by the court it must be filed at the Companies Registry and it cannot then be varied without court approval. In such circumstances the court will demand that further class meetings are held in order to approve the variation.

A further posited disadvantage of the scheme of arrangement is that, as noted, it involves no moratorium. In the period between the initial formulation of a scheme and its becoming effective by court order, each individual creditor is thus able to exercise all the rights and remedies that he or she possesses against the company debtor. Cork estimated that, because of the complex procedure involved, this period of high vulnerability was unlikely to be less than eight weeks. In this period the troubled company cannot prevent winding up or the random seizure of assets by individual creditors, and this will make it extremely difficult to launch even the simplest scheme. In 2000 the Insolvency Service recommended that it should liaise with the CLRSG to give full consideration to proposals for a moratorium in schemes of arrangement, one to resemble the CVA moratorium then proposed (and later

27 Note that the Companies Act 2006 s. 901 now requires a company to deliver to the registrar a court order that alters the company’s constitution. It also requires that every copy of the company’s articles subsequently issued must be accompanied by a copy of the order unless the effect of the order has been incorporated into the articles by amendment.
28 Cork Report, para. 406 (discussing the Companies Act 1948 s. 206 scheme, the statutory predecessor of s. 425 of the Companies Act 1985).
29 Ibid., para. 408.
implemented), and in its Final Report the CLRSG recommended further DTI consideration of the issue. The 2006 legislative restating of the rules on schemes, however, provided no addition of a moratorium. Schemes may, accordingly, have to be coupled with administration orders if any protection is to be secured.

It should, finally, be noted that the prominent role of the company’s existing management in a scheme of arrangement may bring some advantages (for example, the mentioned lack of disincentives to respond to troubles) but there may be concurrent disadvantages. Schemes of arrangement depend substantially on the management of the company to take new initiatives, often defensively. These qualities may often be lacking in companies, particularly troubled companies. As Cork noted:

> It is, however, often the case that, where a company has become insolvent, the management has lost interest, or lost its grip, and there is a vacuum. All too often a scheme of arrangement with creditors would be of advantage to all concerned, but there is no one with the authority within the company, the means of information, and the energy to push the scheme through.

In recent years the scheme of arrangement has revived in popularity—a revival due, in no little part, to the constructive attitude taken by the courts, whose concern to facilitate the implementation of schemes has been exemplified in an approach to assessing junior creditors’ ‘real economic interests’ with reference to the sums that such parties would receive in the alternative to the scheme (notably by enforcing their bonds within a winding up).

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31 It has been argued, however, that the lack of a moratorium provision combined with a simplified scheme of arrangement procedure could actually facilitate the restructuring of companies in providing a cheaper and more cost-effective process: see J. Tribe, ‘Company Voluntary Arrangements and Rescue: A New Hope and a Tudor Orthodoxy’ (Mimeo, Kingston University, 2008).


33 In the Takeover Panel’s consultation paper, Schemes of Arrangement (Takeover Panel, London, June 2007) the Code Committee noted that schemes of arrangement have been used increasingly in recent years to effect takeover transactions regulated by the Takeover Code. (The aim of the consultation paper’s proposals is to codify the application of the Code to such schemes.) See further ‘Takeover Panel Consults on Schemes of Arrangement’ (2007) 12 Sweet & Maxwell’s Company Law Newsletter 8.

34 As in Re My Travel Group plc [2005] 1 WLR 2365: see Segal, ‘Schemes of Arrangement and Junior Creditors’, p. 51; and p. 481 above.
As for ways forward, the CLRSG’s Final Report of 2001 advocated that the requirement that a majority in number of those who cast the votes needed to agree a scheme be dispensed with so that a threshold of 75 per cent in value alone would apply.\textsuperscript{35} Regarding the latter point, the CLRSG had argued that in many modern listed companies shareholders consisted to such a great extent of nominees that the decision of the true owners ‘bears little or no relation to whether or not a majority in number is attained’.\textsuperscript{36} No other meetings of members of a company, the Committee pointed out, required a majority other than by reference to value or voting powers.

Looking more broadly at reforms to section 895 procedures, there is a strong case for contending that the procedures for schemes of arrangement should be modelled along the lines of those relating to CVAs so that the class meeting regime as presently set up should be replaced with a statutory framework of meetings in combination with remedial powers to challenge the process by parties who are able to demonstrate that they have suffered prejudice – as per the Insolvency Act 1986 section 6 provisions on CVAs. Improvements in the transparency of the CVA process (as discussed below) could also be applied to schemes of arrangement.

Adopting this revised procedure for schemes of arrangement would offer a cheaper and quicker route to affirmation than mechanisms involving the court in routine approvals and decision-making on the procedural requirements of individual corporate circumstances. Cork, indeed, doubted whether ‘painstaking perusal of documents by court officials with little or no experience of commerce or finance provides any real protection for creditors or contributories’.\textsuperscript{37} There would be efficiency gains without material losses in fairness or accountability. As for the requirement of a numerical as well as a 75 per cent by value majority, the argument in favour of the existing rule is that this serves to limit the ability of creditors with large claims to impose their wills on their smaller creditor brethren. A further consideration is that if the schemes of arrangement process is streamlined so as to involve lower levels of court scrutiny

\textsuperscript{35} CLRSG, \textit{Final Report, 2001}, para. 13.10. See also C. Maunder, ‘Bondholder Schemes of Arrangement: Playing the Numbers Game’ (2003) 16 \textit{Insolvency Intelligence} 73 at 76, for argument that removing the majority in number requirement would make schemes (now used as the tool of choice for many major restructurings involving bond issues) more ‘flexible and attractive as well as saving significant amounts of costs for the debtor company and its creditors without necessarily putting at risk the rights of minority creditors’.

\textsuperscript{36} CLRSG, \textit{Completing the Structure}, p. 216.

\textsuperscript{37} Cork Report, para. 419.
and if it continues to differ from the CVA by its non-reliance on the independent IP, there is a case for retaining small creditor protections in excess of those applicable to CVA procedures. Small creditors, after all, might rightly complain about their exposed positions if very large creditors were able to agree arrangements with managers under conditions of low scrutiny and little independent oversight and small creditors could only rely on \textit{ex post facto} challenges in court: challenges that might well have to be mounted by parties who are ill-resourced, ill-informed and generally very poorly placed to protect their positions.

Is there a case for retaining the scheme of arrangement process when resort might be made to other procedures such as CVAs and administrations? This is a matter to be returned to once the CVA device has been discussed.

\textbf{Company Voluntary Arrangements}

The CVA, like administration, owes its origins to the Cork Committee. Cork considered that the law it reviewed was deficient in failing to provide that a company, like an individual, could enter into a binding arrangement with its creditors by a simple procedure that would allow it to organise its debts.\textsuperscript{38} Under the then law, the company would have to obtain the separate consent of every creditor or else use the slow and cumbersome scheme of arrangement process.\textsuperscript{39} The Insolvency Act 1986 sections 1–7 set out a simpler scheme based on the Cork recommendations, and these provisions were hailed as the arrival of a new ‘rescue culture’ in English insolvency procedures.\textsuperscript{40} The Insolvency Act 1986 provides that the directors of a company can take the initiative in setting up a voluntary arrangement, though the first steps can be taken by the liquidator or the administrator if the company is being wound up or is in administration. It is not necessary for the company to be ‘insolvent’ or ‘unable to pay its debts’ for the procedure to be used. The directors may nominate an IP to act in relation to the CVA and may make a proposal for consideration by a meeting of the company’s members and creditors. It is common for the

\textsuperscript{38} \textit{Ibid.}, paras. 400–3.
\textsuperscript{39} See the then Companies Act 1985 ss. 425–7 (formerly Companies Act 1948 ss. 206–8), a scheme of compromise or arrangement; Companies Act 1985 s. 582 (formerly Companies Act 1948 s. 287), a scheme of liquidation and reconstruction; or Companies Act 1985 s. 601 (formerly Companies Act 1948 s. 306), a ‘binding arrangement’.
directors to produce the proposal with the assistance of a licensed IP. The person nominated to act in a CVA as a trustee or supervisor must, within twenty-eight days of notice of the proposal for a CVA, report to the court, stating whether, in his opinion, meetings of the company and creditors should be summoned to consider the proposal. The proposal needs to be approved by 75 per cent of creditors voting in person or by proxy by reference to the value of their claims. It also requires the approval of 50 per cent in value of the members/shareholders present at a shareholders’ meeting. If approved, the scheme becomes operative and binding upon the company and all of its creditors who were entitled to vote at the meeting or would have been so entitled if they had had notice of it. The scheme even binds those creditors who did not approve the proposal. The scheme is administered by a supervisor, usually the person who was the nominee, who must be a qualified IP, and a CVA operates under the aegis of the court but without the need for court involvement unless there is a disagreement requiring judicial resolution.

41 Or longer if the court allows: Insolvency Act 1986 s. 2(2).
42 Where the nominee is not the liquidator or administrator he must also state in his report whether, in his opinion, the proposed CVA has ‘a reasonable prospect of being approved and implemented’: Insolvency Act 1986 s. 2(2).
43 Value being determined by the number of votes conferred on each of them by the company’s articles of association: Insolvency Rules 1986, r. 1.20(1).
44 Where there is a conflict between a creditors’ meeting decision to approve a proposal and a shareholders’ meeting decision, the creditors’ meeting decision prevails, subject to the shareholders’ right to challenge by application to the court: Insolvency Act 1986 s. 4A(2), (3), (4).
45 Insolvency Act 1986 s. 5. The CVA thus binds even unknown creditors and creditors not receiving notice of the meeting because it was sent to the wrong address. A person entitled to vote at the meeting (whether or not with notice) can apply to court (under s. 6(2)) on the grounds that the CVA unfairly prejudices the interests of a creditor, member or contributory of the company or that there has been some irregularity at the meeting; see Re Trident Fashions [2004] 2 BCLC 35. On the position of creditors not bound by the CVA see Re TBL Realisations Ltd, Oakley-Smith v. Greenberg [2004] BCC 81, [2005] 2 BCLC 74; L. C. Ho and R. Mokal, ‘Interplay of CVA, Administration and Liquidation: Part I’ (2004) 25 Co. Law. 3; cf. R. M. Goode, Principles of Corporate Insolvency Law (3rd edn, Sweet & Maxwell, London, 2005) pp. 401–3.
46 Insolvency Act 1986 s. 7(2).
47 See the Insolvency Act 2000 Sch. 2, para. 3 for amendments to the circumstances in which the court may replace a nominee (i.e. for failure to submit a report, death or where impracticable or inappropriate for nominee to continue to act).
48 See Insolvency Act 1986 s. 7; Re Pinson Wholesale Ltd [2008] BCC 112 – on a s. 7 application by joint CVA supervisors, the court was willing to imply a term into the statutory contract effected by the CVA so as to provide for fair remuneration for the joint supervisors who had successfully claimed £70,000 from a former office holder in relation to the company.
What a CVA does not do within the terms of section 4 of the Insolvency Act 1986 is affect, without agreement, the rights of secured creditors of the company to enforce their securities: meetings shall not approve any proposals or modifications that interfere with such enforcement rights except with the concurrence of the creditor concerned.\footnote{Insolvency Act 1986 s. 4(3).}

Similarly, company or creditors’ meetings cannot approve proposals or modifications providing for the paying of preferential debts other than in priority to non-preferential debts or other than equally with other preferential debts.\footnote{The Insolvency Act 1986 Part I contains provisions obliging preferential creditors to accept a decision made by a majority of them even if passed in a separate class meeting. This contrasts with the Companies Act 2006 s. 895.}

Nor did the Insolvency Act 1986 provide for a general moratorium and a period of protection during which the company can draw up and consider an arrangement.\footnote{This contrasts with the ‘interim order’ available in the case of insolvent individuals under the Insolvency Act 1986 ss. 252–4.} A moratorium could only be achieved under the Act by combining a proposal for a CVA with an application to the court for the appointment of an administrator.\footnote{See now Insolvency Act 1986 Sch. B1; ch. 9 above.}

This would constitute a complex and expensive procedure. The introduction of a CVA moratorium for small companies, as will be seen below, was the major change effected by the Insolvency Act 2000.

The gestation period for this development was, however, considerable. In 1993 the DTI concluded that, on balance, an immediate moratorium would be useful in allowing discussions to take place between the company, major creditors and secured lenders.\footnote{DTI/Insolvency Service, \textit{Company Voluntary Arrangements and Administration Orders: A Consultative Document} (October 1993) (DTI 1993) p. 11. On landlords’ right to peaceable re-entry see ch. 9 above. The arguments ranged against the moratorium, however, were that it is a device open to abuse by directors of companies that have no chance of turnaround and that it tends simply to prolong agonies, dissipate more assets and make realisations less efficient.} It would also allow the company to carry on trading without facing such threats as landlord distraints or winding-up petitions or repossessions of goods under hire purchase or leasing contracts. This was to take effect on the filing in court by the directors of an intention to set up a CVA together with a consent to act by the nominee, but only if the moratorium was additional to the existing CVA procedure and involved an appropriate level of
supervision. The 1993 proposals went to consultation and the DTI reported two years later that a 'broad consensus' had favoured a short moratorium for rescue purposes. A proposed new CVA procedure was presented and aimed 'to make company rescue simpler, cheaper and more accessible, particularly for the smaller company'.

The small companies’ moratorium

In February 2000, the Insolvency Bill was introduced into Parliament. It received royal assent on 30 November 2000 and its moratorium provisions came into effect on 1 January 2003. The 2000 Act amends the Insolvency Act 1986 by inserting a new section 1A and a new Schedule A1 (which provides for the 'small companies' moratorium). Consistently with the DTI’s proposals, this legislative change allows the directors of an ‘eligible’ company to obtain a moratorium when proposing a CVA under Part I of the Insolvency Act 1986. A company is eligible under the IA 1986 Schedule A1, paragraph 3(2) if, in the year before filing for a moratorium or the prior financial year, it has satisfied two or more of the requirements for constituting a small company under section 382(3) of the Companies Act 2006. This means that moratoria will only be available to companies with at least two of the following requirements: a turnover of not over £6.5 million per annum; fewer than fifty employees; and a balance sheet total which does not exceed £3.26 million. These are very small companies indeed. It can be argued that if moratoria are useful to small companies they should be of benefit to all companies. The Insolvency Act 2000 leaves open the possibility of extending the moratorium to larger companies by providing that the Secretary of
State may promulgate regulations to modify the terms of eligibility for a moratorium. One reason why eligibility might be extended arises from the vulnerability of the current rules to abuse. As the Law Society pointed out in its comments on the Insolvency Bill 2000, a company might have an incentive to arrange its affairs so that it meets the requirements for being a small company in order to gain the protection of a moratorium for a CVA.

A company may not file for a moratorium if an administration order is in force; it is being wound up; an administrative receiver has been appointed; a CVA has effect; there is a provisional liquidator; or in the prior twelve months a moratorium has been in force, or a CVA has ended prematurely and a section 5(3)(a) order has been made, or an administrator has held office. Before a moratorium is obtained, the directors will submit to the nominee the proposed terms of the CVA and a statement of company affairs. The nominee will then indicate to the directors, in a statement, his opinion on whether the CVA has a reasonable prospect of approval and implementation; whether the company is likely to have sufficient funds to carry on its business; and whether meetings of the company and creditors should be summoned to consider the proposed CVA. Filing for a moratorium is carried out by the directors and involves submission to the court of a statement of proposals and of company affairs. The court also receives, inter alia, a nominee statement. The moratorium commences on filing the appropriate documents and lasts until the day on which the meetings of the company and its creditors are first held.

The effects of the moratorium are to offer protection against petitions for winding up or administration orders, meetings of the company,


In commenting on the Trade and Industry Committee Report on the draft Insolvency Bill, the Government said that ‘the results of experience to date should be a significant factor in any decision to extend eligibility for a moratorium’: see Trade and Industry Committee, Fourth Special Report, Government Observations on the First and Second Reports from the Trade and Industry Committee (session 1999–2000) HC 237.


Ibid., para. 8. The time limit for the holding of the first meetings is twenty-eight days from the day on which the moratorium comes into force, unless an extension is granted under Sch. A1, para. 32.
winding-up resolutions, appointments of receivers and other steps ‘to enforce any security over the company’s property or to repossess goods in the company’s possession under any hire purchase agreement except with the leave of the court’.64 No other proceeding or execution or legal process or distress can be commenced, continued or levied against the company except by court leave, nor can a landlord forfeit the lease of a company’s premises by means of peaceable re-entry.65

Security granted during the moratorium is only enforceable if, at the time of granting, there were reasonable grounds for believing that it would benefit the company.66 The company is not allowed to obtain credit of over £250 during a moratorium from a person who has not been informed that the moratorium is in force.67 Disposals of company property and payments of debts and liabilities existing prior to the moratorium are only permissible if there are reasonable grounds for believing that such actions will benefit the company or there was approval by a meeting of the company and its creditors (or the nominee in absence of such ‘moratorium committees’).68 Property of the company subject to security or held in possession under hire purchase agreement can be disposed of with court leave or consent of the security holder/owner of the goods.69 In the case of dispositions of property subject to a security which, as created, was a floating charge, the security holder’s priority will not change regarding property representing the property disposed of.70

Where court leave is given as described, this is to be notified by the directors to the Registrar of Companies within fourteen days or liability to a fine results.71 During the moratorium the nominee is obliged to monitor the company’s affairs for the purposes of forming an opinion on whether the proposed CVA has a reasonable prospect of approval and implementation and whether the company is likely to have sufficient funds during the remainder of the moratorium to allow it to carry on its business.72 The nominee must withdraw his or her consent to act if he or she forms the opinion that such reasonable prospects of funds are no longer likely, if he or she becomes aware that the company was not, at the

64 Ibid., para. 12(1).
65 Ibid., para. 12(1). On peaceable re-entry see P. McCartney, ‘Insolvency Procedures and a Landlord’s Right of Peaceable Re-entry’ (2000) 13 Insolvency Intelligence 73 and ch. 9 above.
68 Ibid., paras. 18, 19, 29 and 35. 69 Ibid., para. 20. 70 Ibid., para. 20(4).
71 Ibid., para. 20(8) and (9). 72 Ibid., para. 24(1).
date of filing, eligible for a moratorium or if the directors fail to comply with their duty to supply the nominee with information needed to form an opinion on the above matters.\footnote{Ibid., para. 25(2).} On withdrawal of nominee consent, the moratorium ends.

As for challenges to the nominee’s actions, any creditor, director or member of the company or other person affected by a moratorium may apply to the court if dissatisfied with an act or omission or decision of the nominee during the moratorium.\footnote{Ibid., para. 26.} The court is then empowered to confirm, reverse or modify any nominee decision, give him directions or make such other order as it thinks fit. The acts of directors within the moratorium can be challenged similarly.

The meetings of the company and creditors are to be called by the nominee when he or she thinks fit and these meetings shall decide whether to approve the proposed CVA with or without modifications.\footnote{Ibid., paras. 29–31.} Such modification shall not, however, affect the enforcement rights of secured creditors without consent or the priorities or pari passu payment of preferential debts.\footnote{Ibid., para. 31(4) and (5).} A person entitled to vote at either meeting or the nominee has a right to challenge the CVA in court on the grounds that it unfairly prejudices the interests of the creditor member or contributory of the company; or that there has been a material irregularity in relation to or at either meeting.\footnote{Ibid., para. 38.}

Once an approved CVA has taken effect, the person formerly known as the nominee becomes the supervisor of the CVA\footnote{Ibid., para. 39. The Insolvency Act 2000 s. 4(4) amended the Insolvency Act 1986 s. 389: to act as a supervisor or nominee of a CVA the individual in question must be an IP or a person authorised to act as a supervisor etc. by a body recognised by the Secretary of State for that purpose: see IA 1986 s. 389A.} and any of the company’s creditors or other persons dissatisfied by any act, omission or decision of the supervisor may challenge this in court.\footnote{Insolvency Act 1986 Sch. A1, para. 39(3).}

Achieving a successful rescue may also require that the directors are able to effect advantageous transactions with third parties. Here, however, the terms of the Insolvency Act 2000 create unhelpful uncertainties. Such third parties will be reluctant to deal with the directors if they are not certain that they will be protected from a subsequent failure of the moratorium or a non-approval of the voluntary arrangement. Schedule A1, paragraph 12(2) of the Insolvency Act 1986 now suspends section 127 of the Insolvency Act 1986 (which prohibits property dispositions
after the commencement of a winding up unless the court has otherwise authorised.\textsuperscript{80} It does so where a petition for winding up has been presented before the beginning of the moratorium. The effect is that section 127 will not operate to render void any dispositions of property, transfers of shares or alterations in status of the members of the company during the moratorium. Such dispositions are then governed by the moratorium provisions. Uncertainties arise because there may not be a petition for winding up pending at the date of the start of the moratorium. The Law Society has argued that there should be an express provision confirming that ‘the criteria for disposals, payments, charges and other permitted transactions during the moratorium regime fully supplant the criteria for escaping all the “normal” invalidating provisions of the Insolvency Act 1986 and third parties acting in good faith are protected in being party to such transactions’.\textsuperscript{81} If that is not the case, said the Society, there should be provisions allowing directors to seek court confirmation that any transactions are valid and proper. A danger is that if such worries are not countered, companies may be encouraged to petition for a winding up immediately before filing for a moratorium in order to protect transactions within the moratorium from being attacked as preferences or transactions at undervalue under the Insolvency Act 1986 sections 238 and 239.

\textit{The CVA as an efficient rescue mechanism}

If a CVA is to lead to rescue rather than liquidation it needs to achieve a number of results.\textsuperscript{82} First, the business needs to generate cash profits that are sufficient to pay off past debts and deal with ongoing liabilities. Second, the credit control procedures of the company must be effective enough to avoid such an accumulation of bad debts as is likely to prejudice the recovery. Third, there will need to be a corporate strategy, implementable through the CVA proposal, that will lead to financial survival by taking all necessary steps, such as disposals of non-core activities or assets where appropriate. In order to achieve these results,

\textsuperscript{80} On the Insolvency Act 1986 s. 127 see e.g. G. Stewart, ‘Section 127 and Change of Position Defences’ (2003) \textit{Recovery} (Autumn) 6; and further ch. 13 below.

\textsuperscript{81} Law Society Company Law Committee, \textit{Comments}, p. 6.

a further requirement is likely to be directorial commitment and motivation. Enterprising directors will often possess incentives to leave a troubled company for greener corporate pastures, especially if they have no equity interest or do not require the business to succeed in order to protect their income. A CVA, accordingly, may need to create incentives for good directors to see the rescue through.

A number of difficulties will face the proponents of a CVA. In the first place this is a ‘debtor in possession’ system that leaves in control the directors who have led the company into difficulty. The prospects of continuing poor management are, accordingly, real. 83 Suppliers will often be reluctant to continue normal trading with the company and they, as well as main creditors, will have to be persuaded to support the CVA. Creditors may often suspect that those putting forward CVA proposals are using the CVA as a device that will allow the management to set up a phoenix operation in order to effect a transfer of the business and its assets and leave creditors empty handed. Directors’ motives for seeking a CVA may similarly be called into question because the institution of a CVA will rule out charges of wrongful trading on a subsequent liquidation. 84

The uptake of CVAs has been disappointingly low since 1986. In 1999–2000 there were 526 CVAs (and appointments) compared to 427 administrations and 1,665 receiverships. In 2005–6, two years after the introduction of the CVA moratorium, there were only 540 CVAs compared to 2,661 administrations and 565 receiverships. 85 In a series of reports 86 the DTI reviewed the reasons why CVAs have not proved

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83 Cook et al., Small Business Rescue, report that continued poor management was a frequently cited problem.

84 Note, however, that the Insolvency Act 2000 imposed new ‘whistleblowing’ obligations on the nominee/supervisor: see now Insolvency Act 1986 s. 7A. The 2000 Act also sought to prevent abuse of the CVA mechanism ‘by installing a degree of integrity reinforced by the criminal law’: see now IA 1986 s. 6A (see L. S. Sealy and D. Milman, Annotated Guide to the Insolvency Legislation 2007–08 (Thomson/Sweet & Maxwell, London, 2007) p. 35).

85 Numbers of CVAs were, moreover, considerably down on the previous two years: see Insolvency Service, Enterprise Act 2002 – Corporate Insolvency Provisions: Evaluation Report (Insolvency Service, London, 2008) p. 17. Potential use of CVAs has, however, been extended to National Health Service Trusts: see National Health Service Act 2006, s. 53; ‘In view of the difficulties currently encountered in this sector one suspects that this provision will not be underused in the years to come’: D. Milman, ‘Corporate Insolvency Law: An End of Term Report’ (2007) 214/5 Sweet & Maxwell’s Company Law Newsletter 1 at 2.

popular and the IS played a central role in developing the reform proposals that were implemented with the Insolvency Act 2000.

Many of the reasons for the non-use of CVAs overlap with the reasons for the low resort to pre-Enterprise Act 2002 administration orders that were considered in chapter 9. Cost has been a material factor. Research has suggested that for very small companies the CVA may be too expensive a procedure to exploit and that there is often a preference for making a clean break and using liquidation to save some of the business rather than the company. In one survey, only 8 per cent of companies undergoing CVA processes had turnover of less than £100,000 in the last financial year. The DTI’s 1993 Consultative Document included in its list of ‘barriers to the use of CVA provisions’: the secured creditor’s right to appoint a receiver; the directors’ lack of knowledge and IP’s lack of experience of the provisions; fear by directors of provisions connected with the Insolvency Act 1986 and supervised by IPs; and rescues being attempted too late. To these reasons, a study for the ICAEW has added the suggestion that IPs have been deterred from using CVAs by the perceived risk, lack of effective control and uncertainty involved in the process and the difficulty of trying to forecast cash flows up to five years ahead. The same study noted that IPs may worry about their committing to turnarounds that depend on improved management, and to engaging in considerable amounts of work only for the rescue to founder.

The DTI argued in 1993 that some of the above disincentives and barriers could nevertheless be reduced in effect. The lack of knowledge of directors could be countered by awareness campaigns and education, and directors’ fears of insolvency processes might be responded to by placing rescue provisions in companies’ statutes rather than in insolvency legislation, or by relabelling IPs as ‘rescue consultants’. The lateness of rescue efforts could be remedied by improving directors’ use of financial information and by raising the consciousness of auditors and non-insolvency advisers to make them more aware of, and more likely to recommend, rescue processes.

Other barriers to use were, however, particularly severe in relation to CVAs. A major problem was lack of finance to fund corporate operations during CVAs. Banks tended to act cautiously in consideration of their own

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88 Cook et al., Small Business Rescue.
89 Ibid.
90 Ibid.
91 DTI 1993, p. 20.
shareholders’ interests and in fear of ‘throwing good money after bad’.

The DTI opinion was that a foremost weakness of the CVA was the absence of a moratorium. As indicated above, however, the use of the CVA has not increased materially since the moratorium came into effect in 2003 and this may suggest that the other disincentives to use that are cited above may have proved more powerful than the DTI supposed in 1993.

Have the Insolvency Act 2000 changes produced an efficient rescue regime? R3’s Ninth Survey of Business Recovery, published in 2001, indicated that where CVAs are used, there is a 74 per cent preservation rate. As for returns to creditors, the R3 Twelfth Survey of Business Recovery (2004) indicated that CVAs returned just under 50 pence in the pound to creditors overall compared to around 30 pence for administrative receiverships, compulsory liquidations and administrations. For unsecured creditors, the CVA proved much more rewarding, with CVAs averaging returns of 17 pence in the pound compared to 5.4 pence for administrative receiverships and compulsory liquidations and 6.3 pence for administrations.

It remains to be seen whether the rescue potential of the CVA will develop in coming years. In the past, general concerns have been voiced in relation to the role that preferential creditors have played in CVA processes, the nominee’s scrutiny role, rescue funding, corporate relations with landlords or utility suppliers and those who lease the tools of the trade to the company. It should be emphasised, moreover, that the CVA moratorium, as now set up, only applies to very small companies and here some particular problems may arise. Nominees, after the Insolvency Act 2000 amendments, have to be prepared to state in writing at the outset that the CVA has a reasonable prospect of being approved and implemented and also that the company is likely to have sufficient funds available during the moratorium to enable it to carry on business. In order to place themselves in a position to make such a statement responsibly, nominees may have to engage in extensive consultations with

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92 Ibid., p. 15. On distributing moneys held by CVA supervisors once the company goes into liquidation and whether liquidation terminates the CVA, see the guidelines laid down by Peter Gibson LJ in Re NT Gallagher & Son Ltd [2002] BCLC 133 at 150.
93 The SPI Eighth Survey (covering 1997–8) indicated that where CVAs were used, 37 per cent of jobs were saved (receiverships saved 31 per cent, administrations 40 per cent and company voluntary liquidations 11 per cent). The SPI was renamed R3, the Association of Business Recovery Professionals, in January 2000.
95 See Insolvency Act 1986 Sch. A1, para. 6(2).
proposed funders as well as major suppliers and other trading partners. Assurances from such parties will have to be sought and trading projections analysed. The overall effect, it has been suggested, may be that the amount of work involved, and the attendant expenses, will prevent the moratorium CVA procedure from performing as a cost-effective device for smaller companies.\footnote{See Smith and Neill, ‘Insolvency Act 2000’, p. 85. R3 also made this argument: see R3, ‘The Moratorium Provisions for the Company Voluntary Arrangement Procedure in the Insolvency Bill 2000’ (2000) 16 IL&P 77.} The CVA, moreover, may be further reduced in its attractiveness because the moratorium does not protect the company during the period in which proposals are being developed and a nominee may fear that consulting with creditors before a moratorium comes into effect may trigger their taking precipitate action against the company.

Crown creditors and CVAs

In the consultations that the IS held in its 1999 Review Group discussion paper on rescue and reconstruction mechanisms the ‘most heartfelt’ response on CVAs concerned ‘the uncommercial attitude of the revenue departments (Inland Revenue and Customs and Excise (HMRC)) to proposals for CVAs’. At that time the Crown enjoyed preferential status for such debts and IS consultees complained that the revenue departments’ insistence on 100 per cent payment, and the time taken to consider proposals, frustrated many CVA proposals that unsecured creditors would otherwise approve. Respondents consistently criticised the apparent unwillingness of these departments to deal with CVA proposals on their merits or to take a longer-term view of the prospects of a company’s survival. The Review Group recommended that the Inland Revenue (IR) and Customs and Excise should work to develop a more commercial approach to CVAs so that proposals were judged on their merits and, where appropriate, less than 100 pence in the pound should be settled on if it was judged that a CVA would offer superior returns.\footnote{IS 2000, p. 24.}

In order to produce a more consistent and responsive approach to CVA proposals, the Review Group recommended that the two revenue departments should investigate integrating their work on CVAs, look at the staffing implications of a more responsive approach and consider the need to bring in private sector skills to bear on decisions relating to CVAs and their commercial viability. They should also, said the Review Group, explore with the Insolvency Service how to take a more proactive role in...
warning directors of the possible consequences of continuing to trade during insolvency and of the possible need for professional advice.

In accordance with these suggestions, the IR and the Customs and Excise set up a Voluntary Arrangements Service (VAS) in Worthing which has been running since 2 April 2001. It is managed by the IR on behalf of HM Revenue and Customs.\(^9_8\) The stated aims of the VAS are ‘to help its customers, to work collaboratively with the private sector and other government departments and to make a full contribution to business rescue by supporting viable businesses through periods of temporary financial difficulty’.\(^9_9\) To this end, the VAS publishes criteria by which it will judge the acceptability of proposals put to it by troubled companies.\(^1_0_0\)

The Enterprise Act 2002 abolished the Crown’s right to be paid as a preferential creditor.\(^1_0_1\) Has this development enhanced or detracted from the CVA as a rescue process? In the lead up to the 2002 Act there was a general acceptance that abolition of the Crown’s preferential status would produce more successful CVAs\(^1_0_2\) but, in 2003, the President of R3 reported a number of R3 members’ concerns that, in the light of abolition, the VAS had changed its policy on voting for voluntary arrangements. In response to communications on this matter, the VAS ‘emphatically confirmed that there is absolutely no effort being made by them to increase the amount of return from voluntary arrangements’.\(^1_0_3\) The VAS emphasised that it supported proposals that were workable and designed to increase returns for creditors, including the Crown, without detracting from the company’s survival prospects.\(^1_0_4\)

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\(^9_9\) Ibid., p. 18.
\(^1_0_0\) On HMRC standard modifications that it likes to see in CVAs and HMRC expectations on the duration of CVAs see G. Krasner, ‘Duration of CVAs’ (2006) Recovery (Winter) 3.
\(^1_0_1\) Enterprise Act 2002 s. 251.
\(^1_0_2\) In 1999 the Review Group reported the broad view that this would be the effect of abolition since: ‘the larger the dividend that can be proposed to unsecured creditors, and as importantly, the earlier it can be paid to them, the more likely they are to support proposals which would allow the survival of the company’: see IS 2000, pp. 25–6. The Review Group added that it would be important that the benefits of abolition should accrue to unsecured creditors and not to the holders of floating charges – hence the Enterprise Act 2002’s creation of the ring-fenced fund or ‘prescribed part’ under which a percentage in value of assets subject to a floating charge has to be given over to form a fund available to unsecured creditors: see now IA 1986 s. 176A; and ch. 3 above.
\(^1_0_4\) See ibid.
The nominee’s scrutiny role

An advantage of CVA procedures since the Insolvency Act 2000 is that moratorium protection from creditors can be achieved without the need to incur the trouble and expense of a court action. The IP who acts as nominee accordingly fulfils an important role in assessing prospects of success and filtering out non-viable proposals. This is a reason for insisting that the nominee be a fully qualified IP, or a person authorised to act as a nominee or supervisor by a body recognised by the Secretary of State. The role is, however, a difficult one since nominees rely heavily on information supplied to them by the directors and they will not have the power or time to conduct thorough investigations. One commentator described the predicament: ‘If too much reliance is placed on the nominee as a filter it will inevitably lead to escalation in cost as nominees seek to protect their own position by “due diligence”, or become conservative in recommending a CVA as viable; the result is that the proposed cheap and speedy procedure aimed at smaller companies will become prohibitively expensive and slow.’

The Insolvency Act 2000 demands that when the nominee submits to the directors a statement which indicates an opinion on, inter alia, whether the CVA has a reasonable prospect of approval and implementation, the nominee is ‘entitled to rely on the information submitted to him’ by the directors in their CVA proposal ‘unless he has reason to doubt its accuracy’. The Law Society cautioned that there was a ‘clear danger’ in the nominee simply relying on the information supplied by directors. Concern has also been raised that for a nominee to be able to give the statement referred to above, he will need to be involved ‘in the day to day management of the business and to have carried out a

105 Of course, after the reforms of the Enterprise Act 2002 it is now also possible to put a company into administration (and gain the protection of a moratorium) without going to court: see ch. 9 above.
106 Insolvency Act 1986 s. 4(2).
107 It is noteworthy also that the chairman of a creditors’ meeting will be allowed by the court to value claims on the basis of the evidence produced by the creditor or debtor and has no duty to investigate independently: see Re Newlands (Seaford) Educational Trust [2007] BCC 195. (Chair supported in valuing landlords’ claim – for in excess of £1 million – at £1 in accordance with Rule 1.17(3) of the Insolvency Rules 1986, since representations did not allow the ascertaining of the claim’s appropriate value.)
109 See now Insolvency Act 1986 Sch. A1, para. 6(2).
110 Insolvency Act 1986 Sch. A1, para. 6(3).
111 Law Society Company Law Committee, Comments, p. 5.
significant investigation’. 112 This could prove expensive. Concern was also expressed that the nominee will have significant responsibilities without authority in that he has no control over the assets which he would have if he were a provisional liquidator or other office holder, nor does he control the actions of the directors during the period of the moratorium. 113

A further worry that was expressed by the Law Society perhaps evidenced a low opinion of the professional standards of IPs. The Society said: ‘We are also concerned that companies will be encouraged to shop around amongst those authorised to act as nominees until they can locate one prepared to provide an appropriate statement in order to secure a moratorium. This concern was shared by the Select Committee.’ 114 The Society added that such loopholes created the potential for a voluntary arrangement to go badly wrong, bringing the whole process into disrepute amongst creditors. 115

In defence of the Insolvency Act 2000 regime, it could, however, be argued that nominee scrutiny, even if erring on the defensive side, is liable to be quicker and cheaper than resort to court and that the twenty-eight-day limit of the moratorium should restrict some of the dangers of abuse that are associated with the longer terms of the United States Chapter 11 moratorium. 116

Rescue funding

A fundamental challenge for troubled companies is that of securing new funds in order to finance continuing activities while a CVA is being negotiated and in order to provide for the longer-term survival of corporate operations. 117 The availability of longer-term financing will crucially affect the success or failure of the CVA since creditors are unlikely to agree to the company’s proposals without the prospect of secure funding. 118 The SPI survey for 1997–8 suggested that in 43 per cent of cases the biggest barrier to turnaround was lack of appropriate finance 119 and R3’s 1998–9 survey indicated that in one in five cases of

114 Law Society Company Law Committee, Comments, pp. 4–5.
115 Ibid., p. 5. 116 See ch. 6 above.
117 The adequacy of an adequate funding stream for the period until approval can be secured is a legal as well as practical requirement: see IA 1986 Sch. A1, para. 6(2)(b). On rescue and funding more generally see chs. 6 and 9 above.
companies with a turnover of over £5 million ‘the main factor preventing a more positive outcome was the inability to secure funding’. 120

In many cases it is the company’s own bank that has to be persuaded that there is a viable future for the company and generally the IPs guiding the CVA will attempt to secure the bank’s approval for proposals before other creditors are approached. Other sources of funds are also available. The BERR, for instance, sponsors a Small Firms Loan Guarantee scheme which provides a guarantee covering 75 per cent of loans of up to £250,000 with terms of up to ten years. Other financing options include new equity funding and the provision of funds by the firm’s managers.

Short-term funding will generally be sought, as noted, through negotiation with the company’s main lender (usually the bank); through negotiating limited credit periods with major suppliers; or by sale of assets. Negotiating supplier credit periods is, however, a fraught process for directors because such trading or credit may expose them to liabilities for fraudulent or wrongful trading 121 and it may involve further dissipation of the assets charged to creditors. Many such steps will in practice have to be carried out with the approval of secured lenders because the spending of money or selling of assets will reduce the security cover of such lenders.

A further option for enhancing funding during a moratorium might be offered by provision for super-priority. The issues surrounding such potential changes have been discussed in chapter 9 and will not be rehearsed here.

Landlords, lessors of tools and utilities suppliers

The rights of peaceable re-entry by landlords have been discussed in chapter 9 and that debate will not be repeated here. 122 As for those who lease tools to the company and utilities suppliers, the Insolvency Act 1986 Schedule A1 provisions on the moratorium state that during the

120 R3, Ninth Survey of Business Recovery in the UK. See also statement by R3, ‘R3 Calls for Government to Commit to Action on Business Rescue’ (2001), that the ‘most intractable problem in business rescue today is the provision of post-rescue finance’. R3’s Twelfth Survey of Corporate Insolvency in the UK reported (p. 26) that loss of finance was the major cited factor in the failure of companies surveyed.

121 Insolvency Act 1986 ss. 213 and 214; see further ch. 16 below.

122 On the ability of creditors to use a CVA to force landlords to give up their rights in return for rights under a CVA – and landlords as creditors who do not fall within the class of creditors who are not bound by a CVA – see Thomas v. Ken Thomas Ltd [2006] EWCA Civ 1504 and P. Godfrey, ‘Legal Update’ (2007) Recovery (Spring) 9–11. See also the discussion of landlords, unfair prejudice and the Powerhouse case at pp. 509–12 below.
moratorium no steps may be taken ‘to repossess goods in the company’s possession under any hire purchase agreement except with the leave of the court. No other proceeding and no execution or other legal process may be commenced or continued and no distress may be levied against the company or its property except with the leave of the court.’

This provision is based on Insolvency Act 1986 Schedule B1, paragraphs 43(3) and 43(6) dealing with the post-Enterprise Act administration order moratorium which, together with case law, makes it clear that the moratorium on enforcement applies to goods supplied on hire purchase or similar agreements (which include conditional sale agreements, chattel leasing agreements and retention of title agreements).

Utility supplies to troubled companies are protected at present by section 233 of the Insolvency Act 1986 which governs the situations in which an administration order is made, an administrative receiver or provisional liquidator is appointed, a CVA is approved by meetings of the company and of creditors, or the company goes into liquidation. In these circumstances, where the office holder (administrator, administrative receiver and so on) requests that gas, electricity, water or telecommunications supplies be continued, the supplier may make it a condition of supply that the office holder personally guarantees payment of supplies, but that supplier shall not make it a condition of supply (or effectively make it a condition of supply) that any outstanding charges be paid. In the case of a CVA moratorium it would be appropriate to make such a provision effective at the time at which the CVA moratorium comes into force (when relevant documents are filed or lodged with the court).

**Expertise**

The IP’s expertise in, and orientation to, rescue has already been discussed but consideration should be given to the CVA procedure and whether this is conducive to the making of informed and expert judgements on corporate rescues. Research into the operation of CVA procedures in the 1990s suggests that the expertise of IPs in operating CVA

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123 Insolvency Act 1986 Sch. A1, para. 12(1)(g) and (h).
124 Hire purchase agreements and conditional sale agreements are defined in the Consumer Credit Act 1974 s. 189(1) (see Insolvency Act 1986 s. 436); and chattel leasing agreements and ROT agreements are defined in the Insolvency Act 1986 s. 251.
125 Insolvency Act 1986 Sch. A1, paras. 7 and 8. 126 See ch. 5 above.
procedures may vary enormously. Flood and his colleagues suggested in 1995 that knowledge about CVA processes was very highly concentrated within the body of IPs: ‘three individuals’ names arose time and time again’. These were the key players and other IPs tended to have very modest experience or knowledge concerning CVA procedures.\(^\text{127}\) The rise of the rescue culture can be expected, however, to have significantly developed the orientation and experiences of IPs regarding the rescue potential of the CVA.\(^\text{128}\)

If attention is focused, however, on the CVA process as a whole and its ability to deliver expert decisions, it should be remembered that this is not a procedure in which an IP lays down a judgement from on high. A CVA tends to involve an extended process of negotiation between the IP, the directors, the banks and other creditors. With this point in mind, a key issue is whether this is a negotiating process that is able to take on board the relevant information and produce sound decisions on rescue. One difficulty here may have stemmed, pre-rescue culture, from the widespread ignorance of professional lawyers, bankers and accountants concerning CVAs. A second problem may centre on the need to generate trust within CVA procedures. An important role of the IP is to develop such trust between different groups of creditors and the company directors. Without mutual confidence, even the best-informed, most astute commercial judgements will come to nothing. Of central importance here is faith in the competence of the management team and its ability to turn fortunes around.\(^\text{129}\) It follows that the expertise built into the CVA procedure will depend to a great extent on the skill not merely of the IP but also of the company’s directors. Nor can the part to be played by the major creditors be ignored: these are the parties who have to be convinced that a CVA will succeed. The major creditors have to possess the expertise in rescues that allows them to distinguish between good and less convincing CVA proposals.

Above all else then, the CVA demands a co-ordination of expertise. It is a procedure that might be thought to conduce to such co-ordination since the CVA provides a forum for discussion of the rescue scheme’s strengths and weaknesses. The quality of that discussion may, however,


\(^{128}\) On the reorientation of the IP within the developing rescue culture see ch. 5 above.

\(^{129}\) See Flood *et al.*, *Professional Restructuring*, p. 19.
be sub-optimal for a number of reasons. First, there may be conflict of interest between creditors of different classes who bear different levels of risk and who, accordingly, see proposed solutions in different lights. These conflicts may produce disagreements and conversations at cross-purposes. Second, the company’s directors may not see solutions in the same light as other involved parties because they have different perspectives or interests. They may, for instance, be reluctant to accede to the IP’s and creditors’ wishes to install new directors because the directors’ estimations of their own value to the company may be higher than those of the IPs and creditors. Third, such differences of interest may reduce levels of trust below optimal levels and this may affect information flows: when, for instance, directors conceal facts from the IP because they fear some adverse reaction such as replacement. Finally, the standard of participation in the negotiation may be low because the key players are not fully trained in CVA procedures or are not fully in touch with the company’s state of affairs.

What can be done to improve expertise? If the CVA is seen as a broad-based negotiation it follows that it is not enough to improve the knowledge of IPs concerning CVAs. Other involved actors have to be brought up to speed also. Steps designed to improve performance here might involve training all company directors in basic insolvency procedures and the provision of similar training for bankers and other major creditors. Within the banking industry attention might also be given to the provision of a continuing expertise in insolvency at the appropriate organisational level. Over and above such sectoral training it may be appropriate to develop interdisciplinary skills so that accountants, bankers and lawyers can work on rescues together. As Flood et al. comment: ‘It is worth reflecting that professional relationships across jurisdictional boundaries are crucial to the satisfactory resolution of something like the CVA.’

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Accountability and fairness

Information and transparency are vital prerequisites of accountability within CVAs. CVAs, as noted, only come into effect (under the Insolvency Act 1986 section 5) when proposals have been approved by both the meeting of the company and the meeting of the creditors. Creditors who are considering the proposal put forward after discussions

130 Ibid., p. 23.
between the IP and the directors need to be given information on such matters as: the assets and valuations; projections of income on future contracts; cost savings and ongoing expenses; whether suppliers and customers will remain loyal; potential repossessions/forced sales; whether third-party funds are available; the commitment of the directors; and potential claims against the company.\textsuperscript{131} The IP is obliged to take reasonable steps to be satisfied that assets and liabilities are not materially different from the position outlined in the proposal; that the proposal will be implemented as represented and that there is no ‘already manifest yet unavoidable unfairness’ in admitting, rejecting or valuing voting claims.\textsuperscript{132} Here much depends on the skill of the IP and his/her commitment to giving a full picture to the company and creditors. Guidelines on best practice are made available to IPs by the Association of Business Recovery Professionals (R3). There are, moreover, incentives to inform: as has been pointed out, the IP’s role in a CVA demands that central importance be given to the creation of trust among affected parties.\textsuperscript{133} As for judicial scrutiny, there are indications that the courts will be inclined to defer to the professional judgements of IPs. In \textit{SISU Capital Fund Ltd v. Tucker} Warren J dismissed a challenge from bondholders, stating that there was no unfair prejudice arising from the terms of the CVA that affected their position as creditors. Furthermore, the court was not in a position to judge whether proposals put forward as part of the CVA could be improved upon – this was a matter for the professional judgement of the IPs.\textsuperscript{134}

The process of holding the IP to account demands not merely that information be made available but that this can be used. For a creditor this will mean that the creditors’ meeting has to be attended or a proxy be used. (Under the Insolvency Rules 1986 (Rule 1.17(1)) every creditor ‘who was given notice of the creditors’ meeting’ is entitled to vote at the meeting.) There is no procedure, though, for advertising for creditors of whom the company may not be aware at the time of summoning the

\textsuperscript{132} Ibid., pp. 15–16; Greystoke v. Hamilton-Smith [1997] BPIR 24, 28. It is a criminal offence for a past or present officer of a company to make ‘any false representation’ or commit any other fraud to obtain creditors’ or members’ approval: Insolvency Rules 1986 (SI 1986/1925) r. 1.30. An ‘officer’ here includes a shadow director (r. 130(2)). See also Insolvency Act 1986 Sch. A1, paras. 41 and 42; IA 1986 ss. 6A and 7A.
\textsuperscript{133} See Flood \textit{et al.}, \textit{Professional Restructuring}, pp. 5, 20–2.
\textsuperscript{134} \textit{SISU Capital Fund Ltd v. Tucker} [2006] BCC 463. Warren J did, however, give guidance on how to structure proposals to avoid complaints of unfair prejudice under IA 1986 s. 6.
meeting. (The DTI had advocated a requirement to advertise the moratorium in the Gazette and a newspaper in its 1995 paper.) Under the Insolvency Act 2000 amendments, however, advertising is called for when the moratorium comes into force. A CVA approved by a creditors’ meeting, nevertheless, binds all parties who are entitled to vote at the meeting (whether or not they were present or represented) or who would have been so entitled had they been given notice.

As for the interests of unknown creditors in a CVA, these are dealt with in Schedule A1, paragraph 38 of the Insolvency Act 1986, which gives parties who have not been given notice of the creditors’ meeting a power to apply to the court to challenge a decision of the meeting on the grounds of unfair prejudice or material irregularity. They are given twenty-eight days from the date of their awareness that the meeting has taken place to make such an application to challenge. The court, if satisfied of the basis of such a challenge, can revoke or suspend the decision but can also direct the summoning of further meetings to consider revised CVA proposals. This provision substitutes for the DTI’s 1995 proposal that a further meeting of creditors should be convened where the effect of unknown claims would be to reduce the payment to creditors by 10 per cent or more. It is arguable that an advertising requirement would be fair to ‘unknown’ creditors likely to be bound by the CVA and it would enhance overall transparency and conduce to effective creditor communications.

Holding the directors to account may be as important in a CVA as the appropriate accountability of IPs. During a moratorium the directors will continue to manage the affairs of the company and secured creditors may fear that secured assets may be dissipated, with the possible result that if the CVA is not approved there will be little left over to satisfy the security. Some respondents to the DTI’s 1993 proposals (notably IPs and lenders) expressed concern at the low level of monitoring involved in the CVA moratorium, but the 1995 revised proposals suggested that levels of supervision by the IP nominee would ‘very much depend on the company’s circumstances’. The level of supervision should be settled before the nominee agrees to act, said the DTI, and it might include the nominee having full access to the company’s records and premises. Variations in supervision levels were called for because the level of supervision appropriate for a company with a large number of

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retail outlets operating on a cash basis would differ from that called for in relation to an operation relying on one director serving two or three customers. What there should be, said the Department, was a statutory level of supervision comprising scrutiny of weekly management accounts by the nominee. Further control of directorial activities during the moratorium would be provided for by a series of provisions. First, criminal sanctions and civil penalties would apply to directors who, for example, concealed, removed or destroyed assets and/or records; second, directors would only be able to dispose of assets (other than in the ordinary course of business) with the approval of the nominee and either the court or the creditors’ committee; and third, there would be general provisions for creditors and shareholders to apply to the court for relief. The Insolvency Act 2000 amendments duly made provision for such criminal sanctions, asset dispositions and applications for relief.

The philosophy underlying such control provisions was that directors who were left in control of the troubled company should be strongly aware of their obligations: ‘the supervision and regulation of directors’ activities and the existence of penalties for non-compliance are thought necessary to provide a very clear signal that abuse of the moratorium period will not be tolerated. It should also allay concerns that creditors may have about management being left in charge of the company during the moratorium period.’

The fairness of the approval process has been debated with regard to three main issues: the unfair prejudice rule; whether the approval majority for creditors’ meetings is set at the right level; and whether shareholders should, through the company meeting, have a power to approve the CVA at all.

Unfair prejudice

Under section 6 of the Insolvency Act 1986 any creditor who was entitled to vote at the creditors’ meeting may apply to court to challenge the CVA on grounds of unfair prejudice or material irregularity. In relation to the former ground, a notable difference between the CVA and the Companies Act 2006 scheme of arrangement creates considerable scope for allegations of unfairness. In the scheme of arrangement, as discussed above, account is taken of the divergences of interest between different creditor groups. Each class must approve with a majority in number representing three-quarters

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in value of the creditors for a scheme of arrangement to be approved. This
is not the case in a CVA where all creditors vote together and, provided
that the threshold of three-quarters in value in favour is reached, the CVA
is approved. Such an arrangement can lead certain creditor groups to
pursue their own interests in a contentious manner and the courts have
looked at the issues in a number of cases.\textsuperscript{144} In the \textit{Wimbledon Football
Club} case,\textsuperscript{145} Lightman J stated that unequal or differential treatment of
creditors in the same class did not constitute unfairness \textit{per se} but might
require an explanation; that, in looking at the unfairness issue, the sur-
rounding circumstances should be considered, including alternatives to
the arrangement at issue (taking in both liquidation and the possibility of a
fairer scheme);\textsuperscript{146} and that differential treatment might be required to
ensure fairness or the continuation of the business. Where, however, a
group of creditors uses its votes to deprive a creditor or group of their
rights against third parties while preserving its own rights, the courts are
likely to find that unfair prejudice is suffered. This was so in \textit{Re a Debtor
(No. 101 of 1999)}\textsuperscript{147} and in the important \textit{Powerhouse} decision.\textsuperscript{148}

\textit{Powerhouse} concerned the possibility that a troubled company might be
able to ‘cram-down’ landlords by obtaining approval for a CVA in which
those landlords surrender their proprietorial rights. In that case, a strug-
gling electrical retailer (PRG Powerhouse Ltd) wanted to rid itself of thirty-
five unprofitable leases (on underperforming stores) in pursuit of turn-
around. The CVA demanded, \textit{inter alia}, a release by the landlords but also a
release by the parent company of Powerhouse from the lease guarantees
that it had given. The CVA was approved in February 2006 at a meeting to
which \textit{all} creditors were invited –whether or not the CVA directly affected

\begin{footnotes}
\item[146] [2005] 1 BCLC 66 at para. 18. In \textit{Re Greenhaven Motors Ltd} [1999] 1 BCLC 635, however, Chadwick LJ stated that the court’s role was not to speculate on whether the
proposed arrangements were the best available: the onus was on the disaffected cred-
itors to show that some option presenting less prejudice to unsecured creditors was
available to the company.
\item[147] [2001] BCLC 54 (creditors used their votes to force the Revenue to receive a reduced
amount for its debt while retaining their own rights in full and this was held to be
unfairly prejudicial).
\item[148] \textit{Prudential Assurance Co. Ltd v. PRG Powerhouse Ltd} [2007] BCC 500. See the discus-
Law Newsletter} 1; L. Verrill and P. Elliot, ‘Reflections on the Powerhouse Case’ (2007)
\textit{Recovery} (Autumn) 28.
\end{footnotes}
them. Some of the unwanted landlords sought a declaration that the CVA was ineffective and/or invalid in so far as it purported to affect their rights against the parent company guarantors. (Posing the question: had the guarantees provided by PRG been released or ought they to be treated as released as a result of the CVA?) In the alternative they sought the revocation of the CVA approval under section 6 of the Insolvency Act 1986 on the grounds that it was unfairly prejudicial to them and/or the meeting was materially irregular since all creditors were allowed to vote on the CVA.

Etherton J found that the CVA was indeed unfairly prejudicial to the claimants. He did not rule that the CVA was invalid because it purported to affect claims against parties other than Powerhouse (i.e. the guarantors). The proposals for the CVA had contained a number of alternative mechanisms to effect the release of third-party guarantees enjoyed by various landlords. The judge decided that, on the particular wording of this CVA, the release of the guarantees was enforceable.\(^{149}\) The claimants did, however, win on the ‘unfair prejudice’ point. The landlord creditors had been asked to give up not only their rights against Powerhouse but also against the guaranteeing parent company. The effect would be to move them from being better off than other creditors (because of their guarantees) to being deprived of claims and guarantees. Key points were that: the CVA gave the landlords no extra benefit for the value of the guarantees – all landlords, including those without the benefit of the guarantees, were treated in the same way; all other categories of creditor unaffected by the CVA were to be paid in full; and a winding-up would have allowed the guaranteed landlords the benefit of the guarantees. Had the landlord creditors voted as one class of creditors, they would not have approved the CVA. The effect of the single vote for all creditors was to swamp the interests of the landlord creditors and this constituted unfair prejudice.\(^{150}\) On the particular facts of this case, the landlords succeeded but none of the grounds which proved successful present insuperable

\(^{149}\) In other words a CVA can propose that a guarantee be treated as being released. Etherton J stated ‘it follows in my judgment there is nothing to preclude Powerhouse enforcing clause 3.14 against the guaranteed landlords including the claimants … on the true construction of the CVA and of the guarantees the claimants are obliged to Powerhouse to treat the guarantees as having been released’: see further Verrill and Elliot, ‘Reflections on the Powerhouse Case’, p. 29.

\(^{150}\) On ‘unfairness’ Etherton J referred to the review by Warren J in SISU Capital Fund Ltd v. Tucker [2006] BCC 463. There is no single or universal test but the cases showed that a comparative analysis should be conducted under which all the circumstances were considered, including the alternatives to what was proposed and the practical consequences if the CVA went ahead.
obstacles to stressed companies wishing to cram-down unwanted landlords in future.151

The approval majority for creditors’ meetings
The creditors’ approval majority is set out in Rule 1.19 of the Insolvency Rules 1986 and demands, as noted, that, to be effective, approvals must be given by a three-quarters majority in value of the creditors present in person or by proxy and voting on the resolution. This rule contrasts with the position for creditors of companies in administration, a simple majority by value of whom is required in order to agree restructuring proposals. The 75 per cent rule, said the DTI, was designed to encourage companies only to enter a moratorium if a successful rescue is likely and to provide an effective bar to unsound proposals being accepted.152 The requirement was also said to recognise that the decision of the meeting would affect the return to all creditors. In 1999 the IS suggested that a way to promote more use of CVAs would be to change the voting provisions so as to reduce the threshold for acceptance by creditors.153 Post-consultation, however, the IS doubted whether such a reform would be advisable. It was moved by the argument that lowering the threshold would not necessarily have any significant effect on acceptance levels; and that concerns would be aroused by binding creditors against their will by a simple majority.154

The shareholders’ power to approve the CVA
The argument that shareholders should not participate in the CVA approvals process through the company meeting can be represented thus: ‘The present rules require there to be a meeting of shareholders. This gives them a veto over any CVA. Given that they have no economic interest in the insolvent company, that is unjustifiable.’155 This criticism of shareholder voting contrasts with the approach put forward by the DTI in 1995.156 The Department argued that shareholders were not usually deprived of their shares when a CVA was proposed and that they should, therefore, have a right to receive information about the CVA and vote on it with or without modifications. The DTI considered,

151 See Chalkiadis, ‘Powerhouse’, p. 4: ‘All that is needed is some more detailed thought and some careful drafting.’ Thus landlords are likely, inter alia, to revisit the security of leases being granted and to seek to strengthen that security for the future: see further Verrill and Elliot, ‘Reflections on the Powerhouse Case’, p. 29.
however, that the decisions of shareholders should not prevail over those of the creditors unless they could show to the court that they were being unfairly prejudiced. The reasoning here was that shareholders should not have any say in whether a CVA was accepted if they did not have a demonstrable financial interest at the time. The proposal was thus akin to the situation in a liquidation: ‘If the company is insolvent the shareholders are in no worse position than if the company were to go into insolvent liquidation rather than enter into a CVA. If, however, the company is saved, their shares may begin to reflect real worth.’¹⁵⁷ The proposal to allow the shareholders to go to court on grounds of unfair prejudice was designed to allow shareholders’ positions to be taken into account when there was an interest that was being unfairly affected.

The DTI view is preferable to the ‘no economic interest’ approach insofar as it is difficult to deny the actual and potential interest of a shareholder in the CVA.¹⁵⁸ This is a procedure that does not necessarily commence with the company’s insolvency: the directors can propose a CVA prior to insolvency (when shareholders still possess valid interests).

What the insolvency legislation does is to provide that a decision to approve a CVA is effective if taken by both the creditors’ and company meetings or the creditors’ meeting on its own.¹⁵⁹ Where a CVA is approved, it has effect as if made by the company at the creditors’ meeting but where a decision of the creditors’ meeting differs from one taken by the company meeting, a member of the company can apply to the court which may either order the decision of the company rather than the creditors to have effect or make such order as the court thinks fit.¹⁶⁰ A person entitled to vote at either a creditors’ or a company meeting has, as noted, power to challenge a decision in court on the grounds of unfair prejudice or that there has been a material irregularity at either meeting.¹⁶¹ If the court is satisfied on the ‘unfair prejudice’ or ‘material irregularity’ grounds, it is given powers of revocation, suspension or direction.¹⁶² Provisions, accordingly, give primacy to the creditors’ meeting but do

¹⁵⁷ Ibid., p. 16.
¹⁵⁸ On the economic interests of junior creditors in a s. 895 CA 2006 scheme of arrangement see pp. 480–1 above and Mann J in Re My Travel Group plc [2005] 1 WLR 2365. (The Court of Appeal in Re My Travel Group plc [2005] 2 BCLC 123 deemed that Mann J had not, in fact, needed to determine the economic interest issue because the only issue was whether the meetings of creditors with whom My Travel intended to make an arrangement had been properly constituted, which they had been.)
¹⁵⁹ Insolvency Act 1986 Sch. A1, para. 36(2).
¹⁶⁰ Ibid., para. 36. See also IA 1986 s. 5 regarding non-moratorium CVAs.
¹⁶¹ Insolvency Act 1986 Sch. A1, para. 38. ¹⁶² Ibid.
allow creditors with interests that are liable to be prejudiced by a CVA to challenge the approval of the CVA or the process followed in such approval.

It might be questioned whether there is any purpose in providing for a members’ meeting when the CVA can be approved by the creditors’ meeting on its own. Such a meeting does, however, provide shareholders with a forum and a route to information and discussion that would otherwise be lacking. Such a meeting, moreover, might, in some situations, alert shareholders to issues of potential prejudice of which they were unaware. It can be supported on that basis.

Conclusions

CVA procedures have been enhanced by the moratorium but, in concluding this discussion, it is worth emphasising that legal provisions on CVAs can only go so far in effecting corporate rescues. The CVA does offer a reasonably accountable and fair mechanism for rescue but residual concerns must relate to the degree of co-ordination between directors and IP supervisors that any particular CVA will involve; the absence of provisions advertising proposed CVAs; whether a regime for super-priority funding is necessary for effective rescue; and whether training for directors is a prerequisite for effective rescue.

If seen in broader terms, the CVA procedure can be said to be based on a ‘forum’ approach to insolvency: one that operates on the basis that rescues can be negotiated into existence. This approach assumes that creditors will produce mutually acceptable solutions if all possibilities can be discussed openly and at low cost. This notion is open to criticism by those who see conflicts of interest as looming large in insolvency. From this perspective, it might be argued that the CVA is unlikely ever to offer the most popular or effective route to rescue because in most areas of corporate trouble the creditors tend to have such divergent interests and powers that rescue options are most likely to be arrived at by degrees of imposition rather than negotiation.

Drawing such a contrast suggests that a way to improve rescue prospects through CVAs may be to institute changes that will reduce the divergences of interest (or perceived divergences of interest) between different creditor groupings. How, though, can this be done consistently

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164 Introduced by the Insolvency Act 2000.
with allowing financing options to remain flexible? One route forward may be to revise the legal rules so that oppositions of interest are less starkly drawn. This can be done, for example, by offering more information to unsecured creditors or by opting for courses of action that favour unsecured creditors where this involves no cost to the charge holder. Another route would be to institute changes not through legal adjustments of interest but by measures designed to change the cultures, values and assumptions of involved parties: to encourage banks, for example, to identify their own long-term interests more closely with those of the body of unsecured creditors and employees.

Arguing from a further perspective, it might be contended that what really affects prospects of rescue is not so much the legal process involved, or the arrays of interests encountered, but the levels of business skill that are involved. Reforms reflecting this point of view could focus on continuing steps designed to enhance the skill levels of nominees and supervisors as well as those of directors. Improvements here might be secured through increased attention to training and the qualifications necessary for adopting any of the normal named roles. The measures might be constituted on a mandatory or a voluntary basis.

At this point we should return to a question posed earlier in relation to section 895 schemes of arrangement: is there a case for retaining these when resort can be made to CVAs or administration? The Company Law Review Steering Group suggested, as noted, that there would be strong support for a process allowing company managers to impose reorganisation proposals on a minority and it is arguable that there are circumstances in which internally generated reforms may produce rescues more efficiently, expertly, accountably and fairly than procedures involving external practitioners. A streamlined version of the existing schemes of arrangement procedure may have a place in modern company law. Where the troubled company happens to be managed by directors who are able to initiate turnarounds and where these directors are able to see the need for such steps before prospects of rescue have become minimal, the scheme of arrangement has a valuable role. Again this raises the issues of directorial training and incentives within the insolvency process.

Finally, it should be noted that schemes of arrangement and CVAs are both procedures that operate with distinct visions of the insolvency process in mind – ones that make numerous assumptions about the

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165 CLRSG, *Completing the Structure*, p. 205.
actors that should be involved, the procedural and substantive rights the parties should have and the ways in which prospects of rescue are best secured. The visions of insolvency seen within these processes may not be the same as the visions implied in other processes such as receiverships or administrations and it may be asked whether consistency between these visions (or even a single agreed vision) should be aimed for. This is an issue to be returned to in the next chapter.
Rethinking rescue

These are interesting times for corporate rescue. On the one hand, a new emphasis on rescue has developed over the last decade or so and turnaround has emerged as a main priority in dealing with troubled companies. The ‘rescue culture’ has been evident in legislation and in endorsements by the UK Government and also the judiciary. The banks have instituted new intensive care regimes and a new group of turnaround specialists has come onto the scene to assist in the process of dealing with corporate troubles at an ever-earlier stage in their development. In parallel, increasing attention is being paid to the management of risks to corporate welfare. On the other hand, the advent of ‘the new capitalism’ and the commodification of credit have produced a fragmentation of interests in troubled companies and a new set of pressures that favour exiting from relationships with distressed firms rather than doctoring such companies. This fragmentation has imposed new strains on the ‘London Approach’ and has given rise to new difficulties in securing agreements to informal turnaround proposals.

Against this background, considerable changes have been made to insolvency procedures. The phasing out of administrative receivership has been accompanied by a rebirth of administration and the CVA procedure has been enhanced with a moratorium for small companies. The Crown’s status as preferential creditor has been removed and the ‘prescribed part’ has been introduced in order to provide greater economic protection for unsecured creditors. Holders of floating charges have not only largely lost the right to appoint administrative receivers but have been made to bear the cost of giving unsecured creditors the benefit of the prescribed part. As for fixed charge holders, membership of this club has been restricted after Spectrum Plus and the courts’ new inclination to treat charges over book debts as

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floating rather than fixed. The arrival of the ‘pre-packaged’ administration has led to new levels of concern regarding the undermining of statutory procedures and the substitution of closed agreements for traditionally more transparent processes.

Rescue procedures, it should furthermore be pointed out, operate as packages. If, accordingly, we ask whether the procedures that have been discussed in the last five chapters are appropriate or capable of improvement, we should consider not merely the individual processes involved but the broad package of procedures on offer. If that package is assessed, this raises the issue of coherence and whether the different procedures hang together in sympathy or undercut each other. It may be argued that it is beneficial to provide companies with a number of different routes to rescue, but that contention will only hold if those routes are in harmony. If some modes of rescue undermine others, the effect of variety may not be benign choice but inefficiency and confusion.

An overall assessment of rescue procedures must also bear in mind that different procedures may be applied to different stages of corporate troubles. Some routes into the post-Enterprise Act administration, for instance, demand that the company is, or is likely to be, unable to pay its debts. Other routes do not, nor is the CVA procedure tied to insolvency or near insolvency. The importance of this point is that at different stages of corporate difficulty, the aspirations and objectives of parties may vary. At a very early stage of corporate trouble it will be natural for directors and other parties to focus on rescue and the machinery for achieving this. On the brink of insolvency, the law and the involved parties may be concerned with how the remaining assets can be most efficiently distributed to creditors. These differences of emphasis are also likely to be reflected in the extent to which different parties’ rights stand to be adjusted so as to encourage rescue. When rescue is the chief end it will be appropriate to facilitate this objective by adjusting creditors’ rights (for example, by prohibiting enforcement of these). When distribution is the main objective, the emphasis will more properly be on the effective enforcement of creditors’ rights.

A difficult situation arises when shareholder interests in a company are diminishing in a period just before insolvency. What is special about insolvency – and rescue more particularly – is that the nature of the game

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3 See IA 1986 Sch. B1 para. 11(a); para. 22 with para. 27(2).
4 Ibid., paras. 14 and 35: administration applications by holders of qualifying floating charges.
and even the list of players will vary as the company progresses through difficulties towards insolvency or turnaround. This can be seen in the position of a shareholder of a company. When a healthy company is operating, the directors may be perceived as working to further the shareholders’ interests. In an insolvency the position has changed. The company cannot pay its debts and the directors are now operating not with the company/shareholders’ assets but with those of the creditors. The interests of the creditors, at this stage, fall to be looked to as primary objects of directorial endeavour and procedural fairness to creditor interests becomes a first priority.

The difficulty for a designer of rescue procedures is that a procedure may operate across corporate life, from the situation in which the company is essentially healthy but needs to reorganise or adjust operations, right through to the company’s entry into insolvency. The procedure may thus have to protect rights that are shifting in relationship to each other and it will have to operate fairly when what is procedurally and substantively fair will change in accordance with the shifts in rights that occur as the company nears insolvency.

How then should a system of rescue procedures be designed? Do present rescue procedures match up to such a design? First, there should be clarity concerning the objectives in sight – the ends that are to be achieved efficiently. This means that a rescue system must be precise about the relative weights to be given to rescue and asset distribution. Nor should it be forgotten that the same insolvency laws that serve rescues may also need to accommodate the purposes of healthy operating


7 For a general guide to such design see United Nations Commission on International Trade Law (UNCITRAL), Legislative Guide on Insolvency Law (UN, New York, 2005).
companies. It would not, for instance, make sense to create efficient rescue procedures if the processes interfered unduly with, or imposed excessive costs on, healthy companies (for instance, because the rescue procedures can be abused for non-rescue reasons, as some fear may be the case with Chapter 11 in the USA). There is, accordingly, a balance to be set between rescue and operational concerns.

It may well be that at different stages of corporate life and decline, the optimal balances of different objectives will change. Rescue processes can cope with such difficulties but it is undesirable for different rescue procedures to target priorities divergently when operating at the same stage in corporate troubles. Here we saw the problems with the system of floating charges and the tension between pre-Enterprise Act administrative receivership and administration. The administration regime incorporated a moratorium and gave protection from creditors, and in doing so it effected a particular balance between ongoing corporate concerns (for example, to obtain financing when healthy), the interests of creditors and the wider interests to be served by rescue. The floating charge and administrative receivership system undermined administration (not to say schemes of arrangement and CVAs) and did so by setting out to achieve different ends (notably protection of the floating charge holder’s interest) at the same time as schemes of arrangement and CVAs looked to broader rescue interests. Insolvency law spoke with two voices and provided one procedure that undermined another. The route to a clearer design of insolvency/rescue regime is to decide on the appropriate balance of interests and to set up a procedure that pursues those interests consistently with that balancing. This argument favours a movement towards a ‘single gateway’ rescue regime where possible – and indeed the Enterprise Act 2002 moved in this direction by restricting the use of administrative receivership in favour of the enhanced administration process.

A second prerequisite of clear rescue design is the identification of those values to be pursued in a rescue. Again these need to be targeted with consistency. This book, as indicated in chapter 2, argues that emphasis should be given to efficiency, expertise, fairness and accountability throughout the various stages of rescue. Efficiency, it has just been noted, demands clarity concerning objectives, and one recurring message of the last five chapters has been that efficiency in rescue may require that directors are able to resort to a rescue procedure before the chances of turnaround have become hopeless. Here the addition by the Insolvency Act 2000 of a small companies’ moratorium to the CVA procedure may
be helpful, but questions can be asked about the continued requirement that when directors or the company seek entry to administration the company must be, or be likely to become, unable to pay its debts.8

Turning to the issue of expertise, if we consider the allocations of managerial and oversight functions in English rescue procedures – and do so with a view to the trust impliedly being placed in different experts – we see quite different assumptions being made. Many informal rescue procedures, including the London Approach, rely on a process of negotiation between the companies, directors, the bank(s) and other creditors. If formal processes are examined, we see that schemes of arrangement place faith in the expertise of the directors, subject to court oversight, and there is no need to resort to an independent IP to formulate or implement the scheme. The directors remain in control and a great deal of faith is placed in their initiative and ability to take corrective steps to avert disaster. The CVA, in contrast, places control in the hands of an external expert. The company’s directors, as noted, may propose a CVA but this must provide for a nominee to supervise the CVA’s implementation and the nominee must be qualified to act as an IP in relation to the company.9 This faith in the expertise of the independent IP may sometimes be well placed (increasingly so as IP experience with CVAs grows) but any expert judgement may have to survive an extended negotiation procedure, involving the IP, the directors, the banks and other creditors. This negotiation, moreover, may be conducted in a context of only limited trust. At the end of the day, then, expertise has to flow from a process of co-ordination with the IP at the helm.

In administration, the expertise of the IP is again central in both setting up the process and implementing it, but, given the role of the company’s directors in instituting 70 per cent of non-court-order entries into administration,10 the skill of those directors in seeing the need to institute an administration is also important. As noted, the company has to be near to, or actually, insolvent for directors or the company to trigger administration and the window of rescue opportunity is, accordingly, very narrow. This gives more prominence to the galvanising role of the company directors. The law here trusts the directors’ expertise too little

8 See IA 1986 Sch. B1, paras. 11(a), 12(1)(a) and (b), 22 with 27(2)(a).
9 Note that with the ‘small company’ CVA, established by the Insolvency Act 2000, nominees do not specifically have to be IPs: see ch. 11 above.
to allow the debtor to stay in possession, but sets up a procedure whose rescue prospects depend crucially on the same directors.

To summarise, in looking for the expertise that will generate successful rescues, insolvency law operates with a scattergun approach rather than a considered analysis of informational position, training, disinterestedness, specialist knowledge of the market, ability to judge financing options or commitment to implementation for rescue purposes. The formal procedures relevant to rescue again speak with inconsistent voices: schemes of arrangements are marked by high trust in directors; CVAs look to independent experts and negotiated or group expertise; and administrations look to independent experts that rely on directorial triggers. To repeat, a system of insolvency law that is thought through should operate on assumptions concerning expertise that are consistent rather than vacillating. These assumptions, moreover, could be based on analyses of the kind of factors noted above, along with the host of others that together underpin the exercise of independent judgement. All of these discrepancies are compounded by the growth of processes such as the pre-packaged administration that do much of the ‘traditional’ work of rescue procedures through informal mechanisms and which are largely unregulated, unstructured and varying in approach.

A discussion of accountability within rescue procedures proceeds on similar lines. Schemes of arrangement involve no oversight of directors by IPs but control by meetings of creditors and members together with judicial oversight. CVAs require that IPs structure directors’ proposals and the latter also have to be approved by creditors and members. The skill of the IP is crucial to the flow of information and accountability to creditors and members in a CVA. An array of criminal sanctions and civil liabilities also serves to hold directors to account in cases of concealment, removal or distribution of assets and/or records. General court scrutiny is also made possible by provisions allowing creditors and shareholders to apply for relief. In administration, court involvement has been reduced by the Enterprise Act 2002 reforms and accountability to shareholders is absent in so far as the members are not involved in approval of the administrator’s proposals (which are approved by the creditors alone). The accountability found within ‘pre-packs’ contrasts more dramatically with the above descriptions and constitutes a potential undermining of statutory requirements of openness and access.

Shareholders can, however, apply to the court under the Insolvency Act 1986 Sch. B1, para. 74 if they have a complaint that the proposals will unfairly harm their interests.
Looking at accountability in different insolvency procedures, we again see not only varying rules but also divergent philosophies. Schemes of arrangement build on the notion that directors can be left largely free from monitoring by IPs but CVAs and administrations imply that there is considerable value in specialist control over the directors’ behaviour, proposals and informational roles. In administrations there is no need for shareholders’ approval. This contrast with schemes of arrangement procedures may be defended by some on the grounds that administration necessarily occurs when the company is close to insolvency but it is perhaps jumping the gun to argue that shareholders should drop out of the approval process completely when insolvency is a likelihood, rather than a given.

Finally, the issue of fairness falls to be considered. Considerable emphasis is placed on fairness to minority interests in schemes of arrangement. Meetings of creditors and shareholders have to approve proposals and, as noted in chapter 11, it is the court’s protective stance on this front that produces a complex process with elaborate provisions on notice. In relation to CVAs one means of ensuring fair treatment of creditors is through the approvals mechanism and the requirement of 75 per cent in value approvals. As noted, though, this rule contrasts with not only the class-based system of schemes of arrangement but also the simple majority required in administration. CVAs, moreover, have to be approved by shareholder meetings whereas administrations do not. As argued above, the exclusion of shareholders from votes on administrations may be difficult to justify, at least in the pre-insolvency situations that Schedule B1 of the Insolvency Act 1986 covers. It can also be contended that administrations do not fairly take on board the interests of parties beyond creditors, notably employees. The primary purpose of making an administration order under Schedule B1 paragraph 3 of the Insolvency Act 1986 is rescuing the company as a going concern but the employee stakeholders whose livelihoods are at stake are offered no formal input into the decision-making process governing administration. Where a ‘pre-pack’ administration is used, the particular danger is that less powerful creditor interests may be railroaded to an outcome and have very little say in the route taken or the nature of that outcome.

In summarising on fairness, we see that the law relating to the various insolvency procedures operates with divergent assumptions on the rights of parties involved in insolvency. As a result, the models of fairness implicit in the processes discussed are inconsistent. The law does have to confront the difficult problem of changing balances between the
interests of certain classes. This is apparent in the position of the shareholder in, say, the administration procedure since the shareholder’s interest can be said to be considerable pre-insolvency but diminishing as full insolvency looms. An organised approach to insolvency law would decide which parties have which rights at which stages of insolvency and set the rules accordingly and consistently across the procedures.

To conclude on rescue procedures, the individual procedures possess strengths and weaknesses as outlined, but, as an overall system, they may be said to constitute a disjointed package. There are a number of potential explanations for this state of affairs. Many such explanations are historical and political. Long-established deference to security interest holders as major property owners created a resistance to organised rescue strategies and sets of laws that might be seen as interfering with such property rights. Cork’s recommendations were cherry picked and post-Cork law reforms in this area were for many years piecemeal efforts that failed to take on the broader strategic issues. The Enterprise Act 2002 reforms have been welcomed in many quarters as moving towards a more generally collective regime – though, as seen above, that regime still has to face residual challenges.

The argument presented in this book is that insolvency law can and should take on board the shifting nature of rights and relationships in troubled corporate affairs. Other things being equal, however, it should offer a range of insolvency processes that caters for the values of efficiency, expertise, accountability and fairness and does so on the basis of assumptions that are consistent across different procedures. At present, formal and informal rescue processes offer a range of routes to turnaround but that variety creates a potential for tensions and conflicts.

Finally, we should return to the issues raised at the start of this chapter and consider whether current procedures address an outdated set of challenges and fail to provide the rescue procedures that modern restructurings and credit market conditions really require. In chapter 9 we saw that this argument has been presented forcefully by the European High Yield Association (EHYA) which has contended that current


restructuring processes are ill-suited to the growing complexities of capital structures, the dispersion of debt and the multiplicity of parties generally involved with troubled companies. The EHYA’s case for a court-supervised restructuring process deserves to be looked at on its merits – for present purposes, however, it is the making of such a case that raises an important point. It is one thing to decide what is wanted from a corporate insolvency regime and to attempt to design a system accordingly. It is another to ensure that a rescue regime that is good for today’s companies and markets will adjust appropriately to tomorrow’s conditions. The need for monitoring and appraisal is constant and the ongoing challenge is to produce approaches to corporate rescue that both satisfy current concerns and are also responsive to needs for change.
PART IV

Gathering and distributing the assets
Gathering the assets: the role of liquidation

Liquidation is the end of the road for the troubled company. It involves its winding up and the gathering in of the assets for subsequent distribution to creditors. On the commencement of liquidation the principle of collectivity takes effect\(^1\) and this is reflected in a moratorium on hostile actions and the restraining of uncompleted executions.\(^2\) Liquidation, nevertheless, raises issues of efficiency, expertise, accountability and fairness as much as processes involving prospects of rescue. This chapter explores those issues as well as the conceptual underpinnings of liquidation. Liquidations are encountered in three main forms: voluntary, compulsory and public interest, and to set the scene, it is necessary to review the varieties of liquidation and the legal framework that supports the liquidation process.

**The voluntary liquidation process**

A voluntary liquidation of a solvent company is termed ‘a members’ voluntary winding up’ and, where an insolvent company is involved, this is then known as ‘a creditors’ voluntary winding up’. This distinction flows from the Insolvency Act 1986 sections 89 and 90 which provide that if the directors have made a statutory declaration of solvency under section 89, a members’ voluntary liquidation\(^3\) occurs, but that the liquidation is a creditors’ voluntary liquidation in the absence of such a declaration.

Both types of voluntary liquidation are, however, triggered by the actions of the company’s members. These members can initiate a

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\(^1\) For discussion see ch. 2 above and ch. 14 below.

\(^2\) See Insolvency Act 1986 ss. 126–8, 130(2), 183. See e.g. *Re Modern Jet Support Ltd* [2005] BPIR 1382; and, on the court’s unfettered discretion to lift the s. 130(2) stay, *New Cap Reinsurance Corp. Ltd v. HIH Casualty and General Insurance Ltd* [2002] BPIR 809 at 819 (Jonathan Parker LJ).

winding up by passing a special resolution in favour of a voluntary liquidation.\textsuperscript{4} Resolutions must be advertised in the \textit{Gazette} within fourteen days of passing (on penalty of a fine where the officers of a company are in default).\textsuperscript{5}

Creditor involvement in a creditors’ voluntary winding up is provided for in the rule that a company must call a creditors’ meeting within fourteen days of the meeting at which the resolution for voluntary liquidation is to be proposed.\textsuperscript{6} Such creditors, moreover, must be given at least seven days’ warning and a notice of the meeting has to be placed in the \textit{Gazette} and two local newspapers. This advertisement must give the name of the IP who is qualified to act as the company’s voluntary liquidator and it must also indicate the place where a list of creditors can be found.

A main source of information to creditors is the Statement of Affairs that the Insolvency Act 1986 section 99 requires the company directors to lay before the creditors’ meeting. The directors, moreover, must nominate one of their number to run the creditors’ meeting.\textsuperscript{7} The members

\textsuperscript{4} Insolvency Act 1986 s. 84(1)(b). The Companies Act 2006 (Commencement No. 3, Consequential Amendments, Transitional Provisions and Savings) Order 2007, SI 2007/2194, introduced changes to the rules relating to company meetings and resolutions, some of which affected the resolutions which need to be taken to put a company into liquidation. Thus, for example, from 1 October 2007, the Insolvency Act 1986 s. 84(1)(c) provision was repealed (this provided that the company could be wound up voluntarily if it resolved by extraordinary resolution that it ‘cannot by reason of its liabilities continue its business and that it is advisable to wind up’).

\textsuperscript{5} Insolvency Act 1986 s. 85(2).

\textsuperscript{6} Ibid., s. 98; Insolvency Rules 1986 rr. 4.51(as amended), 4.53, 4.62. Under the Companies Act 2006 s. 307 the period of notice required for a meeting of a private company at which a special resolution is to be proposed was reduced from twenty-one days to fourteen days (although the company’s articles may specify a longer period: s. 307(3)). In relation to private company winding-up resolutions the articles can also prevail regarding the majority needed for a meeting to be held on short notice – set at 90 per cent of voting rights per s. 307(5) CA 2006. See also Re Centrebind Ltd [1967] 1 WLR 377 which held that failure to comply with the specified meetings procedures did not invalidate proceedings but, now, the Insolvency Act 1986 s. 166 prevents a liquidator, as a general rule, from exercising any section 156 powers (e.g. of property disposal) until the creditors’ meeting required by section 98 has been held. Section 166(5) of the Insolvency Act 1986 gives the court powers to make directions where there has been a failure to comply with sections 98 and 99: on the exercise of these see R. Tateossian, ‘The Scope of Section 166(5) Insolvency Act 1986: An Analysis’ (2001) Finance and Credit Law 4.

\textsuperscript{7} Failure of the nominated director to attend the meeting will not necessarily invalidate proceedings: see Re Salcombe Hotel Development Co. Ltd [1991] BCLC 44, [1989] 5 BCC 807.
of the company may also nominate a liquidator at their meeting but if members and creditors choose divergently, the nominee of the creditors will be appointed. Where the company is not content with a creditors’ choice, a challenge may be made in court within seven days. As for the powers of the company’s directors, these are limited by section 114 of the Insolvency Act 1986 which covers the period prior to the appointment of a liquidator and only allows directorial powers to be exercised with the sanction of the court or in order to secure compliance with section 98 provisions on the creditors’ meeting or section 99 on the directors’ statement of affairs.

The person chosen to act as a liquidator in a creditors’ voluntary winding up must be a qualified IP. IPs, moreover, often have a strong influence on choice of liquidator. As Milman and Durrant indicate:

> IPs commonly offer a service to their commercial clients of attending on their behalf at creditors’ meetings of their insolvent debtors and reporting on the proceedings free of charge. Professionals in the field, usually representatives of the larger accountancy firms, are well known to each other, and commonly discussions take place before the meeting to find out which of them commands the most voting power, now measured by value of the debt under Rule 4.63(1). By arrangement, some of the professionals attend the creditors’ meeting, and frequently one of them proposes the appointment of one of the others, either as liquidator, in place of the members’ nominee, or, more commonly nowadays, as joint liquidator.

Joint liquidators may be appointed by such a process and the court has power to appoint a further liquidator to join a sole liquidator. On appointment, any liquidator has fourteen days in which to advertise his appointment in the Gazette and to notify the Companies Register.

In a creditors’ voluntary liquidation, creditors play a central control function. They are placed in a fiduciary position regarding the company

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8 Insolvency Act 1986 s. 100(2).
9 Ibid., s. 100(3); Insolvency Rules 1986 r. 4.102.
10 Insolvency Rules 1986 r. 4.100.
12 Re Sunlight Incandescent Ltd [1906] 2 Ch 728.
13 In furtherance of the EC Directive 2003/58/EC the Companies (Registrar, Language and Trading Disclosures) Order 2006 requires that the statement that a company is in liquidation must be included not only on all its stationery but also on its website (amending IA 1986 s. 188(1)(a)).
and its assets and act in the main through the Liquidation Committee. This body has a maximum membership of five creditors and five contributories. Creditors, moreover, possess the preponderance of power since they can veto all or any of the contributories (under section 101(3) of the Insolvency Act 1986). The quorum for such a committee is two members, and any member may be removed by the creditors at large. It has a right to information as the liquidator is advised to report all relevant matters to it. Members may require meetings to be called but generally meetings are instituted at the discretion of the liquidator.

Creditors may apply to the court for directions; they have powers to remove liquidators or apply to the court for removal of a voluntary liquidator; and they may ask the court to have the company compulsorily wound up under the Insolvency Act 1986 section 116.

As for court supervision of voluntary liquidations, this is light and it is not a day-to-day activity. The court may, nevertheless, become involved where there is a request to remove a liquidator or where a liquidator, contributory or creditor applies to it to determine a question arising in the winding up or to use the powers it might employ in a winding up by the court to enforce calls or other matters.

When voluntary liquidation is entered into, the general powers of the directors, as noted, cannot be exercised, but a series of powers is given to the liquidator under section 165 and Schedule 4 of the Insolvency Act 1986. The liquidator, with the sanction of the Liquidation Committee or the court, may pay any class of creditors in full; make compromises or arrangements with creditors or alleged creditors; compromise calls, debts, potential debts, claims and any question relating to the assets or the winding up of the company. Security, moreover, may be taken in the course of discharging these claims.

The sanction of the Liquidation Committee is not required in relation to the exercise of a number of other powers, including: the bringing or

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14 See Insolvency Act 1986 s. 101. On the functions, membership and procedural rules relating to Liquidation Committees see also IR 1986 rr. 4.151 ff.
15 Insolvency Act 1986 s. 112.
16 Ibid., s. 171(2).
18 Insolvency Act 1986 s. 112. Confirmation of the winding-up procedure through the court is possible throughout the EU under Council Regulation (EC) No. 1346/2000 (implemented by Insolvency Act 1986 (Amendment) (No. 2) Regulations 2002) and foreign companies with centres of main interests in the UK can be wound up voluntarily (in addition to compulsorily under the Insolvency Act 1986 s. 221(4)); Re TXU Europe German Finance BV [2005] BPIR 209, [2005] BCC 90.
19 IA 1986 s. 103.
20 Obtainable in advance or by ratification.
defending of actions or legal proceedings on behalf of the company;\(^{21}\) carrying on the business of the company as is necessary for a beneficial winding up; selling or transferring any of the company’s property; executing deeds for the company and using its seal; proving in the insolvency of any contributory; dealing in bills of exchange; borrowing against the security of a company’s assets; taking out letters of administration to the estate of a deceased contributory; appointing an agent to perform business; and doing all such other things as may be necessary for the winding up of a company’s affairs and distribution of its assets.

These powers described are general and implied. A number of statutory powers sit alongside these, however. All types of liquidator may disclaim onerous property under the Insolvency Act 1986 sections 178–82. This may be done without court leave\(^{22}\) and notwithstanding the liquidator taking possession of the property, attempting to sell it or exercising rights of ownership in it.\(^{23}\) Onerous property here includes unprofitable contracts or other property that is not saleable or readily saleable or such that may create a liability to pay money or perform an onerous act.\(^{24}\) The effect of disclaiming is to terminate the rights and liabilities of the company with regard to the property disclaimed, but rights and liabilities of other parties are not affected.\(^{25}\) In exercising this power the liquidator’s hand may be forced by interested parties who may require the liquidator to decide whether there is an intention to

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\(^{21}\) The onus appears to be on an objector to establish that an action was not beneficial to the winding up: see Hire Purchase Co. v. Richans [1887] 20 QBD 387.

\(^{22}\) A notice of disclaimer ‘in the prescribed form’ has to be filed in court under Insolvency Rules 1986 r. 4.187 and Form 4.53.

\(^{23}\) Insolvency Act 1986 s. 178(2).

\(^{24}\) Ibid., s. 178(3). Per Chadwick LJ in Re SSSL Realisations (2002) Ltd, Manning v. AIG Europe Ltd [2006] Ch 610, [2006] BCC 233 – ‘a contract is not an “unprofitable contract” … merely because it is financially disadvantageous or merely because the company could have made or could make a better bargain. The critical feature is that performance of the future obligations will prejudice the liquidator’s obligation to realize the company’s property and pay a dividend to creditors within a reasonable time’ (at para. 42).

disclaim, and the liquidator has twenty-eight days to give notice of disclaiming or then forfeit the right to disclaim. If, moreover, persons suffer a loss as a result of the liquidator’s disclaiming, they can prove as creditors in the winding up.

As will be discussed further below, the statutory powers of liquidators allow them to set aside prior transactions at undervalue or transactions which amount to preferences. Liquidators, moreover, may obtain orders for the examination of company affairs in order to secure information and may apply for an order that directors or former directors make a contribution to the assets. If the liquidator wishes to obtain court guidance on questions relating to a winding up, an application can be made under section 112 of the Insolvency Act 1986 and the court may also be asked to appoint a special manager. When a liquidator is appointed he or she is not personally bound by pre-liquidation contracts enforceable against the company, except where he or she has actually adopted them. Such contracts, however, retain their force with regard to the company unless they are disclaimed by the liquidator. Contracts entered into by liquidators for the purposes of effecting a winding up do not bind them personally since they act in this regard as agents of the company.

As for the duties of the liquidator, the first of these is to realise the company’s assets effectively and to apply the company’s property in satisfaction of the company’s liabilities pari passu so that there is a distribution among the members according to their rights and interests in the company. There is a duty to contact known creditors and meet their claims as well as an obligation to consider all known debts before distributing assets. Where dividends are to be paid, liquidators must give notice of their intention to declare a dividend and must provide for debts relating to claims undetermined at that time and the claims of creditors who may not have had time to establish their proofs because of the distance of their place of residence. When a dividend is declared,

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26 Insolvency Act 1986 s. 236. 27 Ibid., s. 214. See ch. 16 below.
28 Insolvency Act 1986 s. 177. 29 Re S. Davies & Co. Ltd [1945] Ch 402.
30 But see Plant (Engineers) Sales Ltd v. Davis (1969) 113 Sol Jo 484 regarding contracts under seal.
31 Insolvency Act 1986 s. 107. For discussion of the pari passu principle see chs. 14 and 15 below.
33 Insolvency Rules 1986 r. 4.180(2). 34 Ibid., r. 4.182.
however, creditors who have not proved cannot disturb the dividends. Dividends must be paid by the liquidator when this is possible and proper accounts, minutes of meetings and records must be kept. The liquidator is in a fiduciary position in relation to the company and must not derive personal profit from his role: this rules out employing him to do legal work flowing from the winding up.

Liquidators can be removed by the court or the creditors and may only resign by reasons of ill-health, retirement from insolvency practice, conflict of interests or changes in personal circumstances that make it impossible for them to continue to act. Where a resignation is to be effective, a creditors’ meeting must be called and asked to accept this. In the absence of such an acceptance, the liquidator may apply to the court. A creditors’ voluntary winding up terminates normally with the realisation of all available assets and their distribution to claimants in order of priority. After this is done, the liquidator must call final meetings of members and creditors to which accounts of realisations and distributions must be submitted. These accounts must, in turn, be sent to the Companies Registry within a week of the meeting. The Registrar will then record the liquidator’s account and return under the Insolvency Act 1986 section 201 and the company is deemed dissolved three months from registration of a return. After this date the company does not exist and can neither be sued nor initiate court proceedings.

36 See Milman and Durrant, Corporate Insolvency, p. 91; Re Gertzenstein Ltd [1997] 1 Ch 115; r. 4.149 of the Insolvency Rules 1986 allows the court to set aside dealings between the liquidator and his associates which involve company assets. For a detailed discussion of the liquidators’ general duties see B. McPherson, The Law of Company Liquidation (5th edn, Lawbook Co., Australia, 2007) paras. 8.30 ff.
37 In AMP Enterprises Ltd v. Hoffman (The Times, 13 August 2002) Neuberger J (regarding a section 108(2) application for replacement) emphasised the dangers of encouraging applications by disgruntled creditors, the importance of maintaining standards of independence and the bearing in mind of any costs and delay involved in replacement. In Re Buildlead Ltd (in liquidation) (No. 2) [2005] BCC 138 liquidators undertaking a creditors’ voluntary winding up were removed under s. 108(2) because they had lost the confidence of key creditors due to the over-zealous approach to investigating a possible preference claim. The loss of confidence was key – there was no need to show any breaches of duty on the liquidators’ part: see further D. Milman, ‘Winding Up of Companies: Reflections on Recent Jurisprudence’ (2006) 4 Sweet & Maxwell’s Company Law Newsletter 1, 4.
38 Insolvency Act 1986 s. 106. 39 Ibid., s. 106.
Compulsory liquidation

Compulsory liquidation or winding up by the court generally involves actions initiated against the company’s wishes, in contrast to members’ or creditors’ voluntary windings up. Proceedings are commenced by a petition that may be presented by any creditor (including contingent or prospective creditors), the company, the directors (with all directors joining the petition acting as a board following unanimous or majority resolution), a contributory or the clerk of a magistrates’ court in enforcement of a fine. Receivers and administrators are also able to present petitions: in the case of the former, to aid realisation of the assets and, in the case of the latter, after a distribution. In the case of creditors whose claims are disputed by the company, the court will exercise a discretion and will tend not to accede to the petition where the company disputes the claim on substantial grounds and in good faith. The creditor whose claim is genuinely disputed is thus poorly placed to assert that the company has ‘neglected to pay’ the debt. Where, moreover, the debtor company has an enforceable cross claim against the petitioner –

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40 Ibid., s. 124(1). Where a voluntary winding up has been commenced and the majority of creditors wish it to continue, a petitioning creditor has to show some good reason for there to be a compulsory winding up: see Re Ziceram Ltd [2000] BCC 1048.

41 Insolvency Act 1986 s. 124(1).

42 See Insolvency Act 1986, Sch. B1, paras. 65, 66, 83, 84; and pp. 390–2 above.

43 Re London and Paris Banking Corporation (1875) LR 19 Eq 444; Brinds Ltd v. Offshore Oil [1986] 2 BCC 98. See further Favermead Ltd v. FPD Savills Ltd [2005] BPIR 715, where a disputed debt was present, and Abbey National plc v. JSF Financial and Currency Exchange Co. Ltd [2005] BPIR 1256, where the dispute was not deemed to be ‘real, genuine and substantial’; see also dicta of Pumfrey J in Re Ringinfo Ltd [2002] 1 BCLC 210 at 220. See generally A. Keay, ‘Disputing Debts Relied on by Petitioning Creditors Seeking Winding Up Orders’ (2000) 22 Co. Law. 40. Keay argues (p. 46): ‘To qualify as a substantial dispute a dispute must be real and not fanciful, but it does not matter that the company bears malice towards the petitioner … But, where at least £750 is indisputably owed to the petitioner, after taking into account the disputed part of the debt, courts may decline to dismiss the petition.’ See also Hammonds (a firm) v. Pro-Fit USA Ltd [2007] EWHC 1998 – a case which highlights the difference between winding up and administration, e.g. in showing the difference between the treatment of disputed debts under the two procedures. In the winding-up context the court’s practice is that petitions based on a disputed debt will normally be dismissed. According to Warren J, this practice does not apply to administration – a procedure designed to revive and rescue a company rather than to end the company’s life. In administration the court has a discretion at large, unconstrained by practice, as to whether or not to make an order on the particular facts of the case. Thus, where there may be a dispute regarding a creditor’s claim raised by the company, the creditor may be well advised to consider applying for an administration order: see further T. Smith, (2007) Recovery (Winter) 12.
for a sum exceeding the claim – the court may dismiss or stay a winding-up petition.\(^{44}\)

The primary grounds for a winding-up petition are that ‘the company is unable to pay its debts’.\(^{45}\) The Insolvency Act 1986 deems this inability to occur: (a) if a creditor who is owed over £750 has served the company with a written demand for payment (in prescribed form at the company’s registered office) and the company has ‘for three weeks neglected to pay the sum or to secure or compound for it to the reasonable satisfaction of the creditor’;\(^{46}\) or (b) if, in England and Wales, execution or other process issued on a judgment, decree or order of the court in favour of a creditor of the company is returned unsatisfied in whole or in part;\(^{47}\) or (c) if it is proved to the satisfaction of the court that the company is unable to pay its debts as they fall due;\(^{48}\) or (d) if it is proved that the value of the company’s assets is less than the amount of its liability, taking into account its contingent and prospective liabilities.\(^{49}\) Petitions based on the above grounds will also commonly refer to the grounds set out in the Insolvency Act 1986 section 122(1)(g) that ‘the court is of the opinion that it is just and equitable that the company should be wound up’.\(^{50}\)

Procedurally, a winding-up petition has to be served on the company and other parties as well as advertised according to the Insolvency Rules.\(^{51}\) Service at the company’s registered office is demanded and advertising must take place at least seven days after service and at least seven days before the hearing. The period between presentation of a winding-up petition and its hearing is a difficult one for the company and the petitioner. The company will often want to continue trading and petitioners may fear that the directors will dissipate assets and devalue their claims. In anticipation of these potential problems, the law provides

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\(^{44}\) See Re Bayoil SA [1999] 1 WLR 147, though the court may decide to deal with a cross-claim in the litigation: see Re Richbell Information Systems Inc. v. Atlantic General Investments Trust Ltd [1999] BCC 871.

\(^{45}\) Insolvency Act 1986 s. 122(1)(f). See further ch. 4 above.

\(^{46}\) Insolvency Act 1986 s. 123(1)(a). \(^{47}\) Ibid., s. 123(1)(b).

\(^{48}\) Ibid., s. 123(1)(e). \(^{49}\) Ibid., s. 123(2).

\(^{50}\) See Ebrahimi v. Westbourne Galleries Ltd [1973] AC 360; Re J. E. Cade & Son Ltd [1991] BCC 360. Section 122(1) also provides that a company may be wound up if: the company has by special resolution resolved that it be wound up by the court; it, being a public company, has not been issued with a share capital requirement certificate within a year of registration; it is an ‘old company’; it does not commence or operate business for a whole year; or the number of its members is reduced to below two.

\(^{51}\) Insolvency Rules 1986 rr. 4.8–4.10.
that where a petitioner can show that there is a serious risk that the directors will dissipate the company’s assets and prejudice their claim, the court can appoint a provisional or interim liquidator to oversee the assets until the petition is heard.\textsuperscript{52} This person may be a private IP but usually the Official Receiver will be appointed.

Protection for claimants is also offered by the rules on avoidance of transactions and the retrospectivity of the rule governing the start of a winding up. When a winding-up order is made, the winding up is deemed to commence at the time of presenting the petition.\textsuperscript{53} Section 127 of the Insolvency Act 1986 covers dispositions of company property after this time and provides that any such dispositions and transfers of shares or alterations in the status of the company’s members shall be void unless the court otherwise orders.\textsuperscript{54}

More general shielding of the company is offered by sections 126 and 128 of the Insolvency Act 1986, which provide that, during winding up, a company creditor or contributory may apply to the court for a stay of legal proceedings against the company and that, again during a winding up, any attachment, sequestration, distress or execution in force against a company is void.

\textsuperscript{52} Insolvency Act 1986 s. 135. The Public Interest Unit of the Insolvency Service, also known as the PIU, deals with provisional liquidations. The court can appoint a provisional liquidator to take control of the company at any time after a petition to wind up a company has been presented. The provisional liquidator can either be the Official Receiver or a licensed insolvency practitioner. The usual function of a provisional liquidator is to protect the company’s assets and records until the court makes a ruling on the winding-up petition. In cases dealt with in the PIU, this will usually, but not always, mean that the company will be made to cease trading.

\textsuperscript{53} Ibid., s. 129(2).

\textsuperscript{54} See Bank of Ireland v. Hollicourt (Contracts) Ltd [2001] 2 WLR 290, [2001] 1 All ER 289, [2001] 1 BCLC 233 (CA). (Where a bank which is merely acting as an agent of a troubled company honours a cheque drawn on co-account unaware of a petition’s presentation, the liquidator can recover from the payee only. The bank was not liable under section 127 to make restitution to the company of amounts paid to the company’s creditors out of its account following presentation of a winding-up petition.) See C. Pugh, ‘Hollicourt to Reduce Banks’ Exposure under Section 127’ (2001) 17 IL&P 53; H. Mistry, ‘Hollicourt: Bringing the Authorities Out of Disarray’ (2001) 22 Co. Law. 278; A. McGee and G. Scanlon, ‘Section 127 IA 1986: Practical Problems in its Application’ (2004) 25 Co. Law. 102. See also Re Tain Construction [2003] All ER 91, [2004] BCC 11 – change of position defences to a claim under s. 127 should be available. The deputy judge in Re Tain noted potential tensions between such restitutionary defences and the pari passu doctrine (both of which were based on ‘an overarching concept of fairness’): see further G. Stewart, ‘Section 127 and Change of Position Defences’ (2003) Recovery (Autumn) 6 at 7; cf. L. C. Ho, ‘Pari Passu Distribution and Post-petition Disposition: A Rationalisation of Re Tain Construction’ (21 November 2005, SSRN). See also ch. 14 below. The courts also have sought to bring clarity by offering procedural guidance on section 127 validation orders: see Practice Note: Validation Orders [2007] BCC 91.
As for the discretion of the court to grant a winding-up order, this will normally be exercised in favour of the petitioner if there is no opposition. The court may, however, refuse an order under section 125 of the Insolvency Act 1986 if it is opposed by the majority of creditors. In deciding this issue, the court will look to the numbers of opposing creditors, to the value of the debts owed, and to the quality of those creditors. On this last point, the court will give less weight to the claims of creditors who are connected with the company (for example, as directors or shareholders) or who are fully secured (and so have a limited interest in the liquidation). The court, moreover, will resist the use of liquidation to serve the petitioners’ ulterior motive rather than general creditor benefit.

As soon as a winding-up order is made, the Official Receiver automatically assumes the role of the liquidator until another liquidator is appointed. After this time no legal actions may be taken against the company without the leave of the court and, subject to any conditions imposed by the court, the winding-up order ends the powers of the directors, passes control of the company’s assets to the Official Receiver and operates as notice discharging the employees (except where the business continues for the purposes of beneficial winding up, the liquidator indicates a wish that employment should continue and the employees agree to continuation). A winding-up order does not, in itself, however, repudiate other types of contract and the company is not deprived of the legal title to its assets.

The liquidator is an officer of the court and has powers (and is obliged) to take into his custody or control all the property of the company. Under section 144 of the Insolvency Act 1986 this includes all the

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55 Conversion to compulsory liquidation may be supported by the court, particularly where there is a deemed need for investigation into the directors’ conduct.
56 See, for example, *Re Holiday Stamps Ltd* (1985) 82 LSG 2817; *Re Flooks of Bristol (Builders) Ltd* [1982] Com LR 53.
57 *Re Vuma Ltd* [1960] 1 WLR 1283.
58 *Re Flooks of Bristol (Builders) Ltd* [1982] Com LR 53.
60 Insolvency Act 1986 s. 136(1) and (2). As in voluntary liquidation the powers of the directors cease.
61 See *Re Oriental Bank Corporation (Macdowell’s Case)* (1886) 32 Ch D 36.
63 On the implications of status as an officer of the court see e.g. C. Villiers, ‘Employees as Creditors: A Challenge for Justice in Insolvency Law’ (1999) 20 Co. Law. 222.
property to which the company appears entitled. He or she may call on officers and employees of the company to provide statements of affairs and, as in a voluntary liquidation, there is a power to disclaim onerous property and contracts. There is, in addition, a discretion to call meetings of creditors and contributors, though these parties may compel the calling of a meeting if they have the support of one tenth in value of their body.

Turning to controls over the liquidator in a compulsory winding up, he or she will be answerable to the Liquidation Committee of a company’s creditors set up under section 141 of the Insolvency Act 1986. The liquidator may, with the sanction of the court or the Liquidation Committee, exercise any of the powers set out in Parts 1 and 2 of Schedule 4 of the Insolvency Act 1986 (payment of debts, compromise of claims etc., institution and defence of proceedings, carrying on of business of the company) and, as in a voluntary liquidation, the liquidator may carry out, without the need for court approval, the set of powers contained in Part 3 of Schedule 4. In compulsory liquidations, however, liquidators will be subject to control to a greater degree than in voluntary liquidations. They will, for example, require the sanction of the court or committee to initiate or defend legal proceedings in their name or in the name of the company, or to carry on the business of the company. Court review of liquidator activities is provided for by section 168(5) of the Insolvency Act 1986 which allows any person aggrieved by a liquidator’s act or decision to apply to the court, whereupon the court may confirm, reverse or modify the act/decision and make orders as it thinks fit.

The key function of the liquidator is to ‘secure that the assets of the company are got in, realised and distributed to the company’s creditors and, if there is a surplus, to the persons entitled to it’. Failure to fulfil that function may result in penalties for the liquidator, which may

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64 Insolvency Act 1986 s. 131; Insolvency Rules 1986 rr. 4.32–4.38.
65 Insolvency Act 1986 s. 168. A creditor who wishes to vote and who requires dividends is required to submit (lodge) a formal claim – a proof of debt – to the liquidator: IR 1986 rr. 4.73, 11.6(1). On proof of debt see, for example, Wight v. Eckhardt Marine GMBH [2004] 1 AC 147, [2003] 3 WLR 414; I. Fletcher, ‘Right to Participate in a Distribution’ (2004) 17 Insolvency Intelligence 91; Day v. Haine and Secretary of State [2007] EWHC 2691 (protective awards granted to employees after a company had gone into liquidation were held not be provable debts as they had been made after the date of liquidation (decision reversed on appeal – [2008] EWCA Civ 626)).
66 Ratification is, however, possible for uncontentious actions: see r. 4.184(2).
67 Insolvency Act 1986 s. 143(1).
involve misfeasance actions,68 deprivations of costs69 and actions for negligence.70 Duties that must be discharged include keeping proper accounts and lodging, with the Insolvency Service’s account at the Bank of England, any funds realised. The accounts of the liquidator will be audited by the Secretary of State and there is an obligation to file accounts and returns under section 170 of the Insolvency Act 1986. It is, moreover, the duty of the liquidator to keep minutes of meetings and administrative records, to act independently and to avoid conflicts of interest.

The end of a compulsory liquidation occurs when the liquidator has realised all the potential assets of the company and distributed all available funds. The liquidator will then report to the final meeting of creditors which may release him. If the liquidator is not so released he or she may apply to the Secretary of State.71 The liquidator must report the outcome of the final meeting to the court and the Companies Registry and, when three months have elapsed, the company will automatically dissolve.72

**Public interest liquidation**

The BERR and the Financial Services Authority (FSA) have powers to petition the court to wind up a company on ‘just and equitable’ grounds.73 These powers, typically, would be used to stop enterprises trading where they engage in practices that defraud customers and swindle the vulnerable – where, for example, worthless insurance policies or non-existent products are sold to the public or dubious financial schemes are marketed.74 They are powers that bypass the requirement

69 *Re Silver Valley Mines* (1882) 21 Ch D 381.
71 Insolvency Rules 1986 r. 4.121.
72 An expedited process for dissolving a company is available in Insolvency Act 1986 s. 202 where the company’s realisable assets will not cover the cost of the liquidation and where full investigation of the company’s affairs is not required. Here the OR may apply to the Registrar of Companies for an early dissolution order, though twenty-eight days’ notice of the intention to apply has to be given to the company’s creditors and contributories and administrative receiver (if there is one).
74 For discussion see Report of the Review Committee on Insolvency Law and Practice (Cmd 8558, 1982) (‘Cork Report’), paras. 1745–51, noting the particular problem of ‘pyramid selling’, which involves purchasers of products being induced (usually by commissions) to sell to others and to recruit these persons in turn as sales operatives:
that creditors must be owed in excess of £750 if they are to petition the court for a winding up and are especially useful where it comes to light that a company is defrauding large numbers of creditors of relatively small sums of money: as where 40,000 football World Cup tickets were sold by a company but no tickets were supplied.\textsuperscript{75}

The Secretary of State for BERR has powers under section 124A of the Insolvency Act 1986 to present a petition to the court to wind up a company. This may be done where it appears to the Secretary of State that it is ‘expedient in the public interest that a company should be wound up’.\textsuperscript{76} The basis for the Secretary of State’s conviction on this front must be a report or information obtained under Part XIV of the Companies Act 1985; a report made by inspectors under sections 167, 168, 169 or 284 of the Financial Services and Markets Act 2000 (FSMA 2000); any information or documents obtained under sections 165, 171, 172, 173 or 175 of FSMA 2000;\textsuperscript{77} information obtained under section 2 of the Criminal Justice Act 1987;\textsuperscript{78} or information obtained under section 83 of the Companies Act 1989. The court, in turn, is empowered to wind the company up ‘if the court thinks it just and

\textsuperscript{75} See Campbell, ‘Protection by Elimination’, p. 131.

\textsuperscript{76} The Secretary of State thus acts not to protect his or her own interests but in the interests of the public: see Keay, ‘Public Interest Petitions’, p. 297; Re Lubin Rosen and Associates Ltd [1975] 1 WLR 122 at 129. On defining the public interest as the interest of ‘the public at large’ see Megarry J in Re Lubin Rosen at 129 and see also Nicholls LJ in Re Walter L. Jacob & Co. Ltd [1989] 5 BCC 244 at 256.

\textsuperscript{77} See Insolvency Act 1986 s. 124A(b), as amended by the Financial Services and Markets Act 2000 (Consequential Amendments and Repeals) Order 2001 s. 305. Section 305 further details that where the company is an open-ended investment company (within the meaning of FSMA 2000), regulations made as a result of section 262(2)(k) of FSMA 2000 are relevant for the Secretary of State’s decision.

\textsuperscript{78} The Serious Fraud Office (SFO) has a specific remit to investigate serious or complex fraud and to prepare reports that may be used as a basis for winding-up petitions. Information and evidence collected by the SFO (under section 2 of the Criminal Justice Act 1987) may be passed to the CIB for the purposes of a winding-up petition under s. 124(a) of the Insolvency Act 1986: see Campbell, ‘Protection by Elimination’, p. 131.
equitable’. Indeed, the court may make any order it thinks fit, including an interim order.\textsuperscript{79}

As for the Financial Services Authority (FSA), this body possesses powers to petition for a winding up under FSMA 2000. Section 367(1) of FSMA 2000 provides that the FSA may ask the court to compulsorily wind up any company or partnership which is or has been an authorised person\textsuperscript{80} or an appointed representative\textsuperscript{81} or is carrying on or has carried on a regulated activity without authorisation in contravention of the general prohibition on this in FSMA 2000. On such a petition, the court may wind up the body if it is unable to pay its debts\textsuperscript{82} or if the court ‘is of the opinion that it is just and equitable that it should be wound up’.\textsuperscript{83} The Secretary of State has some of the same powers that the FSA possesses under FSMA 2000, but not the FSA’s insolvency powers.

The philosophies underpinning PIL do, however, vary both between petitioning institutions and across the processes of securing and enforcing a PIL. To start with the BERR, this Department acts through the Companies Investigation Branch (CIB) (which is located within the Insolvency Service, an executive agency of BERR). The ruling objective of the CIB is to protect the public from the activities of unscrupulous or otherwise errant companies and their directors or employees. The purpose here is not necessarily to trigger the liquidation of a company that is insolvent. The company does not have to be shown to be insolvent in order to petition the court.\textsuperscript{84} Nor, indeed, is the major purpose of the CIB to put the company out of business – it is to put an end to a practice or way of conducting business that is harmful to the public, though not necessarily illegal.\textsuperscript{85}

\textsuperscript{79} The court may, as an alternative to winding up, extract an undertaking from the company or its directors: see \textit{Bell Davies Trading Ltd v. Secretary of State for Trade and Industry} [2005] BCC 564 and (on the court’s general discretion) Re \textit{Supporting Link Ltd} [2004] BCC 764.
\textsuperscript{80} Per s. 31(2) FSMA 2000 (a person within Part IV FSMA 2000 permitted to carry on one or more regulated activities, a firm qualifying for authorisation under Schedule 3 or 4 or a person otherwise authorised under FSMA 2000).
\textsuperscript{81} Per s. 39(2) FSMA 2000 (a party contracted by an authorised person to engage in business of a prescribed description).
\textsuperscript{82} FSMA 2000, s. 367(3)(a). \textsuperscript{83} \textit{Ibid.}, s. 367(3)(b).
\textsuperscript{84} On why it might be in the public interest to wind up a solvent company see \textit{Re A Company (No 007923 of 1994)} [1995] BCC 634, 637; Keay, ‘Public Interest Petitions’, p. 300.
The FSA’s position might be contrasted as being more explicitly ‘regulatory’. When the FSA petitions the court, it does so in relation to regulated parties and activities and it does not petition in pursuit of ‘the public interest’ as stated in those terms. The Secretary of State has, as noted, to make a section 124A petition on the basis of evidence derived from specified reports or sources of information. The FSA, in contrast, has neither the obligation to refer to such designated bodies of evidence nor the duty to apply the ‘expedient in the public interest’ test in deciding whether to apply for a winding up. Under FSMA 2000 the court may look to whether the body is insolvent or whether it is just and equitable to wind it up but the FSA petitions in pursuit of its statutory objectives, namely of maintaining confidence in the financial system, promoting public understanding of the financial system, securing the appropriate degree of protection for consumers and reducing financial crime. The FSA thus proceeds with a more particular focus than the CIB, which may act in order to uphold principles of commercial morality quite generally, but which is not concerned to sustain the health of a particular sector or to retain confidence in a particular market.

Differences in the legal powers of the FSA and CIB create potential differences of approach. The FSA has a wider range of specific statutory powers than the CIB. These allow it to stop an objectionable commercial practice by an individual or company within the financial services sector. These powers may thus rule out the need to apply for PIL in many instances. If, for instance, the FSA is concerned about the trading behaviour of an individual or company which is an authorised person, it can use its administrative powers and does not need to seek court approval before it acts. For instance, it may exercise its ‘own initiative’ power to vary an authorised person’s permission to carry on regulated activity – as set out in Part IV of FSMA 2000. Under section 53(2)(a) of this Act the FSA may exercise this power so that a variation is of immediate effect and the Authority is likely to act urgently where this is necessary to protect consumer interests, where financial crime is involved, where the person or company has submitted misleading information to the FSA, or there is concern about the company’s ability to continue to meet its conditions of carrying out business. Where, similarly, there are worries about the practices of persons (whether authorised or not), section 380 FSMA 2000 allows the FSA (and, to a more limited extent, the Secretary of State) to

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86 See Insolvency Act 1986 s. 124A(1).
87 FSMA 2000 s. 367(3)(a) and (b).
88 Ibid., ss. 2–6.
89 See FSA Enforcement Handbook (FSA Online).
apply to court for an injunction to restrain a contravention of a relevant regulatory requirement. Section 381 also allows the FSA (but not the Secretary of State) to apply to the court to injunct a person to restrain a market abuse. In addition to section 380 or 381 restraining injunctions, the FSA (and, in some cases, the Secretary of State) may ask the court to restrain a person from disposing of or dealing with assets. Restraining injunctions may be sought in a precautionary manner – where the FSA has evidence that there is a reasonable likelihood that a person will contravene a requirement of the 2000 Act – and these and asset freezing orders may be obtained from the court on an interim basis. Nor should it be forgotten that conduct that might be the subject of an injunction application may also be an offence or a regulatory breach for which the FSA has prosecutorial or disciplinary powers under the 2000 Act.

To return to CIB-instituted petitions to wind up in the public interest, philosophical differences are also encountered at different stages in the process from application to enforcement. The CIB’s central concern may be to protect the public from the actions of an individual or firm, but it cannot be assumed that the courts will take an identical or purely protective view when considering if it is ‘just and equitable’ to wind up. It is clear from decided cases that the courts will not accept the Secretary of State’s arguments unquestioningly, but will consider and test these in the same manner as the submissions of other parties. The courts, moreover, will not look in a narrow fashion at the interests of the public but will balance the interests of all parties involved – the company, the members, creditors and investing members of the public. There is, in addition, some evidence that certain judges may temper their instincts to protect the public by demanding evidence of some culpability on the part of the company or its directors. Courts generally stress that ordering the winding up of an active company is a very serious step and, in declining a winding up in Re Secure and Provide plc, Hoffmann J seemed to lay particular stress on the issue of blameworthiness. In that case, the

commercial practice at issue was that of using pyramid selling schemes to market insurance packages. The Secretary of State’s petition alleged fraud on the part of the company but Hoffmann J refused the petition. He accepted that some of the statements used in the sales literature were either exaggerated or wrong but he also believed the evidence of the scheme’s designer who claimed that he had acted in good faith and had not intended to deceive. His Lordship thought that winding up was not justified as it would have been a ‘grossly disproportionate response’ to the errors involved.94

Hoffmann J’s approach here might be interpreted as inconsistent with a strict public protection rationale – which would seek to shield the public from potentially harmful conduct whether the behaviour involved was deliberate or not. It might be countered that in Re Secure and Provide plc the court was really taking exception to the quality of the evidence that the DTI had amassed against the company.95 In another case, however, Secretary of State for Trade and Industry v. Travel Time (UK) Ltd.96 the court was again concerned with whether the public had been deliberately defrauded or misled and suggested that where a petition was presented it was desirable, though not essential, that there be evidence of some intentional or dishonest deceit of the public.

Such judicial reasoning leaves certain questions hanging, notably whether issues of culpability are relevant because the courts are reluctant to take the serious step of winding up without there being some blame-worthiness to merit this, or whether the courts are interested in deliberation and blameworthiness because the courts are concerned to protect the public by upholding standards of commercial morality – which, in turn, calls for evidence on the degree of culpability that a particular practice involves. Consistent with the latter approach is the judgment of Nicholls LJ in Re Walter L. Jacob & Co. Ltd.97 A key issue in that case was whether the petition for winding up should be refused because the company had ceased trading in securities immediately before the presentation of the petition and therefore no longer presented a threat to the investing public. His Lordship was unpersuaded by this line of

94 See also Re A Company (No. 007923 of 1994) [1995] BCC 634 and Re A Company (No. 007924 of 1994) [1996] 15 Lit. 201 – petitions refused, giving credit to the fact that the directors involved had all honestly believed that they were acting lawfully.
95 See Campbell, ‘Protection by Elimination’, p. 132, who notes that such ‘antipathy to the DTI’s poorly researched argument presented ex parte’ was further manifested by the court allocating the provisional liquidator’s costs against the Secretary of State.
argument, stating that it would ‘offend ordinary notions of what is just and equitable that, by ceasing to trade on becoming aware that the net is closing around it, a company which has misconducted itself on the securities market can thereby enable itself to remain in being despite its previous history’. Nicholls LJ granted the petition, stating that the public interest required that individuals or companies who deal in securities should maintain at least the generally accepted minimum standards of commercial behaviour and that those who, for whatever reason, fall below those standards should have their activities stopped. He emphasised that his judgment sent a message to the financial services community: ‘of spelling out … that the court will not hesitate to wind up companies whose standards of dealing with the investing public are unacceptable’.

When awarding costs, the courts, it seems, will be prepared to advert to issues of culpability and to take even retribution into account. Directors whose defences to petitions cause unnecessary losses to other parties are plainly liable to be penalised by the courts. Where a petition to wind up is sought, it is common for a provisional liquidator to be appointed and the Insolvency Service has considerable experience in fulfilling this role. Again, however, the approach of the Insolvency Service (IS) may not be identical to that of the CIB. An official of the IS made the point at interview: ‘The purpose, from the CIB’s point of view, of appointing Official Receivers as provisional liquidators is to close the business down and we can’t do that because, as a provisional liquidator, we are acting as an officer of the court not as a liquidator and we are as answerable to the company as we are to the petitioner. There is thus a divergence here between the approaches of the IS and its sub-department: “The CIB want to stop the company trading, stop the wrongdoing, but we [the IS] have to be sure that it isn’t a viable concern – our job is to protect the estate, only that – to collect and protect the assets pending the determination of the court. There is a certain tension there

98 Ibid. at 257H. 99 Ibid. at 256E. 100 Ibid. at 258A. 101 Secretary of State for Trade and Industry v. Aurum Marketing Ltd [1999] 2 BCLC 498; Re North West Holdings plc; Secretary of State for Trade and Industry v. Backhouse [2002] BCC 441 – the Court of Appeal ordered that the owner-controller of two companies (B) should pay the costs of the section 124A liquidation because B had not given any serious consideration as to what was in the interests of the companies and their creditors apropos defending the petition. Per Aldous LJ the costs had been expended for B’s individual interests and it was therefore just that B paid the Secretary of State’s costs even though B was not a party to the proceedings. 102 Interview, Insolvency Service, 15 March 2002.
and we have been working on this [aspect] for three years now and it has been pretty tense throughout that time.\textsuperscript{103}

Such tensions and differences of approach as are described above raise questions about the philosophical consistency of the PIL process and these differences, in turn, may impinge on the potential of the PIL regime to protect the public against the actions of errant directors. This is a matter to be returned to in chapter 16 below.

The concept of liquidation

When the Cork Committee reviewed the state of insolvency procedures in 1982 it was concerned that liquidation, like other ways of dealing with insolvency, was based on a myth: that creditors would control processes. The principle underlying insolvency law, from at least Victorian times to the 1980s, was said to be that: ‘Since the estate is being administered primarily for the benefit of the creditors, they are the persons best calculated to look after their own interests.’\textsuperscript{104} In accordance with this notion, the Companies Act 1948 section 246 obliged the liquidator to have regard to any directions given by the creditors in general meeting or by the committee of inspection and, in exercising certain powers, the liquidator required express authority from the committee of inspection.

It was suggested to the (receptive) Cork Committee that the system of creditor control was illusory because of apathy and indifference on the part of the creditors. Three reasons were given for the weakness of creditor oversight: first, the general belief that most liquidators were efficient, reliable and experienced; second, the propensity of business creditors to allow for occasional bad debts in fixing prices and to write these off so as to reduce taxable profits, a propensity producing a lack of real interest in insolvency processes; and, third, an acceptance that in most cases of insolvency the general body of creditors was likely to receive only a small dividend. Such factors produced a situation, said Cork, in which creditors were reluctant to attend meetings or serve on committees and where there was an indifference towards the supervision of insolvency processes.\textsuperscript{105}

\textsuperscript{103} Ibid. \textsuperscript{104} Cork Report, para. 912. \textsuperscript{105} A new body aiming to encourage activism on the part of creditors was established in 2004 when the Insolvency Creditors Association was set up, its spokesman stating that it planned to turn matters around so that creditor involvement became the norm rather than the exception: see (2004) Recovery (Summer) 6.
Cork made a number of recommendations that were designed to encourage ordinary creditors to play an active role in insolvency proceedings.106 A broader solution was, however, to involve a rethinking of the insolvency procedures ‘[t]o move away from the concept of creditor control toward one based on creditor participation’. This shift, in turn, would be achieved by requiring liquidators (like receivers and administrators) to give more information to creditors generally and to reduce the duties placed upon creditors.

In terms of the benchmarks employed throughout this book, what Cork proposed was a change in emphasis so that liquidation could be seen less as a matter of accountability and control (by creditors) and more as an issue of expert (professional) management by the IP: though in combination with higher levels of transparency and more modest (but more realistic) levels of creditor supervision. Whether liquidation operates in a manner that is supportable by reference to the chapter 2 benchmarks is the next concern.

Efficiency

Central to liquidators acting efficiently is the effective protection of the entitlements of creditors in the gathering together of the insolvency estate. In such endeavours, liquidators are assisted by the Insolvency Act 1986 which seeks to avoid a number of transactions that might defeat creditors, notably actions involving: dispositions after presentation of the winding-up petition;107 late executed floating charges;108 transactions at undervalue;109 preferences;110 and transactions defrauding creditors.111

Such provisions, if enforced, allow creditors’ entitlements to be restored and, furthermore, in the case of wrongful trading, provide for

106 For example, Cork’s proposals to increase the share in the distribution available for the general body of creditors by reducing preferential debt and conferring a stake in receiver realisation. See now the ‘prescribed part’ provisions in IA 1986 s. 176A(2): see ch. 3 above and chs. 14 and 15 below.
107 Insolvency Act 1986 s. 127. 108 Ibid., s. 245. 109 Ibid., s. 238. 110 Ibid., s. 239. 111 Ibid., s. 423. Other provisions, such as Insolvency Act 1986 s. 244 (extortionate credit transactions) and Companies Act 2006 ss. 860, 874 (non-registration of charges), also seek to prevent transactional avoidance. See generally D. Milman and R. Parry, A Study of the Operation of Transactional Avoidance Mechanisms in Corporate Insolvency Practice, Insolvency Lawyers’ Association Research Report (1997); R. Parry and D. Milman, ‘Transaction Avoidance Provision in Corporate Insolvency: An Empirical Study’ (1998) 14 IL&P 280.
compensatory payments to be made by directors.\textsuperscript{112} Efficient application of these laws may also deter the directors of troubled companies from taking actions that prejudice legitimate creditor interests.\textsuperscript{113} Such efficient enforcement action by liquidators is only possible if there is access to the funding that is necessary to pursue cases against errant directors.\textsuperscript{114} This section of the chapter accordingly focuses on the funding of liquidator actions but also considers whether liquidators are well placed to amass the information that is necessary for the effective deploying of legal challenges. Whether liquidation and the rules on the avoidance of transactions operate substantively fairly as between different creditors (or between creditors and others) is left to the next section, but overlaps are inevitable and fairness clearly demands that there be efficient enforcement.

The background to funding and its importance to liquidators is that liquidators will often view litigation from a position of reluctance to pursue some actions (for example, avoidable transactions) where there are economically powerful defending parties (for example, banks) or where lucrative professional relationships (with, say, banks) are liable to be soured. As Parry and Milman note: ‘It should not be forgotten that the receivership and investigation work, which banks put the way of IPs, will be a far more lucrative source of income than transaction avoidance.’\textsuperscript{115} Liquidators, moreover, have to protect the insolvency estate by entering a game in which their own funding problems could routinely be exploited by defenders as a tactic designed to kill the case.\textsuperscript{116} As for those funding problems, a number will be faced by liquidators.\textsuperscript{117} The difficult reality a liquidator encounters is that actions will have to be taken when a company is insolvent and necessarily short of funds, a position not aided by the non-eligibility for legal aid of a company in administration or liquidation.\textsuperscript{118} The Cork Committee commented that the task facing the liquidator was ‘too difficult’ and led to a paucity of challenges to

\textsuperscript{112} See Insolvency Act 1986 s. 214; see further ch. 16 below.
\textsuperscript{113} See R. Parry, ‘Funding Litigation in Insolvency’ [1998] 2 CfiLR 121.
\textsuperscript{114} See further ch. 16 below.\textsuperscript{115} Parry and Milman, ‘Transaction Avoidance’, p. 282.
\textsuperscript{116} Ibid. On the difficulties of office holders where the costs and expenses of insolvency proceedings exceed the assets in the estate see H. Anderson, ‘Insolvent Insolvencies’ (2001) 17 IL&P 87. For an instance in which a director was ordered to pay the costs of a successful winding-up petition in the public interest as he induced the company to defend the petition to serve his ulterior interests, see Secretary of State for Trade and Industry v. Backhouse [2002] BCC 441.
\textsuperscript{117} See Milman and Parry, Study, ch. 2.\textsuperscript{118} Access to Justice Act 1999 s. 4.
illegitimate payments, and, to date, a series of problems confronts the liquidator.

In some circumstances there may be sufficient liquid funds in the pool of realised assets to fund litigation. If the liquidator wishes to litigate to protect creditor interests, he will need the approval of the creditors’ Liquidation Committee to bring an action in the company’s name and, following the Enterprise Act reforms, will require the sanction of the creditors if seeking to bring clawback proceedings. Such creditor sanctioning cannot, however, be taken for granted and the liquidator cannot assume that the unsecured creditors will be prepared to use the funds made available to them by virtue of the ‘prescribed part’ rules as a fighting fund. In the case of an unsuccessful action brought by the liquidators in their name personally, they may claim indemnification in respect of costs borne, but a significant issue here is the place in the order of priorities that such claims will occupy.

Before the Companies Act 2006 amendment it had become clear that the general costs and expenses of the liquidator could not be paid out of floating charge realisations. The 2004 House of Lords decision in *Leyland DAF Ltd; Buchler v. Talbot* made this plain in overruling *Re Barleycorn*. Their Lordships’ position was that a distinction was to be drawn between the proceeds of the free assets, which belong to the company and are administered by the liquidator in a winding up, and the proceeds of assets subject to a floating charge, which belong to the charge holder. Each of these funds was to be treated as bearing its own costs but

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119 Cork Report, para. 1257.
120 See Insolvency Act 1986 Part II, Sch. 4, para. 4.
121 See EA 2002 s. 253, which inserts para. 3A into Part 1 of Sch. 4 of the IA 1986.
122 In compulsory liquidation the court’s sanction is required.
123 I.e. proceedings under ss. 213, 214, 238, 239, 242, 243 or 423 of the Insolvency Act 1986. See Lord McIntosh, Third Reading of Enterprise Bill, House of Lords, 21 October 2002, col. 1123: ‘it is a commercial decision for the creditor to choose between, say, a five pence in the pound dividend payable now or whether to allow the liquidator to pursue a claim which may result in a fifty pence in the pound dividend at a later stage’. See also S. Davies, *Insolvency and the Enterprise Act 2002* (Jordans, Bristol, 2003).
An advantage of this position was that it stopped general creditors from funding actions from floating charge assets with a view to generating recoveries that would belong exclusively to them and not the floating charge holder. The line taken in Leyland DAF affirmed that winding-up proceedings were for the benefit of unsecured creditors – and to be funded by such creditors from the ‘free’ assets.

The decision in Leyland DAF did, however, reduce the likely size of the asset pool available for paying liquidation expenses and thus increased IPs’ prospects of not being paid their costs and expenses for winding up a company – which, in turn, might be expected to have reduced liquidators’ inclinations to pursue office-holder actions. Critics argued, moreover, that it was a nonsense to have different expenses regimes for liquidations and administrations. A product of that difference was that Leyland DAF gave IPs an incentive to conduct de facto liquidations through the Schedule B1 administration procedure since the expenses of that procedure have statutory priority over the floating charge.

Leyland DAF can, accordingly, be seen as underplaying the public interest role of liquidation proceedings and the value of such proceedings in reinforcing commercial morality – notably through the institution of investigations and the reporting requirements that may result in the prosecution of company officers. It can also be said to have allowed

128 See McCormack, ‘Swelling Corporate Assets’, p. 63
131 ‘In the light of the Leyland DAF ruling, no IP will spend time investigating and incur personal risk in situations where his or her fees and expenses are in doubt’: see R. Welby, ‘Antecedent Recoveries and Litigation Funding – A Practical Perspective’ (2006) Recovery (Winter) 32. Walters, in ‘Floating Charges and Liquidation Expenses’, points out that such considerations led the Association of Business Recovery Professionals (R3) to press the Government to reverse the Leyland DAF position. McCormack posits, however, that the Leyland DAF decision could lead to a ‘richer source of funding available to pursue recovery proceedings; namely, an all-assets floating charge holder’: ‘Swelling Corporate Assets’, p. 65.
133 Administrators’ expenses and remuneration are paid in priority to a floating charge: see Insolvency Act 1986 Sch. B1, para. 99(3) and ch. 9 above. For an argument that the incentive to use administration might inadvertently prove rescue-enhancing see L. Hiestand and C. Pilkington, ‘The Impact of Leyland DAF’ (2005) Recovery (Spring) 18.
134 See further ch. 16 below. For judicial endorsement of the public interest role of liquidations see Re Pantmaenog Timber Co. Ltd [2004] 1 AC 158.
secured creditors to free ride on the public interested actions that are funded out of assets belonging to unsecured creditors.\footnote{See R. Mokal, ‘What Liquidation Does for Secured Creditors and What It Does for You’ (2008) 71 MLR 699.}

\textit{Leyland DAF} has, however, been reversed by section 1282 of the Companies Act 2006 which provides for the insertion of a new section 176ZA into the Insolvency Act 1986. This insertion was effected by Statutory Instrument in April 2008 and provides that the expenses of winding up ‘have priority over any claims to property comprised in or subject to any floating charge created by the company and shall be paid out of any such property accordingly’ and that this applies so far as the assets of the company available for payment of general creditors are insufficient to meet them.\footnote{See the Insolvency (Amendment) Rules 2008 (SI 2008/737) which came into effect on 6 April 2008. The amended Rules provide specifically that the assets available for the payment of the general creditors include the proceeds of any legal action which the liquidator has power to bring. Only property that is covered by a fixed charge thus escapes the claims of liquidation expenses. See I. Fletcher, ‘Companies Act 2006: Reversal of \textit{Leyland DAF} Ruling’ (2007) 20 Insolvency Intelligence 30.} Any sums constituting the ‘prescribed part’ made available to meet unsecured claims under section 176A(2)(a) of the 1986 Act will not be included within the pool of assets which are to be applied to meet liquidation expenses ahead of distributions to the general creditors.\footnote{See section 176ZA(2)(a). For arguments that the reversal of \textit{Leyland DAF} will cause secured lenders to demand additional collateralisation – and that this will detract from the City of London as a centre for project finance and securitisation transactions – see Financial Markets Law Committee, \textit{Issue 120 – Section 868 of the Company Law Revision Bill: Statutory Reversal of Leyland DAF} (FMLC, London, March 2006).}

The granting of ‘super-priority’ to liquidation expenses places emphasis on the categorisation of expenditure as an expense of the liquidation.\footnote{See generally Boyle and Birds’ \textit{Company Law} (6th edn, Jordans, Bristol, 2007) pp. 938–40.} Reference here must be made to Rule 4.218 as amended.\footnote{Said by Lord Hoffmann in \textit{Re Toshoku Finance (UK) plc, Kahn v. Commissioners of Inland Revenue} [2002] 1 WLR 671 (paras. 15–17 and 38–9) to contain a complete list of what counts as a liquidation expense – and subject neither to implied qualification nor court discretion.} This rule makes it clear that the liquidator’s remuneration is such an expense, as are liabilities incurred before the liquidation in respect of property retained by the liquidator for the benefit of the estate (such as rent or hire purchase charges). Rule 4.218 includes as expenses ‘any necessary disbursements by the liquidator in the course of his administration’ and the
House of Lords held, in *Toshoku Finance*,¹⁴⁰ that this includes liability to corporation tax.¹⁴¹

Originally, the costs incurred by the liquidator in unsuccessfully seeking to recover assets were not treated as expenses of the liquidation. In *Re M. C. Bacon Ltd (No. 2)*¹⁴² Millett J ruled that the costs of unsuccessful preference and wrongful trading actions could not rank, for priority purposes, as taken for the purpose of preserving, realising or getting in the assets within Rule 4.218(1) of the Insolvency Rules 1986,¹⁴³ nor could they be regarded as expenses of the winding up for the purposes of section 115 of the Insolvency Act 1986. The Court of Appeal in *Re Floor Fourteen Ltd*¹⁴⁴ reasserted¹⁴⁵ the restrictive approach taken in *Re M. C. Bacon*¹⁴⁶ and deemed that the expenses incurred by a liquidator in pursuing claims under section 214 and section 239 of the Insolvency Act 1986 were indeed not ‘expenses of the liquidation’.¹⁴⁷

Matters have since changed, however. Rule 23 of the Insolvency (Amendment) (No. 2) Rules 2002¹⁴⁸ amended Rule 4.218(1)(a) of the Insolvency Rules 1986 to provide that costs properly chargeable in

¹⁴¹ On statutory liabilities to pay redundancy and unfair dismissal payments as non-necessary disbursements and expenses of the administration see *Allders Department Stores Ltd (in administration)* [2005] 2 All ER 122, [2005] BCC 289; ch. 17 below.
¹⁴² [1990] 3 WLR 646. See also *Re Yagerphone* [1935] Ch 392.
¹⁴⁴ In *Katz v. McNally* [1997] BCC 784 the Court of Appeal had gone some way in countering the reasoning of Millett J in *Re M. C. Bacon (No. 2)* and in assuring office holders that litigation expenses could be met from the company’s assets.
¹⁴⁵ For comment and criticism of *Re Floor Fourteen* see A. Walters, ‘*Re Floor Fourteen Ltd in the Court of Appeal*’ (2001) 22 Co. Law. 215; T. Pope and M. Woollard, ‘Part 2 – Lewis*’ (2001) 14 Insolvency Intelligence 20; G. Stewart, ‘Liquidation Expenses – Litigation*’ (2001) Recovery (July) 8 – who argues, inter alia, ‘it surely cannot be right that the recoupment by a liquidator of his costs of preference and wrongful trading actions depends solely upon whether or not he succeeds. The test must be whether it was reasonable and prudent for him to bring the action in the first place … it is excessive and contrary to the principles of office-holder responsibility to make it necessary for the liquidator to get prior court clearance for incurring costs (presuming that there is a judicial basis for the court intervening which the Court of Appeal in *Lewis* found difficult to identify).’
¹⁴⁶ SI 2002/2712 which came into force on 1 January 2003.
relation to any legal proceedings which the Official Receiver or liquidator has power to bring, whether in his own name or that of the company, are payable as a first priority out of the assets.149 While this amendment endeavoured to assist liquidators by ameliorating the difficulties caused by the Court of Appeal decision in Re Floor Fourteen150 and allowing them to recover such costs out of the company’s assets, the reality is, of course, that those assets may be limited. The amended rule, moreover, did not appear to cover the costs of solicitors and others doing work in relation to the investigation of preferences, transactions at undervalue or wrongful trading: the amendment refers simply to costs relating to ‘the conduct of any legal proceedings’.151 This omission appeared to sit at odds with the views expressed by the House of Lords in Re Pantmaenog Timber Co. Ltd152 concerning the importance of investigation and emphasising that such investigation was part of the duty of an office holder.153 In 2008, however, the Insolvency (Amendment) Rules (SI 2008/737) were promulgated, which, as noted above, stemmed from the power under the Companies Act 2006 section 1282 insertion of section 176ZA into the Insolvency Act 1986. These Rules amend the Insolvency Rules 1986 by replacing r. 4.218(1)(a) with new r. 4.218(1), (2) and (3)(a) and by inserting new rr. 4.218A–4.218E. The amendments relate to liquidation expenses and in particular provide expressly for the expenses of liquidation to be payable also out of the proceeds of any legal proceedings which the liquidator has power to bring in his own name, or in the name of the company, and also for the recovery of expenses and costs relating not only to the conduct but also to the preparation of any such legal proceedings.154

149 Thus Rule 4.128 now deems the costs of such proceedings to be expenses of the liquidation.


152 [2004] 1 AC 158. See p. 552 above.

153 See speeches of Lords Millett and Hope in Re Pantmaenog.

154 The right of recourse to floating charge assets is restricted with respect to litigation expenses. If the costs of the proceedings to be instituted, continued or defended are likely to exceed £5,000 and the liquidator thinks that recourse to the floating charge assets will be needed to meet those costs, then the approval or authorisation of the creditor(s) whose financial interest is most likely to be affected by the payment of such costs must be obtained. (The liquidator has a right to apply to the court for approval in specified circumstances, e.g. urgency: see rr. 4.218B and 4218E.)
One method for securing financing may be for liquidators to obtain funds from individual creditors so that their interests can be protected. Such creditors, however, may be slow to provide cash for a number of reasons. First, they may be wary of the lengthy legal processes involved, the uncertainties of any positive result and the potential wrecking tactics of defendants. Small creditors may prefer to cut their losses and large creditors may be happier to absorb the loss rather than become involved in funding a process whose outcome is uncertain. Second, creditors may be wary of the motives of the liquidator and may fear that actions are taken not so much to protect creditors as to increase professional fees or to enforce commercial morality. If creditors believe that public interest concerns are driving the liquidator’s strategy, they may be highly unenthusiastic about subsidising protection of these. Third, creditors may fear that if they fund an action that fails, the court might make a costs order against them under the Supreme Court Act 1981 section 51. Fourth, creditors who are asked to fund an action cannot be offered, in return, a higher proportion of the proceeds of an action than is to be distributed to other creditors: the pari passu principle will apply. (Here there is a contrast with the position in Australia where the court can order distributions of recoveries that reward funding creditors.)

A further potential method of financing litigation is for the liquidator to agree with an outside funder that the latter will be assigned the claim for an agreed sum or will finance the action in return for a share in the fruits of the litigation. The case of Re Oasis Merchandising Services

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158 On the development in ‘litigation funding’ in the UK (the growing practice of inviting third parties, such as banks or hedge funds, to put up funds to allow a legal claim to be pursued) see N. Tait, ‘Lawyers Test Litigation Funding Waters’, Financial Times, 5 January 2007: noting pioneering developments in Australia and the arrival of ‘for profit’ litigation-funding companies (who receive fees equivalent to about 30 per cent of...
involved such selling of the fruits of an action. In that Court of Appeal decision, attention was paid to *Grovewood*, which had considered that a sale of the fruits of an action was not a ‘sale’ for the purposes of the Insolvency Act 1986 Schedule 4, paragraph 6 and so was not exempt from the rules on champerty. *Oasis* was more favourably disposed than *Grovewood* to allow such sales and the Court of Appeal noted that there was much to be said for allowing liquidators to sell the fruits of actions, provided that the purchasers were not given the right to influence the liquidator’s conduct of the proceedings. More negative, however, was the *Oasis* attitude to the disposal of rights of action that are personal to the liquidator (as are many transactional avoidance rights). In *Oasis*, the Court of Appeal rejected an arrangement whereby the liquidator assigned the potential proceeds of an Insolvency

net settlements plus costs). On a setback to the business of financing lawsuits for profit and the ‘throwing out’ of the multi-million dollar negligence claim against a City accountancy firm Moore Stephens see M. Murphy, ‘Third-party Lawsuit Funding Hit as Case Thrown Out’, *Financial Times*, 19 June 2008.


160 *Grovewood Holdings v. James Capel & Co.* [1995] BCC 760; but see *ANC Ltd v. Clark Goldring and Page Ltd* [2001] BCC 479 (Robert Walker LJ at p. 485) and *Farmer v. Moseley Holdings Ltd* [2002] BPIR 473 (Neuberger J at p. 470), indicating that liquidators should have the power to assign fruits of action without infringing rules on champerty.

161 The rule on champerty prohibits the selling of a cause of action or its fruits to a party with no legitimate interest in the proceedings. As a general rule such sales are not champertous in insolvency if it is within the office holder’s power (under Insolvency Act 1986 Sch. 4, para. 6 – the ‘insolvency exception’) to sell or dispose of the assets of the company: see Parry, ‘Funding Litigation in Insolvency’, p. 123. See Walters, ‘Modern Doctrine of Champerty?’, P. Winterborne, ‘The Second Hand Cause of Action Market’ (2001) 14 *Insolvency Intelligence* 65 (who notes, at p. 66, the conflicting public policy considerations operating in assignment of causes of action cases, namely (1) that causes of action should not be traded and that persons without a legitimate interest in litigation should not become involved, and (2) that office holders should not be prevented from pursuing legitimate causes of action (and recovering valuable funds for creditors) due to lack of funding).

Act 1986 section 214 wrongful trading action in return for litigation finance provided by a commercial body. The court, moreover, held that an assignment was not possible because the fruits of the wrongful trading action were not ‘property’ subject to the liquidator’s power of sale under Schedule 4, paragraph 4 of the Insolvency Act 1986. An important distinction was drawn between assets that are the property of a company (including rights of action open to the company prior to winding up) and assets arising only after liquidation and recoverable only by the liquidator. The latter were not to be regarded as the ‘company’s property’ under Schedule 4, paragraph 6. Particular court objection was also taken in *Oasis* to the reservation by the funder of certain powers of control over the litigation. The Court of Appeal noted that the wrongful trading provisions possessed a penal aspect and considered that acts of such a nature should remain within the control of the office holder (an official acting under court direction).

Objections to the restrictiveness of *Oasis* can, however, be taken. It might be argued, first, that allowing the funding of liquidator actions through the assignment of proceeds would do more potential good (in assisting creditor protection and deterring errant directorial behaviour) than it would cause harm in undermining the administration of justice (by giving a commercially uninvolved party an interest in the case or allowing ‘trafficking’ in cases). The dangers involved in such funding arrangements can, moreover, be reduced by restrictions on the degree of control over the litigation process that can be conceded to a funder – perhaps limiting this to such matters as choice of lawyer or a voice in settlement negotiations – for, as has been pointed out, commercial realities demand that funders be given some influence.

A second objection is that the *Oasis* approach gives too little attention to the merits of a case when it deems a stay of proceedings to be the appropriate judicial response to the funding of liquidation litigation by

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164 See discussion in ch. 16 below.
167 See the judgment of Peter Gibson LJ at [1997] 2 WLR 764 at 777; *Giles v. Thompson* [1994] 1 AC 142 (some funder interference acceptable).
the assignment of proceeds. Where the case is strong and there is good evidence of malpractice to the detriment of creditor interests, it is arguable that the courts should take this factor into account in deciding whether to allow an action to proceed.\(^{169}\)

A further difficulty with *Oasis* is that it draws a distinction between the Insolvency Act 1986 section 212 misfeasance action (which the law treats as corporate property able to be assigned) and section 214 wrongful trading action (which cannot). Apart from the conceptual difficulties involved in treating proceeds of wrongful trading actions as non-assignable,\(^{170}\) this produces perverse incentives to ‘overload’ misfeasance and bring actions under section 212 or to test the limits of directors’ duties at common law when claims may fall squarely within section 214. One commentator has dubbed this ‘absurd’.\(^{171}\)

Finally, it can be argued that *Leyland DAF*\(^{172}\) impliedly overruled *Oasis* by holding that debenture holders’ and unsecured creditors’ assets form two separate funds. The import of this is that it would be strange to hold that office-holder recoveries were not available to pay the expenses of the liquidation (because they were not ‘assets of the company’) when those expenses had been incurred for the exclusive benefit of the unsecured creditors – especially since such recoveries are a fund available for the unsecured creditors.\(^{173}\)

Conditional fee arrangements (CFAs) offer another potential means of funding liquidator actions.\(^{174}\) Under such agreements, the liquidator will pay no lawyers’ fees in an unsuccessful action but will be charged a ‘success fee’ or ‘uplift’ by the legal firm if the desired outcome is

\(^{169}\) *Ibid.*, p. 23. See Abraham v. Thompson [1997] 4 All ER 362; Stocznia Gdanska SA v. Latvian Shipping Co. (No. 2) [1999] 3 All ER 822 (proceedings only to be stayed if, on the particular facts, the likelihood of abuse is sufficient to deny access to justice).

\(^{170}\) Armour and Walters have said: ‘if office holder recoveries were not “assets of the company” in liquidation, then how were they to be administered, given that the statute directs the liquidator to distribute only “assets of the company”?’: *Funding Liquidation*, p. 323.

\(^{171}\) Walters, ‘Enforcing Wrongful Trading’, p. 158.

\(^{172}\) *Re Leyland DAF Ltd; Buchler v. Talbot* [2004] 2 AC 298.

\(^{173}\) Armour and Walters, *Funding Liquidation*, p. 323. Arguably this point holds in spite of the effect of the Companies Act 2006 s. 1282 in overruling *Leyland DAF* regarding the payment of liquidation expenses out of floating charge holders’ returns.

achieved. Proceedings by liquidators relating to companies being wound up are ‘specified proceedings’ to which conditional fee arrangements can be applied. Lawyers’ costs are usually the largest element of the sums that liquidators require in order to pursue those assets that a debtor may have hidden away. The liquidator’s ability to retain lawyers on a conditional fee basis is designed to facilitate actions since the risk of legal fees is transferred to the liquidator’s own lawyer and the risk of having to pay the other side’s costs in an unsuccessful case can be covered by insurance. The main attractions of such arrangements for clients are said to be that it removes the burden of funding the matter on an ongoing basis – since solicitor’s costs do not have to be paid as the case progresses – and such a strength of client position can increase the chances of securing an early settlement. Even if the case is lost, the client will not have to pay the solicitor’s basic charges or the success fee.

The introduction of conditional fee arrangements has been found, however, not to have made a huge impact in the insolvency sector. This may be because informal arrangements of a similar nature are already being used by solicitors and liquidators and because restrictions have limited the enthusiasm of practitioners. It has, for instance, been suggested that solicitors did not warm to the upper limit of 25 per cent that is imposed on their demanded recoveries. A further difficulty has arisen because conditional fees do not adequately deal with adverse costs, which, under the Insolvency Lawyers’ Association Model Conditional Fee Agreement, have to be borne by the liquidator or the estate as client. Many IPs will, accordingly, give serious consideration, before pursuing an action, to the personal financial risks involved.

Insurance for adverse costs is possible, as noted, and recent years have seen a growth in the availability of legal costs insurance. The London market in such insurance has been said to have been boosted by the Government’s decision to widen the use of no-win no-fee agreements: solicitors’ firms that take on such conditional fee work will very often insist that their

175 Note that conditional fees are not like contingency fees employed in the USA. The US style agreements often provide for a client to pay the lawyer a percentage of the damages if the client wins. An English lawyer is still restricted from agreeing with a client to be paid a percentage of the recoveries from an action. See further LCD Consultation Paper, ‘Access to Justice with Conditional Fees’, March 1998.
177 Christopher, ‘Conditional Fee Arrangements’, p. 38.
178 Milman and Parry, Study, p. 21.
179 Ibid.
180 For advice that they should do so see Welby, ‘Antecedent Recoveries and Litigation Funding’, p. 35.
clients take out insurance to cover opponents’ costs in the event of a lost case. Liquidators, nevertheless, may see such insurance as not entirely problem free. In order to obtain cover, a counsel’s opinion will often be required and this may be costly. Liquidators have to find the premiums out of the available company funds and premiums have risen sharply in recent years. The conditions that insurers impose on such cover (for example, demanding the use of lawyers on the insurance company’s panel) may also restrict the liquidator’s enthusiasm for such arrangements. There is, moreover, evidence that solicitors’ firms will tend to demand a very strong case indeed before proceeding on a conditional fee basis.

The above analysis suggests that efficient liquidator action to protect the interests of creditors is likely to be impeded by funding difficulties. What can be done to ease these difficulties? A first step would be to amend the law as stated in the Insolvency Act 1986 so as to allow liquidators to assign shares in the fruits of an action, provided that they do not cede control of such claims. As Milman and Parry conclude: ‘A much wider range of parties [should be allowed] to undertake transactional avoidance litigation. Commercial organisations, which are increasingly prominent in the area of litigation finance, should be permitted to purchase and prosecute actions to avoid dubious transactions and the courts should be prepared to reconsider their traditional hostility to such “trafficking”’.

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181 See Welby, ‘Antecedent Recoveries and Litigation Funding’, p. 35: ‘such policies can have traps for the unwary’.

182 See BDO Stoy Hayward Survey, reported in (1999) 12 Insolvency Intelligence 48, revealing that 75 per cent of those questioned considered that such restrictive clauses in insurance agreements were a deterrent to taking out cover.

183 Milman and Parry, Study, p. 39. Winterborne suggests that the claims that office holders can bring (under ss. 339, 340, 214, 238 or 239 of the Insolvency Act 1986) cannot be assigned because this would be to delegate a statutory power. Where, in contrast, a claim is one that the company could have brought, the cause, as noted, is an asset that can be sold by the office holder for the benefit of creditors with the terms of Sch. 4, para. 6: Winterborne, ‘Second Hand Cause of Action Market’, p. 67. See also ANC Ltd v. Clark Goldring and Page Ltd [2001] BPIR 568.

184 Milman and Parry, Study, pp. 39–40. The practice of ‘litigation funding’ (inviting third parties such as banks or hedge funds to put up funds to allow a legal claim to be pursued) is still in its infancy in the UK but may be given fresh impetus as IPs grow more proactive in pursuing claims and as ‘access to justice’ issues loom large as the UK Government has sought to cap or reduce legal aid: see Tait, ‘Lawyers Test Litigation Funding Waters’.
State funding of ‘public interest’ litigation to prevent avoidance has also been put forward as a response to funding difficulties, and the Harmer Report on insolvency law reform in Australia recommended this for the corporate insolvency arena. This funding might be organised around a levy on directors or companies and reimbursement of the fund could be provided for in the case of successful liquidator actions. Indeed, Katz and Mumford have suggested that the Insolvency Service explore the system of aid that is made available by the New Zealand Insolvency Service, which provides funding for cases which it believes are winnable (recovering funds out of the proceeds of the action). This is not, however, a problem-free area and processes would have to be established so as to avoid the taking of speculative cases or cases that lack real merit and are pursued for tactical reasons.

A further way of funding avoidance litigation would be to make use of the profits of the Insolvency Services Account (ISA) (which imposes a levy on compulsory liquidation funds paid into and out of the account). The profits of the ISA have been used to investigate the past conduct of parties (including directors) for the purposes of bringing prosecutions or disqualification proceedings. It has been argued that the deterrent effects of disqualification are undramatic and that:

The funds in the ISA could be better employed in subsidising ... the costs of investigating and bringing financial claims against directors, shadow directors and recipients of the benefits of voidable transactions. Financial claims against them ... would be a far more effective deterrent and public protection and, what is more, would bring more tangible benefits to the creditors.

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185 Milman and Parry, Study.
188 A. Katz and M. Mumford, Making Creditor Protection Effective (Centre for Business Performance, ICAEW, 2008 Draft) Part 5. The authors note that when it comes to creditor protection and office holder fees, the insolvency office holder has an unusual role, and one that may well involve conflict. ‘On the one hand he is charged with protecting creditors’ interests, but on the other hand his own commercial interests and the right to charge fees may be detrimental to creditors’ interests. There is a subtle balance to be struck.’
189 Since 1 April 2004 moneys from voluntary liquidations need only to be paid voluntarily into the ISA and all deposits earn interest at a competitive rate: see ch. 5 above.
A further move in the direction of Australian law might also be desirable. In that country the court has the power to approve an arrangement in which a creditor who has indemnified the liquidator against the costs of proceedings can be allocated a higher share of the proceeds recovered: one that reflects the degree of risk assumed by the creditor.\(^\text{192}\) In the UK the court might be given the power to approve such arrangements between liquidators and funders as seem appropriate and fair to all affected creditors under the court’s inherent jurisdiction.

Funding is not the only difficulty that liquidators face in attempting to combat transaction avoidance. The substantive rules of insolvency law can also be criticised as giving secured creditors, normally banks, excessive levels of protection.\(^\text{193}\) The law on the avoidance of preferences, for instance, is set out in section 239 of the Insolvency Act 1986 and is designed to protect *pari passu* distribution by stopping an insolvent company from favouring one creditor at the expense of others. Section 239 modified the law, in a manner prompted by Cork,\(^\text{194}\) so as to allow a liquidator to succeed in a challenge by establishing that one contributing influence behind the transaction was the desire to prefer.\(^\text{195}\) In the case of *M. C. Bacon Ltd*,\(^\text{196}\) however, Millett J held that a defence exists if it can be shown that the directors entered a transaction not in order to prefer but with a view to securing financing in order to keep the business going. This focus on subjective motivation increases the liquidator’s problems of proof, though, in the case of beneficiaries to the transaction who are connected persons, there is onus reversal so that such a person has to show that the transaction is not influenced by a desire by the company to prefer.\(^\text{197}\) An objective or ‘effects’ test in the law of preferences would eradicate the problems brought to the fore by *Re M. C. Bacon Ltd* and would correspond to the approach taken in other jurisdictions such as Australia and the USA.\(^\text{198}\) As Milman notes, this removal of the ‘desire’ test could be balanced by an opportunity to defend the transaction if it was *bona fide* in the ordinary course of business and for the benefit of the company.\(^\text{199}\)

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\(^\text{192}\) See *Re Glenisla Investments Ltd* (1996) 18 ACSR 84.

\(^\text{193}\) Milman and Parry, *Study*, p. 36.


\(^\text{195}\) See Insolvency Act 1986 s. 239(5).

\(^\text{196}\) [1990] BCLC 324.


\(^\text{199}\) D. Milman, ‘Revitalising the Assets of an Insolvent Company – Where Are We Now?’ (2002) 2 Sweet & Maxwell’s Company Law Newsletter 1 at 4: ‘This trade off would of course require a reversal of the burden of proof in such cases.’
alternative step of assistance to liquidators would be the institution of a statutory presumption of preference where there is a grant of security so that the court should set this aside unless the debenture holder is able to give good reason for sustaining it. Liquidators would also benefit by abolition of the requirement (in sections 238, 239 and 245 of the Insolvency Act 1986) that the liquidator should show that the company was unable to pay its debts within the meaning of section 123 of the Insolvency Act 1986. The incompleteness of company financial records and problems of valuation may make proof of insolvency at the relevant time very difficult for the liquidator, who would be assisted by abolition of this requirement in favour of establishing that the company subsequently became insolvent within the specified time period. Milman and Parry have argued that in dealing with transactions at undervalue the law should recognise (contra Millett J in Re M. C. Bacon Ltd) that creating a security does devalue a company’s assets so that in looking to section 238 of the Insolvency Act 1986 (transactions at undervalue) a devaluation effected in this way is only acceptable if the recipient of the transaction can show that a corresponding economic benefit has accrued to the company. The obiter comments of Arden LJ in Hill v. Spread Trustee Company Limited seem consistent with such an approach.

Turning now to information, there is little utility in providing for a properly funded liquidation system if liquidators are ill-informed concerning the extent and whereabouts of the insolvent company’s assets or concerning relevant directors’ dealings. The liquidator’s powers, as already outlined, do, however, contain extensive powers to gather information, and section 235 of the Insolvency Act 1986 provides that officers, employers, administrators or administrative receivers of the company (past and present) have a duty to provide the liquidator with such information as may reasonably be required. The liquidator may also ask the court to exercise its powers under section 236 of the Insolvency

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200 Milman and Parry, Study, p. 38.
203 See, for example, Daltel Europe Ltd (in liquidation) v. Makki [2005] 1 BCLC 594 – courts may be prepared to grant orders for private examination and discovery of documents under section 236 despite the fact that the officer in question was subject to proceedings brought by the liquidator. Section 235 complement the powers that have persons examined either publicly (IA 1986 s. 133) or privately (IA 1986 s. 236) before the court. Note also that company officers are required to be proactive, and not merely...
Act 1986 to call before it for examination any officer of the company, any person known or suspected of having in their possession any property of the company or any person supposed to be indebted to the company; or any person whom the court thinks capable of giving information concerning the business dealings, property, etc. of the company. Account books, papers or records may also be demanded by the court and powers of seizure and arrest are provided for in section 236(5).

The court has a broad discretion to conduct examinations in order to further a winding up and the liquidator will have some influence on the exercise of that discretion. The view of an officer that an examination is required is normally given ‘a good deal of weight’ but the power to examine is not designed to offer liquidators special advantages in ordinary litigation and should not be operated oppressively. Its purpose has been described as allowing the officer ‘to get sufficient information to reconstitute the state of knowledge a company should possess’. The House of Lords has held that an order could properly be made to extend to all documents and information which officers reasonably require to carry out their functions.

reactive, under Insolvency Act 1986 ss. 206–11: see Re McCredie, The Times, 5 October 1999, per Henry LJ. (The Insolvency Act 1986 s. 208(1), for example, makes it a criminal offence to fail ‘fully and truly to discover to the liquidator all the company’s property’ and to fail to deliver up company property under the director’s custody and control. The same applies to books and papers.) The court has the power to order the production of books, papers or records which relate to the company even if they are not the company’s property and the company itself could not have obtained them: Re Training Partners Ltd [2002] 1 BCLC 655.


205 Re Embassy Art Products Ltd [1987] 3 BCC 292.

Turning to the issue of transaction costs, it can be said that a liquidation regime is only efficient in the technical sense if it operates with minimal transaction costs. If, accordingly, there is a good case for streamlining the process, this may point to underachievement on efficiency. Whether there is such a case was an issue raised by the Insolvency Service in September 2007 when it published a consultation document on streamlining insolvency procedures.208 This document proposed to change the relevant items of primary legislation by means of a Legislative Reform Order209 in order to effect the following steps:

1. To provide more flexibility in the means of communication, and the exchange of information, between insolvency office holders and creditors (and others) by: instituting ‘opt-in’ arrangements for creditors who wish to receive information or participate in proceedings; allowing notifications to be by electronic communication (where required to be ‘in writing’); and allowing meetings to be held through media rather than physically.
2. To remove the need for liquidators and trustees in bankruptcy to obtain sanction for certain actions.
3. To allow discretionary advertising of the appointment of a voluntary liquidator.
4. To remove the requirement that liquidators summon annual meetings of members and/or creditors to account for their acts and dealings.
5. To remove the requirement for any document in insolvency proceedings to be sworn by affidavit and replace it with a requirement for verification by a statement of truth.
6. To end the need for an insolvency practitioner, acting as liquidator, to submit a report to the Secretary of State on the conduct of the

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208 A Consultation Document on Changes to the Insolvency Act 1986 and the Company Directors’ Disqualification Act 1986 to be made by a Legislative Reform Order for the Modernisation and Streamlining of Insolvency Procedures (Insolvency Service, London, 2007). In February 2008 the IS announced that the consolidation of insolvency secondary legislation and the restructuring of the Insolvency Rules 1986 (originally announced in 2005) had been further delayed and, at the time of writing, the date for completion is 1 October 2009.

209 Made under section 1 of the Legislative and Regulatory Reform Act 2006. The IS recognised that the changes to secondary legislation (see above) will require amendments to primary legislation. Thus an opportunity is presented to attempt to modernise, streamline and make easier for users some processes in the insolvency legislation – thereby hopefully increasing returns to creditors.
directors of a company if he has already submitted such a report as administrator of the same company.

7. To remove the requirement that the Insolvency Services Account be held with the Bank of England.

8. To remove the court power to order that a person owing moneys to a company in liquidation pay those moneys into an account, in the liquidator’s name, at the Bank of England.

At the time of writing, the Insolvency Service is yet to act on the above proposals but it does appear likely that modernising and streamlining the communications systems that operate within liquidation will ensure a lowering of overall transaction costs. The consultation process will no doubt prove useful in seeking to ensure that such efficiencies are not secured at the cost of diminutions in accessibility, transparency and accountability.

**Expertise**

A liquidator must be a qualified IP[^210] and the general characteristics of IPs have been discussed in chapter 5 above. The issue of particular concern here is whether the winding-up process, as presently set up, is consistent with the exercise of an appropriate level of expertise. In asking this question, it is not necessary to assess the potential of the liquidator as an agent of possible rescue. His or her role is more focused than that of, say, an administrator and centres on gathering in the assets and distributing them. It is in the gathering process that there is a particularly strong role for expertise. At this stage of operations, the liquidator has both to defend the body of corporate assets and seek to increase it. The former task is evident in liquidator dealings with those who claim that property in the possession of a company does not form part of the estate: because, for instance, it is asserted that the owner has retained title. Socio-legal studies of practice reveal, in this area, a high level of IP expertise and dominance.[^211] Claimant suppliers to companies are often out of their depth and IPs tend to be in possession of the goods, to know the supply needs and to be both legally competent and familiar with the legal game being played. They are sophisticated repeat players who will

[^210]: Insolvency Act 1986 s. 388.
use devices such as delay and bluff to protect the assets of the estate. Liquidators, moreover, have an incentive to deploy their expertise to the full: their fees have to be paid out of the assets that are realised and the less that is removed from the company by, say, successful uses of the retention of title device the more remains for fee-paying purposes. Questions may arise as to the fairness of such arrangements but lack of liquidator expertise is not the primary issue.

The challenge to the expertise of the liquidator is perhaps more severe when he or she attempts not to retain assets but to secure these, for example, by using the avoidance powers given to liquidators to challenge transactions that prejudice creditors. What is clear from the empirical research, however, is that the self-policing of insolvency professionals can operate in a manner that upholds ethical or professional standards, as where IPs use their powers in order to remove from office at the creditors’ meeting a liquidator of whose conduct they did not approve.

Running counter to such expert upholding of standards, however, is the tendency of IPs to use their professional expertise at creditors’ meetings not to further transparency in liquidation processes but to engage in self-serving activities of a collective or individual nature. Wheeler argues that the creditors’ meeting is often used by IPs as a public forum to parade their standards of practice; to compete for the work involved in the liquidation (by ‘stealing’ the liquidation from the provisional liquidator through use of rhetoric to gain creditor support); and to sideline creditors and exclude trade creditors from a process amounting to an ‘exclusionary discourse’. Such an account, of course, emphasises the danger of evaluating insolvency processes by using a benchmark of expertise without reference to objectives: liquidation may be a process that lends itself to certain misdirections of expertise.

Accountability

In both voluntary and compulsory liquidations the liquidator is obliged to convene a meeting of creditors to consider his removal from office if he is requested to do so by more than 25 per cent in value of the creditors, and if he fails to do so the creditors may apply to the court to order such a

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212 Ibid., p. 90. See also ch. 3 above and ch. 15 below.
214 Ibid., pp. 367–9.
meeting. At such a meeting, a simple majority of those present and voting may remove the liquidator.

Such may be the formal position but, on the ground, the accountability of a liquidator – particularly to the creditors’ meeting – may operate quite differently. Legal accountability may be described as ‘empty rhetoric’. As was seen in the last section, IP expertise and repeat playing may produce dominance over the creditors’ meeting rather than accountability so that such meetings are seen by IPs and liquidators not so much as holdings to account as opportunities for pursuing or defending business.

Does the Human Rights Act 1998 (HRA) introduce the prospect of greater legal accountability for liquidators? The HRA applies to the decision-making procedures of all public bodies and it is unlawful under section 6 for a public authority to act in a way that is incompatible with a Convention right. A liquidator is liable to be considered as a public authority under section 6(3) as he or she undertakes a public function, for the benefit of society as a whole. (An administrator of a company is also likely to be seen as a ‘public authority’.)

The European Court of Human Rights (ECHR) has held that Article 6 of the Human Rights Convention is satisfied where there is a proper right of appeal to a court and the determining of rights is properly reviewable by the court after a fair hearing. In the case of liquidator activities relating to a company being wound up by the court, the Insolvency Act 1986 provides for court control in sections 167(3) and 168(5). The courts, however, have indicated that they will only interfere with a liquidator’s decision on grounds of reasonableness and that they would think carefully before replacing an

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216 IA 1986 ss. 171, 172.  
219 The position is less clear in relation to administrative receivers, supervisors of voluntary arrangements and office holders when not undertaking ‘public functions’: see Simmons and Smith, ‘Human Rights Act 1998’, p. 170.  
honest and independent liquidator just because he had fallen short of the ideal in one or two respects.\textsuperscript{222} It has been questioned, however, whether this approach meets Article 6 requirements.\textsuperscript{223} Suggested areas where liquidators may face HRA attack have included: preventing trading by presenting a winding-up petition;\textsuperscript{224} exercising investigative powers;\textsuperscript{225} and using confidential statements.\textsuperscript{226} The potential impact of the HRA should not, however, be exaggerated since the concept of ‘justifiable interference’ will shield the decisions of many office holders, as will the usual array of informational, evidential and resource restraints that limit challenges through court action.

If Wheeler’s portrait of the creditors’ meeting rings true and there is less to creditor scrutiny than meets the eye, what is to be done? Here it could be argued that the answer is not to increase levels of judicial oversight: that would do little for the less well-informed and less well-positioned creditors and might do much to increase costs and delays. The appropriate response may be for the IP profession to police its professional standards more rigorously so that greater attention is paid to informing creditors and listening to them rather than holding them at a distance by conducting an arcane ‘players’ dialogue’.

\textit{Fairness}

Avoidance of transactions

Fairness in liquidation demands that the general body of creditors be protected from dispositions of the company’s assets in the period leading up to liquidation which confer improper advantages on certain creditors or other parties. It demands that the collective nature of the insolvency process be protected.\textsuperscript{227} The law on the avoidance of transactions,

\textsuperscript{222} See \textit{AMP Enterprises Ltd v. Hoffman} (\textit{The Times}, 13 August 2002). For an instance of the court’s ordering the removal of a liquidator in the absence of evidence of misconduct – but on grounds that it was unlikely that the liquidator would pursue the directors with sufficient rigour – see the Court of Appeal in \textit{Re Keypack Homecare Ltd} [1987] BCLC 409.
\textsuperscript{224} Insolvency Act 1986 s. 127.
\textsuperscript{225} \textit{Ibid.}, ss. 235–6; see \textit{Re Esal Commodities Ltd} [1988] PCC 443 at 457–8.
\textsuperscript{227} For an example of a court preferring a petition to wind up rather than one for an administration order because the former brought the independence and objectivity of the Official Receiver and more collective control over choice of any liquidator in succession see \textit{El-Ajou v. Dollar Land (Manhattan) Ltd} [2007] BCC 953.
accordingly, seeks to protect collectivity and the principle of \textit{pari passu} distribution and to deal with the unjust enrichment of a particular party at the expense of the general body of creditors.\textsuperscript{228} This section of the chapter discusses the major avoidance provisions that are found in the Insolvency Act 1986, namely: preferences (sections 239–41); transactions at undervalue and transactions defrauding creditors (sections 238, 240–1, 423); and avoidance of floating charges (section 245).

Preferences

A preference occurs when a creditor – to the detriment of other creditors – receives more from a company before it goes into liquidation than he or she would have obtained in a formal distribution in liquidation. The broad aim of preference law is to ensure the fair treatment of creditors in a liquidation, but it can also be claimed that preference laws increase the assets available for distribution to creditors by protecting the collective nature of the liquidation process.\textsuperscript{229} Preference laws may thus be thought to discourage the piecemeal dismembering of the estate in the lead up to liquidation and thus to maximise its value. As Prentice points out, however,\textsuperscript{230} preference law claws back transactions only where there is a desire to prefer and this means that the law will only deter such dismembering if the parties involved are aware of the impending insolvency of the company.\textsuperscript{231}


\textsuperscript{229} On the advantages of collectivity see the discussion in ch. 2 above; T. H. Jackson, \textit{The Logic and Limits of Bankruptcy Law} (Harvard University Press, Cambridge, Mass., 1986) pp. 16–17. On different bases for the preference provisions see McCormack, ‘Swelling Corporate Assets’, who suggests three possibilities: ensuring fairness between creditors; preventing premature collapse of the company; and protecting the collective nature of liquidation proceedings. A fourth potential ground might be ‘preserving commercial morality and the prevention of fraud’: see Lord Mansfield in \textit{Alderson v. Temple} (1768) 98 ER 1277, 1279, discussed in McCormack ‘Swelling Corporate Assets’, p. 44.

\textsuperscript{230} Prentice, ‘Some Observations’, p. 443.

\textsuperscript{231} Directors may, however, fear that if they grant a preference they may be vulnerable to a disqualification order under the Company Directors’ Disqualification Act 1986 Sch. 1, Part 2, para. 8 which makes preferences relevant in assessing unfitness to take part in the management of the company: see ch. 16 below.
Under the terms of the Insolvency Act 1986 sections 239–41, a liquidator can successfully challenge a transaction as a preference by showing that: the transaction was entered into within six months of insolvency, or within two years if the defendant is a person ‘connected with a company’; the recipient is a creditor, surety or guarantor of any of the company’s debts; the company does anything which places the recipient in a position that, in the event of the liquidation, will be better than the position he would have been in had the thing not been done; the company was influenced in deciding to enter into the impugned transaction by a desire to make a preference; and at the time of, or as a result of, the preference the company was unable to pay its debts and was insolvent within the meaning of the Insolvency Act 1986 section 123.

A controversial aspect of the law here is its subjective basis, as seen in the need for the liquidator to show that the company was ‘influenced’ by a ‘desire’ to prefer. On this point, Cork examined the case for objectivity but concluded that proof of intention to prefer should be retained in the law and that ‘genuine pressure by a creditor should continue to afford a defence’. The law, said Cork, should be reluctant to allow the recovery of payments made to discharge lawful debts due and Cork considered that recovery was only justifiable if the payment was ‘really improper’. As critics have suggested, however, this misses the point since it may well be thought to be improper to subvert pari passu by preferring one creditor to another in the lead up to insolvency. What is clear is that the liquidator’s task in protecting both the estate and the principle of equal distribution is made harder by the need to show the influence of a desire to prefer. On how dominant the section 235(5) desire to prefer must be, the case of Re M. C. Bacon Ltd casts some light. Millett J, in an influential judgment, stated that it was not necessary to adduce direct evidence of the desire – which could be inferred from the circumstances of the case – but the desire must have influenced the decision or the transaction being attacked by the liquidator. It was not necessary to show that the desire was the only or the decisive factor behind the preference: it

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232 The onset of insolvency is defined in the Insolvency Act 1986 s. 240(3) as the date of the commencement of the winding up (at the time of presentation of the petition for winding up per s. 129(2) or the passing of the resolution for winding up in a voluntary winding up per s. 86). Administrators can also challenge preferences: s. 239(1) and (2).
233 Insolvency Act 1986 s. 240(1)(a).
234 Cork Report, para. 1256.
236 [1990] BCLC 324.
might only be one of the influencing factors. In the case of preferences to persons connected with the company, there is some assistance for the liquidator in section 239(6) of the Insolvency Act 1986 which creates a (rebuttable) presumption of a section 239(5) desire to prefer.237

The use of a subjective test here has been dubbed ‘unrealistic and unreasonable’.238 It is always difficult for a court to ascertain subjective motive239 and especially problematic in the case of a corporate body with no easily identifiable mind.240 The courts have proved reluctant to make inferences concerning the mind of the debtor company241 and, in many cases, troubled companies make payments to creditors not in order to execute a preference but in order to ease creditor pressure or to ensure continuity of business activity.242 If, accordingly, the creditor is not a ‘connected’ person, the liquidator faces an uphill task in establishing the desire to prefer as well as the company’s insolvency.243

A further difficulty for the liquidator is that a payment to a creditor may be made when a company is acting in a disorganised fashion. In this confusion it may be especially difficult to show the influence of a desire to prefer and it can be argued that fairness – through protection of pari passu distribution – is as deserving of protection from transfers that are unthinking as from those that are designed to prefer.244 The argument for a subjective approach is weak if couched simply in terms of Cork’s desire to see companies pay ‘lawful debts properly due’.245 Cork also argued that the diligent creditor ‘might in principle be allowed to retain

237 See e.g. Re Cityspan Ltd; Brown (Liquidator of Cityspan Ltd) v. Clark [2008] BCC 60 where the liquidator’s claim was successful and the director was ordered to pay a sum to the liquidator, with interest at base rate plus 1 per cent; Weisgard v. Pilkington [1995] BCC 1108 where directors failed to rebut the presumption of a desire to prefer. In Re 38 Building Ltd [1999] BCC 260 the family beneficiaries of a trust executed by a troubled family company were held not to be preferred connected persons since the trustees of the fund were collectively to be treated as creditors for the purposes of s. 239.
238 Keay, ‘Preferences in Liquidation Law’.
239 As recognised by the Cork Report at para. 1253.
243 See K. Offer, ‘Influential Desire and Dominant Intention’ (1990) 3 Insolvency Intelligence 42.
244 On the centrality of protecting pari passu in preference law, see the Privy Council in Lewis v. Hyde [1997] BCC 976, 979. On pari passu see ch. 14 below.
245 Cork Report, para. 1256(a).
the fruits of his diligence but this contention has limited force in the period leading to a liquidation: if accepted it gives the green light to a creditors’ race to collect. It encourages precipitous actions and it undermines the collective approach to liquidation with all its advantages of efficiency and fairness.

Cork also favoured adherence to the established legal rule that transfers made under pressure from creditors could be defended as there was no free intention to prefer in such circumstances. Again, however, the position is difficult to sustain as it undermines collectivity by rewarding those who indulge in a race to collect. The position invites creditors to apply pressure (again precipitately) and it favours more powerful creditors who are given an incentive to collude with companies to give the appearance of pressure.

What, though, of the argument that an objective ‘effects-based’ approach to preferences is undesirable as it would make creditors nervous of having any dealings with the troubled company; that it would chill commercial activity in a generally undesirable way? In response, it can be said that financing for companies is not likely to be less forthcoming (or less continuing) under an effects rule than under a subjective rule that positively encourages them to demand repayment of their loan at the first sniff of trouble. Should the contrary prove to be the case, a ‘creditor’s defence’ rule could be introduced to protect transactions that are made in good faith as part of the ordinary course of business (a defence seen in some jurisdictions that adopt effects-based preference rules). This kind of rule should, however, not be endorsed without good cause since it makes the liquidator’s task of protecting pari passu distribution more difficult and, again, favours the powerful creditor.

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246 Ibid., para. 1256(b).
247 Ibid., para. 1256. See Alderson v. Temple (1768) 6 Burr. 2235; 98 ER 1277; Scott v. Thomas (1834) 6 C&P 661; Re Liebert (1873) 8 Ch App 283; Smith v. Pilgrim (1876) 2 Ch D 127; Re FLE Holdings [1967] 1 WLR 140 (where it was indicated by the court that if the company mistakenly believed it had to pay because of the pressure its intention was not to grant a preference but to save itself).
249 See New Zealand Companies Act 1955 s. 266(2); Countrywide Banking Corporation Ltd v. Dean [1998] BCC 105 (PC) (payment not in course of business but part of disposition of business).
To conclude on preferences, it cannot be claimed that the current law with its subjective test operates in a manner that comes near to maximising creditor fairness. The present subjective approach and its weak protection of *pari passu* has the effect of adding further to the unfair burden that unsecured creditors bear: they, after all, are the parties that depend on strong application of the *pari passu* principle. An objective approach has been seen to lead to more frequent and more successful liquidator actions to set aside unfair preferences and, overall, would increase fairness.

Transactions at undervalue and transactions defrauding creditors

Under section 238(4) of the Insolvency Act 1986, a transaction at undervalue is entered into by a company if, at a relevant time, it makes a gift to a person or enters into a transaction on terms giving the company no consideration or enters a transaction for a consideration whose value in money or money’s worth is significantly lower than the value of the consideration provided by the company. In *Brewin Dolphin*, Lord Scott suggested that, in considering the issue of undervalue, the value of an asset being offered for sale is *prima facie* ‘not less than the amount

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250 See further chs. 14 and 15 below.


252 Within two years (connected person) or six months (unconnected person) of insolvency: the rule on the relevant time is the same as for a preference and is contained in the Insolvency Act 1986 s. 240.

253 Dealings with different parties may be treated collectively in assessing the transaction as a whole and the consideration given: *Phillips v. Brewin Dolphin Bell Lawrie Ltd* [2001] 1 WLR 143. See K. Dawson, ‘Transaction Avoidance: *Phillips v. Brewin Dolphin Considered*’ (2001) 72 CCH Company Law Newsletter 1; G. Moss, ‘Avoidance of Transactions – No Cherry Picking’ (2001) 14 Insolvency Intelligence; R. Parry, ‘Case Commentary’ [2001] Ins. Law. 58; B. Hackett, ‘What Constitutes a Transaction at an Undervalue?’ (2001) 17 IL&P 139; D. Milman, Editorial, ‘Swelling the Assets’ [2001] Ins. Law. 85; R. Mokal, ‘Consideration, Characterisation, Evaluation: Transactions at Undervalue after *Phillips v. Brewin Dolphin*’ [2001] JCLS 359. In *Brewin Dolphin* shares in a company with a business worth £1.25 million had been sold for £1 but the purchasers’ parent company had simultaneously promised to pay four years’ worth of computer lease payment to the vendor, which happened to total £1.25 million. The House of Lords concluded that there was so much uncertainty as to whether the payments would be made that no value at all should be given to the sub-lease and the agreement to make payments under it and consequently there had been a transaction at undervalue. In so holding Lord Scott looked beyond the artificial division of the agreements that the participants made and at the wider picture and adopted a flexible interpretation of ‘consideration’ based upon a commercial reality test.
that a reasonably well-informed purchaser is prepared, in arms length negotiations, to pay for it.\textsuperscript{254} As for the nature of the consideration that may be traded at undervalue, the prevailing view had long been that the grant of security could not amount to a transaction at undervalue because the grant of security did not \textit{per se} reduce the value of the debtor’s assets.\textsuperscript{255} It has now, however, been suggested in the Court of Appeal that the grant of a security can amount to a transaction at undervalue\textsuperscript{256} and that where there is no consideration given for a charge, that charge is capable of being struck down under section 423.\textsuperscript{257}

In contrast with the law on preferences (section 239), the liquidator’s power to challenge transactions at undervalue under section 238 does not depend on establishing any particular intention or motive on the part of the company, but the ‘in good faith and for the purpose of carrying on its business’ defence\textsuperscript{258} favours parties seeking to sustain a transaction. If, however, the liquidator succeeds in a section 238 challenge, the court must make such an order as it thinks fit for restoring the position to what


\textsuperscript{255} The logic of Millett J in the case of Re M. C. Bacon Ltd [1990] BCC 78 at 91–2.

\textsuperscript{256} Notably where the equity of redemption retained is less than the value of the assets prior to the granting of the charge – which will not always be the case: see R. Stubbs, ‘Section 423 of the Insolvency Act in Practice’ (2008) 21 Insolvency Intelligence 17, 21.

\textsuperscript{257} See Hill v. Spread Trustee Co. Ltd [2007] 1 WLR 2404, [2006] BCC 646; although it was not necessary for the Court of Appeal to express a final view on these points, Arden LJ stated that: ‘Obviously there was no change in the physical assets of the debtor when the security was given but there seemed to be no reason why the value of the right to have recourse to the security and to take priority over other creditors, which the debtor created by granting the security, should be left out of account.’ The judgment of Millett J in \textit{M. C. Bacon Ltd} [1990] BCC 78 was doubted and Arden LJ suggested (arguably building on the ‘commercial reality’ approach of Brewin Dolphin [2001] 1 WLR 143 and citing comments by Lords Hoffmann and Millett in Buchler v. Talbot [2004] 2 AC 298, paras. 29, 51) that granting a security may constitute a disposition in favour of the lender and could be a transaction at undervalue (para. 138); see also Stubbs, ‘Section 423 of the Insolvency Act’. It is arguable, following the decision in \textit{Hill v. Spread Trustee Co. Ltd}, that the possibility of challenging charges under ss. 238 and 423 is again a live issue amongst insolvency and restructuring professionals: see A. Cohen, ‘Legal Update’ (2006) Recovery (Winter) 8, 10. For a case in line with \textit{M. C. Bacon Ltd} see \textit{Re Mistral Finance Ltd} [2001] BCC 27.

it would have been had the company not entered the transaction.²⁵⁹ This will have the effect of placing the recovered assets back in the pool and making them available for the benefit of creditors generally.²⁶⁰

As a device for ensuring the fair treatment of creditors in liquidation, this action is limited by the ‘in good faith and for the purpose of carrying on its business’ defence. Liquidators, for instance, might find it difficult to challenge golden handshakes; or ex gratia payments to retiring directors, dividend payments or grants of security for existing unsecured loans.²⁶¹ In the case of the latter, in particular, there is, again, considerable opportunity for powerful creditors such as banks to benefit, to the eventual cost of the body of smaller unsecured trade creditors.²⁶²

A precondition for bringing an action under section 238 regarding a transaction at undervalue is that the company must have been unable to pay its debts at the time or have become unable to do so because of the transaction. Excluded from coverage, however, are transactions entered into by the company in good faith for business purposes where there were reasonable grounds for believing the transaction would benefit the company.²⁶³ In the case of potentially questionable transactions with directors, (the then) section 320 of the Companies Act 1985 sought to provide some control by requiring general meeting approval for transactions with directors or persons connected with them during times when the company is trading. This section, however, offered little protection where directors controlled the general meeting. The CLRSG argued that if a transfer of assets to a phoenix company²⁶⁴ had taken place, an effective remedy for a liquidator, one compensating creditors, would be

²⁵⁹ Insolvency Act 1986 s. 238(3). See Lord (liquidator of Rosshill Properties Ltd) v. Sinai Securities [2004] BCC 986, [2005] 1 BCLC 295 – the court would not necessarily be deterred from making an order under section 238(3) by the fact that the applicant secured creditor could not be put back into the position he was in immediately prior to the compromise. It was at least arguable that the court’s primary, and possibly only, concern under section 238(3) was the restoration of the company’s position.


²⁶¹ Note that administrators can also use s. 238: see s. 238(1).

²⁶² See Re M. C. Bacon Ltd [1990] BCC 78.

²⁶³ Insolvency Act 1986 s. 238(5)(a); Re Inns of Court Hotel Co. (1868) LR 6 Eq 82. The burden of proof in establishing these defences rests on the party seeking to avoid the application of section 238: see Re Barton Manufacturing Co. Ltd [1998] BCC 827.

²⁶⁴ The term ‘phoenix’ company was used to describe the practice of putting a company into voluntary liquidation (or receivership) at a time when it owed large sums to its unsecured creditors; the liquidator (or receiver) would frequently be appointed by a
to enforce remedies under section 320.\textsuperscript{265} The CLRSG accordingly recommended that section 320 should be amended to state that where, at the time of a section 320(1)(a) transaction, the company was insolvent (or became insolvent because of the transaction and went into insolvent liquidation within twelve months of the approval) and the second party to the transaction was a connected person or a director, the resolution would not be valid for section 320 purposes if it would not have been passed without the votes of the director (and/or connected persons) unless the transaction in question was supported by an independent valuation.\textsuperscript{266} The corresponding sections in the new Companies Act 2006, however, contain no such provision – sections 190–6 are in substance the same as their predecessors although arguably set out in a more accessible format.

Transactions at undervalue are also dealt with under the heading of ‘Transactions defrauding creditors’ in section 423 of the Insolvency Act 1986.\textsuperscript{267} This remedy has its roots in the bankruptcy laws of the sixteenth century and operates with the same definition of a transaction at undervalue as is used in section 238. Section 423 actions, however, differ from those under section 238 in so far as they incorporate no time limits for the transactions challenged.\textsuperscript{268} Liquidators do not have to show that the controlling shareholder (who might have also taken a floating charge over the company’s undertaking); and the liquidator (or receiver) would sell the entire business at a knock-down price to a new company incorporated by the former controllers of the defunct company. Consequently what was essentially the same business would be carried out by the same people under the same or a similar name in disregard of the claims of the creditors of the first company – the second, new company rising ‘phoenix-like’ from the ashes of the old. Section 216 of the Insolvency Act 1986 is aimed at countering the ‘phoenix’ syndrome: see further ch. 16 below.

\textsuperscript{265} CLRSG, \textit{Modern Company Law for a Competitive Economy: Final Report} (July 2001) pp. 327–30. The CLRSG recommended amending the Insolvency Act 1986 s. 216 so that the court would not ordinarily grant leave under section 216 if there was a material transfer of assets (within twelve months prior to liquidation) to a new company in which a director of the first company was also interested, unless there was compliance with the (amended) section 320.

\textsuperscript{266} Such a revised rule would offer the same Companies Act 1985 s. 322 remedies as would obtain in the absence of approval, including the right of the company to set the transaction aside and to sue the director to account for his profits or to indemnify the company against its losses.


\textsuperscript{268} The Insolvency Act 1986 s. 423 arguably cannot be used to extend the time zone for contesting preferences: see \textit{Re Lloyd’s Furniture Palace Ltd, Evans v. Lloyd’s Furniture Palace Ltd} [1925] Ch 853. See also \textit{Law Society v. Southall} [2001] EWCA Civ 2001
company was insolvent at the time of the transaction but they do have to establish that the company had entered into the deal with an intention\textsuperscript{269} to put the assets beyond the reach of, or otherwise pre-
judice, a person\textsuperscript{270} who is making or who may make a claim against
the company.\textsuperscript{271} A further difference between sections 238 and 423 of
the Insolvency Act 1986 powers is that, in the case of the former, the
court shall make an order to restore the position prior to the transac-
tion, but under section 423 the court is empowered to make a similar
order or to protect the interests of persons who are victims of the
transaction: a power that will allow the court to order property to be
handed over or reimbursement to be made to a particular prejudiced
party.\textsuperscript{272}

\textsuperscript{269} In \textit{Hill v. Spread Trustee Co. Ltd} the Court of Appeal stated that section 423(3) requires
a person entering into a transaction to have a particular purpose – it was not enough
that the transaction has a particular result. In \textit{Inland Revenue Commissioner v. Hashmi}
[2002] 2 BCLC 489 (Court of Appeal) it was said (by Arden LJ) that a purpose must be a
real, substantial purpose in contrast with what might be a consequence; or that, per
Laws LJ, the applicant must establish the debtor’s ‘substantial motivation’ by one of the
section 423(3) aims when entering the transaction; or that a ‘substantial purpose’ of the
transaction was to permit the debtor to escape his or her liabilities (Brown LJ).

\textsuperscript{270} This may be a single creditor, and it has been said to be immaterial that creditors as a
Spread Trustee Co. Ltd} [2007] 1 WLR 2404, [2006] BCC 646 – there was no reason why a
person could not cease to be the person within s. 423(3) but become a victim for the
purposes of s. 423(5) before the court made its order so as to be a person whose interests
may be protected by such an order. Section 423 was sufficiently flexible to allow this.

\textsuperscript{271} \textit{See Arbuthnot Leasing International Ltd v. Havelet Leasing (No. 2)} [1991] 1 All ER 591.
The requirement of prejudice in s. 423(3)(b) will not be satisfied where a party transfers
an asset that is so encumbered that it lacks value or if, prior to the transaction, the
company has no asset of value: see \textit{Pinewood Joinery v. Starelm Properties Ltd} [1994] 2
BCLC 412, [1994] BCC 569. The intention to place assets out of reach of creditors does
not have to be the sole purpose of the debtor: see \textit{Chohan v. Sagar & Another} [1992]
BCC 306, 321; \textit{Spa Leasing Ltd v. Lovett and Others} [1995] BCC 502; Elwes,
‘Transactions Defrauding Creditors’.

\textsuperscript{272} A victim for such purposes is a person capable of suffering prejudice, which may include
Avoidance of floating charges

A liquidator may seek to increase the fund available for unsecured creditors by challenging the practice of lenders obtaining new floating charges during a company’s troubled times in order to better their position in an anticipated insolvency distribution. To this end, the liquidator can resort to section 245 of the Insolvency Act 1986 which is designed to invalidate floating charges that are executed close to insolvency and which secure post-indebtedness without providing new assets or benefits to the company. Section 245 provides for challenge where the charge has been made with a connected person within two years ending with the onset of insolvency; or with any other person within twelve months of that date. A charge will not be invalidated under this section to the extent that the assets have been increased by the sum of the value of fresh money, goods or services supplied to the company at the same time as or after the charge; any discharges or reductions of any debt of the company (again at the same time or after the creation of the charge); and such interest as is payable on the above consideration. Such fresh sums must have been passed to the company and it is not enough if those are forwarded by the lender to the company’s bank to reduce an overdraft that the third party has guaranteed. This is because the money paid to the bank has not become freely available to the company and so is not paid to it within the meaning of section 245.

This is an area of statute law that has proved difficult for liquidators to put to good effect. Section 245 covers floating, but not fixed, charges, and it does not have purchase where the company has paid off the debenture holder secured by the floating charge. If the floating charge is in favour of an unconnected person, the liquidator will have to prove that the company was then unable to pay its debts per section 123 of the Insolvency Act 1986 or was, as a result of the transaction, unable to pay its debts as they fell due. The effect of the loan under which the

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273 On the ‘same time as’ see Re Shoe Lace Ltd (sub nom. Power v. Sharp Investments Ltd) [1994] 1 BCLC 111 where Sir Christopher Slade stated (at p. 123) that, in order to come within the terms of s. 245(2)(a), moneys paid before the execution of the debenture would have to be paid at a ‘minimal’ interval so that payment and execution could be regarded as ‘contemporaneous’.


275 The effect of a successful challenge is to invalidate the floating charge but the debt is not extinguished.

276 See the definition in Re Patrick and Lyon Ltd [1933] Ch 786. Additional tests of inability to pay debts (e.g. the balance sheet test) also operate here: see ch. 4 above.
floating charge was created has to be taken into account and the liquidator may have a complex and difficult case to make out: section 245(4) places the onus on the liquidator as challenger of the charge to show that the company was insolvent. Overall, then, section 245 is designed to increase fairness in the insolvency process but its effect is limited by the noted difficulties experienced by the liquidator. Where, however, an action might constitute a preference or a late floating charge (as where a floating charge is granted to a previously unsecured creditor just prior to liquidation) the liquidator might prefer a section 245 challenge rather than a preference avoidance action under section 239. A floating charge would be invalidated automatically if covered by section 245 and there is no need to show that the grantor was influenced by a desire to prefer. In the case of non-connected persons, moreover, the vulnerability period under section 239 is six months but, under section 245, it is twelve months. Finally, section 245 challenges are possible when the transaction occurs during solvency whereas, for section 239, the ‘insolvency’ requirement is absolute.277

Fairness to group creditors

In asking whether liquidation processes operate fairly, it is necessary to consider the special position of creditors of groups of companies. What constitutes a group is not formally defined in English law278 but it is a concept understood commercially as a family of related companies or businesses in which one company (the parent or holding company) maintains effective control over the others through shareholding and managerial controls.279 Issues of fairness arise if it is asked whether the

277 See McCormack, ‘Swelling Corporate Assets’, p. 53.
278 The Companies Act 2006 refrained from addressing the issue of liability within corporate groups: see pp. 592–3 below. Parent and subsidiary companies and undertakings are respectively dealt with in the Companies Act 2006 ss. 1159 and 1162. See also the Companies Act 2006 s. 399 for requirements for consolidated group accounts. On the definition of the corporate group for accounting purposes see Boyle and Birds’ Company Law, pp. 500–4. See also C. Napier and C. Noke, ‘Premium and Pre-acquisition Profits: The Legal and Accounting Professions and Business Combinations’ (1991) 54 MLR 810.
law imposes risks on creditors (of parent companies or subsidiaries) that are inequitable. This question is the first concern here. A second issue – whether any unfairnesses the law imposes in the group context are justifiable as efficient – is one which will be returned to. Unfairness in this discussion will be treated as being involved where risks are imposed on parties who are significantly less well placed than others to evaluate risks; to adjust their terms of business to reflect such evaluations; or to bear the consequences of economic harms that result from such risk bearing.

Here we are dealing with no small issue. The corporate group has developed during the last century to become an almost uniform form of business and one that routinely crosses national and regulatory boundaries. Most businesses of any size or substance now conduct their operations through subsidiaries that are owned by a parent company. The essential problem, however, is that there is a disjuncture between the law’s vision of the limited liability company and the reality of commercial life. The law does not hold parent companies liable for subsidiaries because it treats companies as juristic persons with separate corporate personality. The reality is that groups operate as economically and managerially cohesive operations, often with high levels of unity. They move resources around and operate as organically whole institutions.

For managers and shareholders of the parent company there are a number of reasons for operating via the group mechanism. It has been

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280 See the discussion of non-adjusting creditors at pp. 607–14 below.


283 See, for example, Austin, ‘Corporate Groups’; T. Eisenberg, ‘Corporate Groups’ in M. Gillooly (ed.), The Law Relating to Corporate Groups (Butterworths, Sydney, 1993); CLRSG, Modern Company Law for a Competitive Economy: Completing the Structure (DTI, November 2000) ch. 10.
suggested that a primary reason is to distribute risks in a manner that serves the group as a whole.\(^{284}\) The group device, however, also provides a degree of managerial autonomy for buying, selling or operating certain business activities; it allows geographically dispersed businesses to be managed separately; it caters for compliance with local laws (where, for example, a country demands a home-based corporate presence); it can allow tax advantages to be achieved; it may usefully limit the influence of anti-trust laws or a regulator (by removing parent companies from the regulator’s domain); it allows legal liabilities of various kinds to be shifted and limited in ways that protect the parent company; it provides a means of keeping labour costs down;\(^ {285}\) and it allows for investments, profits and losses to be distributed in ways that maximise benefits to the group.\(^ {286}\)

In spite of the prevalence of the group, insolvency law very largely fails to take on board the interdependency of many companies.\(^ {287}\) The law is still focused almost exclusively on the individual company; there is no legally developed doctrine of group enterprise or notion of ‘group interest’; there are no clear rules on the liability of the parent company for the firms within its group; and there is virtually no legal control over the complexity of the group’s structure.\(^ {288}\) The creditors of companies within a group can only assert claims against their particular debtor company, not the group. The potential for unfair treatment stems from the ability of a parent company’s directors to manipulate the rules governing limited liability companies to the group’s or parent company’s advantage. A typical large group may involve more than a hundred subsidiaries or subsidiaries of subsidiaries and some of the latter may be placed as far as five removes from the main board of directors.\(^ {289}\) These extended organisations are tied together by arrangements of ownership, contract, management and economic interdependence yet the

\(^{284}\) See CLRSG, *Completing the Structure*, p. 177.


\(^{287}\) The legislature failed to take the opportunity to address or resolve the issue under the Companies Act 2006. See further pp. 592–3 below.

\(^{288}\) See T. Hadden, ‘Regulating Corporate Groups: International Perspectives’ in McCahery, Picciotto and Scott, *Corporate Control*.

companies involved are regarded by the law as so many independent units.

This difference between commercial reality and legal framework can result in unfair allocations of risk to creditors for a number of reasons. The creditors of a subsidiary face at least the following difficulties. They may face enormous costs in calculating the risks they are bearing, because the parent company enjoys freedom to move resources and risks around the group in a manner that favours the group rather than the subsidiary. Corporate decisions will be made with a view to maximising overall returns rather than ensuring the health of any subsidiary and it may be extremely difficult to assess the financial or risk position of a subsidiary at any one time. Creditors of subsidiaries within a group may be misled about the ownership of assets that are available to pay their debts; transactions within groups may not be conducted at arm’s length; assets may be transferred, or loans given, at non-market rates; and guarantees and dividends may be given without reference to the interests of the companies affected. A firm may be made excessively dependent on other group firms for funds, business or both, and one firm may be used clandestinely within the group as a dumping ground for losses, liabilities and risks. A further problem for a subsidiary creditor is that amidst the above complexities it may be difficult to find out such basic matters as which companies are members of the group and which inter-company dependencies are intra-group. Nor can creditors of subsidiaries take comfort in the rules governing directors’ duties. The tradition of the law dictates that directors owe duties to their own company, not to the subsidiaries that their decisions may affect. The directors of a

291 ‘Firms enjoy considerable freedom both in law and practice to determine the limits of their boundaries’: see Collins, ‘Ascription of Legal Responsibility’, pp. 736–8, on ‘the capital boundary problem’.
parent company, moreover, may use cross-holdings to entrench themselves in control of the group, yet they may have very small commitments of capital themselves.

The above considerations may make creditors of a subsidiary nervous.\(^{295}\) Other consequences of the law may move them towards indignation. The Cork Report noted a scenario in which a wholly owned subsidiary is mismanaged and abused for the benefit of a parent company but in which loans from the parent company are employed. When the subsidiary goes into liquidation its creditors find that the parent company submits a proof in respect of its loan and a substantial proportion of the funds realised by the liquidator go to the parent company and (where the loan is secured) do so before the unsecured creditors of the subsidiary are repaid.\(^ {296} \)

Cork saw such a legal position as ‘undoubtedly defective’\(^ {297} \) and one commentator has noted widespread criticism of the process by which ‘the liberal creation of undercapitalised subsidiaries [creates] a second level of limited liability protection for businesses wishing to insulate themselves from enterprise liabilities’.\(^ {298} \) Realigning the law so as to deal with the problems posed by groups has, however, not proved easy. The difficulties can be outlined by considering the main proposals that have been canvassed to date. These can be grouped into three broad responses: subordinating debts owed to companies within the group to the claims of non-group creditors; consolidating group debts; and tightening directors’ obligations and liabilities.

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\(^{295}\) If a subsidiary becomes insolvent the parent and other subsidiaries may still prosper ‘to the joy of the shareholders without any liability for the debts of the insolvent subsidiary’: see Re Southard [1979] 1 WLR 1198 (CA), per Templeman LJ.

\(^{296}\) The rules on transactional avoidance may come into play: see Insolvency Act 1986 ss. 239 and 245; Re Shoe Lace Ltd (sub nom. Power v. Sharp Investments) [1994] 1 BCLC 111; Milman, ‘Groups of Companies’, p. 225. Proof of debt between group members was allowed in Re Polly Peck International plc (No. 3) [1996] 1 BCLC 428. On instances where the parent company may not deny liability see Milman, ‘Groups of Companies’, pp. 226–8.

\(^{297}\) Cork Report, para. 1934; the words ‘seriously inadequate’ are used of the law at para. 1950. See also paras. 1924 and 1928 for reflections of views that the position was ‘offensive to ordinary canons of commercial morality’ and that it was ‘absurd and unreal to allow the commercial realities to be disregarded’.

\(^{298}\) See Milman, ‘Groups of Companies’ p. 225, and for judicial concern see Staughton LJ in Atlas Maritime Co. v. Avalon Maritime Ltd (No. 1) [1991] 4 All ER 769 at 779. On the capacity of groups to avoid the legal regulation of business transfers and TUPE (on TUPE see ch. 17 below) see Michael Peters Ltd v. Farnfield & Michael Peters Group plc [1995] IRLR 190.
Subordination was a route advocated in limited form by Cork. Several parties who gave evidence to the Cork Committee argued that all debts owed by a company in liquidation to other companies in the same group should be deferred to the claims of external creditors. Cork, however, drew a distinction between debts arising from ordinary trading activities between group companies and debts ‘which in substance represent long term working capital and which arise from finance provided by the parent company’. In making this distinction, Cork drew on the US courts’ equitable jurisdiction to subordinate, as preserved by statute, under which the courts examined the conduct of parties and tended to look for fraud, mismanagement, wrongful conduct or under-capitalisation where finance was by the controlling shareholder. Cork suggested that it would not be equitable to subordinate in the case of ordinary trading debts but it would be fair to do so in the case of liabilities, secured or unsecured, which are owed to connected persons or companies and which represent all or part of the long-term capital of the company.

One problem with Cork’s approach (which has not been implemented) is that the distinction upon which it builds constitutes an invitation to lengthy and expensive litigation. A further issue, however, relates to the broad exemption of ordinary trading debts. In a group there are, as noted, real dangers that transactions at other than market value will be entered into for manipulative reasons (for example, to load risks onto a subsidiary whose creditors are ill-placed to respond to such a risk shift). There seems no reason why such transactions should

301 11 USC s. 510(C) 1978, giving statutory recognition to the ‘Deep Rock’ doctrine (the name being taken from a subsidiary company featuring in Taylor v. Standard Gas and Electric Co. (1939) 306 US 307) where the claims (as a creditor) of a controller of a company can be subordinated to the claims of the other creditors: see Landers, ‘Unified Approach’, pp. 597–606.
303 Cork recommended that where such liabilities were secured by fixed or floating charges that security should be invalid as against the liquidator, administrator or any creditor to the company until all claims to which it had been deferred were met: Cork Report, para. 1963.
304 See Milman, ‘Groups of Companies’, p. 229. Cork’s rejection of subordination for ‘ordinary trading activity’ claims was not argued out: the Committee merely reported hostility in the United States Congressional hearings and the fact that it was ‘not persuaded’ on its own account.
escape subordination because they are encountered in an ordinary trading context. If the objective is fairness to creditors of subsidiaries, debts to group companies relating to such transactions should be subordinated.

A second major response to unfair risk shifting is to consolidate (to lift the veil on the group)\(^{305}\) to deal with the commercial realities and to order a pooling of the assets of related companies in liquidation so as to improve the dividend prospects for creditors. There are a number of ways to implement such an approach. In Germany the legislation of 1965 (Konzernrecht) dealt with the issue in a formalistic way by seeking to lay down the parameters of formal legal relations between the companies in a group.\(^{306}\) The drawback of such a strategy is that it produces a somewhat rigid legal framework that may unduly restrict enterprise, prove unresponsive to change and yet not remove the need for judicial intervention. An alternative method relies more explicitly on the use of judicial discretion. In New Zealand, legislation passed in 1980 empowered the courts to order one company in a group to contribute towards the assets of a fellow group company in the event

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\(^{305}\) On the English courts’ approach to lifting the veil in the group context see Adams v. Cape Industries [1990] 2 WLR 657; discussed by S. Griffin in (1991) 12 Co. Law. 16. See also Boyle and Birds’ Company Law, pp. 76–80; Schulte, ‘Corporate Groups’. The European Court of Justice shows more inclination to treat a group of companies as a single economic entity: see Istituto Chemioterapico Italiano SpA v. EC Commission, Case 6, 7/73 [1974] ECR 223; SAR Schotte GmbH v. Parfums Rothschild SARL, 218/86 [1992] BCLC 235. In the USA the flexible concept of equitable subordination has been adopted and piercing the veil of incorporation is also resorted to. On piercing the veil in the United States context, see Landers, ‘Unified Approach’, who would pierce the veil whenever the parent company has failed to endow the subsidiary with sufficient resources to make it economically viable or failed to observe the legal formalities for creating a separate corporation.

of the latter’s insolvency. Such orders are to be granted when the court considers this just and equitable, and attention will be paid to the role of the parent company, especially its part in the subsidiary’s collapse. In the case of collapses of the group as a whole, the New Zealand law grants judges an analogous discretion to pool the assets and liabilities of the group. Here the New Zealand courts must have regard to the extent to which the related company took part in the management of any of the other companies; the conduct of any of the companies towards the creditors of any of the other companies; the extent to which the businesses have been combined; the extent to which the causes of the liquidation of any of the companies are attributable to the actions of any of the other companies; and such other matters as the court thinks fit. A similar approach has been adopted in Ireland and, in Australia, pooling was advocated by the Harmer Committee and the Corporations and Securities Advisory Committee. In the latter jurisdiction, the Corporations Amendment

307 Companies Amendment Act 1980 (New Zealand); see now Companies Act 1993 s. 271(1)(a); see further Austin, ‘Corporate Groups’, pp. 84–6.
310 Companies Act 1993 (New Zealand) s. 272(1).
311 Companies Act (Ireland) 1990 s. 140 (contributions) and s. 141 (pooling). In France statutory provisions address the parent–subsidiary relationship on a number of points but also rely on judicial discretion: see Milman, ‘Groups of Companies’, p. 231.
312 Australian Law Reform Commission, General Insolvency Inquiry, Report No. 45, para. 857: discussed in Austin, ‘Corporate Groups’, p. 86; Corporations and Securities Advisory Committee, Corporate Groups: Final Report (May 2000) at para. 6.97 and recommendations 22 and 23 (proposing that liquidators should be allowed to pool the assets of two or more companies in liquidation with the prior approval of all the unsecured creditors of those companies and that courts should be permitted to make pooling orders in the liquidation of two or more companies). See also J. Harris, ‘Pooling Options for Insolvent Corporate Groups’ (2005) 26 Co. Law. 125 (arguing the need for legislative provision for liquidators to pool in appropriate circumstances (see now the Corporations Amendment (Insolvency) Act 2007)); Harris, ‘Corporate Group Insolvencies: Charting the Past, Present and Future of “Pooling” Arrangements’ (2007) 15 Ins. LJ 78; J. Dickfos, C. Aderson and D. Morrison, ‘The Insolvency Implications for Corporate Groups in Australia – Recent Events’ (2007) 16 Int. Ins. Rev. 103. In Australia, prior to the 2007 legislation, the Federal Court had suggested that a voluntary administrator has the power to propose (without court approval) a pooling arrangement as part of a deed of company arrangement (Mentha v. GE Capital Ltd (1997) 154 ALR 565; Re CAN 004 987 866 Pty Ltd [2003] FCA 849) and the Australian
(Insolvency) Act 2007 introduced legislative amendments to provide that the courts may, by order, determine (on ‘just and equitable’ criteria) that a group is a ‘pooled group’. The effect of such an order is that unsecured creditors are able to claim against any or all of the companies in the pooled group – who are rendered jointly and severally liable for the unsecured debts owed by each member. The court’s power here requires that each company in the group is being wound up and the pooling order applies to debts or claims that are present or future, certain or contingent, and whether ascertained or sounding only in damages.

In the USA, the court may order consolidation (known as ‘substantive consolidation’) under the auspices of its general equitable powers and courts allowed pooling on the basis that where it is impracticable to keep the assets and liabilities of different companies in a group separate they may be consolidated if consolidation is for the benefit of creditors generally: see Dean-Willcocks v. Soluble Solutions Hydroponics Pty Ltd (1997) 13 ACLC 833, 839; Re Ansett Australia Ltd (2006) 151 FCR 41: discussed by J. Harris, ‘Seeking Court Approval for Pooling Arrangements: Lessons from the Ansett Case’ (2006) 24 C&SLJ 443.

See Corporations Amendment (Insolvency) Act 2007 Sch. 1, s. 579E(12)(a)–(f): for example, the court must have regard to the extent to which a company in the group, officers or employees of a company in a group was/were involved in the management of any other companies in the group; the conduct of a company in the group or officers or employees of a company in the group towards the creditors of any of the other companies in the group; the extent to which the circumstances that gave rise to the winding up of any companies in the group are directly/indirectly attributable to the acts/omissions of any of the other companies in the group or the officers or employees of any of the other companies in the group; the extent to which the activities and business of the companies in the group have been intermingled; the extent to which creditors of the companies in the group may be advantaged or disadvantaged by the making of the order; and any other relevant matters.

Section 579E(1).

Section 579E(2) and (3). For discussion see Harris, ‘Corporate Group Insolvencies’, pp. 91–2. The court must not make a pooling order if it is satisfied that such an order would disadvantage an eligible unsecured creditor materially and that creditor has not consented to the order: s. 579E(10)(a); or if the company in the group is being wound up under a members’ voluntary winding up and the court is satisfied that a member (not being a company in the group) would be materially disadvantaged and has not consented to the making of the order: s. 579E(10)(b).


As opposed to procedural consolidation where the bankruptcy proceedings of different entities are consolidated for procedural purposes only, having no effect on creditors’ substantive rights. On US ‘substantive consolidation’ see further A. Borrowdale, ‘Commentary on Austin’ in Grantham and Rickett, Corporate Personality, pp. 91–2.
will do so where the companies’ affairs are inextricably linked or the creditors can be shown to have dealt with the debtor companies as a single economic unit. In such consolidations the group assets and liabilities are dealt with as a single unit as part of a pooling arrangement.\footnote{For an account of the informal pooling arrangements in the BCCI group liquidations see C. Grierson, ‘Issues in Concurrent Insolvency Jurisdiction: English Perspectives’ in Ziegel, Current Developments. On US consolidation see further C. Frost, ‘Operational Form, Misappropriation Risk and the Substantive Consolidation of Corporate Groups’ (1993) 44 Hastings LJ 449; C. Grierson, ‘Shareholder Liability, Consolidation and Pooling’ in E. Leonard and C. Besant (eds.), Current Issues in Cross-Border Insolvency and Reorganisations (Graham and Trotman, London, 1994). Note can also be made of the possibility of consolidated legal insolvency procedures apropos groups of companies spread within the EU under the Council Regulation (EC) No. 1346/2000: see I. Fletcher, Insolvency in Private International Law (2nd edn, Oxford University Press, Oxford, 2005) ch. 7.}

A further route to consolidation, parent company contributions and an acknowledgement of commercial realities, lies through holding the parent liable for debts of the subsidiary where there is insolvent or wrongful trading. Section 588V of the Australian Corporations Law 2001, as amended, for instance, renders a parent company liable for a subsidiary’s debt when the latter has carried on trading while insolvent or likely to become insolvent and the parent or any of the parent’s directors was aware or should have been aware of such trading.\footnote{See I. Ramsay, ‘Allocating Liability in Corporate Groups: An Australian Perspective’ (1999) 13 Connecticut JIL 329.} The strength of this approach is that it does not rely on a finding that the parent company is a shadow director of the subsidiary but imposes a positive duty on the parent to safeguard the interests of the subsidiaries’ unsecured creditors. The weakness is that it relies on finding a relationship of parent to subsidiary and legal definitions of this relationship may both fail to capture instances of de facto control and be vulnerable to circumvention through manipulation of shareholdings.\footnote{Ibid. One suggestion for limiting such vulnerability to evasion is to resort to definitions of subsidiarity that are founded in economic substance rather than legal classification.}

In English law, liability for wrongful trading under section 214 of the Insolvency Act 1986 also applies to shadow directors,\footnote{On shadow directors see ch. 16 below.} who are defined (in section 251) as persons ‘in accordance with whose directions or instructions the directors of the company are accustomed to act.’\footnote{The concept was borrowed from the Companies Act 1985 s. 741. See now Companies Act 2006 s. 251.} The concept of a shadow director can encompass a parent company
and this paves the way for liability for wrongful trading and contributing to the insolvent company’s assets by order of the court (under section 214(1)). Such use of the shadow direction concept does not make parent companies generally liable for the debts of subsidiaries but it may cover situations of wrongful trading and it looks to the realities of economic control rather than the formalities of ownership.323

The courts have dealt with the matter of parent companies as shadow directors. In *Hydrodan*324 it was made clear that the issue was whether the directors of a subsidiary exercise their own independent discretion and judgement and that, to prove shadow directorship, it had to be shown that the board of the subsidiary did not exercise this discretion and judgement but acted in accordance with the directions of the parent company. A broadening of approach can be discerned in *Deverell*325 where, in the Court of Appeal, Morritt LJ suggested *inter alia* that the fact that the board of directors may be characterised as subservient clearly indicates the existence of a shadow directorship.326 *Deverell* thus opens the door to the liability of a parent company to a subservient subsidiary’s creditors, but there are limitations to this remedy. As noted, it only applies where wrongful trading is established and, second, it looks to instances in which the parent board dominates the subsidiary board as a matter of governance. Whether it will cover situations where the companies are commercially linked but are formally and managerially independent is far less certain.327

It is noteworthy that Cork declined to recommend that a holding company be liable for an insolvent subsidiary company’s debts.328 Some of the Committee favoured the radical view (that the parent company should always be liable) and other members of the Committee favoured the New Zealand discretionary approach. Cork, however, drew back from making a recommendation because of anticipated effects on entrepreneurship, difficulties of apportioning liability, potential impacts on long-term existing creditors and other ramifications

323 See Collins, ‘Ascription of Legal Responsibility’, p. 741, who argues that the concept opens the possibility of offering a powerful response to the ‘capital boundary problem’.
328 See the discussion in Ferran, *Company Law and Corporate Finance*, pp. 39–40.
outside insolvency: notably that the directors of a parent company would have to have regard for not only the interests of that company but also the interests of other group companies. Such matters were so important, said Cork, that a wide review covering company and insolvency law issues was needed.\(^{329}\) The response to the point concerning a widening of directors’ duties, of course, may be that the directors of parent companies now possess such extensive powers to influence subsidiaries by methods of such extremely low transparency that such a broadening of directors’ obligations could be healthy.

A further method of making holding company assets available to creditors in subsidiaries is the proposal discussed by the CLRSG in 2000.\(^{330}\) In the mooted ‘elective regime’ the parent company would guarantee the liabilities of the subsidiary and would satisfy certain publicity requirements. The subsidiary, in return, would be exempted from Companies Act requirements relating to annual accounts and audit. By 2001, however, the CLRSG had been convinced by consultees that there was no solid case for ‘the elective regime’.\(^{331}\) Concerns were expressed to the CLRSG about the regime’s low potential to reduce burdens on groups significantly.\(^{332}\) Further worries were that the proposed regime would offer little help to the creditors of subsidiaries since parents could ‘ring-fence’ valuable assets in subsidiaries kept out of the elective regime; and that the requirement that electing subsidiaries must be ‘wholly owned’ provided a way of evading the bite of the parental guarantee.\(^{333}\) It could, additionally, be objected that the regime could be abandoned by parental rescinding and that it did not pool the assets of the group for the benefit of the claimants, but only the assets of the parent, which may not amount to much if the parent is not asset-rich (perhaps because it had removed assets offshore).\(^{334}\) The proposal would, moreover, involve an unacceptable loss of publicly available information at the individual company

\(^{330}\) See CLRSG, *Completing the Structure*, ch. 10.  
\(^{332}\) The requirements of HMRC would still have to be satisfied and this diminishes the reductions of costs that the elective regime offers: see A. Boyle, ‘The Company Law Review and Group Reform’ (2002) 23 Co. Law. 35. Assessment of risk would also still be necessary despite a guarantee of liabilities since there are residual risks of the parent company. For creditors of subsidiaries analysing parent company risks may be complex and time-consuming.  
\(^{333}\) See Boyle, ‘Company Law Review’, p. 36.  
\(^{334}\) See Muchlinski, ‘Holding Multinationals to Account’. 
level and would distance the creditors of a subsidiary from the information that they need in order to assess risks.

A third canvassed response to the difficulties faced by group creditors is to develop the concept of duties of dominant shareholders. Thus it has been suggested that a dominant shareholder (the parent company) should owe fiduciary duties (of loyalty and fairness) to its subsidiary and other subordinated companies and that the dominant parent should have the burden of proving that transactions with the dominated company are fair, unless those transactions have been authorised by ‘disinterested’ shareholders.

All the above suggestions are designed to reduce the unfairnesses that stem from the facility with which the directors of a parent company can shift risks to the creditors of a subsidiary. The broad objections to this ‘family’ of proposals are that they would interfere unwarrantably with directors’ managerial freedoms, would violate the separate entity principle, would stifle enterprise and would create uncertainty – that it is better to tolerate present unfairnesses than to escalate overall costs very substantially in pursuit of fairness. This seems, however, no answer to the case for subordinating parent company debts to other debts. That case is based on the unfairness of allowing companies who control subsidiaries to prove for debts alongside other creditors of the subsidiary. The strategic and informational advantages enjoyed by the parent company are adequate compensation for subordination. As far as consolidation is concerned, the least legally uncertain proposal is the radical one – that a parent company should automatically be responsible for the liabilities of a subsidiary. It might be argued, however, that practical uncertainties would raise capital costs unduly. Objectors would contend that a

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335 One posited as building on *US Principles of Corporate Governance*, American Law Institute, Draft No. 5 (1986).

336 See A. Tunc, ‘The Fiduciary Duties of a Dominant Shareholder’ in Schmitthoff and Wooldridge, *Groups of Companies*. See also M. Lower, ‘Good Faith and the Partly Owned Subsidiary’ [2000] JBL 232. On the ‘unfair prejudice’ remedy under the (then) s. 459 of the Companies Act 1985 (now Companies Act 2006 s. 994) (which allows (minority) shareholders to petition the court for relief when the company’s affairs are being conducted in a manner that unfairly prejudices their interests) and the treating of conduct within the subsidiary as within the affairs of the parent company for s. 459 purposes, see *Gross v. Rackind* [2004] EWCA Civ 815 and R. Goddard and H. Hirt, ‘Section 459 and Corporate Groups’ [2005] JBL 247.

337 See, for example, the Law Council of Australia objections discussed by Austin, ‘Corporate Groups’, p. 86 and by J. O’Donovan, ‘Group Therapies for Group Insolvencies’ in Gillooly, *Law Relating to Corporate Groups*. 
welcome effect of limited liability is that the suppliers of credit know the risks they face, they know that these risks are limited and so are induced to lend on reasonable rates. Shareholders and creditors benefit by the certainties generated. If parent groups are liable for subsidiaries, it could be said, such benefits of limited liability are undermined because it is difficult to assess risks across groups.

This argument can, however, be overstated. The shareholders of the parent company will still be shielded from personal liability by the limited liability that they enjoy. It is true that inefficiencies are caused by the uncertainties that flow from the complexities of risk assessments within groups. These do have to be paid for, but non-liability of the parent company for its subsidiaries creates perhaps greater overall uncertainties through incentives to produce poor information flows to lenders to the group. Those lenders will charge rates that reflect uncertainties. Directors of parent companies that are not liable for subsidiaries will perhaps not be too worried: they will consider the balance between the higher capital costs they face across the group (due to the nervousness of lenders to group subsidiaries) and their ability to offload risks onto the creditors of subsidiaries, notably trade creditors. The banks lending to the parent company may not be very concerned either because they will have confidence that insolvency risks are being shifted away from the parent company to the subsidiary and its creditors. Such powerful decision-makers are likely, accordingly, to favour a regime that is highly uncertain and high cost, provided that other parties (the unsecured creditors of subsidiaries) are bearing those costs. Those other parties, however, would be unlikely to welcome such a system.

The advantage of making the parent company liable is that its managers may be induced to take risks responsibly and the parties bearing the risks will be those that are best informed and best able to control the flow of finances. Where the parent is not liable, its managers will be prone to engage in excessive risk taking because they can shift risks to subsidiaries. Indeed, without the liability of the parent, the managers of a subsidiary may also take excessive risks because they may be confident of relocation to another company within the group that has benefited from

339 See Ferran, Company Law and Corporate Finance, p. 32.
340 See Landers, ‘Another Word on Parents’, p. 539: ‘the present system effectively rewards owners who can hide from public view’.
the excessive risk bearing of the first subsidiary.\textsuperscript{342} The creditors and the directors of the parent company will be more efficient risk bearers than the creditors of subsidiaries because the former have far better levels of information. Posner objects to the parent company liability approach on the grounds that lenders to the parent company will have to investigate the creditworthiness of the group’s subsidiaries\textsuperscript{343} but (given their access to group information) it is easier and cheaper for them to do this than for the subsidiary’s trade creditors to review the whole group’s financial risks. General levels of uncertainty, moreover, are likely to be lower where the parent company is liable because the broad incentives favour openness and transparency rather than manipulation and secrecy. Apart from anything else, parent company liability would reduce the tendency to construct massively complex group corporate structures for non-productive reasons (for example, to avoid regulatory obligations or to create ‘dump’ subsidiaries).\textsuperscript{344} The answer to Posner, in short, is not that a parent company is losing its limited liability advantages but that it is retaining these and losing its facility to shift risks unfairly – losing the subsidy to entrepreneurship that is now being paid for by the creditors of insolvent subsidiary companies.

The case for parent company liability, accordingly, seems strong but, as has been seen above, such a radical reform is politically unlikely.\textsuperscript{345} A discretionary regime is more likely to be introduced but it is more vulnerable to attacks for uncertainty. Lenders to companies within the group are liable to charge rates that reflect the difficulties of assessing when and whether the courts will impose liability on the parent company. One proposed solution to this problem is to exempt the parent company from such potential liability where subsidiaries are specified: ‘provided that those subsidiaries are financially managed in a manner which segregates their assets and liabilities from the assets and liabilities of the rest of the group and that the segregation is documented in a manner that would permit a liquidator to trace the assets affected by


\textsuperscript{343} Posner, ‘Rights of Creditors’, p. 517.

\textsuperscript{344} See further Hadden, ‘Regulating Corporate Groups’.

\textsuperscript{345} See Milman, ‘Groups of Companies’, p. 231, and pp. 592–3 above. In December 2006, however, UNCITRAL (Working Group V) commenced consideration of the treatment of corporate groups in insolvency. At the time of writing, this work is still under way: see UNCITRAL Annotated Provisional Agenda for the 34th Session of Working Group V (Insolvency Law) March 2008.
It is difficult, however, to see how such preservation of the separate entity could be managed within the commercial interrelationships and complexities of a group’s structure and how, if attempted, it could be achieved without such restrictiveness as would negate the advantages of group membership.

The discretionary route, it seems, has to face up to the likelihood that it will involve time-consuming and expensive litigation in circumstances where finances are highly constrained. As commentators have observed, this may explain the poor success rate of such mechanisms and even steps to reverse the onus of proof (so that parent companies are presumed liable for subsidiaries’ debts unless they show that they have operated at arm’s length) will not avoid considerable costs. If the creditors of group subsidiaries are to be protected, yet costs kept to a reasonable level, it may be necessary to be bold and to opt for a regime of consolidation.

Conclusions

The above account outlines a number of respects in which the process of liquidation is open to criticism and improvement on the efficiency, expertise, accountability and fairness fronts. A further issue concerns the conceptual underpinnings of liquidation. These should be examined to see if there is value in approaching liquidation in terms that differ from the model implicit in current English insolvency law. Cork espoused a shift from a ‘creditor control’ to a ‘creditor participation’ model of insolvency proceedings but there are other directions from which to approach liquidation. One such direction involves seeing liquidation as other than a process that centres precisely on a set of formal legal rules. This is perhaps against the inclination of lawyers who devote much attention to extensive sets of statutory provisions, but it is already clear from the above account that liquidation can be portrayed in a number of non-rule-centric ways: as an institutional contest involving such different parties as expert insolvency practitioners, banks and other major creditors, directors, shareholders, unsecured trade creditors, the courts and the BERR – participants with very different aims, interests, incentives, levels of information, expertise and access to the insolvency process. Liquidation, moreover, can be seen as a reflection of long-

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established conventions of deference to powerful institutions. On this view, an observer might explain much of the liquidation process in terms of the exalted positions that English insolvency law has long given to powerful secured creditors.\(^{348}\) Linked to this vision are notions that modern English liquidation is driven in shape and operation by those who possess information and skill. It is, on this view, the preserve of the repeat players, as exemplified by the manner in which IPs dominate creditors’ meetings.

Different portraits of liquidation can also be placed in opposition to each other. On the one hand, it can be seen as a process in which professionals act in a detached way so as to ensure that creditors are dealt with fairly and the public interest is served by monitoring the behaviour of directors \textit{ex post facto}. On the other, liquidation can be seen in strictly private interest terms, with IPs, creditors, directors and others all pursuing their own interests in a highly focused manner.

Alternative visions of liquidation can also be generated by moving one’s disciplinary viewpoint away from law. Economists would be liable to espouse a private interest approach but sociologists and anthropologists, for instance, would emphasise the social and cultural contexts within which liquidation takes place and the extent to which liquidation is driven by group-based ideas, understandings and traditions. Psychologists might be expected to place more emphasis on the attitude of the individual and might focus on the approaches that individual IPs tend to adopt because of their background and training.

What, though, do these different ways of seeing liquidation tell us about issues of design, reform and evaluation? A key message is that achieving better performance on the efficiency, expertise, accountability and fairness fronts will not come simply through changes in the legal rules. The world is not that rule-centred and other approaches have to be embraced.\(^{349}\) Training, for example, is a strategy with considerable potential. The liquidation process may be improved through refinements in the training of IPs (in, for example, consultative techniques) or in directorial training (to cover ongoing company contexts and insolvency or near insolvency situations and rescue processes, as well as information-gathering techniques).\(^{350}\) Institutional roles, moreover, might be reconceived so that, for instance,
the part played by the courts in scrutinising processes is reformulated. One way in which this could be done is to replace resort to court with other processes, such as the use of administrative powers. Liquidators, on this model, could be empowered to adopt a designated administrative power to ‘call in’ property that has been transferred out of the estate in a suspect manner. Such a regime could make resort to court a secondary matter rather than a primary process in relating to the relevant set of issues.

Finally, a fresh look might be taken at the overall objectives of the liquidation process – a review that might bear in mind the balance between ends such as efficiency and fairness. Consistency between this area of insolvency law and others is a matter to be adverted to here. It would be muddled thinking to give efficiency primacy of place in relation to one insolvency process but (without reason) to give greater emphasis to, say, fairness or accountability in another. There may, of course, be reasons for differences of emphasis but coherence and clarity demand that we should be clear about these. One such reason may be that liquidation, unlike other insolvency processes, can be seen in non-rescue terms and as relating to a narrower set of interests than, say, administration. To conclude, there is, as noted, much to be done to refine insolvency law as it affects liquidation but insolvency law and processes must be seen in the round and we should be aware of the improvements that can be gained by looking beyond the narrowly legal and towards adjustments in cultures, traditions, incentives, expectations, institutions, training and roles.

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352 See Insolvency Act 1986 s. 208 (misconduct in the course of winding up), s. 234 (getting in the company’s property), s. 235 (duty to co-operate with the office holder), s. 236 (inquiry into company’s dealings, etc.).

353 It should be remembered, as noted above (pp. 569–70), that human rights issues may arise. Under the Human Rights Act 1998 and Article 6 of the Convention there is a right to an independent and impartial tribunal. If an office holder determines the rights of a person, there may be a lack of independence where the office holder is an administrative receiver: see generally Simmons and Smith, ‘Human Rights Act 1998’; Trower, ‘Human Rights’.
The pari passu principle

The pari passu principle is often said to constitute a fundamental rule of corporate insolvency law.¹ It holds that, in a winding up, unsecured creditors shall share rateably in those assets of the insolvent company that are available for residual distribution. In what might be called the ‘strong’ version of pari passu, ‘rateably’ means that unsecured creditors, as a whole, are paid pro rata to the extent of their pre-insolvency claims. This contrasts with the ‘weak’ version of pari passu in which such creditors share rateably within the particular ranking that they are given on insolvency by the law – a system of ranking that draws distinctions between different classes of unsecured creditors (e.g. preferred employees and ordinary unsecured creditors).²

This chapter and the one following consider whether the pari passu principle (hereafter discussed and referred to in its strong version unless otherwise stated) operates in an efficient and fair manner and whether there is a case for approaching post-insolvency distribution in a different way. Issues of accountability and expertise will not be addressed since

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² The strong and weak senses of pari passu referred to here correspond to what have been called the ‘orthodox’ and the ‘multi-layered’ understandings of the term: see L. C. Ho, ‘Goode’s Swan Song to Corporate Insolvency Law’ (2006) 17 EBLR 1727 – suggesting that in the orthodox understanding all creditors of a particular pre-insolvency form (unsecured creditors as a group) share equally. In the multi-layered understanding, as encountered in the UNCITRAL Legislative Guide on Insolvency Law (United Nations, 2005), creditors that are similarly ranked by insolvency law share equally within their given rank. See R. Mokal, Corporate Insolvency Law: Theory and Application (Oxford University Press, Oxford, 2005). See also ch. 15 below.
pari passu is a substantive rule governing the distribution of goods and little is to be gained by asking whether a principle is, in itself, accountable or expert. Whether insolvency principles are administered accountably and expertly are matters dealt with in other chapters.

As noted in chapter 13, creditors are free, prior to winding up, to pursue whatever enforcement measures are open to them: for example, repossession of goods or judgment execution. Indeed, the race goes to the swiftest. Liquidation puts an end to the race as the liquidator is responsible for the orderly realisation of assets for the benefit of all unsecured creditors and for distributing the net proceeds pari passu.3 The pari passu principle, however, can only apply to unencumbered assets of the insolvent company that are available for distribution. If a company holds property as a bailee or trustee, that property is not part of the common pool for distribution. Similarly, goods possessed by the company under a contract of sale that reserves title to the seller until completion of payment do not form part of the pool. Where, moreover, the company has given security rights over property, this property is available for distribution only to the extent that its value exceeds the sum of the secured indebtedness.4

Corporate insolvency law is faced here with two important challenges: how to stipulate which assets will be available for distribution and whether exceptions should be made to the pari passu rule when distributing those available assets. This chapter focuses on the latter issue and chapter 15 considers the construction of the insolvent company’s estate for distribution.

At this point, the discussion of insolvency law rationales that was contained in chapter 2 should be recalled. Different visions of corporate insolvency law will produce different approaches to the distribution and

3 Steps taken to protect the residual estate from leakage can thus be seen as underpinning the pari passu distribution of that estate – the view taken in Re Tain Construction [2003] 1 WLR 2791, [2004] BCC 11, a judicial view described as ‘highly unfortunate and misguided’, an ‘irredeemable mistake’ and a ‘total misunderstanding’ by Look Chan Ho (‘Pari Passu Distribution and Post-petition Disposition: A Rationalisation of Re Tain Construction’ (21 November 2005, SSRN)), who prefers to see preservation of the estate as sustaining the order of priority of distribution. In defence of the court it can be argued that, whatever exceptions to pari passu are allowed (e.g. preferential status), to allow degradation of the residual estate would be to allow bypassing of the pari passu mode of distribution applicable to that estate.

construction of the insolvency estate. If corporate insolvency law is seen as centrally concerned to maximise the assets available for distribution to creditors, their rights in a liquidation will be treated as governed by prior non-insolvency entitlements. What has been bargained for in advance will dictate priorities in a subsequent liquidation. If, on the other hand, insolvency law is seen as having a redistributive role – one that allows prior private bargains to be adjusted in the public interest or in pursuit of democratically established policies – creditors’ rights in a liquidation will be influenced by a range of factors other than rights established outside insolvency and departures from the strong version of pari passu will be more readily contemplated.6

As indicated in chapter 2, the approach taken in this book rejects the narrow ‘creditor wealth maximising’ vision of corporate insolvency law and sees insolvency law as properly concerned with redistributional and public interest aspects as well as with respect for private bargains and property. This implies, first, that exceptions to pari passu may be entertained on their public interest merits and, second, that in constructing the estate of the insolvent company that is available for distribution, it may be legitimate to restrict the extent to which private bargaining will be allowed to circumvent the principles of collectivity and pari passu distribution.

Before considering whether certain exceptions to pari passu can be justified on efficiency or on fairness grounds, the rationale for pari passu should be noted. In terms of efficiency, the case for pari passu is that within a mandatory, collective regime it conduces to an orderly means of dealing with unsecured creditor claims.

Legal costs and delays are said to be kept low by a simple pari passu rule because, in the absence of any legislative direction to differentiate

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between unsecured creditor claims, it avoids the need for courts to make
difficult choices, as would be involved were they to adopt other possible
principles: for example, distribution according to need or inability to
sustain losses.\textsuperscript{7} In terms of the efficiency of the ‘creditors’ bargain’ and
 creditor wealth maximisation’ theories, compulsory, collective pro-
ceedings are held out as reducing strategic costs and increasing the
aggregate pool of assets.\textsuperscript{8} The collectivity of dealings with unsecured
creditors as a class is enhanced by the \textit{pari passu} principle which is
efficient in so far as it avoids the costs of dealing with claims on their
individual merits.\textsuperscript{9}

Fairness in the procedural and substantive senses may also be said
to be protected by the \textit{pari passu} principle in that it prevents an intra-
class race to enforce claims that is destined to be won by the strongest
and swiftest and it also involves equality of treatment between unse-
cured creditors.\textsuperscript{10} Where, of course, the law creates exceptions to
\textit{pari passu}, questions arise regarding the fairness of those exceptional
treatments.

\textbf{Exceptions to \textit{pari passu}}

\textit{Liquidation expenses and post-liquidation creditors}

Liquidation expenses and the claims of post-liquidation creditors will,
for convenience, be dealt with here but, more strictly speaking, they can
be said to fall outside the \textit{pari passu} rule rather than constitute true
exceptions. This is because the strong version of \textit{pari passu} adverts to the

\footnotesize
\textsuperscript{7} See Milman, ‘Priority Rights’, p. 59.
\textsuperscript{8} See Jackson, \textit{Logic and Limits of Bankruptcy Law}, ch. 1; see also ch. 2 above.
\textsuperscript{9} Mokal argues (‘Priority as Pathology’, p. 593) that it is collectivity not \textit{pari passu} that
 avoid values-destroying races to collect; that \textit{pari passu} is not necessary for efficiency.
 Value, however, is lost by processes that give rise to the high costs of dealing with claims
 individually. \textit{Pari passu} reduces such costs within the class of unsecured creditors and
 accordingly may be justified on efficiency (as well as fairness) grounds. There is, in short,
 more to securing efficiency than stopping the race to collect and having creditors form an
 orderly queue. The claims of parties in the queue have to be dealt with efficiently. It can
 be conceded, however, that the claims of unsecured creditors could be dealt with
 collectively and at low cost without reference to \textit{pari passu}, for example by paying
 debts according to date of loan. On the acceptability of alternatives to \textit{pari passu} see
 ch. 15 below.

\textsuperscript{10} On justice in insolvency see J. Finnis, \textit{Natural Law and Natural Rights} (Clarendon Press,
 Oxford, 1980) p. 190; see also ch. 15 below.
pre-liquidation position of unsecured creditors and so has no application to unsecured creditors whose claims arise post-liquidation.\textsuperscript{11} Liquidation expenses are paid out of the company’s assets ahead of all other claims on the estate and are settled in full before even preferential debts.\textsuperscript{12} In order to effect the most beneficial winding up of a company the liquidator may have to sustain a period of continued trading for a given time. This may benefit all creditors. During this period, funds may be required in order to keep employees in post and to achieve continuity in the supply of materials. If creditors were asked to supply funds during this post-liquidation period they would be unlikely to oblige if the debts involved were to enjoy no priority over those of pre-liquidation creditors. Such super-priority can, however, be achieved by treating the liquidator’s transactions with such creditors as expenses of the liquidation so that post-liquidation creditors do not have to prove for a dividend in competition with other creditors.\textsuperscript{13} Expenses of the liquidation (including post-liquidation creditors’ claims) are thus paid first, followed by the claims of preferential creditors,\textsuperscript{14} and only the remaining pool of assets\textsuperscript{15} becomes available for distribution to the general body of unsecured creditors. While it is clear that new transactions by the liquidator constitute post-liquidation claims, difficulties may arise in relation to obligations under existing contracts or leases. The relevant test is whether the liquidator

\begin{itemize}
  \item \textsuperscript{11} See Ho, ‘Goode’s Swan Song’; Re HIH Casualty and General Insurance [2005] EWHC 2125 (Ch) at para. 40.
  \item \textsuperscript{12} See Insolvency Act 1986 ss. 115, 107; Companies Act 2006 s. 1282 (but note s. 1282(3)); Insolvency Rules 1986 r. 4.180(1). See Insolvency Act 1986 ss. 115, 156, 175(2)(a); Insolvency Rules 1986 r. 4.218 regarding liquidators’ costs and expenses. For further discussion of liquidation expenses see Re Leyland DAF, Buchler v. Talbot [2004] 2 AC 298, Re Toshoku Finance (UK) plc [2002] 1 WLR 671, Re M. C. Bacon Ltd (No. 2) [1991] Ch 127, Re Floor Fourteen Ltd, Lewis v. IRC [2001] 3 All ER 499, Enterprise Act 2002 s. 253 and IR r. 4.218(1)(a); and ch. 13 above.
  \item \textsuperscript{13} Rule 12.2 of the Insolvency Rules 1986 lists items to be regarded as expenses of the winding up and r. 4.218, as amended, gives the order of priority for payment of expenses of the winding up – subject, however, to the courts’ powers under the Insolvency Act 1986 s. 156. On paying corporation tax (on interest receivable after the start of a winding up) as a necessary disbursement and an expense of the winding up see Re Toshoku Finance (UK) plc [2002] 1 WLR 671, [2002] BCC 110 (HL); H. Lyons and M. Birch, ‘Insolvency Expenses’ (2005) 18 Insolvency Intelligence 150; D. Milman, ‘Post Liquidation Tax as a Winding Up Expense’ [2000] Ins. Law. 169.
  \item \textsuperscript{14} See Insolvency Act 1986 s. 175(2)(a) and (b).
  \item \textsuperscript{15} Which will have been depleted, of course, by payment to any floating charge holders.
\end{itemize}
had adopted the transaction and taken it over for the purposes of the winding up.16

Before the Insolvency Act 1986, this treatment of post-liquidation debts placed utility companies in a strong position relative to other trade suppliers. The large providers of gas, electricity, water and telecommunications services could use their dominant market positions to compel the payment of debts on accounts incurred before the commencement of a winding up. They would do this by threatening to cut off a supply unless arrears were paid in full or payment was personally guaranteed by the liquidator or receiver.17 Where the supply was essential to preserve the company’s assets, payment was difficult to avoid and the effect was to pay the utility debt in priority even to the statutory preferential creditors.18 Following strong criticism of this process in the Cork Report,19 section 233 (as amended) of the Insolvency Act 1986 prohibited resort to this practice. The supplier may now require the office holder to undertake personal responsibility for payment of any new supply but may not make the availability of a new supply conditional on receiving payment or security for the old supply.

**Preferential debts**

The Cork Committee noted that *pari passu* distribution of uncharged assets was in practice seldom, if ever, attained because, in the overwhelming majority of cases, the existence of preferential debts frustrated such distribution.20 Preferential debts are unsecured debts which, by force of statute, fall to be paid in a winding up in priority to all other unsecured debts (and to claims for principal and interest secured by a

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16 See *ABC Coupler and Engineering Co. Ltd (No. 3) [1970] 1 All ER 656; Re Downer Enterprises Ltd [1974] 2 All ER 1074; Re Oak Pits Colliery Co. (1882) 21 Ch D 322; Re National Arms and Ammunition Co. (1885) 28 Ch D 474; and *Re Atlantic Computer Systems plc* [1992] Ch 505 (for a review of the earlier authorities). More or less automatically included now (subject to the discretion of the court) are continuing rent or hire purchase charges in respect of land or goods in the possession of the company which the liquidator continues to use for the purposes of the liquidation: see *Boyle and Birds’ Company Law* (6th edn, Jordans, Bristol, 2007) pp. 938–9.


18 The legality of this practice was upheld in *Wellworth Cash & Carry (North Shields Ltd) v. North Eastern Electricity Board* [1986] 2 BCC 99, 265.


floating charge)\textsuperscript{21} but which abate rateably as amongst themselves. Preferential debts are listed in Schedule 6 of the Insolvency Act 1986\textsuperscript{22} and, before the enactment of the Enterprise Act 2002, included: inland revenue debts;\textsuperscript{23} certain Customs and Excise debts;\textsuperscript{24} social security contributions for the twelve months prior to the relevant date;\textsuperscript{25} contributions to occupational pension schemes;\textsuperscript{26} certain employee benefits;\textsuperscript{27} and levies on coal and steel production.\textsuperscript{28} Assessed taxes such as income tax and corporation tax were not given preferential status in Schedule 6 of the Insolvency Act 1986 since the government yielded to Cork’s arguments that there was no case for priority in such instances.\textsuperscript{29}

\textsuperscript{21} Preferential creditors rank in priority not only above unsecured creditors, but also above debenture holders with assets covered by floating, not fixed, charges: see Insolvency Act 1986 s. 175(2)(b). See also Insolvency Act 1986 s. 251 which defines ‘floating charge’ so as to include a charge, which, though originally floating, has since become fixed. Thus, any charge which was originally a floating charge but has become a fixed charge (e.g. by crystallisation or by a notice of conversion) before the ‘relevant date’ defined by s. 387 will be subordinated to the preferential debts under s. 175(2)(b), thus depriving such decisions as Re Woodroffes Ltd [1986] Ch 366, Re Brightlife Ltd [1987] Ch 200 and Re Griffin Hotel Co. Ltd [1941] Ch 129 of force. On priority of preferential debts over charged assets see HM Commissioners for Revenue & Customs v. Royal Bank of Scotland plc [2008] BCC 135; Re Oval 1742 Ltd (in liquidation): Customs and Excise Commissioners v. Royal Bank of Scotland [2007] BCC 567 (discussing CA 1985 s. 196 (now CA 2006 s. 754) and the relationship with IA 1986 s. 40).

\textsuperscript{22} See also Insolvency Act 1986 ss. 386, 387; IA 1986 s. 175 (winding up), s. 40 (receivership: see Re H & K Medway Ltd [1997] BCC 853).

\textsuperscript{23} PAYE income tax deductions due from payments made in the twelve months prior to the relevant date (Sch. 6 paras. 1 and 2 – the deductions relate to s. 203 of the Income and Corporation Taxes Act 1988): see generally Keay and Walton, Insolvency Law, pp. 466–71. The decision in Re Toshoku Finance (UK) plc [2002] BCC 110 (HL), as noted above, makes it clear that corporation tax liabilities arising after the start of a winding up are properly to be treated as expenses of the winding up and are therefore to be paid in advance of preferential debts: see Milman, ‘Post Liquidation Tax’.

\textsuperscript{24} Unpaid VAT for six months prior to the relevant date and unpaid car tax; certain betting and gaming duties as well as lottery duty that became due in the twelve months prior to the relevant date (Sch. 6, paras. 4, 5 and 5B); insurance premium tax, landfill tax, beer duty and air passenger duty referable to the six months prior to the relevant date (Sch. 6, paras. 3A, 3B, 5A, 5C).

\textsuperscript{25} Sch. 6, paras. 6 and 7.

\textsuperscript{26} Sch. 6, para. 8.

\textsuperscript{27} Remuneration for up to four months prior to the relevant date subject to the stipulated maximum sum (Sch. 6, para. 9); accrued holiday pay (Sch. 6, para. 10); and any sum loaned and used for the specific purpose of paying employees’ remuneration (Sch. 6, para. 11).

\textsuperscript{28} Sch. 6, para. 15A.

\textsuperscript{29} See Cork Report, paras. 1409–50. Different considerations were said, however, to apply to taxes such as PAYE or national insurance, VAT and car tax since the Crown’s claim in such cases was for money collected by the debtor from other parties and the debtor could properly be viewed as a tax collector rather than a tax payer. Unless such debts were
The coming into effect of section 251 of the Enterprise Act 2002, however, abolished the Crown’s status as preferential creditor. As a result, the preferential debts remaining are: four months of unpaid employee wages (up to a prescribed maximum limit per employee of £800) and accrued holiday entitlements, unpaid contributions to state and occupational pension schemes, and unpaid levies on coal and steel production. Abolition of the Crown preference created a potential given priority the moneys collected would swell the insolvent’s estate to the benefit of private creditors rather than the state. For the case against Crown priority see A. Keay and P. Walton, ‘The Preferential Debts’ Regime in Liquidation Law: In the Public Interest?’ [1999] 3 CfiLR 84; DTI/Insolvency Service White Paper, Productivity and Enterprise: Insolvency – A Second Chance (Cm 5234, 2001) (“White Paper, 2001”) para. 2.19.


Insolvency Act 1986 s. 386, Category 5, Sch. 6. Employees have defined preferential status but can also draw on the National Insurance Fund: for discussion of employee protections see pp. 608–9, 612–14 and ch. 17 below. The Crown’s right of subrogation to employees’ preferential debts paid from the National Insurance Fund remains: Employment Rights Act 1996 s. 18; Pension Schemes Act 1993 s. 127(3).


In the case of insolvencies of insurance companies, the EU Insurers’ Reorganisation and Winding-Up Directive was transposed into UK law by the Insurers (Reorganisation and Winding Up) Regulations 2004 (SI 2004/353, effective 18 February 2004). Regulation 21 applies in the case of a winding up of a long-term insurer, a general insurer or a composite insurer and provides that the debts of the insurer must be paid in the following order of priority: preferential debts; insurance debts; then all other debts. (“Insurance debt” here means a debt to which a UK insurer is, or may become, liable, pursuant to a contract of insurance, to a policy holder or to any person who has a direct right of action against that insurer, and includes any premium paid in connection with a contract of insurance (whether or not that contract was concluded) which the insurer is liable to refund.) Preferential debts are to rank equally among themselves and must be paid in full, unless the assets are insufficient to meet them, in which case they abate in equal proportions. Insurance debts are to rank equally among themselves and must be paid in full, unless the assets available after the payment of preferential debts are insufficient to meet them, in which case they abate in equal proportions. So far as the assets of the insurer available for the payment of unsecured creditors are insufficient to meet the preferential debts, those debts (and only those debts) have priority over the claims of holders of debentures secured by, or holders of, any floating charge created by the insurer, and must be paid accordingly out of any property comprised in or subject to
windfall for the holders of floating charges and, to adjust for this, the Enterprise Act section 252 inserted a new section 176A into the 1986 Act to ring-fence, for the benefit of unsecured creditors, a prescribed part of the company’s net property that, otherwise, would be available to satisfy the claims of holders of debentures secured by floating charges. The quantum of the prescribed part is thus intended to compensate broadly for the benefit to floating charge holders of no longer being subordinated to Crown claims for unpaid taxes and holders of floating charges are not entitled to participate with unsecured creditors in the prescribed part fund as regards any unsecured shortfalls in their security positions except in so far as the fund exceeds the amount needed to satisfy unsecured debts.

According to Patten J in Re Airbase (UK) Ltd, sense could only be made of section 176A(2)(b) if ‘unsecured debts’ excluded the unsecured balance of the secured creditor’s claim and the pari passu rule was ‘modified’ by the provision to ‘differentiate between unsecured creditors with no form of security and the unsecured claims of secured creditors’.

Can preferential debts be justified in economic efficiency terms? A general argument relating to unsecured creditors asserts that if parties constitute involuntary, non-adjusting creditors, their debtors will not bear the full costs of defaulting and so will not take optimal care to avoid default. The debtor will thus take excessive risks with, say, the credit offered by employees and there will be an inefficient allocation of resources in society. Employees who are paid in arrears have little option but to provide credit to their employing company for the period between wage payments.

34 The relevant percentages/quantity to be paid is fixed by the Insolvency Act 1986 (Prescribed Part) Order 2003 (SI 2003/2097): see further ch. 3 above, pp. 108–10.
36 Re Airbase (UK) Ltd, Thorniley v. Revenue and Customs Commissioner [2008] BCC 213. Similarly the holder of a fixed charge facing a shortfall would not be able to participate in the prescribed part: see Walters, ‘Statutory Redistribution of Floating Charge Assets’.
As for the ability to adjust credit terms, this is crucially important. If employees could adjust the terms on which they provide credit so as to take account of default risks, the economic inefficiencies noted would not arise (the risk-related component of the credit arrangement would induce the appropriate level of credit provision and care taken). Employees are ill-positioned to adjust their credit rates to take account of default risks.\footnote{See generally B. Gleig, ‘Unpaid Wages in Bankruptcy’ (1987) 21 UBC L Rev. 61–83. On employees, see C. Villiers, ‘Employees as Creditors: A Challenge for Justice in Insolvency Law’ (1999) 20 Co. Law. 222; ch. 17 below.} When they negotiate employment contracts with a firm there will be little discussion of insolvency risks, the employee is liable to lack the information or expertise necessary to calculate the extent of such risks and, even if employees could make the appropriate calculations, they might well be unable to negotiate wages that incorporate a risk element because they face severe competition in the market for jobs and because others in that market may be unable or disinclined to hold out for such risk elements in their wages. Arguments about the general inefficiencies of unsecured credit do not, however, explain why employees should be more sympathetically treated than other ordinary (e.g. trade) creditors. The latter, as was noted in chapter 3, may also be poorly placed to adjust their terms to cope with default risks.

All unsecured creditors now enjoy the protection offered by the prescribed part and, as argued in chapter 3, this would to some extent limit these inefficiencies in credit supply that stem from non-adjustment of rates. In deciding whether, over and above this, it is desirable in economic efficiency terms to give employees protection beyond that enjoyed by trade creditors, it is necessary to consider the possible basis for favouring some non-adjusting creditors rather than others.

A key factor here concerns the costs of risk bearing. Where given levels of risk are allocated in a manner that gives rise to inefficiency because the decision-maker relieved of risk is liable to behave with sub-optimal care, it is relevant to consider variations in the costs of bearing undue risks. It may, in turn, be desirable to give most protection to those who will incur the greatest costs in bearing the risks at issue.\footnote{See Cantlie, ‘Preferred Priority in Bankruptcy’, p. 430.}

The ability to spread risks increases a party’s capacity to withstand the consequences of default.\footnote{Ibid., pp. 433–44.} Trade creditors will have a certain capacity to spread risks but small suppliers may be very hard hit by defaults. The costs of default in their cases may be high, with employees losing jobs or
even businesses folding. Employees, as noted, are seldom able to spread default risks and so will suffer considerable hardship: for example, where lack of moneys owed prevents them from generating or gaining further employment. Not only are employees poor self-insurers against debtor default (their lack of diversification prevents effective self-insuring) but they will also be unlikely to find insurance markets in which they can contract to spread risks. What makes shifting risks to employees especially undesirable is that the costs of such a risk shift are liable to be higher than when insolvency risks are placed elsewhere. On this reasoning, tort creditors do not merit especially high levels of protection in insolvency because they are less likely than employees to be highly vulnerable to instances of default and, accordingly, they will not usually be extremely high-cost risk bearers. They will routinely have other sources of income, funds and products and risks will be spread by such diversification.

It has been proposed that other creditors (including secured creditors) should be deferred to tort claimants in insolvency but a further consideration here is the special effect that deferment to tort creditors may have on major lenders. Banks, for instance, might be deterred from advancing funds on the basis of secured loans where they face risks of giving way to potentially huge tort claims. As argued in chapter 3, other ways of protecting involuntary tort creditors – such as compulsory tort liability insurance for companies – might prove more consistent with efficient corporate financing.

The issue of vulnerability to risks may also militate against placing pre-paying consumer creditors in a better position than ordinary unsecured creditors. Ogus and Rowley have contended that there are material reasons for giving consumer pre-payers special protection – reasons based on economic efficiency. Their argument, in brief, is that few problems arise in the general provision of credit when there is voluntary choosing of investments, full information and equal bargaining power. In so far as such conditions are lacking in a trading relationship there may be a case for protecting the ill-placed party and, in so far

42 Ibid., p. 437.
44 See pp. 110–12 above.
as one group of creditors is liable to be more poorly placed than another, a relatively superior level of protection is appropriate. Consumer pre-payers, Ogus and Rowley state, may be eligible for such superior protection because they tend to be ‘distanced from the company in a way that the trade creditor typically is not and may well regard the cost of negotiating over the risk of insolvency as excessive in relation to the amount at stake’.  

Consumer pre-payers may also be geographically dispersed (for example, in mail order contracting) which weakens their position, and they will rarely have easy access to such information on the trader as will allow them to assess insolvency risks. (The Office of Fair Trading has reported that it ‘does not regard it as feasible’ that consumers be expected to check on the financial standing of traders.) Finally, many consumer creditors may fail to see themselves as creditors of the company at all, especially where they are led by the trading company to believe that the period of prepayment is short.

Whether consumer creditors are placed in positions materially worse than those occupied by small trade creditors is, however, open to argument. For its part, the Cork Committee decided against special treatment for consumers, saying of consumer and trade creditors: ‘There is no essential difference. Each gives credit and if the credit is misplaced, each should bear the loss rateably.’ What is more strongly arguable is that consumer creditors tend to be lower-cost risk bearers than employees because their risks are more widely spread (across products). This argument suggests that if preferential treatment should be given, employees, not consumer creditors, should be favoured.

A second factor that may influence the case for protecting an unsecured creditor is his or her ability to prevent default and the taking of inefficiently low levels of care. If a party is able to intervene and forestall disaster, we may, on fairness grounds, be less inclined to protect them from default risks by giving them priority than we would in the case of someone who has no power to intervene. On this front, trade creditors

in a regular supply relationship with a debtor may occasionally be able to impose conditions on supply and may adjust terms or decline to supply further items. Small suppliers to a large number of customers are, however, unlikely to be in this position and, in the case of all trade creditors, market conditions and competitive pressures may rule out the institution of preventative measures. Employees may decline to supply further labour if worried about their employer’s solvency but, in a market where alternative employment is unavailable, this may be difficult. If the employee occupies a managerial position in the employing company there may, however, be opportunities to influence decision-making so as to limit default dangers, but such opportunities and influence may be very limited in many cases. Tort creditors, in contrast, will rarely, if ever, be able to take steps to influence default rates, or levels of care, and consumer creditors will occupy a similar position. The above points indicate that in terms of ability to prevent default, there is no particularly strong case for sustaining exceptions to the pari passu principle.

Do considerations of fairness suggest that certain non-adjusting creditors should be preferred to others in insolvency? Here we come to the issue that for Cork was central:

Since the existence of any preferential debts militates against the principle of pari passu distribution and operates to the detriment of ordinary unsecured creditors, we have adopted the approach that no debt should be accorded priority unless this can be justified by reference to principles of fairness and equity which would be likely to command general public acceptance.\(^5\)

Thus it might be argued that if creditors cannot tailor their credit terms it is wrong to burden those creditors with risks that they are in no position to recognise, calculate, adjust terms to, or protect themselves against.\(^5\) This contention, however, found little resonance with consultees of the Insolvency Service Review Groups 1999–2000. Many unsecured creditors cannot adjust and the rationale offers no justification for giving priority to one category of unsecured creditors over another. Fairness considerations point in the direction of general protections for

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\(^5\) Cork Report, para. 1398. It is arguable that the system of preferential debts causes considerable discontent in the ranks of unsecured creditors. A survey reported by Keay and Walton, ‘Preferential Debts: An Empirical Study’, revealed that 68 per cent of respondent IPs thought that there was unsecured creditor discontent.

unsecured creditors – as offered by the prescribed part provisions – but not towards more particular safeguards.

Does fairness demand priority for employee creditors?53 Most employees are likely to be poorly placed to assess the financial standing of their employers, or to insist on employment terms that protect them against insolvency risks. Cork, however, rejected the case for employee creditor priority on the grounds that it would give ‘an excessive degree of indemnity to higher paid employees, including directors and senior management, at the expense of ordinary creditors who in many cases may be more deserving of sympathy’.54 Employees are protected by the Employment Protection Acts,55 said Cork, and there was no need for overlapping insolvency law protections. At present the Employment Rights Act 1996 (ERA) offers employees of an insolvent company more extensive protection than the Insolvency Act 1986. The 1986 Act gives preferential priority to unpaid wages and accrued holiday pay owed and provides for payment by the Secretary of State for up to eight weeks of pay arrears during the statutory minimum period,56 up to six weeks’ holiday pay and a basic award for unfair dismissal.57 The Secretary of State makes such payments out of the National Insurance Fund and then stands in the shoes of the employee in attempting to recover such funds from the liquidator. Less than a quarter of the money paid out of the ERA scheme can be claimed by the Crown as preferential.58

54 Cork Report, para. 1430.
56 I.e. up to eight weeks at up to £330 per week: ERA 1996 s. 186(1)(a); Employment Rights (Increase of Limits) Order 2007 (SI 2007/3570), from 1 February 2008.
57 ERA 1996 ss. 182, 186, 167. Up to six weeks’ holiday pay with a limit of £330 per week, accrued during the twelve months before insolvency. The maximum compensatory award for unfair dismissal is £63,000 (as at 1 February 2008). The NIF also guarantees payments of statutory notice pay (up to a maximum of £330 per week); unpaid contributions to an occupational or personal pension scheme; the basic award for unfair dismissal; up to eight weeks at a maximum of £330 per week of a protective award; and statutory redundancy pay.
58 See Keay and Walton, ‘Preferential Debts Regime in Liquidation Law’, p. 100, who note that on 31 March 1996 £762 million was owed by insolvent employers to the Fund, of which only £177 million (23 per cent) ranked as preferential. The Crown’s right of subrogation to employees’ preferential debts paid from the National Insurance Fund remains (after the changes of the Enterprise Act 2002): Employment Rights Act 1996 s. 18; Pension Schemes Act 1993 s. 127(3).
Current law, accordingly, gives employees limited priority in relation to unpaid wages and the ERA gives further protection. The effect of limited priority in such a regime is to allow the National Insurance Fund to recover a proportion of sums paid out to employees. To abolish employees’ preferential status under the 1986 Act would consequently impose a loss not on employees but on the National Insurance Fund. It would, in doing so, make available considerable sums for other unsecured creditors. This may be no bad thing in economic efficiency terms since the Crown is likely to be a lower-cost risk bearer than the other unsecured creditors referred to, but it may be objected that it is unfair for taxpayers to foot part of the bill for an insolvency when they have enjoyed no direct involvement with the company.\(^5^9\) What the body of taxpayers has enjoyed, it could be riposted, is the prospect of gaining tax revenue from the potentially successful company. Having been happy to accept tax from a viable company and, in this sense, having shared in profits, such taxpayers, it could be said, are in no position to complain if they stand to bear some of the costs of failure. The Cork Committee,\(^6^0\) for its part, favoured the Canadian approach in which the state’s subrogated rights are not preferential. Cork noted Canadian thinking – that leaving a greater body of funds for unsecured creditors would be useful in encouraging them to play a more active part in the administration of the insolvent company’s estate – but the Committee stressed that the case for meeting employees’ debts was rooted in social policy considerations.\(^6^1\)

In such discussions the further question arises as to the appropriateness of treating all employees who are owed wages in like terms. It is possible to distinguish some employee groups from others on the issue of fairness. Directors, for instance, might be thought to be less worthy of protection from the risks of unpaid wages than other employee creditors on the grounds that they can be taken to be better informed about risks; they are better able to monitor the activities of the company; they share ex officio some responsibility for the company’s insolvency; and they are better able to gain compensation for insolvency risks than other

\(^5^9\) The Cork Report, para. 1433, favoured replacing insolvency law priority with statutory employment protection. As the Crown’s general preferential rights are now surrendered and the resulting fund is ring-fenced (subject to a prescribed part), then calls for abolition of employees’ preferential status may have more force: see, for example, D. Milman, ‘Insolvency Reform’ [2001] Ins. Law. 153; Mokal, ‘Priority as Pathology’, pp. 616–20.

\(^6^0\) Cork Report, para. 1434.  \(^6^1\) Ibid., para. 1435.
employees and creditors. This reasoning might be thought to justify excluding company directors from the group of those creditors able to benefit from the prescribed part; giving no priority to such directors’ claims to unpaid wages; and rendering directors ineligible for benefits from the National Insurance Fund in relation to unpaid wages. Directors’ claims would, on such reasoning, be subordinated/deferred to those of other creditors. Such steps might, however, be considered to be too draconian and to exaggerate the extent to which company directors are able to self-inform concerning their company’s insolvency risks, to influence financial risk-taking or to exit from excessively risky situations.

Set-off

A well-established principle of insolvency law is that where there are mutual debts existing between a creditor and a company in liquidation, the smaller debt is to be set against the larger debt and only the balance is to be paid to the creditor out of the insolvency estate. Thus, if company A has supplied materials to now insolvent company B and is owed £10,000 for these but company A also owes company B £6,000 for equipment supplied by company B to company A, the principle of set-off means that £6,000 of the £10,000 debt is extinguished. There is no defence or counterclaim to an action involved here. Company B does not have to go to court to establish a counterclaim, it merely uses the debt to pay off part of the debt to company A. The effect of this, as will be returned to below, is that where company A has provided the £10,000 credit without security, it is placed in a better position than insolvent

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63 On Cork’s approach to discouraging irresponsibility to creditors on the part of directors see Cork Report, ch. 43; and ch. 16 below. See also White Paper, A Revised Framework for Insolvency Law (Cmnd 9175, 1984) which emphasised that all directors should ensure they have full awareness of their company’s financial position; D. Milman, ‘Insolvency Act 1986’ (1987) 8 Co. Law. 61.
company B’s other unsecured creditors with regard to the £6,000 debt which is effectively paid back to company A before other unsecured debts are looked to.

Insolvency set-off applies within the terms of amended Rule 4.90 of the Insolvency Rules 1986 which applies where, before liquidation, there have been ‘mutual credit, mutual debts or other mutual dealings between the company and any creditor of the company proving or claiming to prove for a debt in liquidation’. If there have been such mutual dealings then ‘account shall be taken … and the sums due from one party shall be set-off against the sums due from the other’. Mutuality is essential: sums due from the company to another party will not be included in the set-off. Mutuality demands that the two parties each have a debt owed

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65 Note that after the Enterprise Act 2002 reforms, administrators can be given permission by the court to make a distribution (see Insolvency Act 1986 Sch. B1, para. 65(2)). Administrators, so authorised by the court, can now give notice (per IR r. 2.95) that they intend to make a distribution and the rules of set-off will apply: IR r. 2.85 (as amended by the Insolvency (Amendment) Rules 2005 (SI 2005/527)). The Financial Markets Law Committee (an independent body sponsored by the Bank of England) has argued, however, that there is a need to clarify the Insolvency Rules since counterparties may be discouraged from dealing with a company in administration because of legal uncertainties regarding set-off in administration – notably concerning which set-off rules will apply to the counterparty and whether any liabilities incurred by the insolvent company post-administration will be available for set-off: see FMLC, Administration Set-off and Expenses (Bank of England, London, November 2007). See further R. Heis, ‘Technical Update: Set-off in Administrations’ (2008) Recovery (Autumn) 12.

66 The availability of set-off generally is governed by the following conditions: (1) there must be debts, credits or dealings between the company and the person seeking to assert the set-off and (2) these debts, credits or dealings must be mutual. Mutual debts are liquidated amounts owing from each of the parties to the other. Mutual credits are credits which will eventually result in money claims, e.g. where one party, who is indebted to the other, supplies the other party with property on the basis that the property is to be resold and the proceeds handed over. Mutual dealings are arrangements in which the parties extend credit to each other in respect of individual sums with the express or implied intention that at some point the individual sums will be brought into account and set off against each other: see Boyle and Birds’ Company Law, p. 931. On the arising of a right of set-off see e.g. Rother Iron Works v. Canterbury Precision Engineers Ltd [1974] QB 1 but compare Business Computers Ltd v. Anglo-African Leasing Ltd [1977] 1 WLR 578. On the considerable scope of ‘Crown set-off’ and the operation of set-off in relation to contingent debts see Secretary of State for Trade and Industry v. Frid [2004] 2 AC 506, [2004] BPIR 841; I. Fletcher, ‘Crown Set-off and Contingent Liabilities’ (2005) 18 Insolvency Intelligence 6.

67 Insolvency Rules 1986 r. 4.90(2).

68 Ibid., r. 4.90(3). See Smith (Administrator of Coslett (Contractors) Ltd) v. Bridgend CBC (Re Coslett (Contractors) Ltd (in administration)) [2001] BCC 740 (HL): conversion of a company’s property was not a mutual dealing between the Council and the company (Lord Hoffmann at p. 748); Smith v. Blake [1996] AC 243.
by and to the other but the claims involved need not be connected or of the same type. They may be in contract, tort or restitution, of statutory or other legal origin. Both claims, however, must be monetary in nature. If one debt is proprietary in nature then no set-off is allowed.

A case focusing on the mutuality condition for set-off was *Morris v. Agrichemicals*. In that instance the bank, BCCI, had loaned money to A but had taken a deposit from B, a majority shareholder in the borrower company. The issue for the court was whether the bank was required to apply the rules of insolvency set-off and use the deposits from B to reduce the debts owed to the bank by the borrower company. The House of Lords held that the depositors could not insist on set-off because there was no mutuality: the borrowers owed the bank the sums of the loans but the bank owed the depositors the amount of the deposits. This was the case because the borrower and depositor were legally separate entities, though they were not separate economically. The decision in *Morris* thus contrasted with that of *MS Fashions* where the facts were generally similar but with a key difference: the depositors had not only pledged their deposits for the loans but they had guaranteed the obligation of the borrower and had thus established mutuality of claims for the purposes of mandatory set-off.

The set-off rule applies to all companies in liquidation, be this compulsory or voluntary, where the English courts have jurisdiction to wind up. It does not apply to companies subject to the appointment of an administrative receiver or companies in voluntary arrangements

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71 *MS Fashions v. Bank of Credit and Commerce International SA (No. 2)* [1993] BCC 70; Mokal, ‘Resolving the MS Fashions “Paradox”’.

72 As the depositors owed an obligation to the bank under the guarantee and the bank owed the depositors an obligation in respect of the deposit.
with creditors. The credits and debits involved must have arisen before the company ‘goes into liquidation’: that is, before the time of the winding-up order or the passing of the resolution to wind up the company.\textsuperscript{73} Rule 4.90, as amended in 2005, makes it clear, however, that actual, contingent and future debts owed both \textit{by} and \textit{to} the company are to be taken into account for the purposes of set-off (formerly only contingent and future debts owed \textit{by} the company were taken into account).\textsuperscript{74}

When a debtor company goes into insolvency, the statutory rules set out in Rule 4.90 of the Insolvency Rules 1986 are mandatory\textsuperscript{75} and displace all other forms of set-off not exercised prior to the winding up.\textsuperscript{76} The courts have, however, had to come to grips with various attempts to exclude the mandatory application of insolvency set-off. Thus, in \textit{Rolls Razor v. Cox}\textsuperscript{77} the court held that a washing-machine salesman was entitled to set-off £106 of sale proceeds against the £406 of retained commission that the now insolvent company owed him. The set-off that was involved, said the court, could not be excluded by the contractual agreement between the parties which had purported to rule it out.\textsuperscript{78}

\textsuperscript{73} Note that this is not the same definition of the ‘commencement of winding up’ that is used elsewhere in the Insolvency Act 1986, which refers, for other purposes, to the time the petition was presented or the resolution is passed.

\textsuperscript{74} In the case of \textit{Secretary of State for Trade and Industry v. Frid} [2004] 2 AC 506, [2004] BPIR 841, the House of Lords ruled that a contingent debt to the company could be included in set-off and that it was not necessary for the debt to have been due and payable before the insolvency date – it was sufficient that there should have been an obligation from contract or statute by which a monetary debt would become payable on the occurrence of some future event or events (Lord Hoffmann, at para. 9). See Fletcher, ‘Crown Set-off and Contingent Liabilities’.

\textsuperscript{75} On the mandatory nature of statutory set-off see \textit{National Westminster Bank Ltd v. Halesowen Presswork and Assemblies Ltd} [1972] AC 785; \textit{Morris v. Agrichemicals}.

\textsuperscript{76} See Goode, \textit{Principles of Corporate Insolvency Law}, pp. 214–16, where the five types of set-off are listed as: (1) independent set-off; (2) transaction set-off; (3) current account set-off; (4) contractual set-off; and (5) insolvency set-off.

\textsuperscript{77} [1967] 1 QB 552.

\textsuperscript{78} For criticism of this decision see Goode, \textit{Principles of Corporate Insolvency Law}, pp. 235–7. See also \textit{National Westminster Bank Ltd v. Halesowen Presswork and Assemblies Ltd} [1972] AC 785 where the House of Lords held that a person for whom a right exists cannot waive that right so as to exclude the statutory rules of set-off: see discussion at pp. 619–21 below. In \textit{British Eagle International Airlines Ltd v. Compagnie Nationale Air France} [1975] 1 WLR 758, [1975] 2 All ER 390 (‘British Eagle’) debts were cleared through a clearing house with seventy-six IATA member airlines. The court held that the liquidator of British Eagle had a legitimate claim for the net sum owed by Air France to British Eagle (after sums owed by the latter to the former had been set-off
Why should insolvency set-off be mandatory? Should contracting out of insolvency set-off be resisted on efficiency or fairness grounds? As one commentator has asked: ‘What is so special about insolvency set-off which makes contracting out of it totally impossible whereas contracting out of the pari passu rule is to be possible provided the contracting out operates to the detriment rather than the benefit of the creditor which is a contracting party?’

The Cork Committee noted the efficiency benefits of allowing contracting out of set-off. When the law allowed contracting out, a company in financial difficulties, attempting to reorganise its affairs, found it useful to open a new account with the bankers to whom it was indebted. This account would be maintained in credit and the bank would agree that in a subsequent liquidation it would not set-off any credit balance on the account against existing indebtedness. This meant that the funds in the new account would be handed over intact to the liquidator and the bank would not become preferred to other creditors through the funds in the new account. For its part, the company would be able to run the business on a cash basis for the general benefit of all creditors. After contracting out was legally prevented, such a company might open a new account with a new bank but not, if properly advised, its former bank. Cork deemed this need for new banking arrangements to be an ‘unnecessary and undesirable complication’.

under the statutory rules. To allow pre-insolvency clearing arrangements to continue post-liquidation would offend the pari passu principle as sums due from Air France to British Eagle would, on clearing, be used to satisfy the debts of clearing house member creditors to the ’determent’ of non-members. See further M. Bridge, ‘Clearing Houses and Insolvency’ (2008) 2 Law and Financial Markets Review 418; Oditah, ‘Assets’, p. 466; Mokal, ‘Priority as Pathology’, pp. 598–601. On the ‘football creditor rule’ and a decision indicating that the British Eagle approach is not offended when the claims of certain (but not all) unsecured creditors are paid off, not out of club assets, but by a purchaser of the club, see Commissioners of the Inland Revenue v. Wimbledon Football Club [2004] BCC 638.


81 That is, until the decision in National Westminster Bank Ltd v. Halesowen Pressworks and Assemblies Ltd [1972] AC 785.


83 Cork Report, para. 1341.
urged that contracting out should be allowed. There was no sound reason of policy for the prohibition and there were good commercial reasons for ending it.

In *Maxwell Communications Corporation (No. 2)*, Vinelott J urged, in contrast, that the mandatory nature of insolvency set-off could be justified in efficiency terms because this was a procedure from which the company and the body of creditors could benefit. The creditor could settle at least part of his debt without having to prove for it and the troubled company would be relieved of the need to engage in potentially expensive proceedings in order to recover the debt due to it. Complications such as determination of whether a dividend was owing in the liquidation to a creditor who had waived set-off in circumstances where proceedings against him were still afoot could also be avoided with a mandatory rule. In the *Halesowen* case, also, Lord Simon stressed that set-off was part of the procedure whereby insolvent estates are administered in a proper and orderly way. It was not a private right which those who benefited from it were free to waive; it was a matter in which the commercial community generally had an interest and accordingly this was a right that could not be contracted out of. Counter to such views it might be contended that allowing set-off may create uncertainty in commercial transactions because lenders and business partners will find it difficult to assess the financial status of a borrower, supplier or purchaser since there may exist rights of set-off that will diminish any insolvency estate and these rights will often be ‘invisible’.

In spite of such concerns about the uncertainties caused by set-off, a strong efficiency case for allowing set-off has, nevertheless, been said to be rooted in commercial reality and its overall effect in the lowering of business costs. As one commentator has argued:

> A reduction of exposure by $300 trillion per annum in foreign exchange markets and $50 trillion in swap markets is simply too difficult to ignore. This reduction in exposure has manifold benefits: capital adequacy costs are correspondingly reduced and so is systemic risk. This cost reduction frees capital which benefits the economy at large … the risk reducing effect makes insolvency set-off truly unassailable.

Will mandatory set-off, however, lead to disadvantages for companies in need of turnaround? Mandatory set-off can introduce difficulties for a troubled company, as Cork was aware, because it makes it harder for the

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86 Selvam, ‘Revisiting the Justifications for Insolvency Set-off’, p. 344.
company to refinance its operations by arranging additional credit facilities. This will happen where existing creditors will not agree to the refinancing deal if it involves a new creditor being given preference through set-off. Implementation of the Cork recommendation to allow contracting out of set-off would give greater financing flexibility in such scenarios.

Is mandatory set-off fair? In *Forster v. Wilson* the aim of insolvency set-off was said to be to do ‘substantial justice’ between the parties. This implies that if creditor A owes troubled company B £1,500, yet A is owed £2,000 by B, it is just that the £1,500 debt is allowed to be set-off. The effect, however, is to repay to A £1,500 of his debt as a matter of preference over other creditors of B (who, when deciding to lend, may have seen the debt in the company (B’s) account as an asset). Allowing set-off worsens the position of other creditors who are not engaged in a mutual debt relationship with the company and who may have difficulty in discovering the existence of ‘an unpublished security’. The effect of set-off is to remove from the insolvency estate the asset that is the debt due from the creditor to the company. An alternative would be for A to pay the £1,500 debt to B and then prove for the £2,000 in Company B’s insolvency, taking a percentage dividend on the sum owed alongside other unsecured creditors. To an independent observer this alternative arrangement might seem fairer than set-off because set-off ‘rewards’, with priority, those solvent creditors who happen also to have borrowed

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87 Ibid., p. 343. Mandatory set-off is likely, of course, to make creditors more willing to lend to the troubled company if they also owe debts to the company that are sufficiently large to allow them to set-off their own debts against debts owed to them by the company (see Lord Hoffmann in *Smith v. Blake* [1996] AC 243). When they reach the point at which their loans exceed their debts to the company this incentive disappears since any set-off will apply only to a sum equal to their debt to the company and, beyond that point, they will recover only pro rata as an unsecured creditor.


89 The ‘substantial justice’ purpose attributed to Parke B in *Forster v. Wilson* has been quoted with approval several times: see, for example, *Stein v. Blake* [1996] 1 AC 243 at 251E; *Gye v. McIntyre* [1991] 171 CLRT 609 at 618. In *National Westminster Bank Ltd v. Halesowen Pressworks and Assemblies Ltd* [1972] AC 785 Viscount Dilhorne stated that set-off prevented the ‘unfairness’ of the creditor having to pay off a debt to the company and then prove for a dividend.

90 Selvam, ‘Revisiting the Justifications for Insolvency Set-off’, p. 343.

91 Of course, the principal limiting requirement is that of mutuality. Insolvency set-off is usually said to guard against injustice to the solvent party, i.e. against the solvent party’s having to pay in full knowing it will in turn merely get a few pence in the pound.
from an insolvent company. In short, then, a regime of mandatory set-off involves a trading of efficiency gains and fairness losses.

Subordination

It is clear from the above that the pari passu principle is not one that can be bypassed to one’s advantage by simple contractual agreements with no proprietary effect. It is also clear that statutory exceptions to pari passu are encountered: the Insolvency Rules make set-off mandatory and, again, there is no contracting out of set-off within current corporate insolvency law. On the matter of contractual subordination, however, it is possible to make an effective agreement that one’s own debt will rank behind the other unsecured debts of a company. The ground-breaking decision here was Re Maxwell Communications Corporation plc (No. 2). The question before the court was whether the holders of convertible subordinated bonds might effectively contract not to be repaid until after the general unsecured creditors had been satisfied in full. Vinelott J did not see why bondholders, who had entered into an investment arrangement fully aware of the subordination of their claims, should be elevated to the level of the rest of the creditors at the time of insolvency. The bondholders had freely contracted with relevant knowledge and the court saw no reason to re-open the contractual bargain. Contracting out of the pari passu principle was thus allowed on the basis that a


creditor would be permitted to waive a debt in full (or in part) and that this might be agreed in advance of, or after, a liquidation. After all, noted Vinelott J, a creditor could waive a right to prove in liquidation and could agree to postpone his debt after winding up had commenced. Other creditors, indeed, might have given credit on the understanding that another creditor’s subordination agreement would be effective. Vinelott J also noted that contractual subordination was effective in other leading common law and civil law jurisdictions\(^{96}\) and he considered that, given that such agreements were recognised as effective, to strike them down would be a triumph of form over substance\(^{97}\).

What may be difficult to deny is the value of subordinated borrowing as a form of corporate finance. Subordination may be useful in a number of circumstances,\(^{98}\) notably: to allow shareholders or directors to inject funds into a company where existing creditors will not allow further unsubordinated borrowings; to allow parent companies to enhance the credit of a subsidiary that is issuing securities (so that an appropriate rating for the securities will be obtained); to allow companies to appeal to investors who seek high incomes in return for higher risk bearing; and to allow a bank to issue funds for treatment as capital for capital adequacy purposes.

Why, however, allow contracting out of \textit{pari passu} on subordination but not on set-off or more generally? The key consideration is fairness. On this matter the courts have consistently taken the view that an

\(^{96}\) For example, Australia and New Zealand: see Ferran, ‘Recent Developments’, pp. 206–9 for a discussion of provisions and case law.

\(^{97}\) See also \textit{SSSL Realisations (2002) Limited (in liquidation) and Save Group plc (in liquidation)} [2004] EWHC Ch 1760: see G. Stewart, ‘Legal Update’ (2004) \textit{Recovery (Winter)} 6. Lloyd J decided that where a parent company had covenanted not to prove in a subsidiary’s liquidation until the claims of a senior creditor had been met in full, the \textit{British Eagle} principle did not prevent contractual subordination even though the parent company was in liquidation and its creditors stood to suffer from the subordination. The judge stated that the \textit{pari passu} principle had to be considered separately in relation to the insolvencies of the parent and of the subsidiary and that the parent’s creditors were bound by the consequences of the parent’s agreement to subordinate its claims to those of the senior creditor in the liquidation of the subsidiary. (Other arguments relating to the subordination arrangements – e.g. that they resulted in the parent company creating a (registrable) charge (over book debts) or that the parent’s liquidator might be entitled to disclaim them as ‘onerous property’ under IA 1986 s. 178(3)(a) – were also not upheld by Lloyd J. The judge’s s. 178 ruling, \textit{inter alia}, was upheld by the Court of Appeal: see \textit{Squires (Liquidators of SSSL Realisations (2002) Ltd} v. \textit{AIG Europe (UK) Ltd} [2006] BCC 233.)

\(^{98}\) See Ferran, ‘Recent Developments’, p. 201.
agreement that purports to improve the position of a creditor who would normally be subject to the pari passu rule will not, for reasons of public policy, be effective when the debtor company is in liquidation. Subordination, as mentioned above, however, has been seen, notably by Vinelott J in the Maxwell Communications case, as worsening only the position of the contracting party and, accordingly, as a manoeuvre involving no unfairness to other creditors. This would be the case if such contracts could not be terminated or adjusted in the periods leading up to insolvency.

It is possible, however, to think of circumstances in which, under current conditions, unfairness could be occasioned by use of a subordination agreement. If bank A agrees to advance funds to company B in difficult times and agrees to subordinate its debt to those of creditors C, D and E, creditors C, D and E may be inclined to increase their lending to company B in the knowledge that A’s advance is subordinated to their own claims. If, at a later date, A renegotiates the terms of its loan to B and ends the subordination, lenders C, D and E may have been led to make loans available in unfair conditions. If, in the alternative, the debtor company seeks to make payments to the allegedly subordinated creditor, the unsubordinated unsecured creditors are poorly positioned to protect their own interests as they are not parties to the subordination agreement and the doctrine of privity of contract will rule out enforcement against the company. Nor do arguments that contractual subordinations constitute waivers of statutory rights give the unsubordinated creditors any rights of enforcement or allow them to prevent variations in the terms of the subordination agreement. The potential to subordinate at

100 For Commonwealth judgments consistent with the line of Vinelott J in Maxwell Communications see Horne v. Chester & Fein Property Development Pty Ltd and Others (1986–7) 11 ACSR 485; Ex parte de Villiers, Re Carbon Developments (Pty) Ltd (in liquidation) [1993] 1 SA 493.
101 On reliance on subordination by third-party creditors see Nolan, ‘Less Equal than Others’, p. 495, who argues that there is little that third-party creditors can do to protect themselves against variations in subordination terms. The advent of liquidation should, however, prevent variations after the start of the winding up: see Ferran, ‘Recent Developments’, p. 214.
103 See Nolan, ‘Less Equal than Others’, pp. 496–7, who also reviews arguments that unsubordinated creditors might be able to secure damages from a liquidator who distributes in breach of valid contracts of subordination and arguments that restitution could be sought from subordinated creditors who have received funds contrary to the terms of the subordination agreement: see Ministry of Health v. Simpson [1951] AC 251.
will creates uncertainties in the lending regime, it makes the task of liquidation more complex and this, in itself, will increase costs. Where lenders C, D and E gain the relevant information on subordination (or non-subordination) by A, they are likely to increase their interest rates to reflect any uncertainties in the system. Moving beyond a simple subordination agreement – in which a creditor agrees to rank behind all other creditors of a particular debtor – that creditor may wish to agree to rank behind some, but not all, of the other creditors. A group of creditors, indeed, may seek to agree a ranking order amongst themselves, so that, for example, A, B and C agree to rank behind all other general creditors but to rank between themselves, A first, B second and C last. The central issue here is whether the British Eagle ruling is offended by such arrangements and parties are seeking to opt out of pari passu to their own advantage. Where a creditor agrees to subordinate to some, but not all, other creditors, it is arguable that the pari passu principle is not breached because the subordinator gains no advantage over parties who are not involved in the subordination agreement. Where, as in the example of A, B and C above, a ranking order is agreed, third-party creditor interests are not prejudiced but A will gain a priority advantage over B and C. This is a consensual agreement, however, that has been treated in Commonwealth case law as not infringing the public policy of the pari passu rule.

Deferred claims

Claims may be deferred by statute, that is placed in priority below the claims of other creditors. Thus section 215(4) of the Insolvency Act 1986 provides that ‘where a court makes a declaration under [sections

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213 or 214 of the Insolvency Act 1986] in relation to a person who is a creditor of the company, it may direct the whole or any part of any debt owed by the company to that person and any interest thereon shall rank in priority after all other debts owed by the company and after interest on those debts'. Similarly the Insolvency Act 1986 defers sums due to members of the company by way of dividends, profits or otherwise. Such claims are ranked below those of all other creditors.\(^{107}\) It is clear, however, from the case of Soden\(^ {108}\) that the relevant section (section 74(2)(f)) subordinates to the rights of unsecured creditors only sums due to a member ‘in his character as member’. This covers sums due under the (then) section 14 (Companies Act 1985) statutory contract which draws a contract out of the terms of the company’s memorandum and articles and other obligations imposed by the Companies Act.\(^ {109}\) Sums due to a member independently of that (now) section 33 (Companies Act 2006) membership contract are excluded as, for example, are sums due as court awards in an action for misrepresentation, as in the Soden decision itself. Such sums owed would not be deferred but would rank *pari passu* with unsecured creditors. The broader importance of the Soden decision is the approach it lays down concerning the ranking of claims of members whose financial relationship with their company goes beyond simply share ownership. Issues of set-off are also affected since Soden holds that sums arising out of the statutory membership contract will provide no set-off from, say, non-fully-paid-up shares, but other independent claims outside the statutory contract may be set-off against the obligation of contribution.

**Conclusions: rethinking exceptions to *pari passu***

The following chapter considers whether *pari passu*, in its strong sense, is so frequently bypassed and flawed in shape and application that it is appropriate to look to alternative approaches to distribution. Here, however, it is necessary to consider whether the current exceptions to *pari passu* are in need of reform. Thus far the case for abolishing Crown preferences has been accepted and it has been indicated that there may be reasons for revising the rules on set-off.

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\(^{107}\) Insolvency Act 1986 s. 74(2)(f).


\(^{109}\) See now Companies Act 2006 s. 33: on which see Boyle and Birds’ *Company Law*, pp. 145–52.
Are there, however, other classes of unsecured creditor that are in need of greater or lesser protection than at present? In the case of one group put forward for greater priority – that of consumer creditors – we have seen difficulties with the argument for favourable treatment. The problem with this proposal is that it is difficult to distinguish ‘consumer’ from ‘trade’ creditors since there will be similarity between many of the contractual and practical arrangements entered into by such parties. Many trade creditors, moreover, may not have been repeat players in their dealings with the insolvent company yet many consumer creditors may have sustained a continuing relationship. We have seen that, compared with employees, the case for protecting the consumer creditor may be weak since the consumer is likely to enjoy a greater freedom to contract or decline to contract with the company; is more able to exit from the relationship in favour of forming a connection with another company; is more likely to spread risks by relying on more than one company to supply its required consumer goods; and is accordingly a lower-cost risk bearer than the typical employee.

A further proposal is designed to protect those creditors who have acted in a manner that benefits their fellow creditors. Prentice has argued that where creditor A takes action through the courts to enforce a debt but that action is overtaken by a winding-up order, the court should have a discretion to award creditor A the costs of the litigation but not the benefit of any judgment. Awarding such costs to such creditors would give priority to those costs and would compensate creditor A for the expenses of an action that is likely to benefit other creditors by signalling to them that the debtor company’s viability may be at issue. The court’s discretion, the argument runs, could be used to keep the floodgates closed on precipitate actions to enforce debts and this would discourage enforcement races. The award of such court costs would also prevent debtor companies from prevaricating when asked to settle accounts while using the threat of a voluntary winding up to discourage creditors from pressing their claims: the threat would be empty if the creditor would be liable to recover costs. This might, in turn, prevent unnecessary liquidations. Finally, the principle of pari passu would be respected by limiting the effective priority being given to the costs of the action only.

A difficulty with the proposal is that, as we have seen in chapter 3, signalling is a flawed process. When creditor A seeks to enforce a debt

110 Thereby staying the enforcement of all actions: see further ch. 13 above.
against company B in court, this may be the product of A’s lack of information and panicky state of mind rather than any process of rational evaluation of B’s viability. There may, moreover, be reasons for A’s seeking to enforce a debt at a particular time that are entirely unrelated to B’s viability: the state of A’s own financial affairs (or internal corporate politics) may be the driving factor behind the legal action. It could be responded that the envisaged judicial discretion regarding costs might be employed in a manner that rewards only actions offering good signalling to other creditors but this is to presuppose unrealistic levels of information in the hands of the judiciary. The extent of a discretion to award costs, rather than a right to costs, might be said also to undermine any incentives that creditors might have to bring actions and send signals to other creditors. The state of the present law does allow creditors other than creditor A to nullify the benefits of any judgment obtained by A: the other creditors can simply await A’s judgment and then present a winding-up petition. It could be argued, however, that creditor A did have the option of presenting a winding-up petition him- or herself and that accordingly he/she has no basis for complaint. This argument holds except that the courts will not allow a creditor to use a winding-up procedure to collect small debts. Overall, the case for the proposed discretion to award litigation costs to A seems not to be made out. It is based on assumptions about signalling that are difficult to sustain and it would create, at least to a degree, an incentive to litigate that is liable to render the overall costs of winding up a company higher than would otherwise be the case.

To conclude, it should be emphasised that, in considering exceptions to pari passu, it is the relative cases for preferring the different types of creditor that are at issue. In the above discussion, the group for whom the strongest case for a protected status can be sustained is that of company employees and the criteria relevant to an assessment of that case included: ability to gain and use information concerning default risks; ability to adjust terms to take on board such risks; capacity to exit from excessively risk-laden arrangements; vulnerability to risks; and status as a low- or high-cost bearer of risks. Employees are protected in employment protection legislation but it is questionable whether the Crown should still enjoy the statutory preferential status of employees’ debts through subrogation now that the Crown’s own preferential status has been abolished.

112 I.e. under £750: see Insolvency Act 1986 s. 123(1)(a), though creditors may combine their debts to qualify: Re Leyton & Walthamstow Cycle Co. [1901] WN 275; see ch. 13 above.
Bypassing pari passu

The main potential bases for supporting pari passu as a principle of corporate insolvency law are that it provides an efficient and a fair ground rule for allocating the residual insolvency estate. As was seen in the last chapter, however, exceptions to pari passu produce a principle that is unduly complex and uncertain. This chapter considers the extent to which pari passu can be bypassed1 and a central issue will be whether bypassing is so easily and frequently practised that the value of pari passu is undermined. Here, therefore, we return to the second of the two key problems that corporate insolvency law faces in this area: how a company’s insolvent estate is to be constructed.

As a preliminary point, it should be emphasised that the law does not readily countenance contracting out of collective arrangements for dealing with the insolvency estate. It was noted in chapter 14 that parties may be allowed by the courts to enter into contracts in a manner that worsens their status in the distribution of an insolvent company’s estate.2 What the courts will not do is allow creditors to ‘contract with [their] debtor [to] enjoy some advantage in a bankruptcy or winding up which is denied to other creditors’.3 The House of Lords made it clear in the British Eagle

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1 The word ‘bypassed’ here refers to arrangements that the law allows and which have the effect of preventing assets from being included in the company’s (residual) estate that is available for distribution to unsecured creditors. For a discussion of the circumstances in which the UK courts will allow assets held in the UK to be remitted to another jurisdiction for distribution with results that may diverge from those flowing from UK approaches to pari passu, see HIH Insurance (McGrath v. Riddell) [2008] 1 WLR 852, [2008] BCC 349.
2 Cf. National Westminster Bank Ltd v. Halesowen Presswork and Assemblies Ltd [1972] AC 785 where an agreement (altering a creditor’s priority position) was struck down despite the fact that it would have increased insolvency value to the remaining creditors.
3 Vinelott J in Re Maxwell Communications Corporation plc (No. 2) [1994] 1 All ER 737 at 750.
case⁴ that this would be contrary to public policy whether or not the contractual provision was expressed to take effect only on insolvency.⁵ Effect would not be given to a contractual arrangement that attempted to avoid collectivity by purporting to allow certain creditors to opt out of pari passu distribution of the residual estate to their advantage.⁶ British Eagle⁷ was a member of an International Air Transport Association (IATA) clearing house scheme in which moneys due from airlines to each other would be netted out each month. When British Eagle went into liquidation it owed money to a number of airlines but it had a claim against Air France, which the liquidator sought to recover. Air France

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⁵ See also Carreras Rothmans Ltd v. Freeman Mathews Treasure Ltd [1985] 1 Ch 207 at 226; M. Simmons, ‘Avoiding the Pari Passu Rule’ (1996) 9 Insolvency Intelligence 9. On the principle against divestiture (or deprivation principle), providing that an agreement to divest a person or company of an asset in the event of bankruptcy or liquidation is void for public policy (and its making no difference that no formal insolvency proceedings had begun), see Fraser v. Oystertec plc [2004] BCC 233; L. C. Ho, ‘The Principle against Divestiture in Insolvency Revisited: Fraser v. Oystertec’ (21 November 2005) SSRN; and for criticism of this approach: R. Henry, ‘The Impurity at the Heart of the Oystertec Decision Considered’ (2004) Company Law Newsletter 1; A. Henderson, ‘Fraser v. Oystertec and the Principle Against Divestiture in Insolvency: An Unprincipled Departure’ (2004) 25 Co. Law. 313. It may be the case that if the insolvent estate is deprived of property as a result of an arrangement that was not designed to escape insolvency rules, the courts may allow that deprivation as an exception to the British Eagle principle: see Neuberger J in MMI v. LSE [2001] 4 All ER 223; G. Stewart, ‘The British Eagle has Landed’ (2001) Recovery (December) 7–8. (A company was liquidated and the London Stock Exchange (LSE), in accordance with the LSE articles, deprived the company of its shares on the Exchange. Neuberger J noted that there was no coherent set of rules to enable one to assess where a deprivation provision fell foul of the British Eagle principle but he extracted ten propositions derived from case law. On the facts of the case before him Neuberger J concluded that the deprivation provision fell within the facts to the general British Eagle principle and the liquidator could not sustain his claim.) On third party purchases as distinct from contracting out, see Commissioners of Inland Revenue v. Wimbledon Football Club [2004] BCC 638.

⁶ Contracts that prevent property from entering the estate – i.e. contracts with proprietary effect such as retention of title clauses – will be recognised, as will be seen. For decisions focusing on the intent, rather than the effect, of a contract see Ex parte Mackay (1873) LR 8 Ch App 643; F. Oditah, ‘Assets and the Treatment of Claims in Insolvency’ (1992) 108 LQR 459 at 466.

⁷ See [1975] 2 All ER 390.
argued that British Eagle’s liquidator was bound by the contractual regime of the clearing house scheme and could only collect the sum due after netting out the claims of those creditors who were creditors of British Eagle. The liquidator successfully contended that such a process would breach the *pari passu* principle because it would remove from British Eagle’s estate the sum due from Air France – a sum that, otherwise, would be available to the body of British Eagle’s general creditors. In accepting this contention, a bare majority of the House of Lords accepted crucially that British Eagle’s claim against Air France was a direct one, with IATA acting simply as a collecting agent, rather than a mere element in British Eagle’s net balance with the principal IATA.  

Creditors may not be able to contract out of the *pari passu* principle to their advantage but they can take a series of other steps that will bypass *pari passu*. In taking these steps they are taking advantage of the fact that it is only the assets in which the company has a beneficial interest that are available to creditors. Property held, for instance, on trust by the company will not enter the estate and where the company has granted security over property the asset enters the estate only to the extent of the equity of redemption (the difference between the value of the asset and the sum of the secured indebtedness). Here, as Goode notes, the distinction between property rights and personal rights is vitally important for insolvency purposes: the holder of a property right can enforce it ahead of the general body of creditors, whereas the holder of a personal right can only prove for a dividend in competition with other creditors.

As will be seen below, there may be a strong case for the law allowing holders of property rights to enforce these ahead of creditors’ rights in the insolvency estate. As we will also see, however, the ability to make assets available to a company while avoiding entry of those assets into the corporate estate leads to a deterioration in the position of the ordinary unsecured creditor. ‘Every new property right, every added security

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interest, every proprietary restitutionary remedy, every equity has eroded his or her stake in the insolvency process.\textsuperscript{10}

It is time to consider in detail the devices that can be used to avoid entry into the residual estate and thereby to bypass \textit{pari passu} distribution.

\section*{Security}

If creditors take security over loans they will \textit{take} and \textit{keep} property rights for themselves by way of such security. The property subject to the secured claim thus belongs to the secured claimant to the value of the claim and accordingly it does not enter the insolvency estate and become available for distribution.\textsuperscript{11} Such arrangements may involve fixed or floating charges. As was noted in chapter 3, the institution of security can be supported on broad efficiency grounds, though elements of inefficiency are involved in so far as risks may be loaded excessively upon unsecured creditors. The earlier discussion of attendant issues will not be rehearsed here but the further question of whether security taking involves unfairness should be addressed at this point.\textsuperscript{12}

To give priority to secured creditors and to allow the bypassing of \textit{pari passu} can be argued to lead to no unfairness to unsecured creditors. This contention rests on three main arguments: that the security has been freely bargained or contracted for; that it does not deprive the company of value; and that relevant parties are given due notice of security arrangements and so cannot, with justice, complain.\textsuperscript{13}

The essence of the ‘bargain’ justification is as follows.\textsuperscript{14} When a debtor company grants a security interest to a creditor this will increase the risks faced by the other creditors because it reduces their expected value in an insolvency. Other creditors will, however, be aware of this risk and will

\textsuperscript{10} Goode, \textit{Principles of Corporate Insolvency Law}, p. 58.

\textsuperscript{11} Statute may, however, make certain debts (e.g. preferential ones) payable from the estate in priority to rights to property that is not part of the estate (e.g. that forming the subject of a floating charge). On floating charges see also ch. 3 above.


adjust loan rates accordingly or seek their own security or quasi-security. Voluntary contracting parties, accordingly, are treated fairly because they are free to contract at the rates and on the terms they consider appropriate.

The first objection to the ‘bargain’ argument is that those who enter into arrangements for credit in the commercial world do not always do so from equal negotiating positions. Inequalities, indeed, can be quite striking. Small trade creditors, for reasons discussed in chapter 3, may often be in no position to gain the information that would make them equal bargainers with those seeking security. They may lack the resources, expertise and time to evaluate risks accurately and the nature of their products and business arrangements may not allow for the appropriate adjustments of business terms.

Competitive conditions in the market may also undermine the small trade creditor’s ability to renegotiate interest rates when new securities are offered. (Contractual terms reflecting such conditions may also rule out such rate adjustments.) If equality of bargaining power was evenly spread between different types of creditor, one would expect a random distribution of security taking across all types of creditor but, in fact, the vast majority of security arrangements involve banks, finance houses or building societies, not firms in commercial business. Small trade creditors suffer not only from information asymmetries in relation to banks but also from a lack of economies of scale. Banks, who repeat play (with regard to small as well as large loans), operate with large volumes of lending and offer longer terms of credit than trade creditors. They tend to make extensive use of security, to have specialist advisers and to have lower set-up and monitoring costs. These factors all increase their bargaining power in relation to other creditors.

A second objection to the ‘bargain’ rationale is that a number of creditors are truly involuntary. They cannot take account of security arrangements because they did not choose to become creditors at all.

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16 See Hudson, ‘Case Against Secured Lending’, p. 55. 

17 Ibid., p. 56.

In this position, particularly, are tort victims. When parties agree security arrangements, they expropriate value that otherwise would rest, at least partly, with the body of involuntary creditors.

There are few reasons, furthermore, for treating freedom of contract as sacrosanct. The law has a long history of laying down the kinds of security that can be agreed to (all of which stipulations curtail the contractual freedoms of parties) and Parliament has clearly recognised that the right of a creditor to take security needs to be constrained if a fair balance is to be drawn between the interests of all creditors.19

A final concern is that the ‘bargain’ argument might have impetus where all affected parties are included in the bargaining process but it has little persuasive power when a bargain between a creditor and debtor imposes costs on others: ‘freedom of contract arguments have force only with respect to arrangements that do not create direct externalities … [W]hen the contract directly impinges on the rights of third parties, there is no prima facie presumption of freedom of contract.’20 Arrangements that allow debtors to increase the insolvency share of one party, and which come at the expense of other parties, involve externalities. Priority seeking is, after all, central to security taking.21

The ‘value’ argument offers a response to the last point. It asserts that when a creditor takes security for new value22 this does not prejudice third-party unsecured creditors because the secured creditor is not withdrawing from the company more than he or she paid in.23 A particular difficulty, however, is that after-acquired property clauses may draw assets into the original security

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19 See Report of the Review Committee on Insolvency Law and Practice (Cmd 8558, 1982) (‘Cork Report’) pp. 335–6. Freedom of contract is ignored, for example, when avoiding pre-insolvency transactions: Insolvency Act 1986 ss. 238–41, 245; preferential creditors are given priority even though they have not ‘bargained’ for it: Insolvency Act 1986 ss. 40, 175, 386, 387 and Sch. 6, paras. 8–11, 15A: see chs. 13 and 14 above.


22 I.e. contemporaneous or subsequent value: see further Goode, ‘Is the Law Too Favourable to Secured Creditors?’, pp. 60–3.

23 See ibid. This assumes the terms of the loan are not unreasonable and thus do not require adjustment or setting aside.
arrangement. As each new asset is acquired by the debtor, more and more security builds up without the injection of fresh value by the original secured creditor. That creditor enjoys the windfall benefit of diminishing risks of default and the existing interest rate proves increasingly advantageous to them. New assets do not enter the pool for the potential benefit of unsecured creditors but create such windfalls. The floating charge has thus long been criticised as a device that unfairly allows a charge upon all future property and Cork suggested that: ‘The matter for wonder is that such a device should ever have been invented by a Court of Equity.’

The ‘notice’ argument urges that security is justified when other creditors are duly apprised of the situation. These creditors, it is contended, can be in no position to complain about secured loans when they have been supplied with adequate information. This justification, however, fails to give due consideration to the position of involuntary creditors or to those voluntary creditors who cannot reasonably be expected to adjust their terms to the granting of security. Particular problems, moreover, arise with the floating charge. As Cork noted, the requirement that such charges be registered does little to assuage the feelings of grievance generated by such charges since the register gives very inadequate information to the trade creditor. Where

28 Cork Report, para. 109. In 2005 the Law Commission produced proposals for a new regime of electronic registering of company charges. The Government decided not to implement the Commission’s proposals – which would have allowed the checking of details to be carried out online and, following registration, would have made information available instantly. All charges, unless exempted, would have been covered and the regime would have applied to sales of receivables. Registration would not have been compulsory and there would have been no time limit for registering but, if the company had become insolvent before a charge had been registered, the charge would have been ineffective against the administrator or liquidator. It would also have been ineffective unless the filing preceded the ‘onset of insolvency’. Until it had been registered, furthermore, a charge would have lost its priority to a subsequent charge since priority would have depended on the date of filing. For the proposals see Law Commission, Company Security Interests (Law Com. No. 296, August 2005); Law Commission Draft Company Security Regulations 2006; and generally G. McCormack, ‘The Law Commission and Company Security Interests – A Climbdown’ (2005) 18 Company Law Newsletter 1; ‘The Law Commission Consultative Report on Company Security Interests: An Irreverent Riposte’ (2005) 68(2) MLR 286; M. Bridge, ‘The Law Commission’s Proposals for the
floating charges secure bank overdrafts\(^{29}\) the amount outstanding on the latter may fluctuate daily. It is, accordingly, impossible to tell from the register how much the floating charges secure. Even the latest company balance sheet offers little further assistance on this front since it is usually out of date by some months and will be unlikely to disclose contingent liabilities such as guarantees of the overdrafts of associated companies, which may also be secured by the floating charge. The twenty-one-day time limit as a condition of validity has, indeed, been dubbed ‘inappropriate’, since the proper sanction for failure to make a timely filing is subordination to a subsequent interest before the filing and (in the case of eve of insolvency filing) voidability as a preference.\(^{30}\)

Registration and notice requirements in English law are further weakened by their non-applicability to retention of title under a conditional sale or hire purchase agreement. Where unsecured creditors are not informed about such quasi-security devices, they are unaware of the additional risks they face and the force of the notice argument is again spent.\(^{31}\)

To summarise: the bargain, value and notice arguments are used in asserting the fairness of bypassing *pari passu* by excluding secured property from the insolvency estate. There are, however, material problems concerning the inequalities, competitive conditions and third-party effects of secured credit bargains, not to say their relevance to involuntary creditors. The value argument is undermined by such provisions as relate to after-acquired property and the notice contention is unconvincing in relation to involuntary creditors or to those who cannot adjust, suffer from poor information or are affected by a quasi-security device.

If abolishing security would be inadvisable on efficiency grounds, as was discussed above in *chapter 3*, what could be done to make the balance between secured and unsecured creditors fairer? Looking, first, to the problems of unequal bargaining, the 10 per cent fund was proposed by Cork\(^{32}\) with reference to floating charges and was advocated on fairness grounds, as a response to the ‘real injustice’\(^{33}\) that floating charges were

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\(^{29}\) Most companies grant floating charges to their bankers to secure ‘all sums due or to become due’ on their current overdrafts.

\(^{30}\) Goode, ‘Is the Law Too Favourable to Secured Creditors?’, p. 64. On preferences see Insolvency Act 1986 s. 239 and ch. 13 above. On the registration of charges see Companies Act 2006 Part 25, ss. 860 and 874 of which render charges void for non-registration.

\(^{31}\) See ch. 3 above and pp. 642–8 below on ROT clauses.

\(^{32}\) See Cork Report, paras. 1523–49.

\(^{33}\) Ibid., para. 1527.
capable of producing. A similar simple redress, in the form of the ‘prescribed part’ provisions, was effected by the Enterprise Act 2002 changes.34 As with the Cork proposal, however, the prescribed part rules do not bring assets subject to fixed charges within their remit. Fixed charges, however, may draw within their scope after-acquired assets of the originally specified class. Where the sum of assets covered by the fixed charge grows in value there is a transfer of insolvency wealth from non-adjusting unsecured creditors and an issue of fairness arises. Adjustment in relation to such charges is, however, potentially easier than with floating charges because a view of the registration documents will reveal a specification of assets that offers unsecured creditors some guidance as to the types of asset movement which may affect their potential insolvency claims.

In relation to fixed charges, unsecured creditors’ problems of adjustment are likely to be less severe than with floating charges for another reason: relevant asset movements are liable to be fewer in the case of fixed charges because the debtor has to obtain the fixed charge holder’s permission for asset substitution.35 With floating charges, of course, the debtor is free to deal with the charged assets on their own account and without reference to the chargee. These points suggest that the need for a ‘prescribed part’ fund is perhaps less pressing in relation to fixed charges than it was with respect to floating charges. The prescribed part or ring-fenced fund is no complete answer36 but it does have the merit of reducing the possibility that unsecured creditors will be faced with empty coffers.

One of the major advantages of the floating charge was the ability it gave to all-assets debenture holders to appoint an administrative receiver. It has been noted above in chapter 8 that, prior to the reforms of the Enterprise Act 2002, secured creditors were free to enforce their security interests in a manner that prejudiced the interests of other creditors. In England, the pre-Medforth37 freedom of the debenture holder and the receiver to act purely selfishly was criticised,38 as was the ability of the

35 Where debtors anticipate the need for routine asset substitution they are very likely to agree to the grant of a floating charge.
37 Medforth v. Blake [1999] 3 All ER 97. See ch. 8 above.
debenture holder to throw a spanner in the process leading to the making of an ‘old’ administration order by appointing an administrative receiver. In 2002 the Enterprise Act sought to address such inequalities of enforcement and abolished administrative receivership outside exempted categories and replaced it with a new administration regime for the benefit of all creditors.39

A more radical approach to balancing creditor interests is to repackaging the floating charge and place it within a new, statutory, regime to cover all security and quasi-security interests along North American lines. This potential development has been discussed, inter alia, by the Company Law Review Steering Group and the Law Commission40 and has been referred to above. Such a repackaging of the floating charge41 not only would allow a wholesale review of a confused mass of law but would

39 See chs. 8 and 9 above. ‘Ordinary’ receivers are still appointable, however, and, even post-Medforth v. Blake [1999] 3 All ER 97, a receiver’s primary duty is to the debenture holder. Medforth itself still has its limitations: it cannot be said with certainty, for instance, that the receiver has to take such actions as will benefit creditors generally provided that the appointing debenture holder’s interests are not prejudiced. Nor can we be confident that any obligation to continue the business in the general interest of creditors will be read into Medforth. Medforth may in coming years be treated as demanding no more than the receiver’s managing a business with due diligence where it is decided to continue operating that business. (But see AIB Finance Ltd v. Alsop and Another [1998] BCC 780 and Hadjipanayi v. Yeldon et al. [2001] BPIR 487 at 494–5.)

40 On the case for abolition of the floating charge see Report of the Committee on Consumer Credit (Cmd 4596, 1971) (‘Crowther Report’) para. 5.5.6. The Diamond Report, A Review of Security Interests in Property (DTI, HMSO, London, 1989), suggested that a new register of security interests was all that was needed (paras. 11.6.2, 16.8) though Diamond recommended that negative pledge clauses should be registered (para. 16.10). In 2000 the Company Law Review Steering Group published a consultation document on the subject of registering company charges (Modern Company Law for a Competitive Economy: Registration of Company Charges (URN 00/1213) (October 2000)). It invited views, inter alia, on the merits of going over to the North American approach of a ‘notice filing’ system under which priority is determined by the date of filing. The CLRSG Final Report of 2001 (ch. 12) advocated the introduction of a notice-filing system. See also Law Commission, Consultation Paper No. 164, Registration of Security Interests: Company Charges and Property other than Land (July 2002); Law Commission, Company Security Interests: A Consultative Report (Law Com. No. 176, September 2004); Law Commission, Company Security Interests (Law Com. No. 296, August 2005). The Law Commission’s initial proposals were wide ranging and adopted a functional approach to security along the lines of UCC Article 9 and recommended by the Crowther and Diamond Reports. See also ch. 3 above.

41 The new form of security interest, even if described as ‘floating’, would be a fixed security interest and the floating charge would have disappeared as a distinct security device: see Company Security Interests: A Consultative Report; R. M. Goode, ‘The Case for Abolition of the Floating Charge’ in Getzler and Payne, Company Charges, p. 17.
provide an opportunity to state that the interests of unsecured creditors should not give way to those of secured creditors where this would be unfair in the substantive or the procedural senses.\textsuperscript{42} With the Law Commission’s final report of 2005, however, there came a hesitancy regarding potential impacts on insolvency law which led to an abandonment of the recommendation to remove the fixed/floating charge distinction and the opportunity for such wholesale reform was again missed.\textsuperscript{43}

Changes might also be made so as to reinforce the ‘value’ justification for security, which holds that security is fair when it does not dilute the interests of others. One such reform would be to outlaw secured lending on existing corporate assets (while allowing it on new assets). As noted in chapter 3, however, such a severe restriction on the raising of finance might lead many companies into difficulty. A less draconian step would be to echo Article 9 of the US Uniform Commercial Code,\textsuperscript{44} again, and provide that priority would be given to ‘purchase money security interests’ (PMSIs)\textsuperscript{45} as against earlier creditors with perfected securities.\textsuperscript{46}

\textsuperscript{42} Policy decisions would have to be made concerning the position of preferential creditors (who now rank before floating, and after fixed, charge holders in priority). On Diamond’s position see Diamond Report, p. 85.

\textsuperscript{43} The entire programme of company security reform had to be geared to the timing of the introduction of what is now the Companies Act 2006 and ‘there was simply no time to go working over the insolvency effects of abolition of the floating charge’. The outcome of the Law Commission’s report (and their subsequent Draft 2006 Regulations) amounts to ‘conceptual confusion’ since floating charges, instead of being subordinate to subsequent fixed charges, have priority according to the time of filing, ‘thus obliterating the primary distinction between fixed and floating charges’: Goode, ‘Case for Abolition of the Floating Charge’, p. 20.

\textsuperscript{44} See Bridge, ‘Form, Substance and Innovation’, p. 14; Jackson and Kronman, ‘Secured Financing’, p. 1171; Diamond Report, paras. 11.7.5–11.7.7.


\textsuperscript{46} I.e. those who had registered their interests or given possession of the asset to the debtor.
The PMSI is a security interest that favours a creditor who advances sums to fund the acquisition of a particular asset when those sums are in fact so used. Such an interest prevails over all others in a priority conflict.\(^{47}\) Recognising PMSIs would mean that where a financer provides new assets to the company, the assets would not be drawn into the scope of the floating charge covering after-acquired property. This would reduce the unfairness involved in the floating charge holder gaining the windfall benefit of security in after-acquired assets and doing so at the expense of the later creditor. The PMSI holder can also point to the new value added to the company and the lack of any attendant prejudice to other creditors’ security interests. This is because purchase money loans contemplate payments that correspond to the new asset’s depreciation and so repossession normally satisfies the PMSI creditor. The cushion of free assets that protects earlier lenders against default is accordingly unaffected.\(^{48}\)

The Law Commission’s consultative report of 2004 in fact recommended recognition of PMSIs\(^ {49}\) but their final report of 2005 noted simply that the priority rules on PMSIs were included in the Consultative Report on the assumption that title retention devices were to be covered, and, given the fact that the initial stages of reform would not include such devices, PMSI rules would also be excluded.\(^ {50}\)

A further way to reinforce the value justification for security is to strengthen preference rules. These rules are designed to prevent insolvent companies from preferring one creditor to another within a specific period leading to a winding up.\(^ {51}\) At present, these rules are subjectively phrased in looking to whether the company desired to confer a preference in giving a security. A strengthening of the law would involve a move in the direction of the Australian and US regimes and the adoption of an objective

\(^{47}\) For a definition of the PMSI see Article 9:107 UCC. On procedural requirements to obtain ‘perfection’ see Article 9:312(3). On the operation of simple ROT clauses as PMSIs see Diamond Report, pp. 88–9.


approach. The issue would then be whether the effect of granting the security was to improve the position of one creditor at the expense of others, and the company’s desires would drop out of account.

Turning to the issue of notice, unfairness can be reduced by improving information flows to unsecured creditors. As noted, proposals have been made that secured creditors might have to go beyond mere registration and take reasonable steps to inform unsecured creditors of their intentions if they are to place the latter in a subordinate position. Again, however, it should be emphasised that such requirements may increase costs and the supply of information and notice is only of value to certain unsecured creditors. It is of little assistance to involuntary creditors or to those who are unable to adjust for the variety of reasons already discussed.

To summarise, then, it can be said that bypassing *pari passu* by excluding secured property from the insolvent company’s estate is difficult to justify in fairness terms with reference to arguments based on bargaining and freedom of contract, supply of value and sufficiency of notice: at least this is so given the present state of English law. Inequalities of bargaining positions, information asymmetries, impositions of externalities and enforcement biases undermine the free bargaining rationale. After-acquired property clauses and weak preference rules detract from claims to the supply of new value, and inadequacies of registration processes and inabilities to adjust place question marks against assertions that notice is adequate.

Steps can be taken to reduce unfairness on most of the above fronts and in some cases the same reforms would also improve overall efficiency. Certain reforms have moved in this direction – as with the Insolvency Act 1986


53 See Keay, ‘Preferences in Liquidation Law’; Goode, ‘Proprietary Rights and Unsecured Creditors’, p. 187: defences such as good faith or change of position would still, however, be relevant. An objective approach to preferences is likely to facilitate the prevention of unfair grantings of security on past rather than new value; cf. *Re M. C. Bacon Ltd* [1990] BCC 78. See further ch. 13 above.

54 See LoPucki, ‘Unsecured Creditor’s Bargain’, p. 1948; S. Block-Lieb, ‘The Unsecured Creditor’s Bargain: A Reply’ (1994) 80 Va. L. Rev. 1989. Article 9 filing of a security agreement will not, in itself, ensure that detailed information flows to other creditors since a filing notice may give bare outlines only: it is the right to call for particulars of the security agreement that yields valuable information. See Bridge, ‘Form, Substance and Innovation’, p. 15; Diamond Report, p. 94.

55 See pp. 607–14 above.
section 176A ‘prescribed part’ fund for unsecured creditors. Other steps remain possibilities, such as a compulsory tort liability insurance mechanism designed to reduce the unfairness involved in subsidies from involuntary non-adjusting, unsecured tort creditors.

**Retention of title and quasi-security**

In chapter 3 it was noted that many companies raise finance and arrange the use of assets by using sale arrangements in a manner that substitutes for security. ‘Quasi-security’ devices such as retentions of title, hire purchase and leasing agreements, factoring and sale and lease-back contracts are used in order to supply credit but avoid the scope of pari passu by keeping the assets at issue out of the corporate insolvency estate. The efficiency considerations attending the use of such devices were considered in chapter 3 and concerns noted on a number of fronts: that quasi-security devices may produce inefficient transfers of insolvency wealth away from unsecured creditors; that quasi-security undermines the efficiencies associated with security because it increases the uncertainties associated with lending; that poor information on the use of quasi-security devices and legal unknowns produce unnecessary uncertainties; and that quasi-security devices do not, in reality, deliver real protections for creditors who resort to them.

Before questions of fairness are addressed, it is as well to make clear the nature of the legal limitations that affect quasi-security devices. Rather than deal with all varieties of quasi-security, one example of the genre – the retention of title (ROT) clause – will be focused on here. To commence, the terms upon which title to goods can be retained by a creditor should be outlined.57

56 See pp. 125–33 above.
A simple ROT clause will involve a provision in a contract of sale that stipulates that property in the goods being sold will not pass from seller to buyer until the purchase price has been paid in full.\(^{58}\) Such a clause will not require registration as a security interest in order to be effective.\(^{59}\)

In more complex arrangements, sellers may attempt to reserve title not merely in the original goods (for example, raw materials) but also in the proceeds of sale of such goods or in products manufactured from such goods or in the proceeds of sale of such products.\(^{60}\) In the *Romalpa* case\(^ {61}\) the Court of Appeal held that when a seller S supplies goods to buyer B under a ROT clause and authorises B to sell the goods on condition that B accounts for the proceeds of sale, S may, on B’s insolvency, rely on the fiduciary relationship established\(^ {62}\) and have an equitable right to trace those proceeds and prevent them from falling into the insolvent estate of B. (A key issue is whether the relationship created between the parties is fiduciary rather than merely that of debtor to creditor.) By such use of a ROT clause, S is given a right *in rem* in the

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58 See Sale of Goods Act 1979 s. 19(1) (the statutory basis for ROT clauses). If a seller attempts to reserve merely equitable, as opposed to legal, title to the goods this will be treated as a charge void for non-registration: see *Re Bond Worth Ltd* [1979] 3 All ER 919. On the EC Late Payment Directive and Member States’ obligations to recognise contractually agreed-upon ROT clauses see G. McCormack, *Retention of Title and the EC Late Payment Directive* [2001] 1 JCLS 501.


60 The danger with a complex ROT clause is that it will be found by the courts to create a registrable charge and will be void if not registered under the Companies Act 2006 s. 860: see, for example, *E. Pfeiffer WW GmbH v. Arbuthnot Factors Ltd* [1988] 1 WLR 150, [1987] BCLC 522; *Carroll Group Distributors Ltd v. Bourke Ltd* [1990] ILRM 285; *Compaq Computers Ltd v. Abercorn Group Ltd* [1992] BCC 484.

61 *Aluminium Industrie Vaassen BV v. Romalpa Aluminium Ltd* [1976] 1 WLR 676.

proceeds and does not have to compete with the creditors for a share in B’s insolvency estate.63

In the Romalpa instance, the aluminium foil had not been processed or mixed with other goods. When, however, materials are supplied subject to a ROT clause and there is such a processing or mixing, an issue is whether the seller can rely on the ROT clause to trace into the product that results from processing or mixing. A distinction is to be drawn between cases of mixing goods and instances in which the goods have been processed so as to lose their identity.64 In the Borden65 decision, resin was supplied for use in the manufacture of chipboard and the Court of Appeal held that if S sells goods to a manufacturer knowing that the goods will be subject to the manufacturing process before being sold, there is no fiduciary relationship between S and B and S cannot rely on a simple ROT clause to ensure tracing: a right over the finished product will have to be provided for by express contractual stipulation.66 Borden thus leaves open difficult issues concerning the point at which the seller’s goods lose their identity and become a new product.67 Where the sold goods have been mixed with other goods and are identifiable readily and can be separated easily then the seller can retain them.68 Where, moreover, the goods have been mixed with similar goods then, even if

63 If a buyer has become insolvent then the seller can achieve ‘debt recovery’ via his ability to assert a right in rem. If, on the other hand, the proprietary remedy available to the seller is confined to operating by way of a security charge, then, as noted above, ROT sellers invariably lose out upon the buyer’s insolvency due to their failure to register the security charge as per the Companies Act 2006 s. 860.


66 For an example see a High Court of Australia case involving the sale of steel and claimed entitlement to products manufactured with the steel: Associated Alloys Pty Ltd v. ACN 001 452 106 Pty Ltd [2001] HCA 25, [2000] 202 CLR 588 – discussed in K. Stock, ‘Australian Developments in the Law of Retention of Title’ (2002) 15 Insolvency Intelligence 1; J. de Lacy, ‘Corporate Insolvency and Retention of Title Clauses: Developments in Australia’ [2001] Ins. Law. 64. (In Associated Alloys the majority of the High Court distinguished the English cases and held that a ROT clause could be drafted allowing the seller to trace proceeds of sub-sale by way of trust: see further Lightman and Moss, Law of Administrators, p 475.)


separation is not possible, title may be retained where it is possible to
decide the retaining party’s contribution to the total stock of the goods.
In *CKE Engineering*, Judge Norris QC ruled that where, by agreement,
a zinc ingot had been mixed and melted with other zinc, there was no
difficulty in two companies agreeing that the contents of the melting tank
should be treated as owned in proportion to their contributions and
in giving effect to a ROT clause with respect to an agreed proportion of
the mixed goods. Case law post-*Borden* suggests that when attempts
are made to draft ROT clauses so as to retain title in new products or
proceeds thereof, the courts will construe these as intending to vest legal
ownership of the manufactured product in the hands of the buyer subject
only to a registrable charge in favour of the seller. It may, however, be
possible for the seller and buyer to agree which of them is to become the
owner of any manufactured product: this was the suggestion of Goff and
Oliver LJ in *Re Clough Mill Ltd*. From a creditor’s point of view, a particularly useful version of the
ROT clause is the ‘all-monies’ provision which retains title in the seller’s
hands until all debts owed to the seller on any grounds are fully paid. (It
has been suggested that about half of all ROT clauses are of the ‘all-
monies’ kind.) In an insolvency a benefit of such a clause is that it is not
necessary to identify which items in a stock of supplied goods have been
paid for: with an ‘all-monies’ clause all of the stock remains the seller’s
property. It is arguable that such reference to obligations unconnected
with the immediate sale should be viewed as involving a charge, but in the
*Armour* case the House of Lords did not regard such a clause as
creating a right of security and unanimously held that all-monies clauses
are ‘legitimate retention of title’.

70 See also *Spence v. Union Marine Insurance Co. Ltd* (1867–8) LR 3 CP 427; *Sandeman and
Sons v. Tyzak & Branfoot Steamship Co. Ltd* [1913] AC 680; *Glencore International AG v.
72 [1985] 1 WLR 111, 115, 124. See also *Re CKE Engineering Ltd (in administration)* [2007]
BCC 975. See further de Lacy, ‘Corporate Insolvency and Retention of Title Clauses’, pp. 70–5.
73 See A. Hicks, ‘Retention of Title: Latest Developments’ [1992] JBL 398 at 400; J. Spencer,
‘The Commercial Realities of Reservation of Title Clauses’ [1989] JBL 220 at 227: in
Spencer’s survey 59 per cent of materials suppliers (of various sizes) said that they used
ROT clauses.
75 See Hicks, ‘Retention of Title’, p. 403 and also the discussion therein on part-payment.
The value of an all-monies clause is particularly high when the value of the goods sold is rising. If, for example, paintings are supplied by A to a gallery B under an all-monies arrangement, retained ownership of these will operate in effect as security for the debt the purchaser owes in relation to the purchase price for the paintings but also for other debts (for example, relating to furnishings supplied by A to B under other contracts). Keeping an asset of escalating value out of the insolvency estate has the effect of advancing in priority a series of formerly unsecured debts beyond the immediate transaction. It places that asset out of the reach of floating charge holders and ordinary unsecured creditors.

Do ROT clauses offer a means of bypassing pari passu that creates unfairness? A first key consideration here is that, as noted, ROT clauses do not have to be registered. Unsecured creditors may, accordingly, be unfairly misled concerning the insolvency risks they are running when they supply goods on credit to a company. Trade suppliers, for instance, may see an array of assets in their debtor’s possession but these assets may belong to other parties and there is no register that can be resorted to so as to reveal this information. The existence, never mind the nature and extent, of the ROT clauses will remain invisible. Not only is the pari passu principle bypassed but so are the disclosure protections attending the use of security devices.

Matters are made yet worse for the unsecured creditors referred to because corporate accounts will routinely treat goods supplied under ROT arrangements as purchases by the debtor company. Goods which are not the property of the company concerned thus commonly appear as assets in the balance sheet and it is rare for auditors’ notes on accounts to

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76 But see judges’ comments re the hypocrisy of banks complaining of ROTs when they have the floating charge: Re Clough Mill Ltd [1985] 1 WLR 111.
77 The Cork Report, para. 1645, recommended that ROTs should be restricted to the price outstanding on the goods involved in the transaction and that securing the payment of moneys beyond this should be achieved by the creditor using a fixed or floating charge.
mention retentions of title. As has been commented about ROTs: ‘they remain invisible until they become important’.

When the Cork Committee took evidence on ROTs, a ‘cry for certainty’ was made by ‘consultee after consultee’. The complaint was that claims involving ROTs were often confused and that, without clarity, the prospect of expensive litigation overshadowed commercial life. Cork’s response was to accept that such complexities could not be avoided and could be negotiated around. It could be contended, however, that all unnecessary legal uncertainties compound the informational unfairness that ROTs can occasion.

A second basis for seeing ROTs as conducing to unfairness is that such devices are not equally available to all creditors. The costs of using ROTs may be relatively low for many suppliers because standardised contracts can be employed but, as noted in chapter 3, the suppliers of certain goods, such as fuels, paint, food and fodder, are unable to use ROTs at all because such materials disappear on consumption and leave the creditor with an unsecured claim. The effect is to load insolvency risks unduly onto the shoulders of those suppliers who happen to deal in goods that are consumed in the short term. A similar point can be made in relation to those suppliers who are repeat players and those who are engaged in a series of ‘one-off’ transactions. The latter may find it far more difficult to impose ROT clauses on their debtors.

A third cause of unfairness may arise from the use of ROTs to secure debts beyond the immediate transaction. As already noted, this is a particularly acute problem where the asset involved is of escalating value. That growth in value, combined with an all-monies (or all-liabilities) clause, will not be a windfall that becomes available to the body of unsecured creditors but will serve to prioritise certain unsecured debts (those owed to the asset supplier) and will ultimately leave other unsecured creditors looking at a smaller insolvency estate than they anticipated.

Such unfairnesses as are noted may be compounded by inequalities of bargaining power. Powerful creditors will be able to impose ROT clauses

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81 C. Williams, ‘Retention of Title: Some Recent Developments’ (1991) 12 Co. Law. 54.
82 Belcher and Beglan, ‘Jumping the Queue’, p. 17.
83 Cork Report, para. 1627.
84 Ibid., paras. 1628–9.
85 Contrast the situation and approach taken regarding processed goods in the Antipodes: see Re Weddel (NZ) Ltd [1996] 5 NZBLC 104; Associated Alloys Pty Ltd v. ACN 001 452 106 Pty Ltd [2001] HCA 25, [2000] 202 CLR 588; de Lacy, ‘Processed Goods and Retention of Title Clauses’ and ‘Corporate Insolvency and Retention of Title Clauses’.
86 Of course the floating charge holder is the first to ‘suffer’.
on debtors but those with less market power (or subject to more competitive circumstances) may be unable to retain title.\(^\text{87}\) The ROT is accordingly a device that may prove unfair in so far as it shifts insolvency risks to those who are the newest and weakest players in the market.

There is an argument, however, that use of ROT clauses can be conducive to fairness. The Cork Committee did not advocate the outlawing of ROT clauses in insolvency, noting that this would usually benefit floating charge holders, not unsecured creditors, and stating:

suppliers have opted for reservation of title clauses precisely because they seek to avoid the unfairness which results when they supply goods on credit, a floating charge crystallises and a receiver then takes the goods and realises them for the benefit of the debenture-holder leaving the supplier with nothing. It seems to us that suppliers are entitled, in such circumstances, to take steps to protect themselves and that it would be wrong to deny them the protection they seek.\(^\text{88}\)

Cork was disposed not to curtail contractual freedoms more than necessary\(^\text{89}\) but was faced with its respondents’ ‘wide unanimity’ of view that ROTs should be subjected to disclosure. The Committee recommended that a disclosure requirement along the lines of Article 9 of the US Uniform Commercial Code should be adapted to English needs so that there should be disclosure of names of suppliers imposing ROTs; descriptions of the types or classes of goods covered by the ROT; and the maximum amount that at any one time could be secured by the ROT.\(^\text{90}\) Consumer goods, as covered by the Sale of Goods Act 1979 (covering goods ordinarily bought for private use or consumption), would, on Cork’s recommendations, not be covered by a disclosure requirement. Cork did not take a view on how far tracing should be allowed to extend but, as noted, did consider that a duly registered ROT should be limited to the price outstanding on the goods immediately contracted for and should not take the all-monies or all-liabilities form.

\(^{87}\) See Leyland DAF Ltd v. Automotive Products plc [1993] BCC 389 which demonstrates the potential for a ROT clause to contribute to a supplier’s bargaining power, i.e. where continued supplies are vital to a receiver’s attempts to keep a company running (noted in Belcher and Beglan, ‘Jumping the Queue’, pp. 18–19).

\(^{88}\) See Cork Report, paras. 1633–4; G. Elias, Explaining Constructive Trusts (Clarendon Press, Oxford, 1990) p. 135: ‘It is only fair that suppliers of goods to businessmen should be able to stipulate for ROTs in respect of the goods which they supply. It would be unprincipled to give the power to take property rights by way of security to the lending institutions and nobody else.’

\(^{89}\) Cork Report, para. 1637.\(^\text{90}\) Ibid., para. 1638.
As noted, the Law Commission has put the matter of ROT registration aside for further consideration. Were the Cork recommendations to be implemented, however, they would go some way to meet criticisms based on the unavailability of information concerning ROTs and the unfairness of extending ROTs beyond the immediate transaction. In France and Italy, like the USA, ROTs require registration to be effective but the EC Regulation on Insolvency Proceedings 2000, while making express provision for ROT claims (Article 7), does not require registration.

**Trusts**

Parties involved in commercial relations with a company may, for reasons discussed above, find it difficult to take security or retain title so as to protect themselves against a potential insolvency. The consumer, for example, who pays in advance for goods may be ill-placed to resort to such measures. Another kind of refuge may, however, be available by reference to equitable doctrines which separate property held on trust from property forming part of the insolvent company’s estate. As the Cork

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91 *Company Security Interests* (Law Com. No. 296, August 2005) para. 1.66; see p. 645 and ch. 3 above. Reference can, however, be made to the added weight of the reports of the Diamond and Crowther Committees which both advocated a new register of ‘security interests’ that would have included retentions of title to secure the payment of money. On ROT registration generally see S. Wheeler, ‘The Insolvency Act 1986 and ROTs’ [1987] JBL 180.

92 The Company Law Review Steering Group’s 2000 Consultation Document (*Registration of Company Charges*) put forward proposals for defining those retention of title clauses that are deemed registrable but, as noted, the CLRSG’s *Final Report* (ch. 12) would have treated complex, but not simple, ROTs as registrable in its proposed notice-filing system. For discussions leading up to the suggested new notice-filing system for registrable charges set out in the Law Commission’s Draft Company Security Regulations 2006 (which, as indicated, contra to many proposals, did not in the end extend to ROTs) see Law Commission, Consultation Paper No. 164, *Registration of Security Interests: Company Charges and Property other than Land* (July 2002); Law Commission, *Company Security Interests* (Law Com. No. 296, August 2005); and generally McCormack, ‘Law Commission and Company Security Interests’; McCormack, ‘Rewriting the English Law of Personal Property Securities and Article 9 of the US Uniform Commercial Code’ (2003) 24 Co. Law. 69.

93 Per Article 4(2)(m): ‘The law of the State of opening of proceedings shall determine the conditions for the opening of those proceedings, their conduct and their closure. It shall determine in particular: … (m) the rules relating to the voidness, voidability or unenforceability of legal acts detrimental to all other creditors.’ See Lightman and Moss, *Law of Administrators*, p. 478.

Committee stressed, property held by an insolvent company on trust for others has never passed to the liquidator representing the general body of the company’s creditors because the liquidator takes on the ‘free assets’ of the insolvent company. Proprietary interests in favour of third parties prevail against the general body of creditors unless, of course, they are invalidated under any particular statutory provisions (e.g. those relating to the avoidance of floating charges or non-registration of charges). If a lender is placed in the position of a beneficiary of a trust imposed on the company, that lender has a claim in rem against the money at issue in priority to all others claiming against the company’s assets. As with retention of title, it is thus possible to avoid pari passu distribution by keeping property out of the body of assets available for settling the company’s debts.

This section of the chapter outlines the conditions under which the law will recognise trusts in the corporate insolvency context. It then considers efficiency issues arising from the use of trusts and finally looks to questions of fairness. (Questions of accountability and expertise were dealt with in chapter 13 when assessing liquidation processes in which the principle of pari passu distribution is applied to the residual estate.)

**The recognition of trusts**

For a trust relationship to be recognised, the courts must find there to exist both an equitable proprietary interest in the property in question and a fiduciary relationship. Circumstances satisfying these conditions may involve three distinct types of trust: express, resulting and constructive. For an express trust to be established there are ‘three certainties’ to be shown to be present: of intention, subject matter and objects. On the first point, intention will not necessarily involve writing (unless land is bypassing pari passu 649

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95 See Cork Report, para. 1042.

96 See Milman and Durrant, *Corporate Insolvency*, p. 161.


98 See S. Worthington, *Proprietary Interests in Commercial Transactions* (Clarendon Press, Oxford, 1996) pp. 44–5, who argues that some judges and commentators describe a single express trust while others require two trusts: a primary express trust linked with a secondary trust which operates if the primary trust fails, the secondary trust being variously described as an express trust, a resulting trust or even a constructive trust.

involved)\textsuperscript{100} and the key issue is whether in substance a sufficient intention has been manifested.\textsuperscript{101} As for subject matter, it must be possible to identify the property that is covered by the trust: a special difficulty where money is involved and where trust claims are liable to succeed only if the money at issue is retained in a separate bank account.\textsuperscript{102} Certainty of objects requires clarity concerning the purposes of the trust relationship. If, for instance, there is an intended trust relationship but it is unclear when funds are to be distributed in a particular way, the trust will fail and money held by a company will, on an insolvency, enter the insolvency estate. This was the position in \textit{Re Challoner Club Ltd (in liquidation)}\textsuperscript{103} where members of a company (an incorporated club) donated funds to the troubled company which attempted to create a trust over those funds. The trust terms were too uncertain to identify when the money was to return to the members and consequently the trust failed.

Resulting trusts are based on the presumed intentions of the settlor and are generally held to arise where a party purchases property in the name of another\textsuperscript{104} or transfers property into the name of another.\textsuperscript{105} Constructive trusts\textsuperscript{106} are trusts imposed independently of the intentions of the parties and can be seen as devices used by the courts in pursuit of justice. Cases have suggested that claims to constructive trusts are difficult to establish and in practical insolvency contexts the constructive trust may be of limited importance.\textsuperscript{107} Recent \textit{dicta}, however, in \textit{Re...}
Farepak Food and Gifts Ltd indicate a judicial willingness to recognise the possibility of institutional constructive trusts arising in the context of corporate insolvency.

In relation to corporate insolvency, trusts are of particular importance in two contexts which are worthy of more detailed attention. These are where funds are advanced for particular purposes and where consumers make payments for goods or services in advance.

Advances for particular purposes

During the nineteenth century the suppliers of funds for speculative enterprises commonly protected their investments by advancing moneys not to companies directly but to trustees. The latter would then release funds as required and if the company involved became insolvent any funds left in the hands of the trustees would be recoverable by the investors. Such a procedure offered protection but it did involve the inconvenience of using intermediaries.

Whether funds advanced directly to the company for a specific purpose might be held on trust was the issue considered by the House of Lords in Barclays Bank Ltd v. Quistclose Investments Ltd. In that case,
Rolls Razor Ltd was in difficulties but declared a dividend on its shares and Quistclose loaned the company £209,719 solely for the purpose of paying the dividend. The sum was paid into a separate account with Barclays Bank, with whom Rolls Razor were currently overdrawn. Barclays were aware of the payment by Quistclose. Rolls Razor then went into liquidation before the dividend was paid and Barclays claimed to be entitled to set off the money from Quistclose against the overdraft. The House of Lords decided unanimously, however, that the money had been received by the company and held on a primary trust for payment of the dividend and that, the primary trust having failed, that money was held on a secondary trust for Quistclose. Since Barclays had been given notice of the trust disposition, its own claim failed.

The Quistclose type of arrangement is now commonly used and its effect is to give the lender protection in relation to sums not yet expended on the specific purpose. Such an arrangement differs from a secured loan in that it does not have to be registered and there is no public notice given of the transaction.

Central to Lord Wilberforce’s analysis in Quistclose was the ‘two trust’ approach – involving the primary trust for the initial purpose and the secondary trust for the lender that commences with the failure of the purpose. The ‘two trust’ approach was, however, criticised in the House of Lords in the Twinsectra case of 2002. Lord Millett urged that such an approach created ‘formidable difficulties’ where the trust was for an abstract purpose, since the beneficial interest could not be invested in an abstract purpose (as opposed to, say, a benefiting individual). His own approach was to state that the property was vested in the donor on a resulting trust, with the borrower holding the money as a trustee for the lender and having either a power or a duty to apply the money for the stated purpose. Twinsectra was applied in the Margaretta decision in 2005 but, whether the ‘two trust’ or the Twinsectra approach is adopted, it is clear that, if there is a Quistclose trust and the purpose

113 For recognition of a purpose trust in the context of payments made to administrators to facilitate the discharge of liabilities owed to third parties by the company in administration see Re Niagara Mechanical Services International Ltd (in administration) [2001] BCC 393, described (2000) Recovery (August) 7, [2001] 80 CCH Company Law Newsletter 6.

fails (e.g. because the borrower becomes insolvent) the funds will not form part of the borrower’s estate but will revert to the lender.\footnote{See Sidle, ‘Whose Money is it Anyway?’. Diversity of opinion thus centres on the location of the beneficial interest in the money before the failure of the purpose for which the funds were advanced. Leading views are that there is a trust of the money for the lender with a power to use the money to pay the beneficiary (Lord Millett in \emph{Twinsectra}) or there is an entitlement in the borrower to use the money beneficially subject to the lender’s proprietary right to prevent misuse of the money (R. Chambers, \emph{Resulting Trusts} (Oxford University Press, Oxford, 1997) ch. 3; see also R. Chambers, ‘Restrictions on the Use of Money’ in Swadling, \emph{Quistclose Trust}, p. 77). For a discussion of these and other approaches see Stevens, ‘Insolvency’; Ho and Smart, ‘Re-interpreting the \emph{Quistclose} Trust’; Moffat, \emph{Trusts Law}, ch. 15; A. Tettenborn, ‘Resulting Trusts and Insolvency’ in Rose, \emph{Restitution and Insolvency}.}{116}

In order for a \emph{Quistclose} trust to arise, there must be an obligation to put the money aside for the special purpose. In the highly publicised \emph{Farepak}\footnote{Re \emph{Farepak Food and Gifts Ltd (in administration)} [2008] BCC 22 (Ch). Around 150,000 British families lost an estimated £40 million in the collapse of Farepak: see Editorial, ‘Farepak and the Ghost of Christmas Present’, \emph{Financial Times}, 17 November 2006.}{117} case, the company had operated a Christmas savings scheme involving the collection of money from large numbers of small savers by thousands of agents and the forwarding of such funds to the company in advance payment for Christmas hampers and vouchers. After the company had entered administration on 13 October 2006, the administrators accepted that most of the money collected had disappeared and could not be returned to the customers – who stood, in their thousands, to recover only around five pence in the pound.\footnote{In October 2007 Gordon Brown pledged ‘to ensure justice’ for the victims of Farepak: \emph{Financial Times}, 18 October 2007. Victims received just £8m from a government-backed charity fund: ‘Un-Farepak’, \emph{Financial Times}, 20 November 2007. Earlier in 2007, following the Treasury’s (Pomeroy) \emph{Review of Christmas Savings Schemes} (Treasury, March 2007) the Government announced that it had secured industry agreement to a scheme of ring-fenced accounts for customers’ money. By May 2008, an investigation by BERR’s Companies Investigation Branch had been completed and the CIB was taking advice on possible legal action against the Farepak directors. See J. Pickard, ‘Regulator Completes Farepak Collapse Probe’, \emph{Financial Times}, 13 May 2008.}{118} In the three days prior to the start of the administration, however, the directors had sought to ring-fence moneys received during that short period by creating a deed of trust over funds received into the company’s bank account. Mann J, however, rejected the argument that the company held the customers’ money under a \emph{Quistclose} trust. The collecting agents were agents of the company, not of the customers, and so the money passed to the company when it was given to the agents and not when it was placed in the company’s bank account. Nor was there any requirement that the agents...
should hold the money on trust or that the money be put aside pending transmutation from collected money to goods or vouchers. The relationship between Farepak and its customers was, thus, a contractual one and there was no Quistclose trust.

Consumer prepayments

When consumers make payments in advance to companies for goods or services – for example, by sending money to mail order firms – they run considerable risks. If the company becomes insolvent before the goods or services are supplied (as in Farepak) the consumers have no remedies except as unsecured creditors, a position in which they are unlikely to receive even a substantial portion of their money back. The Cork Report noted that a good deal of public and media concern attended this state of the law and in 1984 an Office of Fair Trading (OFT) survey suggested that there were at least 15 million prepayments per year, that 2 per cent of these involved a loss of money and that total losses exceeded £18 million.

Such difficulties have been responded to in a variety of ways. A number of trade associations have established voluntary compensation schemes and certain statutes deal with prepayments in particular sectors. The Estate Agents Act 1979 section 13 thus requires a client’s

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119 Mann J stated that a failure to keep the received money separate from other money was not fatal to a Quistclose-type resulting trust but that what was crucial in the Farepak situation was the lack of any suggestion that the money had to be put on one side by Farepak pending transmutation from credited money to goods or vouchers. If there were a Quistclose trust then that obligation would have been inherent in it.

120 Nor was Mann J prepared to hold that money received after the company had ceased trading was held on constructive trust: see p. 651 above. He was sympathetic to this possibility, following Neste Oy v. Barclays Bank [1983] 2 Lloyds Rep 658, but the limited evidence available did not provide a sufficient basis for such a decision.


123 Moffat, Trusts Law, p. 765, notes those of the Newspaper Proprietors Association, the Mail Order Protection Scheme and the Direct Marketing Association. See also T. Sears, ‘Turbulence in the Travel Trade’ (2008) Recovery (Spring) 28, describing the operation of protection schemes run by tour operators and travel agencies (e.g. the ABTA bonding arrangement, the ATOL Bonding Protection Scheme, the IATA travel agents’ agency for IATA member airlines). ‘The practical result of this protection for passengers will be that they will not form the bulk of unsecured creditors in a travel insolvency; but rather the bulk will be trade creditors and those who provide the bonding protection for the organisations referred to above’ (at p. 28).
money to be held in trust in a separate bank account.\textsuperscript{124} General legislation also plays a part here in so far as the Sale of Goods (Amendment) Act 1995 provides that pre-paying buyers of part of a bulk will obtain undivided proprietary rights in the bulk.\textsuperscript{125} This amending legislation went some way in helping with problems of identifying the subject of the trust (though the bulk of goods may itself present difficulties of identification) but such legislative responses have not solved all the problems and uncertainties left by judicial decisions in this area.

Customer interests may, however, be protected where it is decided that funds are held in trust for their benefit. A key decision on such trusts is \textit{Re Kayford}.\textsuperscript{126} This case concerned a company (K) that ran a mail order business. K had loaned its main supplier considerable sums of money but the supplier entered financial difficulties. This, in turn, threatened K’s solvency. K was advised by an accountant to open a separate ‘Customers’ Trust Deposit Account’, to pay into it any money received from customers for the purchase of goods which had not yet been delivered and to withdraw money only on delivery of the goods. K accepted the device but, in the first instance, paid money into a dormant deposit account in the company’s name, only at a later stage altering the name of the account. After K had entered involuntary liquidation Megarry J found sufficient evidence of an intention to create a trust. This was contained in the discussions of K’s managing director, the accountant and the bank manager. Megarry J found that the three certainties of a trust were established and commented:

\begin{quote}
No doubt the general rule is that if you send money to a company for goods which are not delivered you are merely a creditor of the company unless a trust has been created. The sender may create a trust by using appropriate words when he sends the money … or the company may do it by taking suitable steps on or before receiving the money. If either is done the obligations in respect of the money are transformed from contract to property, from debt to trust.\textsuperscript{127}
\end{quote}

Megarry J suggested, further, that it was entirely ‘proper and honourable’ for a company to use such a trust account as soon as there were doubts about the firm’s ability to fulfil its obligations. He, indeed, welcomed the taking of such steps.

\begin{flushright}
\textsuperscript{125} See Ulph, ‘Equitable Proprietary Rights in Insolvency’.
\textsuperscript{126} [1975] 1 All ER 604, [1975] 1 WLR 279. \textsuperscript{127} [1975] 1 WLR 279 at 282.
\end{flushright}
There was, however, no trust of customer deposits in *Holiday Promotions (Europe) Ltd*\(^\text{128}\) where the court held that the payment of customer deposits created a purely contractual relationship of debtor and creditor. In *Holiday Promotions*, deposits were not segregated in a separate account but were mixed with company money and, importantly, the company was free to use the deposits for its general purposes. There was nothing in the terms of any contract, nor in the general circumstances, to indicate any intention or agreement that the funds should not form part of the general assets available to creditors.

It would now appear, though, that initial payment into the company’s general account is not necessarily fatal to the existence of a trust. In the *Tiny Computers* case,\(^\text{129}\) a trust was expressly and successfully set up for sums forthcoming from customers. These sums constituted deposits and, in anticipation of insolvency, were deposited with the company’s bank with instructions that the bank should hold the funds on trust for customers in a customer trust account. The complication was that the deposits were paid into the company’s general account from which transfers were periodically made into the customer trust account. The court stated, however, that there was no difficulty regarding certainty of intention or subject matter and that there was certainty of objects since (though difficult) it was possible to determine the relative interests of the depositing customers by referring to the customer lists held by the company.\(^\text{130}\) Where, moreover, there is an intention to establish a trust for listed beneficiaries and there is a shortfall in the trust account, it has been held that beneficiaries’ entitlements should be assessed with reference to the sums owed to them in the trust period rather than by looking at the quantum of funds that had actually been placed in trust for them. Thus in *Sendo International Ltd*\(^\text{131}\) a schedule set out the debts owed to each beneficiary and it was stated that there was a clear intention to release sums equal to the scheduled debts from the security that would otherwise cover those funds. It was the scheduled amounts, accordingly, that were said to define each creditor’s interest.

\(^{128}\) [1996] 2 BCLC 618.
\(^{129}\) *OT Computers Ltd (in administration) v. First National Tricity Finance* [2003] EWHC 1010.
\(^{130}\) A parallel trust for suppliers failed since its object (‘payments due to urgent suppliers’) was uncertain in the absence of any listing of such suppliers and because the term ‘urgent’ was too vague to define any class of beneficiary.
\(^{131}\) *Sendo International Ltd (in administration)* [2007] BCC 491.
**Efficiency**

Do trust devices offer an efficient way for parties to protect themselves when advancing funds or making prepayments? What is clear is that trusts are often set up to ring-fence moneys received in the twilight period prior to an anticipated insolvency since this serves to protect customers and suppliers and it also suggests to the outside world that business is being carried on as usual. This is particularly useful in sustaining a position while a pre-pack or other turnaround strategy is being brought into effect.  

‘Twilight trusts’ can thus be seen as useful in allowing the directors to continue trading in the hope of attracting investors and maximising returns to creditors. The counter view is that such trusts are often used to protect the directors from liabilities for wrongful trading and that the time-consuming and expensive process of setting up such ‘fireproofing’ trusts tends to distract the management of the company away from the needs of a business in crisis. A significant difficulty in using such trusts is that they often have to be set up rapidly and they are, in legal terms, notoriously fragile.

In relation to express trusts and resulting trusts, as encountered in *Quistclose*, there are also issues of uncertainty. As commentators have pointed out, the precise nature of the equitable right to see that the loan is applied ‘for the primary designated purpose’ is unclear and it is not always apparent when the primary purpose is fulfilled, the ‘trust’ spent and the equitable right extinguished. Moffat also notes: ‘Similar uncertainty surrounds the status of the particular class of creditors for whose benefit the primary trust in *Quistclose* was created, i.e. the shareholders post-declaration of a dividend. Are they beneficiaries under a private express trust with associated rights of enforcement? If not, are we presented with an example of a “purpose trust” infringing the beneficiary principle?’

Questions also arise as to the characterisation of the assets to be placed in trust. This area of uncertainty is encountered in the *Carreras*

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133 See Ellis and Verrill, ‘Twilight Trusts’, who question (p. 115) whether it is right for directors to pursue self-protection rather than safeguarding business value.

134 Redstone, ‘Customer Deposits (in the Twilight Zone)’.


Rothmans case. Rothmans owed an advertising agency money for services and renegotiated an agreement so that the sums involved were paid by the agency into a special account for the purpose of paying these expenses. The agency went into liquidation and Rothmans contested their claim to the funds with the liquidator. The case was decided on Quistclose lines and the funds were said never to have belonged to the agency and to be repayable to Rothmans. Such an approach is, however, questionable since the agency had effectively made an existing asset (the Rothmans’ debt) available exclusively to one class of creditor, and this should probably now be seen as a preference or contrary to the principle established in British Eagle.

Quistclose, it should also be noted, involved an attempted corporate rescue, and the extent to which Quistclose principles are liable to be extended by the courts to cover more routine advances of corporate finance is a further area of uncertainty. The courts may well act consistently with the advice of commentators and be less inclined to recognise trusts where rescues are not involved and where the language used does not evidence the intention to establish a trust in rigorous terms. Here, again, the philosophical underpinnings of Quistclose are unclear and further cases raise the questions whether the Quistclose trust is to be seen as an express trust or a constructive trust and whether it is to be viewed in pure trusts law terms or remediably.

Such uncertainties reduce the present value of the Quistclose type of trust as an effective and efficient means of protecting investors but there is no necessary reason why the courts or the legislature could not bring new clarity into this area of the law. If it is asked whether such trusts hold out the promise of effective and efficient protection in routine cases of lending, other considerations have to be taken into account. First, a creditor may demand that a debtor company should place the funds at issue into a special account to be used for a specific purpose but the company may resist such a request for a number of reasons. Administrative costs will be

139 See Belcher and Beglan, ‘Jumping the Queue’, p. 7; Moffat, Trusts Law, ch. 15.
140 See Bridge, ‘Quistclose Trust’.
incurred by the company and these may be seen as excessive and unnecessary. Other creditors may insist on similar separate accounts and there may be fears of a deluge of such requests that, overall, would impose tight and inconvenient restraints on the uses to which money can be put. The company, moreover, may consider that it is not possible to designate specific purposes for its borrowings without giving up the flexibility of financing that it needs to compete in the marketplace. In the face of such company resistance to the use of a *Quistclose* trust, the small supplier of funds or the infrequent/one-off supplier may be ill-positioned to insist on the arrangement and may be ill-equipped to calculate the advantages, disadvantages and ways of arranging such a trust.

Turning to consumer prepayments and the *Kayford* type of trust, this also possesses limitations.\(^\text{142}\) In the first instance, it requires that the consumer, on forwarding money, should use appropriate words to manifest the intention to establish a trust, or the company supplying the goods must itself take actions demonstrating such an intention.\(^\text{143}\) Most consumers will not be aware of the possibilities offered by *Kayford* trusts and are unlikely to use the required forms of words when making purchases. They may not occupy bargaining positions that allow them to insist on such arrangements and the trading companies themselves will have weak incentives to establish *Kayford* trusts. A second difficulty arises from the need to identify the funds at issue. The law provides rules to trace assets in mixed accounts but these rules are complex and do not allow involved parties to predict legal effects clearly. Legal uncertainties also infect the process of establishing a *Kayford* type of trust. Thus, the courts may refuse to recognise such trusts where they are deemed to infringe the *pari passu* principle of residual insolvency distribution and when such infringements will be declared is a matter of some uncertainty.\(^\text{144}\)

Pursuing the issue of efficiency prompts the question whether it is desirable to offer consumer pre-payers the protections of *Kayford* trusts and to place them ahead of other unsecured creditors in whose body they would take their place in the absence of a trust. Practical considerations may undermine the efficiency case for consumer protections through


\(^{143}\) See Ogus and Rowley, *Prepayments and Insolvency*, p. 6.

trusts so that, even if the case for consumer protection was accepted, it could be argued that trusts do not provide the best route to such protection. The OFT recognised in 1984 that administrative costs for firms might be high if separate accounts and trusts were routinely employed.\(^{145}\) These costs would have a disproportionate effect on small new companies. Public policing of such practices might prove expensive since firms would possess incentives to transfer funds from special to general accounts before contracts were fulfilled. Prepayments also provide, in many cases, an ‘essential part of the trader’s working capital’.\(^ {146}\) Ogus and Rowley suggest that in general terms there is no efficiency presumption that such financing is better provided by commercial rather than customer creditors (though they qualify this comment by stating that if poorly informed consumers falsely maintain uneconomic market operations, there may be efficiency losses to society). A danger that can be pointed to with more confidence, however, is that if superior protections were given to consumer creditors, the effect would be to increase the incentives of other parties to take security and to leave fewer assets available for unsecured creditors. A further danger is that funds to replace those currently provided by prepayment might be hard to come by. Ogus and Rowley caution: ‘Given capital market imperfections, it is by no means clear that alternative finance would be available, save at loaded rates of interest, even where the trader was essentially solvent, especially in the case of new enterprise.’\(^ {147}\) The risk is that gains for consumers would be achieved at the price of significant increases in legal and administrative costs.

Other means of consumer protection have been suggested.\(^ {148}\) In rejecting preferred status for consumer creditors and compulsory trust accounts, the Cork Committee relied on more general measures to discourage irresponsible corporate behaviour or limit its effects. These came in the form of tighter disqualification rules for errant directors and the introduction of the wrongful trading concept together with the proposed 10 per cent fund which would be available for consumer as well as other unsecured creditors. Ogus and Rowley pointed out that a number of protective arrangements had already been introduced (most


\(^{146}\) Cork Report, para. 1050.


following negotiations with the OFT) so as to protect consumers in relation to certain types of transaction. Thus, certain statutes such as the Estate Agents Act 1979 demand that clients’ money must be held in trust in a separate account.\(^{149}\) Some trade associations, moreover, had voluntarily established compensation schemes to reimburse disappointed consumers: these, as noted above, were encountered, for instance, in the newspaper, periodical, travel agency, vehicle building and glazing installation sectors. As for further responses to the predicament of consumer pre-payers, these commentators backed Cork on wrongful trading controls as a way forward, and viewed as promising the institution of steps to educate traders on the causes of collapse (where possible involving the banks and expert creditors); the wider dissemination of corporate accounting information; ‘the linking of bank guarantees to the obtaining of secured creditor status – thereby inducing self-interested monitoring of trading company performance’; and the encouraging of voluntary trust funds and insurance bonds. There was, they added, no clearly established public interest case for the compulsory introduction of any of the above solutions.

Before leaving the question of efficiency in relation to trusts, the special case for ‘rescue fund trusts’ should be considered.\(^{150}\) The argument for regularising arrangements whereby finances are supplied to a troubled company for the purposes of assisting in its survival is that it may be in the economic interest of the community to encourage the supply of funds (by consumers, bankers or traders) in circumstances that facilitate rescues and increase corporate survival rates.\(^{151}\) This type of arrangement could operate on a regularised Quistclose basis when a purchaser of goods offers prepayment expressly on the basis that this funding is to assist in a rescue and is given for a specific purpose to be held on trust. Recognition of the trust would thus keep the fund out of the insolvency estate and encourage rescue funding by traders as well as banks.

The possible problem with the trust-based regime, as described, is that it may be open to the same criticisms as were made of the statutory super-priority (SSP) as proposed by the DTI/Insolvency Service in 1993,

\(^{149}\) Section 13.

\(^{150}\) On the general issues attending ‘twilight’ trusts that are established at times of corporate stress and are ‘becoming an integral part of the rescue culture’ see Ellis and Verrill, ‘Twilight Trusts’; Redstone, ‘Customer Deposits (in the Twilight Zone)’; and p. 657 above.

\(^{151}\) See R. Austin, ‘Commerce and Equity: Fiduciary Duty and Constructive Trust’ (1986) 6 OJLS 444 at 455.
dropped in 1995 after consultation and mooted again in 1999. SSP would give providers of funding during a moratorium a statutory super-priority over all existing creditors. (Such lenders would be at the head of the queue for the insolvency estate, not placed outside the queue as would be the case in a trust-based system.) The proposal was dropped in 1995 on the grounds that it might militate against the proper consideration of the viability of the business by a lender: it would lead to inefficiently large incentives to lend and to unjustifiable financing. In such a scenario, the supposed danger is that the highly protected investor encourages the company to continue trading beyond the point where this is justified and this results in greater damage to existing creditors than would otherwise be the case.

Such reasoning, however, is open to question. In a Quistclose type of arrangement where the lender to the troubled company places funds on trust and is well informed, there is no excessive incentive to invest because the investor is not free-riding on the security of other parties but is able to calculate the relevant investment risks and to agree a price or interest rate accordingly. The use of a separate trust account, in this regard, keeps the affairs of the new finance supplier separate from those of the creditors of the company. (It is, of course, the requirements of specific purpose and separate accounting that, as noted, restrict the potential role of the Quistclose trust as a general form of flexible corporate financing.) Inefficiencies might arise where such new trust-based finance suppliers are ill-informed (a position likely where consumer prepayments are involved) or where the company’s creditors have no information on the trust-based funding. More generally, indeed, it can be argued that recognition of the Quistclose-type of trust contributes to a lack of transparency since this is a device that ‘by its very nature will misrepresent to the world, and in particular to prospective creditors, the true financial state of a company’ (an argument to be returned to below in looking at questions of fairness). From the point of view of a company’s existing creditors, there is a balance to be considered in

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154 DTI, Revised Proposals, para. 2.2.
assessing the desirability of encouraging ‘rescue fund trusts’. On the one hand, there are dangers that their positions will be worsened by ill-informed funders allowing the company to descend into greater troubles than would otherwise be the case; on the other hand, it is to their advantage if prospects of corporate decline can be reduced by encouraging injections of rescue funds. This emphasises that any problems in this area stem from deficiencies in information supplies and use rather than from resort to Quistclose-type trusts.

**Fairness**

Do trusts of the Quistclose type operate consistently with the fair treatment of corporate creditors? It can be argued that in Quistclose no creditors were misled into making further loans by the existence of a separate dividend account and the bank was aware of the agreement between the parties. This will not always be the case, however. Quistclose-type arrangements are not subject to the registration and disclosure requirements associated with security and one effect, indeed purpose, of a Quistclose-type transaction ‘may be to create an impression of commercial solidity so as to enable the borrower to continue trading and avoid insolvency, with the consequence that fresh liabilities to creditors will probably be incurred’. Actual and potential creditors of a company may, thus, be deceived in so far as they are led to see the potential insolvency estate as larger than it really is: the property held on an undisclosed trust will lie at the heart of the ‘deception’. Similarly with a Kayford trust, the firm’s general creditors may observe a high level of economic activity and stocking but may not realise that a proportion of this is funded out of consumer prepayments and the involved moneys and assets will at no time enter the insolvency estate. When, moreover, an existing asset (a debt in Carreras Rothmans) is placed in trust for a particular creditor or class of creditor, there is, as has been noted above, a transaction approaching a preference or a breach of British Eagle principles. In Kayford the company chose unilaterally to protect a particular set of (new) customers by means of a new trust arrangement. Megarry J decided that this did not constitute a fraudulent preference because the case involved ‘the question not of preferring creditors but of preventing those who pay money from becoming creditors, by making them the beneficiaries under a

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158 See p. 658 above.
As Goodhart and Jones have argued, however, it is difficult to accept that the customers in Kayford were never creditors since that would demand acceptance that the money received from the customers was subject to a trust the moment it was received. The facts were, however, that the customers forwarded money without any binding undertaking from Kayford to pay it into a trust account. It would clearly be a preference for a company to take money from general funds and pay this into a trust account for the benefit of certain creditors but it is difficult to see how the arrangement adopted in Kayford differed materially from such a process. In summary, then, it is arguable that a Kayford arrangement is likely to infringe British Eagle principles and to involve unfairness for that reason.

Are trust arrangements equally available to all suppliers of corporate funds? Here the problem in relation to the Kayford trust is that it is the voluntary action of the receiving company that establishes the trust and, accordingly, that company may act in a selective or discriminatory manner beyond the control of any particular fund supplier. With a Quistclose trust instituted by the fund provider, disparities of information collection and handling will create a bias in favour of better-resourced funders and repeat players will be advantaged as compared to one-off providers. Overall, as with many other modes of bypassing pari passu, the effect of such trust mechanisms will be to disadvantage the poorly resourced, ill-informed, one-off trade creditor who will, at the end of the day, constitute an unsecured creditor surveying a shrunken insolvency estate.

Such a situation could be avoided, as already noted, by instituting statutory reforms to oblige suppliers to hold consumer prepayments in separate accounts and on trust. Leaving aside efficiency issues and the problem of removing working capital from the company, can a case be made out for such a course of action on grounds of fairness? Treating consumer creditors preferentially (as compared to unsecured trade creditors) might be argued for on the basis of their special vulnerability. Consumer creditors, it could be said, tend to be less wealthy than other creditors; are less likely and able to spread risks through diversification or

159 [1975] 1 WLR 279 at 281.
160 Goodhart and Jones, 'Infiltration of Equitable Doctrine', p. 496.
161 Ibid., p. 497.
162 See the comments of Templeman LJ in Borden (UK) Ltd v. Scottish Timber Products Ltd [1979] 3 WLR 672.
163 See p. 659 above and Cork Report, para. 1053, for rejection of this proposal.
164 See Ogus and Rowley, Prepayments and Insolvency, paras. 5.39, 5.11.
self-insurance; and are not fully voluntary creditors because they are poorly informed concerning insolvency risks, are ill-placed to negotiate terms with traders and, indeed, may not see themselves as credit suppliers.

The Cork Committee was unmoved by these arguments, though it did not respond to them in detail and merely urged that consumer creditors extend credit like traders and said that between the two groups, there is ‘no essential difference’. The problem for the proponents of consumer protection lies in any contention that consumers are in a worse position than all unsecured trade creditors. The small unsecured trade creditor who is not in a continuing relationship with a debtor company may (as indicated in chapter 14) be very poorly positioned to evaluate risks, may not consider himself as a credit supplier and, arguably, may be more vulnerable than the average consumer in cases of default. The consumer may be deprived, on default, of a luxury consumer item; the small trade creditor may lose out on the payment that allows his business to continue. The consumer may suffer a personal loss; the small trader’s loss may affect a host of employees very significantly. Any rationale for preferential treatment that is based on a vulnerability assessment might have to include numbers of unsecured trade creditors as well as consumers. Given these considerations, the case in fairness for special treatment of consumers as a general class seems not to be made out.

To conclude on the use of trust devices, there may be a case for encouraging the use of trust-based protections for parties who supply funds in rescue scenarios. Any potential prejudice to the general body of corporate creditors may then be compensated for by attendant increases in the company’s prospects of survival. In relation to non-rescue situations, the justification for trust devices seems highly questionable on efficiency and fairness grounds. Widespread use of trust arrangements is likely to lead to inflexible regimes of financing that are not efficient and consistent with dynamism in the marketplace. Unfairness is also likely to result because of informational and resourcing disparities, with the end result of worsening the positions of unsecured creditors. Legal uncertainties further compound these problems. The way forward on trust may, as Goodhart and Jones suggest, be to treat fund suppliers as de facto creditors and to seek to ameliorate the position of unsecured creditors more generally rather than to create yet another protected group.

Alternatives to pari passu

In moving to consider possible alternatives to *pari passu* it is useful to focus, again, on what a regime for distributing an estate post-insolvency should achieve. The contention in this book is that insolvency laws and processes should be designed to produce acceptable combinations of efficiency, expertise, fairness and accountability characteristics. This implies that the devices and processes that make up the regime for distribution should offer players in the marketplace a range of low-cost modes of protection against insolvency risks but that they should also avoid allocating risks in ways that produce unfairness or inefficiency and should satisfy principles of accountability and transparency in seeking to ensure that both fairness and efficiency concerns are satisfied.

The means for delivering the above desiderata may, accordingly, be to offer a range of devices (for example, security, retentions of title, trusts) but to set those devices up so that they are legally certain as well as identifiable and employable at minimal cost. The protections offered by insolvency law should also be designed to protect vulnerable parties who would bear insolvency risks inefficiently or unfairly if left unprotected.

How are the vulnerable to be identified? It can be repeated, first, that parties will not be vulnerable if they can (at reasonable cost) secure preferential positions in distributions or if they can (again at reasonable cost) adjust terms and loan rates to reflect risks borne. The Crown is able to position its tax levels in a manner that anticipates default rates – and this is a consideration that endorses the Enterprise Act 2002’s abolition of the Crown’s preferential status. Employees, in contrast, exemplify parties who are ill-positioned to adjust their credit rates to take account of default risks. Some traders may be unable to adjust rates because the time scales they work to are too short, the costs of information collection are too high or relevant data may be unavailable. Accepted commercial procedures within a trade may, moreover, make accurate risk assessment non-feasible.

Another sign of vulnerability – one also noted in chapter 14 – is a low capacity to absorb losses. The ability to spread risks increases a party’s capacity to withstand the consequences of default. The Crown, again,

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166 See ch. 2 above.
is well placed and can spread default risks across taxpayers who, in turn, are likely to be able to cope with marginal increases in tax rates without suffering catastrophic consequences. Resilient traders tend to be those whose businesses are not totally dependent on the viability of one particular debtor and who are involved in the supply of goods or services to a large number of customers. If one of their customers becomes insolvent they are less exposed to disaster than those trade creditors who deal with only one main customer. Most trade creditors are relatively protected in this respect, as are many tort victims. Employees, on the other hand, are seldom able to spread default risks and so are highly vulnerable. Tort creditors and consumer creditors, as has been seen, will tend to be lower-cost risk bearers than employees since they will usually have other sources of income, funds and products, and risks will be spread by such diversification.

Bearing in mind such issues of fairness to the vulnerable and efficiency, it is almost time to consider particular alternatives to pari passu but before doing so we should map out the limitations of the role that pari passu plays in the insolvency process.

The first such limitation is in the breadth of that role. It can be argued that by the time the pari passu principle comes into play many of the difficult insolvency law questions have been posed and answered. There is force in this point. The role of pari passu is defined and limited by the shape of exceptions and bypassing arrangements that insolvency law allows. As has been indicated, those exceptions and bypassing devices raise, in themselves, numerous issues of efficiency and fairness (not to mention expertise and accountability). To allow the use of such devices is not merely to reduce the role of pari passu, it introduces principles and priorities to override pari passu. When teachers say ‘The sweets will be distributed equally to all children in the class’ we see a single, clear principle of fairness. When they say ‘All red-haired children’s appetites will, however, be satisfied first and then equal distribution will take place’, the fairness of Animal Farm comes to mind.

Limitations of scope do not in themselves, however, constitute reasons for abandoning pari passu. Questions arise as to the acceptability of the overriding principles that qualify pari passu but it could still be argued

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170 Ibid. 171 Ibid.

172 For arguments that pari passu is less important than it is generally held out to be, see F. Oditah, ‘Assets and the Treatment of Claims in Insolvency’ (1992) 108 LQR 459 at 468–76; Mokal, ‘Priority as Pathology’; L. C. Ho, ‘Goode’s Swan Song to Corporate Insolvency Law’ (2006) 17 EBLR 1727; see also ch. 14 above.

that *pari passu* is the most appropriate method of redistributing residual assets and that other principles would, even in relation to the residual assets, produce significantly different (perhaps less acceptable) results for residual claimants.

If, however, the role of *pari passu* is seen in terms of ensuring that unsecured creditors are dealt with in an efficient and fair way, it should be noted that there are approaches to this issue that go beyond asking how the residual assets should be distributed and that these can be seen as further limitations on the importance of *pari passu*. Five such approaches can be noted. These look to protect unsecured creditors through:

- rethinking how the estate is constructed (for example, by considering priorities and deferrals);\(^\text{174}\)
- procedural protections (for example, improving transparency and disclosure through insolvency regimes);
- substantive protections (for example, augmenting the residual estate with the section 176A prescribed part fund or directors’ contribution through personal liability);
- reducing insolvency risks (for example, through training of directors, corporate governance improvements, educating traders in reasons for corporate collapse, encouraging banks and secured creditors to monitor);
- spreading insolvency risks: either across groups of companies;\(^\text{175}\) or through compensation schemes;\(^\text{176}\) or through insurance mechanisms.\(^\text{177}\)

If these alternatives are borne in mind it can be concluded that the role of *pari passu* is modest, given that issues concerning *pari passu* are linked to, and surrounded by, a host of not inconsiderable questions. This does not, however, mean that *pari passu* is of insignificant importance.

A second limitation of *pari passu*’s role is that it is not wholly clear. The principle can be said to be weak because it operates in a confused manner due to the multiplicity of potential exceptions and bypassing arrangements encountered in law and practice. The above discussion

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\(^{174}\) A class of creditor that might be dealt with specifically by statute is the company director: see ch. 14 above, pp. 613–14.

\(^{175}\) On insolvency issues raised by corporate groups see ch. 13 above.

\(^{176}\) As in the travel industry via ABTA: see p. 654 above.

suggests that there is scope for clarifying the rules governing exceptions and bypasses. Such clarification might be expected to reduce the costs incurred by parties seeking to protect themselves from insolvency risks but distributional consequences may flow: ordinary creditors who are still ill-placed to secure protections may be faced with a yet smaller residual estate as other parties take greater advantage of newly facilitated protections.

A number of questions are raised. A first issue is whether particular exceptions and bypasses are justifiable in themselves. This chapter and the last have explored a number of issues that arise on that front. A further matter, however, is whether, as a collectivity, the array of exceptions and bypasses involves too great a degree of confusion and too large a mass of uncertainty to offer efficiency and fairness. Viewed collectively, the question is whether a simpler, more rational and legally certain array of devices might be devised. If it is accepted that well-resourced, well-informed creditors will take any steps they think rational to protect themselves against the risks of insolvency, the challenge is to allow them to do this at lowest cost consistent with the fair treatment of other unsecured creditors: to achieve an acceptable balance of efficiency-serving and distributionally fair ends. At present, it could be argued, the worst of two worlds is achieved: the well-resourced expend too much money and time on protection and the poorly-resourced are left with too small a fund to draw from. Such reasoning suggests that a statutory clarification of the law relating to exceptions and bypasses would have much to offer provided that this reduced legal uncertainties and the costs of achieving protections while, at the same time, it provided adequate protections for those who cannot reasonably be expected to negotiate themselves into protected positions.

The final question for consideration in this chapter is whether the residual ordinary creditors who are left with a collectively ‘fair’ fund should be allocated shares in it _pari passu_ or by other principles of distribution. To return to the children in our Orwellian classroom, distribution to the pupils might be governed by a principle of evenness but alternatives could be argued for. Larger shares could, for instance, be given to well-behaved children; to those who lodge confectionery claims first; to those who shout loudest; to those who need sugar most; to those who fared badly in prior distributions; or to those who would create most trouble if not favoured.

Let us now turn to consider the main alternatives to _pari passu_ distribution of the residual estate.
Debts ranked chronologically

A first alternative to pari passu is to provide that debts be repaid from the residual estate with reference to the date of accrual on a first-come-first-served basis. Those with debts established at the earliest dates would, accordingly, be paid first. Such a regime might involve recording and disclosure mechanisms that would allow each creditor to assess the position before entrenching funds.

Such a regime would not, in itself, address the problems of exceptions and bypassing noted above and there might be efficiency costs. As a company entered troubled economic waters it would become progressively more difficult to raise funds since prospective creditors would know that, arriving ‘late’, they would rank low in the distributional order. The effect would be an increasing resort to security, quasi-security and trust devices, and transaction costs would accordingly rise. The newly strong incentive to avoid the estate would, in turn, create increased uncertainty for other prospective unsecured creditors because assessing their lending risks would demand ever more complex and time-consuming analyses of the estate-avoiding measures that have been used in relation to the company. This would involve not only inefficiency but unfairness to the most poorly placed unsecured creditors since the latter would be in no position to evaluate their loan risks.

Debts ranked ethically

It would be possible to pay unsecured creditors according to their, or society’s, needs, so that repayments would be organised on an ethical basis: say, in order to maximise the sum of human happiness.178

Such a utilitarian approach would be vulnerable to the standard criticisms of utilitarianism: how is happiness to be calculated and measured? Whose happiness counts? Does happiness achieved by unethical, even monstrous, means count?179 Even if the tenets of utilitarianism were

accepted, however, applying such an approach to insolvency would be difficult. There would be high levels of creditor uncertainty since predicting positions in the repayment queue would be nearly impossible (how does one unsecured creditor assess the likely advent of another unsecured creditor who is more worthy or needing of payment?). This would produce huge inefficiencies unless simpler, more predictable, more collectivist distributional rules were employed.\textsuperscript{180}

Ethical approaches to repayment, however, raise general issues of collectivity. If the individual position or worth of a creditor is taken into account in distributing the residual estate then that individual position – whether it is assessed according to utilitarian principles or corrective justice\textsuperscript{181} or other ethical principles – will be difficult to assess in advance and inefficiencies and unfairnesses would be caused by the inability of creditors to assess present and future risks. This is not to say that certain classes of creditor (for example, consumers, employees or other non-adjusting groups) might not merit special protections on ethical grounds. Reference to such classes in principles of estate distribution would be possible without the uncertainties involved in individual assessments and we see this approach already in the statutory treatment of preferential creditors. Questions arise, however, concerning the definition of such classes; the relative claims of different classes; the wide divergence of claims to deserve protection within the class membership; and the need to translate such ethical approaches into democratically endorsed policy form.

\textit{Debts ranked on size}

It might be argued that small creditors should be paid at a higher rate of return than those ordinary unsecured creditors who have loaned larger sums to troubled firms. (David Milman has suggested a £750 threshold below which such special treatment should be applicable.)\textsuperscript{182} The basis


for doing so would be that small creditors are more vulnerable and
deserve high levels of protection.

The problem with such a proposal is that it is difficult to correlate the
size of the loan with the vulnerability of the creditor. Small lenders, for
instance, may be better and more energetic risk spreaders than medium
or large lenders: their businesses may involve large numbers of small
loans rather than fewer loans of greater size. Small lenders may be able to
adjust their loan rates quite effectively because the market may offer a
range of deals and attendant risks. Small creditors may be more risk
resilient and lower-cost risk bearers than some larger creditors: where,
for example, the former’s financial eggs are not all in one basket, they
can absorb an insolvency loss fairly easily and there are no substantial
ripple effects flowing from the loss. Nor can it be assumed that small
creditors are necessarily less well informed, expert or strongly positioned
to negotiate than larger creditors. This may depend on the particular
market or organisational set-up involved, the relevant regulatory regime
or even the state of the economy.

Debts paid on policy grounds

If policy grounds underpin the placing of some creditors ahead of the
residual estate this is not so much an alternative way of residual estate
distribution as an alternative construction of the estate as a whole.
A genuine alternative to pari passu in relation to the residual estate
would involve paying different ordinary creditors at different rates.
One mooted candidate for special treatment is the consumer creditor.
It has been argued that this class of unsecured creditor might be entitled
to a higher rate of return as compared to trade creditors because the latter
‘should be more aware of the risks involved in extending credit to the
company’ and because ‘bad debt insurance is increasingly available to
trade creditors’. Consumer creditors, moreover, are said to suffer
disproportionately on the debtor’s insolvency.

It might be countered that the mooted special treatment would make
life more difficult for IPs, would increase transaction costs and should be
opposed on that basis. Such efficiency costs might be worth paying,
however, if more than compensated for by attendant improvements in
fairness. On these points, however, reference can be made to the last

183 Ibid. 184 Ibid., p. 78.
chapter’s discussion of preference for consumer creditors and, to recap, it could be said that many trade creditors are far more harshly affected by corporate insolvencies than the average consumer creditor: their livelihood may depend on payment, and some trade creditors may be less able to evaluate risks, adjust terms or insure against bad debts than some consumers. On such questions of creditor vulnerability much turns, again, on such matters as the type of transaction involved, the pattern of risk spreading, the mode of payment, the market traditions, the levels of competition in the sector, the quality of information on suppliers that is available and the rate of turnover of business in the sector. If one is really concerned with fairness, it could be said, attention should be paid not to consumers as a class but to protections for individual creditors who are ill-positioned to evaluate risks or sustain economic shocks. Here, though, proponents of change are in a difficult position. It is difficult to make a general class claim, and to take on board individual circumstances introduces the uncertainties and inefficiencies noted above in relation to ethical approaches.

Conclusions

Any discussion of pari passu has to bear in mind the link between issues of residual estate distribution and issues of estate construction as a whole. The import of the above discussion is that if fairness and efficiency are sought in the distribution of the residual estate, the case for a generally collective approach is a strong one. To take on board individual positions, vulnerabilities or ethical merits produces too great an accumulation of uncertainties and transaction costs to provide either fair or efficient processes.

It has also been argued above, however, that concerns for the fair and efficient treatment of creditors may be served by looking beyond questions of residue distribution. A blinkered focus on pari passu should, accordingly, be avoided. Not only is it relevant to look to questions of estate construction more generally but attention should also be paid to protections for ‘vulnerable’ risk bearers in the form of procedural requirements (of information provision and disclosure); to substantive protections of a general nature (such as a ‘prescribed part’ fund for ordinary unsecured creditors); to ways of reducing overall risks of insolvency (for example, by improvements in managerial standards and training); and to modes of lowering risks to the vulnerable by spreading insolvency risks. This spreading can be achieved, for instance, by
extending risks across corporate groups; by establishing compensation regimes and by relying on (or instituting and requiring) insurance provision.

_Pari passu_ plays a role in insolvency proceedings but this role is limited by the context described above. Improvements in the legal regime are possible, however. Exceptions and bypasses could be clarified and steps could be designed to limit the extent to which poorly placed creditors bear undue risks because of their inability to adjust terms in the light of assessable risks. One general improvement could be the infusion of greater transparency and more readily available information into insolvency processes (for example, by disclosure rules on ROT clauses). There seems no strong case, however, for major new allocations of preferential status.\(^{185}\) As for the contention that _pari passu_ is not the best way to distribute the residual estate, those alternatives to _pari passu_ that are based on assessments of the individual position or the merit of the creditor would be objectionable, as noted, on grounds of uncertainty, inefficiency and unfairness. Those based on new approaches to the definition of classes face problems of heterogeneity in class membership and of demonstrating why classes selected for new special rates of repayment have claims that are generally stronger than competing classes.

\(^{185}\) A minor new allocation might be claimants seeking restitution of unjust enrichments: see V. Finch and S. Worthington, ‘The _Pari Passu_ Principle and Ranking Restitutionary Claims’ in Rose, _Restitution and Insolvency_.

PART V

The impact of corporate insolvency
Directors in troubled times

The rules and processes that make up insolvency law operate as a set of incentives and constraints that influence how company directors behave at times of both good and bad corporate fortune. This chapter considers how those incentives and constraints operate and examines the assumptions and philosophies that underpin the role of the company director in insolvency law. The analysis offered here continues the approach set out in chapter 2 and asks whether current insolvency law deals with directors in a manner that renders directors appropriately accountable, makes the best use of directorial expertise, fosters efficiently produced outcomes and is consistent with the fair treatment of directors and parties affected by directorial behaviour. For the purposes of clarity of exposition, the issue of accountability will be considered first, since this involves a mapping out of the broad array of influences and constraints that insolvency law applies to directors – a mapping exercise that should provide a useful background to the discussions of expertise, efficiency and fairness that follow.

Accountability

Directorial accountability can operate through a variety of devices – which will be considered below – but the purposes to be served by such devices may also vary. Insolvency law, for instance, might set out to punish an errant director; to protect creditors at risk from directorial actions; or to compensate parties who have suffered losses at the hands of directors. Insolvency law, together with company law, may also seek to achieve a number of other ends such as raising standards of business conduct and entrepreneurship.

A search for the purposes underlying current corporate insolvency law controls over directors can begin with the Cork Report.¹ Cork emphasised that the function of insolvency law was not merely to distribute the

insolvency estate to creditors. Other objectives were to encourage debt recovery (and persuade debtors to pay or propose settlements of debts) and, through investigations and disciplinary actions, to meet ‘the demands of commercial morality’. Central here, then, was the notion that insolvency law and investigative processes would uncover assets concealed from creditors, ascertain the validity of creditors’ claims, and expose the circumstances surrounding the debtor’s failure. Anything less, said Cork, would be unacceptable in a trading community and would lead to ‘a lowering of business standards and an erosion of confidence in our insolvency law’. This was a matter not merely of punishing the errant, said Cork, but of exposing affairs to creditors and encouraging public scrutiny. Society had an interest in insolvency processes and attention, accordingly, needed to be paid to whether or not fault or blame attached to the conduct of the insolvent party, whether punishment was merited, whether the party should be restricted so as to prevent repetition of errant conduct and whether responsibility for the insolvency was attributable to someone other than the director. Cork, thus, emphasised the need for insolvency law to promote the ‘highest standards of business probity and competence’ and noted, in particular, the disquiet that was widespread in the commercial and practitioner communities concerning the lenient manner in which the law dealt with the directors of insolvent companies, which was often compared unfavourably with the law’s stricter approach to the individual bankrupt. Cork accepted that a fresh approach was justified, not least to deal with the dishonesty and malpractices of ‘fly by night’ operators and the losses imposed on ordinary unsophisticated creditors. That fresh approach was to be implemented through Cork’s proposals inter alia for a new concept of wrongful trading liability and broader powers for court disqualification of delinquent directors (with automatic exposure to personal liability for certain debts). These were proposals infused with rationales ranging from punishment to restitution;


3 Cork Report, para. 238.

4 Ibid., para. 239.

5 Ibid., para. 1735.

prevention to retribution. It should not be forgotten, however, that Cork saw proposals that were designed to impose stricter controls on directors as merely one aspect of a package of reforms that, amongst other things, aimed to facilitate rescues and to limit the losses that might result from directorial deficiencies or other misfortunes.

The statutory legacy of Cork will be dealt with below but it is worth noting, first, that recent years have seen a shift in emphasis away from Cork’s concerns both to redress the law’s lenient treatment of directors and to do something about ‘phoenix company’ problems. The Blair Government was marked by a stress on the virtues of entrepreneurship and risk taking as necessary components of wealth creation and the White Paper on Enterprise, Skill and Innovation of 2001 encapsulated this approach with its aims to ‘help create an ambitious business culture’ and proposals including ‘significantly relaxing insolvency rules so that honest businesses and individuals who go bankrupt have a better chance of starting again quicker while cracking down on the fraudulent and irresponsible’.

As for cracking down on ‘rogue’ directors, Companies House, in 1997, created a new website listing directors subject to disqualification orders. In 1998 a ‘hotline’ was set up to allow the public to report rogue directors to the Insolvency Service (IS) and, in 2006–7, the IS took 328 calls, of which 26 resulted in reports to the prosecution authority. In 2000, the Minister for Competition and Consumer Affairs, Dr Kim Howells,

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8 The ‘phoenix’ syndrome occurs when the activities of a failed company are continued by those responsible, using the vehicle of a new company, or where a director engages in serial corporate failure, leaving creditors stranded with those failures, and moves on to a new company while concealing past failures from the public. See S. Frith, ‘Acting as a Director of a Phoenix Company’ (2003) 16 Insolvency Intelligence 37; T. Carter, ‘The Phoenix Syndrome – The Personal Liability of Directors’ (2006) 19 Insolvency Intelligence 38.
12 Insolvency Service, Annual Report and Accounts 2006–7 (HC 752, London, 2007) p. 20. The figure for reports to prosecutors in 2005–6 was 135. Reports can be made online via
announced the setting up by the IS of a specialist team to investigate directors who asset-stripe companies which then become insolvent. The Forensic Insolvency Recovery Service (FIRS) was established as a team of private sector and Insolvency Service partners comprising lawyers, insolvency practitioners and enquiry agents. The team was given powers to take legal actions to recover assets from unfit directors where there had been suspected misappropriation, misfeasance or negligence. Dr Howells urged, in April 2001, that there should be ‘no hiding place’ for unscrupulous directors. Of further interest to creditors and IPs, who will often be concerned to trace assets which may have been moved illegally, is the Assets Recovery Agency (ARA), which was set up in 2003 as a non-prosecuting authority to carry out operational functions including the recovery of assets under the Proceeds of Crime Act 2002. It is also noteworthy that the ‘credit crisis’ of 2007–8, together with growing worries about fraudulent dealings and transfers, produced a new focus on the directorial management of assets near insolvency and the increasing propensity of major lenders and office holders to resort to the services of newly skilled consultants specialising in forensic accountancy.

What, then, are the mechanisms that insolvency law establishes for holding directors to account and controlling their behaviour? If the rules on disqualification are left out of consideration – for discussion later under the heading of expertise – accountability mechanisms can best be reviewed by focusing first on the array of rules that provide for directors’ liability and the associated issues of enforcement. Mention should then be made of the processes that are designed to control the activities of directors by providing that a company may be wound up in the public interest.

enforcement.hotline@insolvency.gsi.gov.uk. The Companies Act 2006 contains provisions increasing the powers to investigate companies: see e.g. CA 2006 Part 32, ss. 1035–9; Boyle and Birds’ Company Law (6th edn, Jordans, Bristol, 2007) pp. 531–4 and 719–30.


Common law duties

A starting point in examining directors’ liability is the set of common law duties that a director owes to a company. In general, a director cannot be made liable in insolvency for the obligations of his or her company.\textsuperscript{16} It has long been established, however, that a director owes a fiduciary duty to act bona fide in the best interests of the company\textsuperscript{17} and, in an insolvency, this duty may come into play. A liquidator, for instance, may mount a claim against the director personally where the director’s negligent conduct has diminished the insolvency estate.\textsuperscript{18}

A second set of issues surrounds the set of duties that directors owe to company creditors. These are usually underpinned by the arguments that, as a company approaches insolvency,\textsuperscript{19} the commercial risks involved fall increasingly on the company’s creditors rather than shareholders; that not all creditors will be well placed to protect themselves (by, for example, taking security, demanding guarantees, spreading risks, or costing such risks into their loan agreements); and that the directors of the company may, in the absence of legal controls, both breach the canons of commercial morality and take unreasonable, unfair and inefficient risks with the creditors’ money.\textsuperscript{20}


As for the nature and content of the duties, the Companies Act 2006, as will be discussed below, codifies the common law’s provision of directors’ duties in a statutory statement but in a manner that leaves the decisions of the courts of relevance with regard to duties to creditors. This is because the 2006 Act (section 170(4)) stipulates that its codified terms are to be applied in a like manner to the common law and equitable principles that predated the Act. Section 172(3) of the 2006 Act, moreover, states that the directors’ general duties to promote the success of the company (under section 172) have effect ‘subject to any enactment or rule of law requiring directors, in certain circumstances, to consider or act in the interests of creditors of the company’.

The courts, however, have taken divergent views on the nature, as well as the content, of the duty owed by directors to creditors. On one approach it is seen as an aspect of the traditional fiduciary duty of directors to act bona fide in the interests of the company, on another, it is viewed as an independent, positive duty owed directly to creditors and founded either on ordinary principles of directors’ duty of care or on tortious principles.

In favour of the idea that duties to creditors flow from the traditional fiduciary duty to act in the best interests of the company, there are a number of English court decisions that build on a series of Commonwealth cases. Notable among the latter is Walker v. Wimborne in which the Australian High Court spoke of ‘directors of a company in discharging their duty to the company [having to] take account of the interest of its shareholders and its creditors’ (Mason J). Similarly, in Nicholson v. Permakraft Cooke J, sitting in the New Zealand Court of Appeal, concluded obiter that directors’ duties to the company ‘may require them to consider inter alia the interests of

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21 See Re Smith and Fawcett Ltd [1942] Ch 304.
During the 1980s the English courts echoed this approach. In Lonrho v. Shell Petroleum Diplock LJ indicated that the ‘best interests of the company’ might not be exclusively those of shareholders ‘but may include those of creditors’. Buckley LJ in Re Horsley and Weight Ltd referred to the ‘loose’ terminology of ‘directors owing an indirect duty to creditors not to permit any unlawful reduction of capital to occur’ and stated that it was more accurate to say that directors ‘owe a duty to the company in this respect’. In both the Court of Appeal and the House of Lords decisions in Brady v. Brady it was indicated (by Nourse LJ and Lord Oliver) that directors needed to consider creditors’ interests if they were to act in the interests of the company.

Contrasting with this approach are dicta suggesting that there is a direct and specific duty that is owed to creditors. Thus, in Winkworth v. Edward Baron Developments Co. Ltd Lord Templeman stated: ‘A duty is owed by the directors of the company and to the creditors of the company to ensure that the affairs of the company are properly administered and that its property is not dissipated or exploited for the benefit of directors themselves to the prejudice of creditors.’ His Lordship’s distinction between the company and the creditors here implied the notion of a specific duty to the latter.

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29 For an attack on the view that fiduciary duties should shift to creditors when the company is in financial distress see J. Lipson, ‘Directors’ Duties to Creditors: Power Imbalance and the Financially Distressed Corporation’ (2003) 50 UCLA L Rev. 1189 (arguing for advertising to power imbalances expressed as disparities of volition, cognition and exit when considering who should benefit from directors’ duties). For opposition to the shift towards duties owed to creditors at any stage before a formal filing see H. Hu and J. Westbrook, ‘Abolition of the Corporate Duty to Creditors’ (2007) 107 Columbia Law Review 1321.
30 [1987] 1 All ER 114. 31 Ibid., at 118.
32 See also Hooker Investments Pty Ltd v. Email Ltd (1986) 10 ACLR 443. If a direct duty to creditors were to be recognised routinely by the courts (which, as noted below, seems unlikely) then the question as to the nature of that duty would arise. Is the duty, for example, to be seen as an extension of the directors’ traditional duty of care or is it to be seen as one grounded in tortious principles? See further Finch, ‘Creditors’ Interests and Directors’ Obligations’.
The most recent indications are, however, that the courts are unwilling to recognise a duty owed directly to creditors and, indeed, academic opinion now seems to accept that the duty is an indirect one. In the *Yukong* case Toulson J considered *West Mercia* and stated that where a director acted in breach of his duty to the company by causing assets of the company to be transferred in disregard of the interests of its creditor or creditors, he was answerable through the scheme Parliament had provided in the Insolvency Act 1986 section 212 (misfeasance or breach of fiduciary or other duty) but ‘he does not owe a direct fiduciary duty towards an individual creditor nor is an individual creditor entitled to sue for breach of the fiduciary duty owed by the director to the company’.

To view duties to creditors as part of the traditional duty to act *bona fide* in the company’s interests is, however, not without problems. Are creditors’ interests to be considered independently or merely in so far as they are relevant to the company’s interests? Are creditors’ interests to be part of a package of claims (i.e. including those of shareholders and employees), in which case how will directors proceed if these constituent company interests conflict?


35 *West Mercia Safetywear Ltd v. Dodd* [1988] 4 BCC 30. In *West Mercia* it was noted that shareholders are replaced by creditors on insolvency as residual claimants, thus implying that the company’s interests are now represented by the creditors’ interests.

36 *Yukong Lines Ltd of Korea v. Rendsburg Investments Corporation* [1998] BCC 870 at 884. As Toulson J indicated, enforcement of the duty can be effected through s. 212 of the Insolvency Act 1986 – a summary remedy which applies if, in the course of winding up, it appears that an officer of the company (s. 212(1)(a)) has been guilty of any misfeasance or *breach of any fiduciary duty* or other duty in relation to the company: see further below.

Creditors’ interests to be assessed subjectively or objectively? Subjectivity may be consistent with principle but would pose problems of accountability and an objective approach could draw the judges into assessment of directors’ business decisions. The judges have yet to resolve these questions, but, as noted above, the weight of argument does currently favour treating the duty to creditors as part of the duty to act in the interests of the company.

The beneficiaries of the duty

Judges have tended to speak of creditors as a homogeneous group but have failed to state clearly whether directors owe a duty to creditors generally, to individual creditors, or to a class of creditors. Attempts have been made to distinguish the interests of existing creditors from those of future creditors but, even in this endeavour, inconsistent approaches are to be encountered. Thus, in Nicholson v. Permakraft Cooke J indicated that future creditors might normally be expected to ‘take the company as it is’ and guard their own interests, whereas in

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38 See Re Smith and Fawcett [1942] Ch 304: the duty is to act bona fide in what the director considers, not what the court considers, is in the company’s interests (per Lord Greene). See also Regentcrest plc (in liquidation) v. Cohen [2001] BCC 494, where Jonathan Parker J, in dismissing a claim brought by liquidators against a director for breach of his fiduciary duty to act bona fide in the best interest of the company, stated the duty was to be judged on a subjective basis; if the director ‘honestly believed that he was acting in the best interests of the company’ he was not in breach.

39 How could creditors ever be secure in the knowledge that consideration of their interests was ever more than lip service? See Sealy, ‘Directors’ “Wider” Responsibilities’.


41 See e.g. Yukong Lines Ltd of Korea v. Rendsburg Investments Corporation [1998] BCC 870. As noted above, enforcement of the duty can thus be effected through s. 212 of the Insolvency Act 1986 – a summary remedy which applies if, in the course of winding up, it appears that an officer of the company has been guilty of any misfeasance or breach of any fiduciary duty or other duty in relation to the company. As for the proceeds of actions for breaches of duties to creditors, a weakness of the law here is that these will not go primarily to the unsecured creditors (who are the parties most in need of protection) but, since the company will be in liquidation, such proceeds will be caught by any security interests the company has granted: see Davies, ‘Directors’ Creditor-regarding Duties’.

42 For an argument that approaches to directors’ duties to creditors fail sufficiently to take account of the divergent positions of creditors, see Lipson, ‘Directors’ Duties to Creditors’.

Winkworth v. Edward Baron 44 Lord Templeman urged that ‘duties were owed to creditors present and future to keep its property inviolate and available for the payment of debts’.

As for existing creditors, these may possess highly conflicting interests: the unsecured trade creditor is in a quite different position from the bank with a floating charge over the company’s property. The courts have yet to offer clear guidance to the director who has to choose between such competing interests 45 and an undifferentiated approach may reduce the force of such a duty quite considerably: ‘Where duties are owed to persons with potentially opposed interests, the duty bifurcates and fragments so that it amounts ultimately to no more than a vague obligation to be fair … If the law does this it abandons all effective control over the decision maker.’ 46

In Re Pantone 485 Ltd 47 it was stated that ‘the creditors’ meant the creditors as a whole, i.e. the general creditors. Consequently, if directors acted consistently with the interests of the general creditors but inconsistently with the interest of a creditor or a section of creditors with special rights in a winding up then the directors would not be in breach of their duty. 48 Distinguishing between classes of creditor seems necessary, however, if nothing else, for the purposes of rendering duties potentially effective. If unsecured creditors are to be protected, the judges will have to construe the duty as owed to them either individually or as a specific class and the latter approach would seem more consistent with the notion of bankruptcy as a collective procedure concerned with pari passu distribution according to pre-bankruptcy entitlements. 49

45 For example, directors may have to choose between using remaining assets to pay off preferential creditors or continuing trading in the hope of benefiting unsecured creditors. (Of course, choosing to trade on for the benefit of unsecured creditors rather than immediately paying preferential debts is not necessarily improper: see Re CU Fittings Ltd [1989] 5 BCC 210 (a disqualification case, noted in V. Finch, ‘Disqualification of Directors: A Plea for Competence’ (1990) 53 MLR 385).)
48 Ibid., 286–7 (Richard Field QC). McKenzie Skene notes that this still leaves questions unanswered, e.g. what is meant by ‘general creditors’ and ‘creditors with special rights in a winding up’; see ‘Directors’ Duty to the Creditors of a Financially Distressed Company’.
49 To give unsecured creditors a class action would guide directors rather than leave them to attempt to be fair ‘to all creditors’ and would not seem prejudicial to secured creditors who would be able to realise their security or appoint a receiver to act on their behalf. Furthermore such an approach could align with the view that directors owe their duty to the company’s residual owners, who stand to lose the most in corporate insolvency, the unsecured creditors.
A further issue that the courts have yet to resolve concerns the exclusivity of the attention that directors should give to creditor interests when those interests fall to be considered.\(^{50}\) In the case of *Whalley v. Doney*\(^ {51}\) Park J said that, at the pre-insolvency stage of financial difficulties, the duties owed to the company extended to encompass the interests of the creditors as a whole as well as those of a shareholder.\(^ {52}\) It is noteworthy here that *Whalley* talks of creditor interests joining those of the shareholder. Some authorities, however, come close to making creditor interests an exclusive focus – at least at the stage when insolvency is questionable or imminent. Thus, in *Brady v. Brady*,\(^ {53}\) Nourse LJ, in the Court of Appeal, indicated that after the advent of insolvency (or doubtful insolvency) the interests of the company ‘are in reality the interests of existing creditors alone’.\(^ {54}\) This implies that the directors have a duty to pursue the advantage of creditors, an approach consistent with the comments of Street CJ in *Kinsela*\(^ {55}\) to the effect that in an insolvent company it is the creditors’ and not the shareholders’ assets that are under the management of the directors.\(^ {56}\) More recently, in the *Colin Gwyer* case,\(^ {57}\) it was emphasised that, where the company was on the verge of insolvency, the interests of the creditors must be considered *paramount*.\(^ {58}\)

A contrasting approach allows directors to act post-insolvency in the interests of the company as a whole, provided that actions do not prejudice creditors. Thus, in *Re Welfab Engineers Ltd*,\(^ {59}\) Hoffmann J considered the position where a company was insolvent but had not been placed in the hands of a receiver. He stated that although the directors were not, at such a stage, entitled to act in a manner leaving the creditors in a worse position than on a liquidation, they had not failed in their duty to the company when they had borne in mind the effect on employees of different courses of action.\(^ {60}\)

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51 [2004] BPIR 75.
54 Ibid., p. 552. This appears unaffected by the House of Lords’ decision in *Brady* and indeed is impliedly accepted by Lord Oliver: see [1988] 2 All ER 617 at 632.
58 See also *Re Pantone 485 Ltd* [2002] 1 BCLC 266. 59 [1990] BCC 600.
60 See Grantham, ‘Directors’ Duties and Insolvent Companies’, p. 578: ‘the importance of *Welfab* lies in Hoffmann J’s affirmation that, while they should not be exploited, so long
A way to resolve such tensions is to read dicta in *Brady* and *Kinsela* as being concerned with the reorientation of focus from shareholder to creditor interests that occurs around the point of insolvency rather than being concerned to address the issue of exclusivity of interest. The judges could endorse *Welfab* and stress that creditor interests fall to be considered on insolvency (or doubtful insolvency) but that such interests do not have to be the exclusive concerns of directors. Just as directors are entitled to look beyond shareholder interests before insolvency\(^\text{61}\) they should be given a degree of flexibility in relation to the interests of the creditors, who, on insolvency, have stepped into the shoes of the shareholders.

**When does the duty arise?**

Even if it is accepted that the duty to creditors flows from the traditional duty to act in the company’s interests, the courts have been tentative in stating when creditors’ interests fall to be considered by directors as part of those company interests. Three positions on the issue can be distinguished:

(a) When a company becomes insolvent the interests of creditors are company interests.

(b) Creditors’ interests transform into company interests as the company approaches insolvency or when insolvency is threatened.

(c) The interests of the company include those of creditors and directors should bear in mind creditors’ interests at all times.

The judges have hovered, sometimes uneasily, between these three positions. In support of position (a) is the *West Mercia*\(^\text{62}\) decision of the Court of Appeal in which a director effected a fraudulent preference and was found to be guilty of a breach of duty (the director had, for his own purposes, made a transfer between accounts in disregard of the interests of the general creditors of the insolvent company). *West Mercia* indicated that where a company is insolvent, a director’s duty to act in the best interests of the company includes a duty to protect the interests of the company’s creditors. Dillon LJ noted with approval Street CJ’s statement in the Australian case of *Kinsela v. Russell Kinsela Property Ltd*:\(^\text{63}\)

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In a solvent company the proprietary interests of the shareholders entitle them as a general body to be regarded as the company when questions of the duty of directors arise … But where a company is insolvent the interests of creditors intrude. They become prospectively entitled, through the mechanism of liquidation, to displace the power of the shareholders and directors to deal with the company’s assets.

Whether insolvency is a precondition of creditor interests being subsumed within company interests is, however, a matter not beyond doubt. A number of cases extend the principle to incipient insolvency or even threatened insolvency. Thus the Court of Appeal in Re Horsley and Weight Ltd\(^{64}\) stated that insolvency, or near insolvency, was a precondition, and a similar stance appeared to be taken by the New Zealand Court of Appeal in Nicholson v. Permakraft.\(^{65}\) In Nicholson the company was solvent at the relevant time but Cooke J considered situations in which directors should consider creditors’ interests. These included circumstances of insolvency or near insolvency or doubtful insolvency or if the ‘contemplated payment or other course of action could jeopardise its solvency’. Such reasoning may accord to some extent with position (b) and the idea that creditor interests fall to be considered in so far as insolvency looms. This is echoed in, for example, Nourse LJ’s dicta in Brady v. Brady\(^{66}\) where His Lordship considered the meaning of ‘given in good faith in the interest of the company’ in section 153 of the Companies Act 1985\(^{67}\) and stated that where the company is insolvent or even doubtfully solvent, the interests of the company are in reality the interests of the existing creditors alone. In Whalley v. Doney\(^{68}\) Park J urged that a company did not have to be insolvent for a director to have breached his duties to the company by being motivated only by the interests of shareholders and employees. In Whalley there was a pre-liquidation sale to an entity in which the principal shareholder and director was a participant and the liquidator argued that the price represented an undervaluation. The judge found for the liquidator on a misfeasance claim and said that the company might have a good claim.

\(^{64}\)[1982] 3 All ER 1045.

\(^{65}\)[1985] 1 NZLR 242. See also Grove v. Flavel (1986) 4 ACLC 654, where the court rejected the argument that there was a general duty owed by directors to protect creditors’ interests irrespective of the company’s financial position.

\(^{66}\)See [1989] 3 BCC 535 at 552.

\(^{67}\)Nourse LJ assumed that the words in the (then) Companies Act 1985 s. 153(1)(b) had the same meaning in that context as when considering directors’ fiduciary duties.

\(^{68}\)[2004] BPIR 75. See also Re Cityspan Ltd [2008] BCC 60.
against a director when the company ‘whether technically insolvent or not, is in financial difficulties to the extent that its creditors are at risk’.69

Certain cases go further, however, and adopt a stance close to position (c) by suggesting that insolvency per se is no precondition to consideration of creditors’ interests. In the High Court of Australia in Walker v. Wimborne70 Mason J indicated that creditors’ interests should be considered even before insolvency because ‘those interests may be prejudiced by the movement of funds between companies in the event that the companies become insolvent’. Thus, creditors’ interests could always be relevant given the theoretical possibility of future insolvency.71 Nicholson v. Permakraft72 is not far short of this position in referring to circumstances in which a contemplated payment or other course of action might jeopardise solvency. There are dicta, moreover, in two House of Lords decisions in which duties to creditors are mooted and the issue of insolvency is not even referred to.73

The courts have thus adopted a variety of positions on directors’ duties to creditors74 but, post-Gwyer75 and Whalley,76 there does seem to be a shift by the English judiciary towards position (b) above. The West Mercia and Gwyer cases, however, did not address the issue of whether the directors’ state of appreciation of the company’s solvency was to be judged objectively or subjectively.77

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69 See Hopkins, ‘A Company’s Interests – A Question of Balance’. See also Colin Gwyer & Associates Ltd v. London Wharf (Limehouse) Ltd [2003] 2 BCLC 153, [2003] BCC 885, where the deputy judge expressed the principle as follows: ‘where a company is insolvent or of doubtful solvency or on the verge of insolvency and it is the creditors’ money that is at risk, the directors, when carrying out their duty to the company, must consider the interests of the creditors as paramount and take those into account when exercising their discretion’.


73 In Lonrho v. Shell Petroleum [1980] 1 WLR 627, Lord Diplock, when speaking of the best interests of the company not necessarily being those of shareholders alone but possibly including those of creditors, made no mention of solvency or insolvency. Neither did Lord Templeman in Winkworth v. Edward Baron Developments Co. Ltd [1986] 1 WLR 1512, when he was speaking of the duty apparently directly owed to creditors.

74 Per Giles JA in Linton v. Telnet Pty Ltd (1999) 30 ACSR 465 at 473: there is significant difficulty in deciding when directors should have regard to creditors’ interests and it depends on the particular facts.


77 In Whalley v. Doney, ibid., Park J seems, indeed, to adhere to both assessments: ‘whether IM Ltd was technically insolvent before the transaction or not (and in my view it was anyway) it was on any view in a dangerous financial position, and Mr Doney knew it’ (emphasis added).
On the ‘prospect of insolvency’ issue, the Cork Committee\textsuperscript{78} acknowledged that although insolvency arises at the moment when debts have not been met as they fall due, ‘the moment is often difficult to pinpoint precisely’. It is often extremely hard to identify when the value of a business starts to fall below the level needed to pay creditors in full. Even on valuations, there are divergent approaches. Thus, the distressed sale value of assets will be very low but the ‘enterprise valuation’ will be high (though very subjective) and there will be numbers of potential valuations between these extremes.\textsuperscript{79} The English courts, nevertheless, would not be without guidance in seeking to devise a legal test. Cooke J in \textit{Nicholson} suggested that, although balance sheet solvency and the ability to pay capital dividends were important in assessing any actions taken, nevertheless:

\begin{quote}
\textbf{as a matter of business ethics it is proper for directors to consider also whether what they will do will prejudice the company’s practical ability to discharge promptly debts owed to current and likely continuing trade creditors … because if the company’s financial position is precarious the futures of such suppliers may be so linked with those of the company as to bring them within the reasonable scope of the directors’ duty.}\textsuperscript{80}
\end{quote}

An alternative approach to definition might be derived from the statutory criteria of the Insolvency Act 1986: for example, the definition of inability to pay debts found in section 123(2) which, \textit{inter alia}, adopts the liabilities test and the strict balance sheet approach of total assets exceeding total liabilities, ‘taking into account contingent and prospective liabilities’. Section 123(1)(e), on the other hand, provides a cash flow test by which a company is deemed unable to pay its debts ‘if it is proved to the satisfaction of the court that the company is unable to pay its debts as they fall due’.\textsuperscript{81}

As for the test to be applied regarding the director’s state of appreciation of the company’s solvency, different approaches, again, might be taken. Templeman LJ took an objective approach in \textit{Horsley and Weight} in stating that if expenditure threatens the existence of the company ‘the directors ought to have known the facts’.\textsuperscript{82} In contrast, it can be argued that the subjective approach is appropriate in all cases involving the

general fiduciary duty of directors to act in good faith in the interest of the company. Thus Jonathan Parker J has stated that this duty is satisfied where the director does what he honestly believes to be in the company’s best interest.83

One reason for moving to greater objectivity, however, is the argument that creditors’ interests warrant greater protection than can be offered by a subjective test. After all, it can be contended, if creditors’ interests only enter the scene when solvency is at issue and if creditors are disadvantaged vis-à-vis shareholders in so far as they are likely to have less information as to the company’s solvency, then a director’s appreciation of whether a transaction will prejudice the creditors further should be measured against an objective benchmark. Such reasoning favours the approach adopted in the wrongful trading provisions of the Insolvency Act 1986 section 214.84 According to this approach, directors should be expected to exhibit the same degree of appreciation of their company’s viability as would reasonably be expected of a diligent person exercising their functions in the company. A standard of performance is demanded, accordingly, which is consistent with the idea of a minimum level of competence.85 Directors, on this view, would be bound to give good faith consideration to creditors’ interests from the moment they know or ought to have concluded that the company’s solvency is at the very least doubtful.

To summarise, then, the judges have yet to state consistently when the duty arises or what state of mind or knowledge renders the director potentially liable. Directors seeking guidance on the former issue have


84 See Insolvency Act 1986 s. 214(4)(a). On s. 214, however, and problems of inconsistency of judicial approach, see pp. 698–703 below.

to rely on a confusion of dicta and statutory tests. Judges may inevitably have to exercise discretion in assessing the point of doubtful solvency in particular contexts but more coherent structuring of that discretion is necessary if directors and creditors are to know where they stand.

An Institute of Directors survey of members was published in 1999 and revealed that there was widespread uncertainty in UK boardrooms over directors’ obligations to consider the interests of different groups of stakeholders when considering corporate actions. Three-quarters of respondents thought that directors’ duties were difficult to understand; over half thought that they had to account to creditors and employees; a quarter thought the same of customers and suppliers, and 87 per cent believed that the law needed to be clarified if directors were to understand their obligations.

In 2001, the Company Law Review Steering Group considered the case for a statutory statement of directors’ duties to creditors in a situation where the company is insolvent or threatened by insolvency. The CLRSG’s consultations led it close to the view that such a statement was needed. As for the director’s obligations at the pre-insolvency stage of corporate decline, the CLRSG draft stated that what is reasonable must be decided in good faith, giving more or less weight to the need to reduce risk as the risk is more or less severe. In deciding how to promote the success of the company for the benefit of its members as a whole the director must take account, in good faith, of all the material factors that it is practicable in the circumstances for him to identify (which includes the need to achieve outcomes that are fair between members).

When the Companies Act 2006 codified directors’ duties, it did not adopt such a risk-based approach, however, and there are reasons why this kind of formulation might be resisted. Such an approach could produce dangers that directors will act excessively cautiously, fail to take reasonable risks and flee from companies at the first signs of trouble. What the 2006 Act did do was set down a statutory statement

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86 News Digest, (1999) 20 Co. Law. 302. 87 On employees, see ch. 17 below.
89 The initial draft statement had not advocated such a statement of a special duty to creditors: see CLRSG, Developing the Framework, paras. 3.72–3.73.
91 The CLRSG was aware of these issues: see ibid., p. 44. For the progression of policy towards the Companies Act 2006 see the White Papers Modernising Company Law (Cm 5553, 2002) and Company Law Reform (Cm 6456, 2005).
of directorial duties but leave directors’ duties to creditors to be governed by an uneasy combination of statute and common law.

**Statutory duties and liabilities**

**General duties**

The Companies Act 2006 offered the first statutory formulation of directors’ duties and these are set out in sections 170–7. (These duties are separate from the company directors’ disqualification legislation.) Section 170 states that the statutory provisions replace the duties of directors at common law and equity but section 170(4) provides that the general duties shall be interpreted and applied in the same way as common law rules or equitable principles and that: ‘regard shall be had to the corresponding common law rules and equitable principles in interpreting those general duties’. The specific duties are: to act within powers (section 171); to promote the success of the company (section 172); to exercise independent judgement (section 173); to exercise reasonable care, skill and diligence (section 174),


94 As noted above, the s. 174 duty is akin to that of s. 214 of the Insolvency Act in its objective expectation of the reasonably diligent person possessing the general skill and experience of a person carrying out the functions of the company director in that company, and is consistent with the common law: see *Re D’Jan of London Ltd* [1993] BCC 646.

95 A statutory derivative action under s. 260 of the Companies Act 2006 allows a member of the company to proceed against a director for a breach of duty or trust or an act or omission involving negligence or default: see G. Pendell, ‘Derivative Claims: A Practical Guide’ (2007) 20 Sweet & Maxwell’s Company Law Newsletter 1. See also A. Keay, ‘Can Derivative Proceedings be Commenced when a Company is in Liquidation?’ (2008) 21 Insolvency Intelligence 49.
For insolvency lawyers, section 172 is of special interest.\textsuperscript{96} It applies a highly subjective standard in demanding that directors act in the way they consider, in good faith, will be most likely to promote the success of the company for the benefit of the members as a whole. They must, in doing so, have regard to (\textit{inter alia}): the interests of employees; the need to foster the company’s business relationships with suppliers, customers and others; and the impact of the company’s operations on the community and the environment (section 172(1)). (It may be presumed that ‘suppliers, customers and others’ in section 172(1)(c) includes creditors.)

Regard must, furthermore, be had to the need to act fairly as between members of the company. With respect to creditors, section 172(3), as noted above, states that the section 172 duty has effect ‘subject to any enactment or rule of law requiring directors, in certain circumstances, to consider or act in the interests of creditors of the company’.\textsuperscript{97} The legal effect, accordingly, is that common law duties are not negated and directors will continue to have an overriding duty to consider or act in the interests of creditors if the company is insolvent or on the verge of insolvency.\textsuperscript{98} The Act thus appears to accept the ‘common law principle of husbandry adopted by the Court of Appeal in \textit{West Mercia Safetywear}'.\textsuperscript{99} What the 2006 Act does not do is provide clarity on when the section 172 duty (to have regard to the list of considerations listed therein) gives way to the established duties to consider or act in the interests of the creditors. As noted, it is often extremely difficult, in practice, to identify the point at which the value of a business falls below the level needed to pay the creditors in full – and the law is not user-friendly in setting out the directors’ obligations at a given time. On the one hand, judicial decisions create a ‘zone of uncertainty’ in which creditor interests have to be taken into account as the company approaches insolvency and, on the other, the troubled director will be attuned to his or her obligation to observe the section 172 duties.\textsuperscript{100} For

\textsuperscript{96} See Keay, ‘Section 172(1) of the Companies Act 2006’.
\textsuperscript{97} The Explanatory Notes to the 2006 Act (para. 332) indicate that s. 172(3) will ‘leave the law to develop in this area’.
\textsuperscript{98} The other sections of the 2006 Act do not contain a similar provision and so all other duties would appear to apply regardless of the company’s solvency.
\textsuperscript{99} Milman, ‘Directors and the Transition to the New Regime’.
\textsuperscript{100} See Baird, ‘Legal Update’, p. 11: ‘The problem being that, if a company is not in the “zone of uncertainty”, it becomes much easier for a director to say that he must “have regard to” things that are contained in s. 172 … Lawyers will have a great deal more to do to make it clear that the “have regard to” matters … must not be allowed to distract directors from doing the right thing when the company’s solvency is in question.’
the courts and legal observers, a residual question is whether the section 172 duties will impact on current approaches to the reorientation of duties as companies approach insolvency.

**Fraudulent trading**

Turning to statutory provisions creating personal liability, directors may be liable to compensate creditors where they have been party to fraudulent trading by the company. Section 213 of the Insolvency Act 1986 provides:

(1) If in the course of the winding up of the company it appears that any business of the company has been carried on with intent to defraud creditors of the company, or creditors of any other person, or for any fraudulent purpose, the following has effect.

(2) The court, on the application of the liquidator, may declare that any persons who were knowingly parties to the carrying on of the business in the manner above mentioned are liable to make such contributions (if any) to the company assets as the court thinks proper.

The purpose of this provision is to compensate rather than to punish. Thus it has been said that there must be a connection between the losses caused by the fraudulent trading and the quantum of compensation and that the court has no power under section 213 to impose a punitive element in the compensation order made.\(^{101}\) The section has a long history and, indeed, was introduced particularly to protect unsecured creditors from the abuse of ‘filling up’ floating charges.\(^ {102}\) Now, however, it is recognised\(^ {103}\) that the aim of fraudulent trading provisions – to discourage directors from carrying on business at the expense of creditors – is severely restricted by the requirement of dishonest intent\(^ {104}\) and

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\(^{101}\) *Morphitis v. Bernasconi* [2003] Ch 552, [2003] BCC 540 (a contrast with cases under the prior legislation: see e.g. *Re Cyona Distributors Ltd* [1967] Ch 889). In *Morphitis* it was stated that the provision catering for punishment was (the then) s. 458 of the Companies Act 1985 which made fraudulent trading a criminal offence. On the nexus between losses and compensation amounts *Morphitis* has been followed by *Morris v. Bank of India* [2005] BCC 739.

\(^{102}\) A process whereby directors lent money secured by floating charges to their asset-less companies, bought stock on credit which became subject to the floating charges, then appointed receivers who sold off the stock to satisfy the directors’ charges, leaving the creditors ‘whistling’. Now, however, the company would have to be kept afloat for two years to avoid the operation of the Insolvency Act 1986 s. 245: see ch. 13 above.

\(^{103}\) See Cork Report, p. 398.

\(^{104}\) In the subjective sense: ‘actual dishonesty … real moral blame’ per Maugham J in *Re Patrick and Lyon Ltd* [1933] Ch 786 at 790. Maugham J noted that the provision was ‘by
the courts’ insistence on strict standards of pleading and proof. Such an approach may be understandable for criminal liability under section 993 of the Companies Act 2006, but its imposition on the civil liability provided for in section 213 of the 1986 Act has led to the latter section’s virtual obsolescence. This obsolescence is now even more apparent with the advent of section 214, the ‘wrongful trading’ provision. What is more, the Court of Appeal appears to have adopted a concept of intention for the purposes of section 213 that is even harder to demonstrate than would be the case in the criminal law. In criminal law it is established by the House of Lords that a person ‘intends’ the consequences of an action that are foreseen as virtually certain – and that whether those consequences were desired or were the main motive for the action is irrelevant. In the Court of Appeal case of Morphitis v. Bernasconi however, Chadwick LJ did not treat the phrase ‘with intent to defraud’ as a composite whole, finding that fraud alone is not sufficient to ground liability and defining the word ‘intent’ in isolation. Thus, according to Chadwick LJ, there had been no ‘intent to defraud’ since the aim or objective underlying the company’s (TMC (1)) trading was to protect the directors from liability under section 216 of the Insolvency Act rather than to defraud creditors or in particular the landlord. It would, however, have been equally possible to recognise that the purpose behind the scheme was to enable TMC (1) to divest itself of onerous leasehold premises while simultaneously protecting the TMC brand or, alternatively, as an attempt to minimise rent payments while forestalling the

105 Ian Fletcher has noted the degree of uncertainty ‘whether civil or criminal proceedings for fraudulent trading will prove to be successful in any given case’: The Law of Insolvency (3rd edn, Sweet & Maxwell, London, 2002) p. 706.

106 Section 214, according to the marginal note, is concerned with ‘wrongful trading’, but it is notable that the word ‘trading’ is not used in the text of the Act: see further L. S. Sealy and D. Milman, Annotated Guide to the Insolvency Legislation (10th edn, Thomson/Sweet & Maxwell, London, 2007) vol. I, p. 233.


issue of a writ. Whether the ruling in *Morphitis v. Bernasconi* will survive scrutiny should the House of Lords consider this matter in the future may be doubtful since, as one commentator has said: ‘the test of oblique intention … in *Morphitis* is wholly out of step with contemporary thinking on the issue in criminal law cases proper’.110

As for the criminal offence of fraudulent trading, this was formerly set out in section 458 of the Companies Act 1985 and is now provided for in section 993 of the Companies Act 2006. This has been called ‘a valuable weapon in countering crime’.111 Problems of under-deterrence, however, prompted the CLRSG to propose, in 2001, that the penalty for the offence should be raised to a level comparable with that for deception under the Theft Act. In due course, the Fraud Act 2006 section 10 increased the maximum penalty under section 993 of the Companies Act 2006 to ten years on indictment and section 9 of the Fraud Act 2006 provided for a similar offence to apply to sole traders who would otherwise be beyond the scope of section 993.

Wrongful trading

Section 214 of the Insolvency Act 1986 owes its birthright to the Cork Committee,112 and, as stated previously, was the White Paper’s great hope for the unsecured creditor.113 In terms of increasing directors’ duties to unsecured creditors, section 214 provides that where a company is in liquidation, a liquidator can apply to the court to have a person who is or has been a director declared personally liable to make such contribution to the company’s assets as the court thinks proper. The liquidator must establish that, at some time before the commencement of the winding up of the company, that person knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation and that the respondent was either a director or a shadow director114 of the company at that time. Here it is noteworthy that

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109 A. Savarimuthu, ‘*Morphitis in the Court of Appeal*’ (2005) 26 Co. Law. 245 at 248.
110 Ibid.
111 See CLRSG, *Final Report*, 2001, para. 15.7. The CLRSG recommended that the offence should be extended to companies incorporated overseas and trading in the UK and to individuals and partnerships. For an equivalent to the Companies Act 2006 s. 993 that is of relevance to sole traders, see the Fraud Act 2006 s. 4.
112 Cork Report, ch. 44.
114 That is, a person in accordance with whose instructions the directors of the company are accustomed to act. On shadow directors see Insolvency Act 1986 s. 251; Company Directors’ Disqualification Act 1986 s. 22(5); Companies Act 2006 s. 251(2); pp. 720–1 below.
a point may arise, during a cumulation of failures to produce funds, when directors must realise that insolvency is unavoidable. Thus, in Rubin v. Gunner and Another, the court found directors to be liable for wrongfully trading after the date at which they ought to have concluded that promised funds would not be forthcoming from an investor who had given numerous assurances but had repeatedly failed to produce the moneys needed to avoid insolvent liquidation. From the said date, said the court, the directors should have concluded that there was no reasonable prospect of the company avoiding going into insolvent liquidation.

A defence is, however, available if the respondent director shows that, having reached the state of knowledge referred to, he took every step with a view to minimising potential loss to the company’s creditors that he ought to have taken (section 214(3)). Here there is a movement away from the subjective test of skill and care applied to directors in the common law cases such as Re City Equitable Fire Insurance Co. Under section 214, a director is judged not only by the knowledge, skill and experience that he actually has (section 214(4)(b)) but also by the ‘general knowledge, skill and experience that may reasonably be expected of a person carrying out the same functions’ (section 214(4)(a)). A director can, therefore, under this limb be judged by standards of the ‘reasonable director’ even though he may be well below those standards himself.

115 See also Katz and Mumford, Making Creditor Protection Effective, part 5, who, in discussing what form of evidence is needed to establish that ‘a director knew or ought to have concluded …’, state that ‘the key evidence includes cash flow forecasts, prepared at intervals, that reflect the perceived seriousness of the company’s financial situation’.
117 For suggestions on steps and strategies which directors could adopt (including, inter alia, taking appropriate outside professional advice, holding weekly board meetings, keeping major creditors and all directors in the loop and recording all recommendations for remedial action made by the directors) see C. Swain, ‘Light at the End of the Tunnel – Operating in the Twilight Zone’ (2006) 19 Insolvency Intelligence 33, 35.
118 [1925] Ch 407.
119 This sets a minimum standard and, in deciding whether this minimum has been obtained, regard can be had to the particular company and its business: see Re Produce Marketing Consortium [1989] 5 BCC 569 per Knox J at 594. For a further discussion of this case see Prentice, ‘Creditors’ Interest’; L. S. Sealy [1989] CLJ 375. See also Park J in Re Continental Assurance Co. of London plc [2001] BPIR 733 for a judicial analysis of the nature of individual directors’ potential liabilities, quantum and issues of several liability versus joint and several liability under s. 214; see further A. Walters, ‘Wrongful Trading: Two Recent Cases’ [2001] Ins. Law. 211.
The wrongful trading section has, however, proved to be a disappointment in terms of numbers of reported cases.\(^{120}\) The reason may be that it is often seen as easier to make out a case of misfeasance, preference or transaction at undervalue than to chart the difficult waters of wrongful trading.\(^{121}\) Central to those difficulties is often the liquidator’s challenge in identifying the ‘relevant date or time’ when the director should have been aware that there was no reasonable prospect that the company would avoid going into insolvent liquidation. Establishing this time will often be problematic, especially if the company’s records are incomplete.\(^{122}\) Also, as Keay has commented, the courts have been reluctant to second-guess directors’ commercial decisions. They usually recognise that directors have to make tough decisions, often in difficult circumstances, and ‘have generally come down on the side of the directors’.\(^{123}\)

Problems in the funding of wrongful trading actions clearly have not helped to develop wrongful trading as a strong force for directorial accountability and these have been discussed above.\(^{124}\)

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120 But in terms of s. 214’s influence on directorial standards of care this has been far reaching: see Re D’Jan [1993] BCC 646; Companies Act 2006 s. 174.
121 The courts require compelling evidence to be convinced of wrongful trading and often prefer to impose liability through other mechanisms. As Milman notes: ‘This is because wrongful trading rarely occurs in a vacuum but usually in a context of other managerial shortcomings which are easier to prove through legal action.’ D. Milman, ‘Improper Trading: Can it be Effectively Regulated?’ (2004) 4 Sweet & Maxwell’s Company Law Newsletter 3. A cited example of a wrongful trading action that failed to impress the court was Liquidator of Marini Ltd v. Dickenson [2004] BCC 172 in which the claim foundered because there was no evidence of an increase in the net deficiency of the company during the relevant period of alleged wrongful trading (an application of Re Continental Assurance plc [2001] All ER 229, where Park J had stated that there had to be more than a ‘mere “but for” nexus … to connect the wrongfulness of the director’s conduct with the company’s losses’): see Milman, ‘Improper Trading’; N. Spence, ‘Personal Liability for Wrongful Trading’ (2004) 17 Insolvency Intelligence 11.
122 The liquidator, in seeking to maximise assets for the general creditors, may, understandably, be tempted to select the time period which would provide the possibility of the highest attainable contribution. On the courts’ approaches as to whether the liquidator’s exact selection of time is sacrosanct or whether there can be some latitude see A. Keay, ‘Wrongful Trading and the Point of Liability’ (2006) 19 Insolvency Intelligence 132. See also Rubin v. Gunner and Another [2004] BCC 686, [2004] 2 BCLC 110, where the liquidator appeared to rely on several dates during the course of the litigation and trial and where a specific time was then settled upon by the court itself.
124 See ch. 13 above. The Insolvency (Amendment) Rules 2008 (SI 2008/737) amend the Insolvency Rules 1986 by replacing r. 4.218(a) with a new r. 4.218(1), (2) and (3)(a) and by inserting new rr. 4.218A–4.218E. (The amendments, inter alia, provide expressly for
approaches to section 214 have, furthermore, not added to the efficacy of the provision. This is an area where there has been an unhelpful confusion about the role and purpose of the law. Cork had envisaged that civil liability for wrongful trading would effect a balance between encouraging the growth of enterprises and discouraging ‘downright irresponsibility’. This balancing, as involved in section 214, has allowed different judges to adopt different approaches to wrongful trading and a degree of uncertainty has resulted. In *Re Produce Marketing Consortium Ltd* Knox J treated the section 214 jurisdiction as ‘primarily compensatory rather than penal’. It is clear, however, from other cases such as *Re Sherborne Associates Ltd* that the wrongful trading provisions are being seen by some judges not so much as a civil remedy to raise standards among directors and to compensate creditors, but as a way to punish directors whose actions are seen as immoral. Such a punitive conception may also sit more comfortably with a ‘pro-enterprise’/‘pro-rescue’ stance rather than a ‘pro-creditor’ position. In *Sherborne*, the actions were dismissed and the judge was sympathetic to the honest, hard-working, well-respected businessmen who acted as directors in times of difficulty.

the expenses of liquidation to be payable out of the proceeds of any legal proceedings which the liquidator has power to bring and also for the recovery of expenses and costs relating not only to the conduct but also to the preparation of any such legal proceedings.)

130 Note, however, that the principal director had died by the time of the hearing and consequently the court may have been anxious not to judge with hindsight someone who was unable to defend himself: see I. F. Fletcher, ‘Wrongful Trading: “Reasonable Prospect” of Insolvency’ (1995) 8 Insolvency Intelligence 14. The dangers of acting on hindsight (noted in *Re Sherborne* itself), and of assuming that what has happened was always bound to happen and was apparent, were noted in *Re Brian D. Pierson (Contractors) Ltd* [1999] BCC 26 when Hazel Williamson QC, in the Chancery Division, declined to be ‘wise with hindsight’ and gave respect to the directors’
the court may exercise its discretion under section 214(1) when deciding the appropriate amount of compensation to be paid by a director and may take account of the degree of culpability exhibited by the director.\(^{131}\) The court can, therefore, note whether the director’s conduct resulted from a failure to appreciate rather than from a deliberate course of wrongdoing; whether or not there were heeded or unheeded warnings from the auditors,\(^{132}\) and whether there was any misappropriation of assets by the directors for their own benefit.\(^{133}\) In *Re Purpoint Ltd*,\(^{134}\) however, Vinelott J did not look kindly on directors who failed to monitor their company’s financial affairs and in *Re DKG Contractors Ltd*\(^{135}\) there was a similar approach to directors who failed to abide by the basic requirements of company law. In *Re Continental Assurance of London plc*\(^{136}\) it was emphasised, moreover, that it was directors who had ‘closed their eyes to the reality of the company’s position … had been irresponsible and had not made any genuine attempt to grapple with the company’s real position’ who had something to fear apropos liability under section 214.

Thus, in exercising their discretions to order directorial contributions, the courts may, as noted, vary their responses according to their espousal of different approaches to section 214, be these compensatory (as in *Re Produce Marketing*)\(^{137}\) or inclined to advert to issues of culpability (as discernible, for example, in such cases as *Re Sherborne, Re Purpoint, Re DKG Contractors* and *Re Continental Assurance*).\(^{138}\) The bite of the wrongful trading provisions is, therefore, diminished not merely by the legal uncertainties that liquidators face on seeing widely varying judicial rulings, but also by the propensity of the judiciary to look to culpability (rather than pure compensation) as a factor of relevance in deciding both judgement as to the company’s prospects. Nevertheless, on the facts, she was satisfied that the directors ought to have concluded that there was no reasonable prospect of avoiding insolvent liquidation and they were liable under s. 214. In *Re Continental Assurance Co. of London plc* [2001] BPIR 733, [2001] All ER 229, however, a sympathetic view of directors appears to have been taken again when Park J rejected a wrongful trading action, noting that the directors had not acted unreasonably in difficult circumstances when they sought expert advice and, reasonably, traded on.


\(^{131}\) See M. Simmons, ‘Wrongful Trading’ (2001) 14 Insolvency Intelligence 12.


\(^{133}\) *Re Produce Marketing Consortium Ltd* (No. 2) [1989] BCLC 520, [1989] 5 BCC 569.


\(^{137}\) [1989] 5 BCC 569.

whether to declare a liability to contribute and subsequent issues of quantum.  

‘Phoenix’ provisions

Personal liability for directors also arises in relation to sections 216 and 217 of the Insolvency Act 1986, the provisions designed to deal with the ‘phoenix syndrome’. These sections prohibit a director of a company that has entered insolvent liquidation from being involved, for the next five years, in the management of a company using the same name as the insolvent company or a name so similar as to suggest an association with it. The prohibition covers using any name by which the old company was known and even a name that has not been used for trading but has been used internally as a promotional shorthand name. The rule also applies to any director who has left a company within twelve months of liquidation. Breach of the rule involves civil or criminal liability and the major effect is to make the person concerned personally liable to contribute towards the debts of the ‘new’ company. An individual may seek the court’s leave to act as the director of a similarly named company, however, and there is evidence that the courts will be well disposed to grant such leave where the applicant was not to blame for the failure of the initial company. An advantage of sections 216 and 217 to the creditor is that these provisions allow an individual to bring an action to

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139 For further discussion of the wrongful trading provisions in the context of efficiency see pp. 741–3, 746–9 below.


recover a specific debt. This is a material difference to actions for wrongful trading (Insolvency Act 1986 section 214) or to transactions at undervalue (Insolvency Act 1986 section 238) which can only be brought by the liquidator and whose proceeds enter the creditor pool for general distribution.\footnote{145}

Transactions at undervalue, preferences and transactions defrauding creditors

Further areas of directorial liability relate to transactions at undervalue and preferences and transactions defrauding creditors under sections 238, 239 and 423 of the Insolvency Act 1986. These provisions and their enforcement have, however, been discussed in chapter 13 and will not be dealt with here.

\textit{Enforcement}

The above discussion sets out the main rules governing the potential liability of directors in cases of corporate insolvency. Matters of enforcement need, however, to be considered if the real accountability of directors is to be assessed. In relation to the common law duties that directors owe to creditors, there are considerable enforcement difficulties. The judges have tended to see directors’ duties to creditors in exhortatory terms and so have failed to grasp the enforcement nettle. If creditors’ interests derive from general duties owed to the company then breaches should properly be dealt with by the company as contemplated in \textit{Nicholson}\footnote{146} and \textit{Walker v. Wimborne}.\footnote{147} The problem, however, is

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\textit{Independent Factors and Finance Ltd} [2007] BCC 45 (CA) and subsequently amended Rule 4.228. See further I. Clarke, ‘Re-use of Company Names: Applications to Court by a Director for Leave to Act’ (2007) \textit{Recovery} (Spring) 32 and the discussion of the ‘phoenix’ problem by the CLRSG, \textit{Final Report}, 2001, paras. 15.55–15.77. The Review Group, \textit{inter alia}, distinguishes between ‘good phoenix’ situations (i.e. where ‘honest individuals may, through misfortune or naïve good faith, find that they can no longer trade out of their difficulties … and the only way to continue an otherwise viable business … may be for them to do so in a new vehicle using the assets and trading style of the original company’) and ‘bad phoenix’ situations (i.e. where individuals ‘seek to abuse the system or deliberately evade their responsibilities’).
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\footnote{145}{See Carter, ‘Phoenix Syndrome’. This recovery mechanism has been used extensively over the past years, particularly by HM Revenue and Customs: see e.g. \textit{HMRC v. Benton-Diggins} [2006] BCC 769, where deputy judge Michael Crystal QC applied the test as to whether there was a real probability of the public associating the two companies.}
\footnote{146}{[1985] 1 NZLR 242.}
\footnote{147}{[1976] 50 ALJR 446, (1976) 137 CLR 1, (1978) 3 ACLR 529.}
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that enforcement of the duty is likely to be difficult before the company goes into administration, receivership or liquidation since creditors cannot rely on the existing board or the shareholders to complain about the ill-treatment of creditors’ interests. On liquidation, the possibility arises of a misfeasance action under section 212 of the Insolvency Act 1986, which allows proceedings where a director has been guilty of ‘any misfeasance or breach of any fiduciary or other duty in relation to the company’. Duties to creditors may thus arise at the stage of doubtful solvency but creditors per se are given a right of action only on winding up.

Such enforcement would, of course, offer little assistance to unsecured creditors since any recovered funds will go to company assets and will come within the scope of any floating charge. The ‘prescribed part’ provisions found in the Insolvency Act 1986 section 176A thus seek to ensure that a certain percentage of the net realisations of property subject to any floating charge will be set aside and made available to the unsecured creditors on the company’s insolvency.

Are creditors, however, in a good position to enforce duties against directors? As has been argued elsewhere, effective enforcement demands an ability to acquire and use information; expertise or understanding of the relevant activity; a commitment to act; and an ability to bring pressure or sanctions to bear on the party to be controlled.

On the first issue, creditors may have not inconsiderable access to information. The disclosure rules operating throughout company

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148 The Insolvency Act 1986 extended the ambit of misfeasance to ‘include breach of any duty including the duty of care’: per Hoffmann LJ in Re D’Jan of London Ltd [1994] 1 BCLC 561 at 562. On misfeasance see further Re Eurocruit Europe Ltd [2007] BCLC 561 (claims under s. 212 do not have a limitation period distinct from that applicable to the underlying claim); Whitehouse v. Wilson [2007] BPIR 230 (clarifies liquidators’ responsibilities to the various stakeholders apropos offers to settle misfeasance claims); Mullarkey v. Broad [2008] 1 BCLC 638 (the onus of proof in misfeasance rests on the claimant); Walker v. Walker and Another [2005] All ER 277 (liquidator ordered to pay the director’s costs as the action was commercially worthless from the start in that the director had limited assets); Re Brian D. Pierson (Contractors) Ltd [1999] BCC 26; Re Westlowe Storage & Distribution Ltd [2000] BCC 851; Re Continental Assurance Co. of London plc [2001] BPIR 733; F. Oditah, ‘Misfeasance Proceedings against Company Directors’ [1992] LMCLQ 207.

149 See Re Anglo-Austrian Printing and Publishing Co. [1895] Ch 152 (damages received from directors for misfeasance are available to the charge holder).

150 See the Insolvency Act 1986 (Prescribed Part) Order 2003 (SI 2003/2097) and chs. 3 and 13 above.

151 Finch, ‘Company Directors’.
legislation generally reflect the principle that these operate for creditors’ as well as shareholders’ benefit. Creditors, like shareholders, can obtain information on the financial state of the company at the Company Registry in the form of copies of certain classes of resolution, annual accounts and directors’ and auditors’ reports. Copies of these documents have, moreover, to be sent to ‘all debenture holders’. When a company enters or nears insolvency, further sources of information arise. Administrators must be furnished with information from the company’s directors to enable the preparation of a notice of the administrator’s appointment and, on the commencement of the procedure, the administrator must provide a statement of affairs to creditors. Where voluntary arrangements are made in order to conclude an agreement with creditors, the directors’ proposal and statement of the company’s affairs will become available to creditors, and when liquidators act they will provide creditors’ meetings with a body of information. Data concerning directorial behaviour may also flow from the creation of contractual rights to information. The terms of debentures may provide for the supply of information and financial data and detailed figures, for example, may be requested on a periodic basis by financial creditors.

As with shareholders, informal sources of information may assist creditors, and major financial creditors will often use their influence to obtain a steady flow of information from senior managers. Major creditors may also obtain representation on the company’s board and subsequently will gain access to new sources of information. Trade creditors will be less likely to use such sources but if a continuing trading relationship has been formed, they may acquire information informally.

Can more be done to inform creditors? One potential response to the ‘phoenix syndrome’ has been put forward by the Federation of Small Businesses (FSB), which has argued that the BERR should designate certain individuals as ‘provisional directors’ where they have been at the helm of several failed companies. Such directors would then be required to disclose their track records so that trade creditors, for instance, would

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152 See Insolvency Act 1986 Sch. B1, para. 47.
153 Insolvency Act 1986 s. 2(2) and (3); Insolvency Act 2000 Sch. A1, para. 30; Insolvency Rules 1986 rr. 1.3(1) and (2), 1.5(1) and (2), 1.12(3); Insolvency Act 1986 s. 3(2) and (3).
be aware of these. Monthly financial returns for the companies of such directors might also be demanded so that creditor monitoring of financial health could be facilitated. The FSB argument here is that such steps offer smaller creditors lower-cost information sources and help them to assess risks. There seems an arguable case for such requirements also on grounds of fairness to unsecured creditors.

Even when creditors possess information, however, they may have problems in using it to good effect. The value of information deriving from insolvency-related regimes may be questioned. Creditors may well gain much information only at a very late stage in corporate troubles and this tardiness will often rule out actions designed to forestall directorial failures or negligence. Creditor expertise, indeed, may vary considerably. Financial creditors might be expected to be expert in assessing risks and managerial performance, but trade creditors may possess expertise in a particular business sector only and may be less able to evaluate directorial performance beyond those areas.

Will creditors be committed to enforcing directorial duties? They may be where they foresee any threat to their prospects of repayment but, in general, creditors are not disposed to review the actions of managers. Factors that might, nevertheless, affect the propensity to enforce might be the size of the investment, the nature of any security, the type of business and the levels of directorial discretion that are usual in the sector. For small trade creditors, such factors may well not come into play unless the debtor is a major purchaser of the creditor’s product. Such creditors will tend to look for supply elsewhere rather than to continue a relationship in the hope of recovering from directors on the basis of a breach of duty.

What incentive, indeed, is there for creditors to seek to recover from directors? Secured creditors will focus on realising their security and only if such realisation fails to meet the sum outstanding will such creditors have anything to gain from the contributions of directors. In the case of creditors secured with floating charges, incentives may similarly operate only to cover shortfalls (directorial contributions will form part of the company’s assets). Ordinary unsecured trade creditors will possess questionable incentives to pursue errant directors since they will be paid after floating charge holders.\(^{155}\)

\(^{155}\) Though some incentive may be provided by the ‘prescribed part’ of funds made available to unsecured creditors which would otherwise have been paid to holders of floating charges: see Insolvency Act 1986 s. 176A. If creditors consent the liquidator could use these moneys as a fighting fund to bring actions: see further ch. 13 above.
After a liquidation has been initiated by qualifying creditors, actions may be brought by creditors against directors under a number of heads: for example, misfeasance actions for breaches of fiduciary or other duties in relation to the company. Such duties, however, are, as noted already, owed to the company and contributions obtained from directors, as a result, will go to the company assets for the benefit of all creditors. Individual creditors may be discouraged from bringing such actions, moreover, because the liquidator may proceed similarly on behalf of all creditors and will have investigative powers that individual creditors do not possess.\(^{156}\) As for liquidators’ actions, we have seen in chapter 13 that creditors may have to indemnify costs where it is anticipated that there may be insufficient assets to support litigation. Section 176ZA of the Insolvency Act 1986 and the amended Insolvency Rules have now, however, provided that litigation expenses are expenses of the winding up\(^ {157}\) – a negation of the Court of Appeal’s decision in Re Floor Fourteen.\(^ {158}\)

The common law duty offers little to the unsecured creditor since it is owed to the general body of creditors rather than unsecured creditors individually or as a class. A duty owed directly to individual creditors seems, as already noted, to have been denied by Yukong\(^ {159}\) and would conflict with insolvency’s collectivist principles, might lead to a multiplicity of suits, and could lead individual creditors to place improper pressure on directors to settle their particular claims.\(^ {160}\) As has been argued elsewhere, the alternative may be to place directors under a duty to unsecured creditors as a class.\(^ {161}\) Such a class action could

\(^{156}\) Insolvency Act 1986 ss. 131–4, 235.

\(^{157}\) See ch. 13 above; Companies Act 2006 s. 1282(1) and the Insolvency (Amendment) Rules 2008 (SI 2008/737) amending the Insolvency Rules 1986 by replacing r. 4.218(1) (a) with new r. 4.218(1), (2) and (3)(a) and by inserting new rr. 4.218A–4.218E. (Expenses of liquidation can also be payable out of proceeds of litigation brought by the liquidator; and expenses and costs relating to the conduct and preparation of any such legal proceedings can be recovered.)


exceptionally allow unsecured creditors collectively to seek injunctions where necessary to prevent directors from acting in a manner jeopardising the company’s solvency or to ensure the consideration of unsecured creditors’ interests in circumstances of marginal solvency.162

The position of creditors generally might be strengthened by another reform: one to allow creditors to take action in the company’s name in enforcement of directorial duties. The Companies Act 2006 sections 260–4 provided a statutory derivative action for members but not for creditors.163 Are there, nevertheless, good reasons for a creditors’ counterpart?164 One reason advanced for the inclusion of creditors has been that, in some circumstances, creditors might be in receipt of better relevant information than is available to ‘other outsiders’.165 The opportunity of using creditors as monitors of corporate management seems, however, a less convincing argument than the need to protect creditor interests. If, as was indicated in Whalley166 and Gwyer,167 creditor interests become company interests not merely post-insolvency but also when insolvency threatens, then it may be appropriate to allow creditors to act before the liquidator comes onto the scene (so as to protect their interests) by injuncting any directorial actions that are likely to prejudice solvency severely.168

Enforcement of the statutory controls over such matters as fraudulent or wrongful trading, transactions at undervalue and preferences depends on action, not by a creditor, but by an office holder of the company. As was made clear in chapter 13, however, liquidators have traditionally faced severe funding problems in resorting to law in order to enforce

162 For their part, directors might have few grounds to fear that unsecured creditors would interfere in the workings of the company. Such creditors would have to demonstrate to a court reasonable cause to anticipate that insolvency would result from the action in question and this would be an onerous burden to discharge.

163 See Pendell, ‘Derivative Claims’; Key, ‘Can Derivative Proceedings be Commenced when a Company is in Liquidation?’.


165 CSLRC, p. 50.


directors’ duties. Although such practical difficulties have to some extent been ameliorated by legislative reform,169 problems of funding allocation170 and legal uncertainty still remain, particularly in the case of wrongful trading, and to date we have seen an accountability regime of seemingly low impact.171

**Public interest liquidation**

As indicated above, one further way to hold directors to account – and to protect the public from errant directors – is to prevent ongoing trading through compulsory liquidation of the company on public interest grounds. This procedure is, in the main, carried out by the Companies Investigation Branch (CIB) of the Insolvency Service.172 As noted in chapter 13, a key value of public interest liquidation (PIL) is that it allows the public authorities to seek a winding up in order to protect consumers and the public from the activities of errant directors – and to do so where no individual member of the public has an economic interest that would

169 See the Insolvency (Amendment) Rules 2008 (SI 2008/737); ch. 13 above.

170 The IP has an unusual role and one that may well involve conflict. As Katz and Mumford (Making Creditor Protection Effective, part 5) note: ‘On the one hand he is charged with protecting creditors’ interests, but on the other hand his own commercial interests and the right to charge fees may be detrimental to creditors’ interests. There is a subtle balance to be struck … Putting to one side concerns as to whether office holders always put creditors' interests ahead of their own, the law has not always been accommodating to office holders who may very properly wish to incur costs to bring recovery actions that have a good prospect of increasing the funds available to creditors. We suggest that the Insolvency Service explore the system of aid made available by the New Zealand Insolvency Service, which provides funding for cases which it believes are winnable (recovering the funds out of the proceeds of the action).’ See also ch. 13 above.

171 Lack of visible enforcement of the wrongful trading provisions may give an excessively negative view of their impact, however, since insolvency practitioners may use the threat of proceedings to concentrate directors’ minds, extract sums from directors in order to settle claims and force quick settlements: see Walters, ‘Enforcing Wrongful Trading’, p. 159; C. Williams and A. McGee, A Company Director’s Liability for Wrongful Trading, ACCA Research Report 30 (London, 1992) p. 16.

172 The FSA also has the power to apply for a ‘just and equitable’ winding up. The FSA has only infrequently proceeded with an application for a just and equitable winding up. When deciding whether to petition for such a winding up, the FSA will consider, amongst other things, whether the needs of consumers and the public interest require the body to cease to operate and whether consumer needs and the public interest can be met by using the FSA’s other powers: see FSA, Enforcement Handbook, online. Some types of breach that are of relevance to the FSA may be covered by other authorities such as professional bodies or overseers or other regulators such as the Director General of Fair Trading or the Serious Fraud Office (SFO).
justify this.\textsuperscript{173} It does not require that any illegal activity is involved\textsuperscript{174} and, accordingly, it does not demand that the criminal burden of proof is satisfied through the amassing of a highly elaborate body of evidence. Nor, indeed, does it have to be established that the errant company is insolvent.

As a device for controlling an individual director, however, PIL may constitute a blunt instrument because it does not target mischiefs or mischief-makers precisely. The misbehaviour at issue may be just one activity being carried out by a healthy company that conducts a range of otherwise reputable trading practices and PIL may destroy ‘any good that may co-exist within the company alongside the bad’.\textsuperscript{175} In some cases, indeed, the reluctance of the court to grant petitions for PILs may be due to such perceived blurriness – and Hoffmann J’s comments about ‘grossly disproportionate responses’ in Re Secure and Provide plc\textsuperscript{176} may reflect this perception. PIL may, indeed, be deployed bluntly because it has to play a role that other controls might well fulfil. In some circumstances the disqualification of a director may be called for but, as will be discussed below, disqualification may have developed into a tool that is ill-attuned to the protection of the public. As one senior official of the CIB put it:

PIL is the only vehicle we have got to stop a company from conducting business we think is wrong. Disqualification was meant to be quick. We saw the 1986 Insolvency Act as meaning the Secretary of State takes a view of the person who should be disqualified. The court’s role is only to determine how long to make the order. There was no concept that you would go and get these massive trials. The idea was you went in and the bloke was disqualified, so you would do it in days ... The courts just messed it up.\textsuperscript{177}

\textsuperscript{173} Under the Insolvency Act 1986 s. 123(1)(a) a creditor’s interest has to exceed £750 before a petition to wind up can be made (SI 1984/1199, para. 2).

\textsuperscript{174} Re SHV Senator Hanseatische mbH [1997] BCC 112, 119; cf. Secretary of State for Trade and Industry v. Travel Time (UK) Ltd [2000] BCC 792. In cases where illegal activities are involved, the criminal law can be used and offences under, say, the Theft Act 1968 such as obtaining property by deception can be prosecuted. The FSA also possesses a variety of options, including some powers that it can exercise without having to seek court approval. The FSA can vary permissions to engage in regulated activities; cancel such permission; withdraw approvals; seek injunctions; issue prohibition orders; apply for restitution orders; apply disciplinary measures; petition for administration orders against companies and partnerships and bankruptcy orders against individuals; and prosecute for criminal offences (FSMA 2000 s. 56).


\textsuperscript{176} [1992] BCC 405, 414. \textsuperscript{177} Interview, CIB, 10 April 2002.
It might be argued, however, that the undertakings regime inserted into the Company Directors’ Disqualification Act 1986 (CDDA) by the Insolvency Act 2000\(^\text{178}\) may have allowed the disqualification system to be redeployed along more responsive lines. The effect of the undertaking system, as will be noted below, is to rule out the need for the Secretary of State to seek a disqualification order from the court. It is seen by senior CIB staff as a device that is potentially useful in some circumstances and has been used in a small number of cases to date. It should be borne in mind, however, that in relation to section 8(2)(A) undertakings, just as in relation to disqualification orders under section 8(1), the Secretary of State will have to form an opinion that it is expedient in the public interest that a disqualification should be made before applying to court for such an order. The feeling of CIB officials seems to be that in relatively clear cases, the undertaking system may offer public protection, but in complex scenarios or where directors are making large profits from gullible parties, unscrupulous individuals are liable to delay giving undertakings for three or so years while they continue to plunder the market.\(^\text{179}\)

A system of more precise targeting would be possible. Within the financial services regime, the FSA (and to a lesser extent BERR) can target specific practices, individuals or firms and the (then) DTI suggested in its 2001 Discussion Paper on Company Investigations that it also should possess a power to seek a targeted restraint order from the courts.\(^\text{180}\) The proposal was that the Secretary of State should be able to seek an order restraining the company from engaging in a specified business activity or carrying on all or part of its business in a specified way.\(^\text{181}\) On controlling particular directors, the DTI argued that, for a restraining order to be effective, it would need to bind directors and the Department put forward for discussion the idea that the Secretary of State should be able to seek an order removing a person from office as the director of a particular company as part of a restraining order.\(^\text{182}\) Such a power, it was mooted, would be less severe than disqualification and might be appropriate where the conduct did not merit such a serious course of action as general disqualification.\(^\text{183}\)

\(^{179}\) Interview, CIB, 10 April 2002.  
\(^{180}\) DTI, Company Investigations, paras. 120–35.  
\(^{181}\) Ibid., para. 120. The DTI conceded that it would be unwilling to use such a power to enter into a ‘regulatory’ relationship with a firm (para. 129).  
\(^{182}\) Directors and company officers responsible for breaches of restraining orders would also be personally liable for relevant debts of a company: ibid., para. 129.  
\(^{183}\) Ibid., para. 126.
A restraining order in the above terms would not, however, be efficacious where the errant company director engaged in ‘phoenix’ manoeuvres\(^\text{184}\) and moved on from the restrained company only to replicate the undesirable practice by operating through a new corporate vehicle. In order to deal with this problem, the DTI consulted on whether restraining orders should be able to ‘follow’ the director in such circumstances.\(^\text{185}\) Such an order would be used to restrict the activities of a director who had been required to give up office under a restraining order. It would deal with objectionable conduct by the director whether acting as a director in a new company or as a sole proprietor.

The Department, moreover, also invited suggestions on whether an interim restraining order should be available where it becomes clear, early on in an investigation, that a practice should be restrained but the investigation still has time to run until completion. This is a power that is less draconian than applying for the immediate appointment of a provisional liquidator and thus brings advantages. Appointing a provisional liquidator might be useful in bringing the powers of the directors to an end and reducing the risk that corporate assets will be dissipated, but it effectively terminates the company’s usual trading and is such a serious step that the court is likely to demand substantial evidence of misconduct.\(^\text{186}\) This, in turn, will require that a good deal of time is spent amassing such evidence and preparing a case. In contrast, an interim restraining order allows the company or director to carry on trading subject to abandoning the harmful practice. The court is being asked to take a relatively modest and specific step and the burden of establishing the case for such an order will be far less onerous (and far less time-consuming) for the CIB. The order possesses similar advantages over a petition for a director’s disqualification order. As for the circumstances in which such an order might be sought, the DTI gave the following example: ‘A multinational conglomerate is operating a lottery as a promotional exercise without complying with the necessary legislation. In such an instance the Department would not wish to wind up the entire company but merely prevent it from continuing an illegal practice. A restraining order would be more appropriate.’\(^\text{187}\)

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\(^{184}\) See pp. 703–4 above.  
\(^{185}\) DTI, Company Investigations, para. 127.  
\(^{187}\) DTI, Company Investigations, para. 15(a).
Can it be said that the PIL process effectively protects the public from the actions of unscrupulous directors? Statistically it is difficult to contend that PIL leads the way among devices designed to protect the public from directorial misdemeanours – only a modest number of companies each year are wound up following PIL petition. It could be argued, however, that until the phoenix problem is adequately dealt with, errant directors are only effectively restrained by the PIL mechanism. It might, nevertheless, be responded that the PIL procedure is insufficiently preventative and only allows corporate operations to be ended when large numbers of creditors have been harmed. As the law presently stands, the CIB has to amass a good deal of information before petitioning the court. The burden of proof in a PIL case may only have to be discharged to the civil, not the criminal, standard but establishing a case, even on a balance of probabilities, may demand that a lengthy and detailed investigation of corporate activities is carried to a conclusion. Here again, the issue of coordination across the PIL process is raised. If a petition is to be triggered by a CIB investigation of a company’s affairs, that investigation may aim to discover a host of issues that go beyond the terms of a PIL petition. These matters will usually be concluded and a report made before action on a PIL is taken. During this research and investigation period, large numbers of the public may be forwarding funds to the company at issue. As noted already, the DTI raised the possibility of its being able to apply for an interim order to restrain a company engaging in a specific activity. Without such a power it was conceded by the DTI that an excessive time may pass during the completion of investigations and the obtaining of the appointment of a provisional liquidator on a winding-up order against the company.

A particular difficulty with PIL is that the CIB, the courts and the Insolvency Service may diverge in their approaches to this as a control device. These divergencies not merely make for philosophical confusion but have the potential to impair the efficiency of the PIL process – as where, for example, the courts place weight on a need to establish corporate culpability before an order is granted but the CIB operates on a different basis – that of public protection rather than blame attribution. To some extent the CIB’s difficulties may, on occasion, flow from its

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188 In 2006–7 the combined number of winding-up orders and disqualification orders obtained by CIB was 116: see Insolvency Service, Annual Report and Accounts 2006–7, HC 752 (Stationery Office, London, 2007).

189 DTI, Company Investigations, para. 131.

190 Ibid.
using PIL where a more narrowly targeted procedure would distinguish more clearly between unacceptable and acceptable directorial or corpo-
rate behaviour and would allow the former to be eradicated without threatening the latter.

PIL does not, in its present form, operate as a highly effective measure for protecting the public from errant directors – it is too confused in conception and too cumbersome in operation. This is not a complaint that can be placed readily at the door of the judges. The courts have resisted the CIB’s petitions on occasion but have tended to do so for reasons that are supportable – because using a winding up to control a specific problem is too ill-focused and extreme a course of action.

As for the deterrent value of PIL and its influence in controlling directors’ business practices and standards of behaviour, it has been pointed out that the PIL procedure has a very low public profile and most companies and their controllers will be unaware of the Secretary of State’s powers until they are brought into effect.191 Here there is considerable scope for promotional work either through BERR public information or through requirements that company direction should involve a level of basic training in the fundamentals of corporate law and governance.192

Recent developments and proposals do, however, offer a way forward for PIL. The proposed restraining order and interim restraining order system would allow the CIB to provide a more rapid response to unacceptable trading than is possible with PIL. It would also allow unaccep-
table directorial or corporate behaviour to be dealt with in a more closely targeted manner than PIL allows. When applied to directors, the restraining order would allow the ‘phoenix’ operation to be constrained and, with the interim restraining order, it would prove a more readily deployable response to mischief than is provided by the directors’ dis-
qualification procedure which, even with the undertaking process intro-
duced by the Insolvency Act 2000, can prove excessively broad and draconian. As for the need for the CIB to apply to the court for a restraining order (as proposed by the (then) DTI) it could be contended that controls analogous to the FSA’s ‘own initiative’ powers should be

192 For a discussion of which see, inter alia, Law Commission and Scottish Law Commission, Company Directors (1999); CLRSG, Final Report, 2001, paras. 3.9, 6.18; Finch, ‘Company Directors’; and pp. 738–9 below.
aimed for – that the CIB ought to have the power to prohibit a certain commercial practice without having to go to court for approval. To this argument it might be objected that it is one thing to give the FSA such a power in relation to a specific sector but a far more serious step to allow the CIB to do this in any sector. Such an objection, however, misses the point that such a power will relate to a specific practice (even, potentially, a specific individual) and so would be limited in scope. The CIB would, moreover, be accountable through the Secretary of State to Parliament for its actions.

Further thought might also be given, first, to ways in which CIB operations can be more closely co-ordinated (informationally and in policy terms) with those of other enforcement agencies and, second, to the triggers for PIL petitions. If the protection of consumers is a major (albeit not exclusive) concern of the CIB then further consideration could be given to the possibility of allowing the National Consumer Council or other consumer representative bodies to play a greater role in triggering PIL petitions, perhaps by developing closer links with the CIB.

To summarise, the PIL process does have potential as a means of controlling directors but it can be seen as coming to a crossroads in its development. It has evolved over the years into a procedural jack-of-all-trades, one that is sometimes awkwardly deployed but which is useful in so far as it can be instituted where objectionable behaviour is difficult to counter with other strategies. What it is not yet is an optimally effective legal device that is co-ordinated into a network of linked controls. The above discussion suggests that PIL is a device that should be retained but that the mooted steps that are designed to give it a secure role within the framework of insolvency law could be pursued with some urgency.

**Expertise**

Does insolvency law encourage directorial behaviour that is expert, honest and free from incompetence? Here the focus will rest on the rules on disqualification before note is made of alternative means of influencing directorial expertise. In so doing it is necessary to consider both the rationales that the judges espouse in disqualifying directors and

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193 See also the above discussion concerning a potential power for the Secretary of State to accept undertakings in lieu of petitioning for a restraining order.
whether the rules are enforced in a manner that actually encourages expert, honest and competent company direction.

The director of an insolvent company may be found unfit to run a limited liability company and be disqualified by the courts under section 6 of the Company Directors’ Disqualification Act 1986 (CDDA). The Secretary of State or Official Receiver may apply to the court for such a disqualification and, on a finding of unfitness, the court must disqualify the director from being concerned in the management of a company for a minimum of two years. It is the use of mandatory disqualification that sets section 6 apart from the other provisions of the CDDA which involve judicial discretion to disqualify and may be used, for example, where there is misconduct in relation to the company (involving, perhaps, conviction of an indictable offence in relation to the company, persistently breaching companies legislation on documents and returns, or participation in frauds or fraudulent trading); where there is a finding of unfitness following the Secretary of State’s application on an inspector’s report or departmental investigation; or where there is a wrongful trading, company direction by an

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194 See CDDA 1986 s. 6(2) for a definition of ‘insolvent’. For the background to s. 6 and to the importance of disqualification in insolvency law’s investigative role, see Cork Report, paras. 235–40, 1813–18; see also I. F. Fletcher, ‘Genesis of Modern Insolvency Law: An Odyssey of Law Reform’ [1989] JBL 365. On disqualification generally see A. Walters and M. Davis-White, Directors’ Disqualification and Bankruptcy Restrictions (Thomson/Sweet & Maxwell, London, 2005).

195 Per CDDA 1986 s. 7(3) it is the duty of liquidators, official receivers, administrators or administrative receivers to report cases of suspected ‘unfitness’ to the Secretary of State.

196 At the Secretary of State’s discretion, CDDA 1986 s. 7(1). In Official Receiver v. Wadge Rapps & Hunt [2003] UKHL 49 the House of Lords stated that the Official Receiver could legitimately use the investigative powers conferred by s. 236 of the Insolvency Act 1986 to gather information to pass to the Secretary of State for the purpose of disqualification proceedings – and this could be viewed as incidental to the functions of winding up, even where there were no assets worth recovering.

197 CDDA 1986 s. 6(4). Mandatory disqualification for a minimum period reflected the Cork Committee’s concern for the tightening up of the previous discretionary jurisdiction of Companies Act 1985 s. 300.

198 CDDA 1986 s. 2. 199 Ibid., ss. 3 and 5.

200 Ibid., s. 4; Companies Act 2006 s. 993; Insolvency Act 1986 s. 10. 201 CDDA 1986 s. 8.

202 Ibid., s. 10. On allowing the company to trade when insolvent even where this does not amount to wrongful trading see C. Bradley, ‘Enterprise and Entrepreneurship’ (2001) 1 Journal of Corporate Law Studies 53 at 66; Secretary of State for Trade and Industry v. Imo Synthetic Technology Ltd [1993] BCC 549; Re Bath Glass [1988] 4 BCC 130.
undischarged bankrupt\textsuperscript{203} or failure to pay under a County Court administration order.\textsuperscript{204}

A change that was designed to allow the disqualification system to be redeployed along more responsive lines is the undertakings regime that was introduced into the CDDA by the Insolvency Act 2000. Sections 1 (A), 7(2)(A) and 8(2)(A) of CDDA 1986 now allow the Secretary of State to accept a disqualification undertaking where it appears to the Secretary of State that there is satisfaction of the conditions for disqualifying a person as an unfit director of an insolvent company (CDDA sections 6 and 7) or where it similarly appears that a director is a person unfit to be concerned in the management of a company (section 8).\textsuperscript{205} It must appear to the Secretary of State that it is in the public interest to accept such an undertaking. The undertaking may be for up to fifteen years and will state \textit{inter alia} that the person will not be a director of a company or in any way directly or indirectly concerned in the promotion, formation or management of a company without leave of the court. The effect of the undertaking system is to rule out the need for the Secretary of State to seek a disqualification order from the court. The aim of the new procedure is to reduce enforcement costs; make regulation more responsive (by reducing the period during which proceedings are pending and directors are still empowered to act); save court resources; and reduce the uncertainties involved in lengthy disqualification processes.\textsuperscript{206} It should be borne in

\textsuperscript{203}CDDA 1986 s. 11.

\textsuperscript{204}Ibid., s. 12. The CDDA is thus aimed at catching a plethora of directorial wrongdoing: for example, paying some creditors but not others (see \textit{Re Carecraft Construction Co. Ltd} [1993] 4 All ER 499, 511; \textit{Re New Generation Engineers} [1993] BCLC 435; \textit{Official Receiver v. Barnes} (\textit{Re Structural Concrete Ltd}) [2001] BCC 478 (regarding non-payment of Crown debts)) and paying the director’s own debts (see \textit{Secretary of State v. Imo Synthetic Technology Ltd} [1993] BCC 549).

\textsuperscript{205}S. 8(1) of the CDDA 1986 is amended by the Financial Services and Markets Act 2000 (Consequential Amendments and Repeals) Order 2001, s. 39 to read: ‘S. 8(1) If it appears to the Secretary of State from investigative material that it is expedient in the public interest that a disqualification order be made against a person who is, or has been, a director or shadow director of a company, he may apply to the court for such an order; s. 8(1A) “Investigative material” means (a) a report made by inspectors under s. 437 of the Companies Act 1985, ss. 167, 168, 169 or 284 of FSMA 2000, regulations made as a result of s. 262(2)(k) of FSMA and (b) information or documents obtained under ss. 447 or 448 of the Companies Act 1985, s. 2 of the Criminal Justice Act 1987, s. 83 of the Companies Act 1989 or ss. 165, 171, 172, 173 or 175 of FSMA 2000.’

\textsuperscript{206}Commenting on the new powers, Kim Howells, Consumer Affairs Minister, said: ‘Ensuring that the business community and consumers are protected from the activities of rogue directors at the earliest opportunity is vital. The new power to
mind, however, that in relation to section 8(2)(A) undertakings, just as in relation to disqualification orders under section 8(1), the Secretary of State will have to form an opinion that disqualification is expedient in the public interest. His decision will have to be based on ‘investigative material’ – which is defined in section 8(1)(A) (as amended)\(^\text{207}\) as (a) reports made by inspectors under s. 437 of the Companies Act 1985, sections 167, 168, 169 or 284 of the Financial Services and Markets Act 2000 (FSMA), or regulations made as a result of section 262(2)(k) of FSMA and (b) information or documents obtained under sections 447 or 448 of the Companies Act 1985, section 2 of the Criminal Justice Act 1987, section 83 of the Companies Act 1989 or sections 165, 171, 172, 173 or 175 of FSMA.\(^\text{208}\)

Other reforms of the disqualification system followed a NAO Report of 1993 which criticised the Insolvency Service’s enforcement endeavours.\(^\text{209}\) There followed a considerable increase in the volume of disqualification proceedings.\(^\text{210}\) In 1998 the IS set up a twenty-four-hour disqualification hotline\(^\text{211}\) to enable members of the public to report possible contraventions of prohibitions on direction and, in 2000, the Government announced the setting up of a specialist team to investigate disqualify administratively will save time in the courts.’ See Comment, ‘“Fast Track” Disqualification is Under Way’ (2001) 22 Co. Law. 213 at 214. On the tension between the public interest in ‘quickie’ disqualifications and the public interest in the promotion of good corporate governance see A. Walters, ‘Bare Undertakings in Directors’ Disqualification Proceedings: The Insolvency Act 2000, Blackspur and Beyond’ (2001) 22 Co. Law. 290; see also pp. 732–3, 751–3 below.


\(^\text{208}\) Part XIV of the Companies Act 1985 (as amended by the Companies Act 1989) remains in force subject to certain new provisions in the Companies Act 2006 inserted into Part XIV by Part 32 of the CA 2006. Thus no attempt has been made to consolidate the legislation on company investigations by the Secretary of State.

\(^\text{209}\) NAO, Company Director Disqualification (October 1993, HC 907). The Enterprise Act 2002 s. 204 introduced a new statutory regime (into the CDDA 1986, ss. 9A–9E) which allows the Office of Fair Trading and other specified regulators to apply to court to disqualify a director of a company where that company has committed a relevant breach of competition law. Discussion of this goes beyond the scope of this chapter: for details see Walters and Davis-White, Directors’ Disqualification and Bankruptcy Restrictions, ch. 6.


\(^\text{211}\) See p. 679 above; in 2006–7 the hotline received 328 calls which resulted in 26 reports to the prosecuting authority (compared to 135 in 2005–6): Insolvency Service, Annual Report and Accounts 2006–7.
directors who asset-strip companies. The Forensic Insolvency Recovery Service (FIRS) was given the power to take legal action to recover money from fraudulent and negligent directors of failed companies.212

The Court of Appeal has also played a role in extending the scope of disqualification. Section 22 of the CDDA extends liability for disqualification on the grounds of unfitness to shadow directors, defined by section 22(5) of the CDDA as persons ‘in accordance with whose directions or instructions the directors of a company are accustomed to act (but that person is not deemed a shadow director by reason only that the directors act on directions given by him in a professional capacity)’.213 In Secretary of State for Trade and Industry v. Deverell214 the concept of the shadow director in CDDA section 22 was at issue and the court widened the category of persons who may be regarded as such directors and so may be covered inter alia by the rules on directors’ liability and disqualification. Morritt LJ was concerned ‘to identify those with real influence in the corporate affairs of the company’. He stated that the intention of Parliament was to protect the public and that ‘all that is required is that what is said by the shadow to the board is not by way of professional advice but is usually followed over a wide enough area and for long enough’. Subservience by the board was not required, a capacity for some degree of independent judgement did not rule out shadow direction, and the influence of the shadow director need not extend to the whole field of the company’s activities.215 The shadow director, moreover, did not

213 See G. Morse, ‘Shadow Directors and De Facto Directors in the Context of Proceedings for Disqualification on the Grounds of Unfitness and Wrongful Trading’ in Rider, Corporate Dimension; S. Griffin, ‘The Characteristics and Identification of a De Facto Director’ [2000] 1 CFILR 126; G. Bhattacharyya, ‘Shadow Directors and Wrongful Trading Revisited’ (1995) 15 Co. Law. 313. A person whose directions or instructions are customarily acted upon by a governing majority of the board can be a shadow director but that majority must act as a consequence of the directions/instructions and the shadow status does not follow where actions are retrospectively linked to directions: see Ultraframe UK Ltd v. Fielding [2005] EWHC 1638.
215 See also Secretary of State for Trade and Industry v. Becker [2002] All ER 280, [2003] 1 BCLC 555, which applied Deverell but suggested that ‘accustomed’ meant that directions had to be given during periods encompassing the general course of the company’s history as opposed to a particular episode or incident. See further S. Griffin, ‘Evidence Justifying a Person’s Capacity as Either a De Facto or Shadow Director: Secretary of State for Trade and Industry v. Becker’ [2003] Ins. Law. 127.
need to wield influence as part of the internal management structure of the company. Whether a communication amounted to ‘directions or instructions’, moreover, was to be objectively assessed. 216 After Deverell, it has been argued that the characteristics of a shadow director appear to be identifiable with those of a de facto director 217 but some commentators have emphasised that ‘the concept of shadow directorship has different defining characteristics and serves fundamentally different purposes to the concepts of de jure or de facto directorship’. 218

In Re Kaytech 219 the court took, as in Deverell, a practical approach to determining whether a person is a de facto director and amenable to the directors’ liability and disqualification rules: all relevant internal and external factors were to be taken into account and the issue was to be determined as a question of fact and not by applying one single test. 220

In applying the disqualification provisions, different judicial philosophies or rationales can be discerned. 221 What might be called a ‘rights’ approach sees directing a company incorporated with limited liability as a valuable asset or right worthy of protection in the exercise of commercial ventures. This model reflects the ‘business enterprise’ perspective on company law, which sees the director as a taker of business risks, subject to a company law that respects and enables his or her freedom to manage rather than rendering managerial decisions liable to judicial second-guessing. 222 An alternative standpoint sees incorporation with limited


217 See Griffin, ‘Evidence Justifying a Person’s Capacity’. In Secretary of State for Trade and Industry v. Hollier and Others [2007] BCC 11, however, Etherton J said that a de facto director had to participate in directing the affairs of the company – he did not have to have day-to-day control and might only act in relation to part of its activities but he had to be part of the company’s governing structure: on which see also Secretary of State for Trade and Industry v. Tjolle [1998] BCC 282 at 290. On de facto directors see Re Kaytech [1999] 2 BCLC 351; Secretary of State for Trade and Industry v. Jones [1999] BCC 366; Re Red Label Fashions Ltd [1999] BCC 308; Secretary of State for Trade and Industry v. Hollier [2007] BCC 11; Statek Corp. v. Alford [2008] BCC 266; J. de Lacy, ‘The Concept of a Company Director’ [2006] JBL 267.


219 See Payne, ‘Casting Light’.


221 See, for example, L. S. Sealy, Company Law and Commercial Reality (Sweet & Maxwell, London, 1984) p. 46.
liability as a privilege, a facility to be used in the public interest. This view could be said to reflect the social responsibility perspective on company law which looks not merely at the interests of investors, managers, directors and creditors but to the ‘legitimate needs, too, of the public interest, of the consumer, of the employee’.

The respective logics of the rights and privileges approaches may be represented as two packages, each comprising a distinct set of tenets. The rights approach implies, in its pure form, the following: that interference with the right to direct a limited liability company is only merited where culpability is present; that culpability is relevant in assessing the period of disqualification on, *inter alia*, retributive principles; that the process of disqualification is accordingly best seen as a penal one; that withdrawal of the right to direct not only deprives the person concerned of an asset but involves stigma; that the onus is on the ‘prosecution’ to justify disqualification; and that unfitness should be proved beyond reasonable doubt in satisfaction of the criminal burden of proof. Furthermore, the *mens rea* required should be intention, recklessness or, at least, gross negligence.

In contrast, the privilege approach sees procedures as not being penal and, accordingly, unfitness may be proved on a balance of probabilities according to the usual civil standard. The privilege approach is consistent with the notion that disqualification is most appropriately justified by the need to protect the public rather than to punish the director. Since disqualification is seen as non-penal, withdrawal of the privilege of direction is not viewed as stigmatic and the period of withdrawal is seen as assessable on protective principles. Nor are employment prospects held to be dashed on a disqualification since business may be carried out by other methods (for example, in partnership or as a sole trader) rather than by the exercise of the privilege of incorporating a limited liability company. Culpability is, therefore, not required in order

to justify disqualification: ‘mere’ incompetence will suffice – as in the *Swan* case where a non-executive director was disqualified for three years on the grounds, not that he knew of certain financial irregularities but because his behaviour on finding out about the irregularities fell below the level of competence to be expected of a director in his position.\(^\text{225}\)

From a privilege perspective, it also follows that public interest considerations may prevail over issues of culpability. Thus, in *Hennelly’s Utilities*\(^\text{226}\) the court allowed a disqualified director to act as a director of a company on accepting evidence that this would allow business expansion. The court took the view that the public’s interest in protecting employment prevailed over its interest in being protected from an errant director.

Were the judiciary to follow the logic of either of the above approaches in a consistent manner, decisions on section 6 CDDA would possess a coherence that they now lack. As things stand, some decisions can be placed firmly within the rights approach, some reflect the privilege viewpoint, and some have a foot in both camps.

The rights approach is marked, as noted, by an emphasis on culpability and an eye to retributive notions of justice.\(^\text{227}\) Thus, judges have distinguished between the fitness of directors of the same company on the basis

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\(^{225}\) See *Secretary of State for Trade and Industry v. Swan (No. 2)* [2005] All ER 102; [2005] BCC 596; and J. Lowry, ‘The Whistleblower and the Non-Executive Director’ [2006] 6 JCLS 249; C. Howell, ‘Secretary of State v. Swan and North’ [2005] JBL 640. For an example of a failure to take advice (on VAT liability after insolvency) not being seen as such incompetence as would justify disqualification see *Secretary of State for Trade and Industry v. Walker* [2003] 1 BCLC 363.

\(^{226}\) *Re Hennelly’s Utilities Ltd* [2005] BCC 452. Conditions were imposed which were capable of being policed and the court took account of the fact that there was a real risk to the future profitability of the company with knock-on effects for employment prospects in the workforce. In *Re Uno plc (Secretary of State for Trade and Industry v. Gill)* [2006] BCC 725 Blackburne J was clearly influenced by the fact that several hundred employees’ jobs were at risk when he found no unfitness regarding directors who had taken a ‘balanced commercial decision to continue trading’ and used customers’ advance deposits as working capital after receiving legal, accounting and insolvency advice. In *Secretary of State for Trade and Industry v. Blackwood* [2005] BCC 366 the Court of Session (in dismissing the Secretary of State’s appeal) indicated underlying sympathy for the directors of a distressed business who had traded on an insolvent business but had done so to protect employees’ jobs rather than to benefit themselves.

\(^{227}\) See *R v. Young* [1990] BCC 549, where the court declared that a disqualification order was ‘unquestionably a punishment’ and ruled that it was inappropriate to link such an order with a conditional discharge. On the retributive tradition see, for example, R. Nozick, *Philosophical Explanations* (Clarendon Press, Oxford, 1981). For arguments favouring conceptualisation of the possible purposes of the disqualification regime in terms of retribution and protection see C. Riley, [2000] CFILR 372 at 373–4.
of their culpability. In *Re Cladrose* a director lacking accounting qualifications escaped disqualification following a complete failure to produce audited accounts and to file annual returns. His colleague, a qualified accountant, was, however, disqualified because of his ‘unwarrantable’ conduct in his failing vis-à-vis the accounts and returns. The latter’s qualifications, it was stressed, rendered his omissions ‘far more blameworthy’ than those of his co-director.

Not only does the rights approach stress culpability, it, as indicated, treats interfering with company direction as stigmatic and involving a serious interference with substantive, rather than merely procedural, rights. Thus in *Re ECM (Europe) Electronics* Mervyn Davies J found no ‘blameworthiness’ sufficient to justify ‘stigmatising’ the director and in *Re Crestjoy Products Ltd* Harman J stressed the ‘substantial interference with the freedom of the individual’ involved in section 6 disqualifications. This emphasis has been echoed in other decisions. Thus in *R v. Holmes* Tucker J said of the disqualification of a director: ‘It deprived him of a businessman’s best asset, that is recognition in the eyes of the public that he is fit to act as a director of a limited company.’

The mandatory nature of disqualification involved under section 6 of the 1986 Act has encouraged such a rights view on the part of some judges. Thus Harman J stated in *Re Crestjoy Products Ltd* that the statutory predecessor of section 6, section 300 of the Companies Act 1985, had given the judges a discretion on whether to disqualify following a finding of unfitness – a discretion exercisable in the public interest. He contrasted this with the position under section 6 CDDA which implied the appropriateness of a more penal approach: ‘disqualification under the former disqualification provision was not penal … [I]t seems to me, however, that when I am faced with a mandatory two year

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228 [1990] BCC 11.
229 See further Finch, ‘Plea for Competence’. In *Secretary of State for Trade and Industry v. Bairstow and Others (No. 2)* [2004] EWHC 1730 a director was disqualified for six years under CDDA s. 8. While not guilty of dishonesty, the director had been grossly negligent in his duties because, although not an accountant, he was ‘very experienced as a director’ and consequently, on the information available to him, he should have noticed that the accounts were misleading.
233 Ibid., p. 396. See also *Re ECM (Europe) Electronics Ltd* [1991] BCC 268 at 275.
disqualification if facts are proved, the matter becomes more nearly penal.\textsuperscript{235} When Hoffmann J decided \textit{Re Swift} in 1992\textsuperscript{236} he felt able to comment in unequivocal terms: ‘these being penal proceedings Mr Ettings must, I think, be given the benefit of the doubt’\textsuperscript{237} while in 1995, in \textit{Secretary of State v. Gray},\textsuperscript{238} Hoffmann LJ (now in the Court of Appeal) was again clearly influenced by the mandatory nature of section 6, indicating that the purpose of making the section mandatory was to ensure that everyone whose conduct fell below the appropriate standard was disqualified for at least two years whether ‘the individual court thought this was in the public interest or not’\textsuperscript{239}.

That the judges often adopt a penal approach is further evidenced by instances in which factors bearing on culpability rather than public protection are deemed relevant in assessing the appropriate period of disqualification. In \textit{Re Sevenoaks Stationers}\textsuperscript{240} Dillon LJ accepted as a mitigating factor the director’s personal monetary losses and lack of personal gain.\textsuperscript{241} In \textit{Re Churchill Hotel (Plymouth) Ltd}\textsuperscript{242} Peter Gibson J decided not to disqualify, noting \textit{inter alia} that the director had apologised for his defaults and ‘expressed regret’ for the failure of the companies.\textsuperscript{243} Similarly in \textit{Re Swift}\textsuperscript{244} Hoffmann J noted that the director had ‘already suffered considerable misfortune’ and had gained nothing financially out of his failure of duty as a director. Consequently he was disqualified for just a year longer than the minimum period. All of these matters relate more readily to culpability and questions of retribution.

\textsuperscript{235} [1990] BCC 23 at 26. See also \textit{Re Cedac Ltd} [1990] BCC 555; \textit{Secretary of State for Trade and Industry v. Langridge} [1991] Ch 402 at 412: ‘While a disqualification order is not of itself penal, it is clearly restrictive of the liberty of the person against whom it is made, and its contravention can have penal consequences’, per Balcombe LJ.

\textsuperscript{236} \textit{Re Swift 736 Ltd} [1992] BCC 93.

\textsuperscript{237} Ibid., p. 95.

\textsuperscript{238} [1995] 1 BCLC 276.

\textsuperscript{239} See also \textit{Re Living Images Ltd} [1996] 1 BCLC 348, where Laddie J spoke of ‘moral turpitude’ and the need for ‘cogent evidence’.

\textsuperscript{240} [1990] BCC 765, [1991] Ch 164. Note that in \textit{Re Sevenoaks} three levels of unfitness to be a director were related to different lengths of the disqualification period. In \textit{Re Polly Peck International plc (No. 2)} [1994] 1 BCLC 574 it was stated that, since the minimum period of disqualification was two years, an order should not be made if the defendant’s misconduct was not serious enough to merit such a term of disqualification.

\textsuperscript{241} [1990] BCC 765 at 780. See also \textit{Re Pamstock} [1994] 1 BCLC 716; \textit{Re CEM Connections Ltd} [2000] BCC 917; cf. \textit{Re Firedart} [1994] 2 BCLC 340, where Arden J refused to accept, as a matter of mitigation, the fact that the director had personally guaranteed the company’s overdraft and had provided security over his own property to the bank.

\textsuperscript{242} [1988] BCC 112.

\textsuperscript{243} Ibid., p. 122.

\textsuperscript{244} [1992] BCC 93 at 97.
than to issues of public protection.245 In *Re Chartmore*246 Harman J imposed the minimum disqualification period on a director who had *inter alia* failed to keep proper accounts, traded on the back of creditors and exhibited a ‘total lack of attention to proper duties’. The basis of this leniency was that the director was ‘still only about 30’, and, in his Lordship’s words, was ‘really very young’ and ‘pretty young’ respectively when the two relevant companies went down.247 This indicated, said Harman J, ‘conduct at the bottom end of the scale of blameworthiness’. Either Harman J possessed a highly optimistic view of maturation as a public protection, or, as formerly in *Crestjoy,*248 he was assessing conduct on punitive principles.

Some cases take an approach that is penal in so far as culpability is seen as justifying disqualification in circumstances where there is no remaining need for public protection. Thus in *Re D. J. Matthews (Joinery Design) Ltd*249 the errant director’s counsel argued that his client had evidenced unfitness in directing two previous companies but had ‘learned his lessons’, was now managing a third company successfully and that, accordingly, the public no longer needed protection from the director’s acting irresponsibly. Peter Gibson J was, however, less inclined to gloss over the past culpability, saying: ‘Just as there is joy in heaven over a sinner that repenteth, so this court ought to be glad that a director, who has been grossly in dereliction of his duties, now wishes to follow the path of righteousness. But I must take into account the misconduct that has occurred in the past.’250

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245 For a case in which culpability and protection are linked see *Re Barings plc, Secretary of State for Trade and Industry v. Baker* [1998] BCC 583 at 590, in which Sir Richard Scott VC urged that evidence of a director’s ‘general conduct in discharge of the office of director goes to the question of the extent to which the public needs protection’.


247 In *Re Melcast (Wolverhampton) Ltd* [1991] BCLC 288 the age of the director was again considered to be a mitigating factor in imposing a more lenient disqualification period. The director was aged sixty-eight and his conduct was deemed by Harman J to warrant a ten-year disqualification period. The director was nevertheless disqualified for seven years because the judge considered that by the age of seventy-five it was unlikely that the director would ever again be concerned in the management of a company. In *Re Moorgate Metals Ltd* [1995] 1 BCLC 503 at 520, in contrast, Warner J considered that the age of the director (seventy) should not be considered as a mitigating factor.


250 Ibid., p. 518. See also *Re Samuel Sherman plc* [1991] BCC 699 at 712 concerning a public company and CDDA 1986 s. 8; *Re Blackspur Group plc (No. 2)* [1998] 1 WLR 422, [1998] BCC 11: disqualification intended to have a real deterrent effect on others. See also *Re City Truck Group Ltd (No. 2); Secretary of State for Trade and Industry v. Gee* [2008] BCC 76, where Mann J stressed the culpability of a director in failing to find out and note that fraudulent activities were going on.
Turning to the privilege approach, the purpose of disqualification for unfitness has been said to be the protection of the public ‘against those who use limited liability to abuse the privileges of limited liability and to … “rip off” the public’.

This offers a view of limited liability as a privilege accorded upon terms and susceptible to withdrawal for the public good rather than because of any need for retribution. The approach is consistent with the notion that disqualification may protect the public in three ways: by keeping unfit directors ‘off the road’; by deterring unfit directors from repeating their misconduct; and by encouraging other directors to act properly so as to raise standards of corporate governance. A director may, on such a view, be disqualified for ‘mere’ incompetence. Thus in Re Bath Glass Peter Gibson J indicated that for a finding of unfitness: ‘the court must be satisfied that the director has been guilty of serious failure … whether deliberately or through incompetence to perform those duties of a director which are attendant on the privilege of trading through companies with limited liability’. Consistent with such a concern for both deliberate shortcomings and incompetence has been a judicial movement away from language focusing on turpitude and towards

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253 See Walters, ‘Directors’ Disqualification’, p. 91. For an argument that there is little evidence of disqualification being used to encourage the broader objectives of protecting customers and standards of directorial behaviour (as opposed to suppressing wealth-reducing opportunism) see Williams, ‘Disqualifying Directors: A Remedy Worse than the Disease?’, p. 221, but, in favour of the ‘broader objectives’ view, see Walters and Davis-White, Directors’ Disqualification and Bankruptcy Restrictions, pp. 32–6, 50; Re Swift 736 Ltd [1993] BCC 312 at 315 (CA); Secretary of State for Trade and Industry v. McTighe [1997] BCC 224; Re Atlantic Computers Ltd, 15 June 1998, Ch D (unrep.); Re Barings plc (No. 5) [1999] 1 BCLC 433; Re Continental Assurance [1996] BCC 888; Re Landhurst Leasing plc [1999] 1 BCLC 286; Re Westmid Packaging Services Ltd [1998] 2 All ER 124; Re Blackspur Group plc (No. 2) [1998] 1 WLR 422.

254 [1988] 4 BCC 130 at 133.

255 For examples of the language of turpitude see Re Dawson Print Group Ltd [1988] 4 BCC 322 (‘breach of standards of commercial morality’); Re CU Fittings Ltd [1989] 5 BCC 210 (‘commercial impropriety’ needed); Re Cedac Ltd [1990] BCC 555 (Mummery J: ‘a lack of commercial probity’ or ‘commercially culpable manner’); Re Park House Properties Ltd [1997] 2 BCLC 530 (Neuberger J: ‘attributable to ignorance born of a culpable failure to make enquiries or, where enquiries were made, of culpable failure to consider or appreciate the results of those enquiries’).
examining if regard has been paid to ‘proper standards’\textsuperscript{256} of ‘probity and competence’.\textsuperscript{257}

The privilege approach thus justifies actions against two very different kinds of errant director, ‘the person who is simply exploiting limited liability in a cynical way with a disregard for proper responsibility’ or alternatively the director who is exploiting it ‘because he is so stupid and ignorant that he is quite incapable of appreciating what has happened and thereby causes large losses by in a sense incompetence’.\textsuperscript{258} In both of these cases it has been indicated that there is a need to ‘protect the public’ from further abuse of the privilege of limited liability.\textsuperscript{259}

The privilege approach does not imply that disqualification is a penal process – rather it is a public policy decision that pays heed to the procedural rights of directors. Thus, in Re Lo-Line\textsuperscript{260} disqualification was portrayed in the following terms:

The primary purpose … is not to punish the individual but to protect the public against the future conduct of companies by persons whose past records as directors of insolvent companies have shown them to be a danger to creditors and others. Therefore, the power is not fundamentally penal. But … disqualification does involve a substantial interference with the freedom of the individual. It follows that the rights of the individual must be fully protected.\textsuperscript{261}

\textsuperscript{256} See Harman J in Re Keypack Homecare Ltd (No. 2) [1990] BCC 117; Peter Gibson J in Re Churchill Hotel (Plymouth) Ltd [1988] BCC 112 at 117.


\textsuperscript{258} Harman J in Re Douglas Construction Services Ltd [1988] BCLC 397 at 402. In Baker v. Secretary of State for Trade and Industry [2001] BCC 273 the Court of Appeal upheld the trial judge’s disqualification order covering a director who had failed to heed clear warning signals, ‘hoped for the best’ and showed ‘incompetence to a high degree’.

\textsuperscript{259} Re Douglas Construction Services Ltd, at 402. In Re Westminster Property Management Ltd, Official Receiver v. Stern [2001] 1 All ER 633, [2001] BCC 121, the Court of Appeal held that the imposition of disqualification (whose primary purpose was deemed not penal but to protect the public against those whose past record as a director has shown them to be a danger to creditors and others) was compatible with, as a justified derogation from, Article 43 (freedom of establishment) and Article 49 (freedom to provide services) of the European Community Treaty.

\textsuperscript{260} Re Lo-Line Electric Motors Ltd [1988] 4 BCC 415.

\textsuperscript{261} Ibid., p. 419. Browne-Wilkinson VC stated in Re Lo-Line (p. 486) that in the normal case an ordinary commercial misjudgement would not justify disqualification – rather the conduct must display a lack of commercial probity or constitute an extreme case of gross negligence or total incompetence.
From the privilege perspective, it matters little whether disqualification affects a director’s personal employment prospects adversely: the public interest is the dominant consideration. The courts, nevertheless, have tended, when applying the privilege approach, to stress that loss of the facility of limited liability does not end all employment prospects. In *Re Southbourne Sheet Metal Co. Ltd* 262 Harman J stated that the disqualification jurisdiction was ‘of a somewhat hybrid character’. It was not a prosecution neither was it an ordinary civil proceeding:

> it is not a penal proceeding. It is not intended to punish the director. It is a proceeding where the DTI or the Official Receiver ... is proceeding with a view to protecting the public by removing from a man the privilege of trading under the cover of limited liability. It does not stop a man’s freedom to trade, either as a sole trader or in a partnership, upon ... ‘his own bottom’, where he is liable down to his last collar stud. 263

The errant director might well take a more serious view of disqualification and its effects, particularly when, in the aftermath, he or she seeks credit under the cloud of such an order. Harman J has, nevertheless, repeatedly stressed that it is always open to any disqualified person to carry on trading in business, on their own account or as a partner. 264

The strength of the procedural protections offered to a director may also depend on the courts’ conception of the disqualification process as non-penal or penal. Thus a notice requirement is more likely to be seen as directory rather than mandatory when a court stresses public protection rather than private interest. 265 Balcombe LJ in *Re Tasbian Ltd (No. 3)* 266 put the unanimous Court of Appeal view in stating that it would not be right to preclude trial of a disqualification issue ‘merely’ because the Official Receiver had supported an *ex parte* application with inaccurate facts. His Lordship stressed: ‘this is public interest litigation’. 267

263 Ibid., p. 734.
264 See also *Re Chartmore Ltd* [1990] BCLC 673 at 675; *Re Probe Data Systems Ltd (No. 3)* [1991] BCC 428 at 434 (see Court of Appeal at [1992] BCC 110). For an example of plans to continue trading by accepting personal liability after disqualification, see *Re D. J. Matthews (Joinery Design) Ltd* [1988] 4 BCC 513 at 518.
265 Contrast the majority and minority judgments in *Re Cedac Ltd* [1990] BCC 555, [1991] BCC 148 (Court of Appeal), concerning application of CDDA 1986 s. 16(1).
267 Ibid., p. 366. For those concerned with employment issues more generally, an attractive feature of the privilege approach, with its focus on the public interest, may be its attention to the wider employment implications of disqualification. Under the former s. 300 of the Companies Act 1985 the judicial discretion to disqualify or not on a finding of unfitness was,
Is there a discernible judicial trend favouring either the rights or the privilege approach? It seems not. Decisions offer examples, as noted, of both approaches, with, for example, *ECM Europe*\(^{268}\) and *Southbourne*\(^{269}\) offering quite different perspectives. Individual judges have also been seen to adopt elements of both the rights and privilege standpoints. Thus Harman J has been noted under the rights heading in *Crestjoy*\(^{270}\) and *Chartmore*\(^{271}\) and as paying heed to privilege-based factors in *Southbourne*.\(^{272}\) Even within individual judgments the language associated with the two approaches intermixes. Thus Dillon LJ’s judgment in *Re Sevenoaks*\(^{273}\) stresses both the public protection rationale of disqualification and the absence of personal gain on the director’s part. A similar confusion is encountered in *Re Keypack*\(^{274}\) and in *Griffiths*\(^{275}\) where disqualification was based on ostensibly protective principles but where the period of disqualification for the ‘offence’ was approached by assessments of culpability.\(^{276}\)

on numerous occasions, exercised so as to avoid undue consequences for clients or employees of the director’s other companies. Thus in *Re Majestic Sound Recording Studios Ltd* \([1988]\) 4 BCC 519 and in *Re Lo-Line Electric Motors Ltd* \([1988]\) 4 BCC 415 (see also *Re Artic Engineering Ltd (No. 2)* \([1986]\) BCLC 253) directors were allowed to continue in office but subject in each case to supervisory arrangements. The mandatory nature of disqualification under CDDA \(1986\) s. 6 might be expected to rule out such courses of action and demand that concessions be made only at the stage of establishing unfitness. That some flexibility of judicial approach remains possible has, however, been made clear in *Re Chartmore Ltd* \([1990]\) BCLC 673, in which Harman J granted leave to waive disqualification in respect of a particular company for a one-year trial period subject to conditions. It may be the case, therefore, that by resort to CDDA \(1986\) ss. 1(1) and 17 – the bases for the waiver in *Chartmore* – continued attention can be given to the employment effects of disqualification. On leave to act under CDDA \(1986\) s. 17 see further Walters and Davis-White, *Directors’ Disqualification and Bankruptcy Restrictions*, chs. 12 and 15; T. Clench, ‘Applications for Permission to Act under Section 17 of the Company Directors Disqualification Act 1986’ (2008) 21 *Insolvency Intelligence* 113; *Secretary of State for Trade and Industry v. Baker* \([1999]\) 1 All ER 1017; *Secretary of State for Trade and Industry v. Rosenfeld* \([1999]\) BCC 413; *Re TLL Realisations Ltd, Secretary of State for Trade and Industry v. Collins* \([2000]\) BCC 998. See also *Re Manlon Trading Ltd, Official Receiver v. Haroon Abdul Aziz* \([1995]\) 1 All ER 988, per Evans-Lombe J: ‘The legislature must have envisaged that it was in the public


\(^{269}\) *Re Southbourne Sheet Metal Co. Ltd* \([1991]\) BCC 732.

\(^{270}\) *Re Crestjoy Products Ltd* \([1990]\) BCC 23, \([1990]\) BCLC 677.

\(^{271}\) *Re Chartmore Ltd* \([1990]\) BCLC 673.\(^{272}\) \([1991]\) BCC 732.

\(^{273}\) *Re Sevenoaks Stationers (Retail) Ltd* \([1990]\) BCC 765, \([1991]\) Ch 164.

\(^{274}\) *Re Keypack Homecare Ltd* \([1987]\) BCLC 409; (No. 2) \([1990]\) BCC 117.

\(^{275}\) *Secretary of State for Trade and Industry v. Griffiths, Re Westmid Packaging Services Ltd (No. 3)* \([1998]\) BCC 836, the Court of Appeal stating that while protection of the public is the primary purpose of disqualification, in truth the exercise engaged in when making a disqualification order is little different from any sentencing exercise.

\(^{276}\)
Both policy considerations and conceptual coherence favour adopting a single approach to disqualification: one based on the notion of privilege/public protection rather than rights/penality. Looking to wrongful trading and fraudulent trading under the Insolvency Act 1986, we have seen above that these contain a compensatory dimension. In parallel with such an approach, there seems no good case for adopting an exclusively penal viewpoint in relation to unfitness where the director’s behaviour does not fall foul of explicitly criminal provisions.

It has been argued that a combined approach may be necessary since ‘disqualification periods are, and can often only be, decided on the basis of a penal principle not a solely protective one’. It has also been suggested that public opinion demands a punitive response to ‘dishonest and fraudulent directors’. If, however, a privilege approach is adopted this does not mean that a director’s misconduct or moral turpitude is irrelevant. Rather (as indicated in Lo-Line) it means that disqualification may, where appropriate, be used to protect the public against the potential misbehaviour of a person who has manifested an undesirable attitude to the privilege of limited liability. The ‘dishonest and fraudulent director’ is thus likely to be dealt with sufficiently severely to assuage public opinion. Central to the privilege approach is, however, a rejection of using disqualification per section 6 merely for the purposes of punishment in the retributive sense.

A privilege standpoint emphasises that incompetence may provide a basis for disqualification. (Incompetence, after all, is, when combined with mismanagement, the major cause of corporate insolvency.) Being

interest that a businessman whose past conduct had justified disqualification should, after an appropriate period in which the public was to be protected and during which it must be presumed he became aware of the consequences of his past failings, have restored to him the right to manage businesses with the protection of limited liability’, at p. 1003.


For example, CDDA 1986 ss. 2, 4, 5. See also CDDA 1986 s. 10 re disqualification for fraudulent trading and wrongful trading. See R v. Holmes [1991] BCC 394 regarding the ‘difficulty’ in reconciling a compensation order, per Insolvency Act 1986 s. 213, and a disqualification order.

S. Wheeler (1990) IL&P 174 at 175.


non-penal, the burden of proof should, according to such a view, be on balance of probabilities, as indicated in *Re Southbourne*..

A privilege approach does not, however, imply that a director’s interests are to be ignored. The errant director does not, on such a view, have a substantive right to retain the facility of limited liability but does possess procedural rights. These exist in the CDDA and offer some protection against potential prejudice in spite of the courts’ increased inclination, on adopting a privilege approach, to treat them as directory rather than mandatory.

A case such as *Re Chartmore* suggests that the courts are capable of giving section 6 a degree of flexibility. Recent cases do not, however, show that a consistent or coherent approach to section 6 disqualifications has been arrived at. The privilege rationale offers a route to such coherence. More importantly it emphasises that, in removing the facility of limited liability, public protection is paramount.

So much for the rationales underpinning the use of disqualification. The second issue for consideration is whether the disqualification rules actually make a difference to expertise, honesty and competence on the ground. On this point, a number of commentators have argued that the impact of the rules has been small. A thousand or so disqualifications a year has been said to ‘make little impact on the legions of the unfit.’ There are around 3 million directors with millions more who could buy a company off the shelf and so current levels of disqualification may have a

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285 See CDDA 1986 ss. 7 and 16; see also S. Wheeler (1991) IL&P 141.
286 See, for example, *Re Cedac Ltd* [1991] BCC 148 (CA), re CDDA 1986 s. 16(1). See *Re Probe Data Systems Ltd (No. 3)* [1992] BCC 110 and *Re Tashbain Ltd (No. 3)* [1992] BCC 358: Court of Appeal judgments re CDDA 1986 s. 7(2) applications.
288 Whether the judges are prepared to accept this approach is, of course, an issue: see ‘The Fourth Annual Leonard Sainer Lecture – The Rt Hon. Lord Hoffmann’ (1997) 18 Co. Law. 194. See further p. 735 below.
small impact and a small deterrent effect. There are, moreover, risks in
the plea-bargaining approach involved in the undertakings regime –
notably that periods of disqualification will be reduced overall and that
the deterrent and control effects of disqualification will be weakened.
From the directors’ point of view, there are dangers that the new regime
creates incentives to accept disqualification early in negotiations (to
avoid escalating costs)\(^{291}\) and that they will be economically distanced
from a just hearing of their case.\(^{292}\)

A further concern regarding the undertakings procedure is that the
low profile of this process might reduce the potential of disqualification
to discourage unfit behaviour through the publicising of disqualification
cases. There is no scope, after all, for undertakings to be publicised by
entry into the register of disqualification orders maintained by the
Secretary of State under CDDA section 18(2). Parties are not required
by the law to agree a statement of unfit conduct and the Secretary of State
has the power to accept a bare undertaking which provides no descrip-
tion of the conduct found to be unfit. The Secretary of State can in
practice, however, demand an admission of unfit conduct for recording
in a schedule to the undertaking.\(^{293}\) On this point, moreover, some
assurance can be taken from *Re Blackspur Group plc (No. 3), Secretary
of State for Trade and Industry v. Eastaway*.\(^{294}\) That case involved a
director who had offered a disqualification undertaking but was unwill-
ing to agree to the annexing of a schedule of unfit conduct. (He feared the
anticipated stigma and the effect on his accountancy career.) The
Secretary of State insisted on the schedule of admissions and the Court
of Appeal stated that it was open to the Secretary of State to form the view
that it was not in the public interest to accept a bare undertaking without
admissions.\(^{295}\) This reinforced the rationale of disqualification as a
means of both protecting the public and setting proper standards
through making the factual bases of disqualification transparent. It
paved the way for the Secretary of State to make it publicly clear what
kind of conduct would be treated as rendering a director unfit.

\(^{291}\) See Walters, ‘New Regime’, p. 93; Practice Direction: Directors’ Disqualification

\(^{292}\) See further pp. 751–2 below.

\(^{293}\) See A. Walters, ‘Bare Undertakings in Directors’ Disqualification Proceedings’ (2001)
22 Co. Law. 290.

\(^{294}\) [2002] 2 BCLC 263.

\(^{295}\) See A. Walters, ‘Bare Undertakings in Disqualification Proceedings’ (2002) 23 Co.
Law. 123.
Two National Audit Office (NAO) Reports (of 1993 and 1999) respectively criticised the efficacy of the Insolvency Service’s administration of the CDDA and cautioned that disqualification was perceived as having only a marginal effect on improving the behaviour of directors generally. A survey, reported in 2001, also revealed that insolvency practitioners were sceptical concerning the effectiveness of disqualification which was ‘not influential … not well placed and … difficult to enforce’. More recently, Williams has argued that, on 2005–6 figures, the direct financial benefit of the regime to creditors had been £14.52 million – which had been achieved at a cost to the public purse of £30 million. Insolvencies directly prevented by the regime were put at an estimated 85 in number in 2005–6 compared to 15,351 insolvencies occurring during that year. As for the effect of the regime in (indirectly) deterring undesirable conduct, Williams suggested that around two-thirds of directors are likely to be unaware of the regime or what ‘unfit’ conduct is and that ‘empirical evidence does not, therefore, suggest that disqualification successfully deters unfit conduct’.

One explanation for the low incidence of disqualification orders may be that the officials who are involved in implementation are no more consistent about the aims and objectives of disqualification than the judiciary. Wheeler, for instance, argues that the disqualification process involves a ‘unique mix of public regulation, public interest and private funding’. She stresses that lack of resources and inefficiencies in the enforcing agency are not sufficient explanations of low numbers of disqualifications and that much can be explained by the inconsistencies of approach that are found amongst IPs and between IPs and the enforcing agency. Her portrait is of an implementation breakdown born out of philosophical differences. In selecting cases for disqualification, she argues, many actions fail to proceed because a large number of conduct reports contain ‘moral frames and end goals which do not accord with

297 See Hicks, ‘Can It Deliver?’, p. 437.
298 Williams, ‘Disqualifying Directors: A Remedy Worse than the Disease?’, pp. 228–32.
299 I.e. through disqualifications preventing further insolvencies involving the same directors.
300 Williams, ‘Disqualifying Directors: A Remedy Worse than the Disease?’, p. 234.
the goals and resulting construction of the public interest used by the Disqualification Unit. 302

In the 1996 Sainer lecture 303 Lord Hoffmann argued that disqualification had done little to raise standards of skill and care and that disqualification for incompetence was extremely rare, with the courts tending to emphasise conduct which breaches standards of accepted commercial morality. ‘It is said that incompetent directors ought to be put off the road for a while like incompetent drivers, simply for the protection of the public. But the courts have never completely accepted this philosophy.’ 304

Sympathy with a ‘rights’ approach to direction may thus make judges reluctant to disqualify in a manner that produces a dramatic impact on standards. Lord Hoffmann noted that the courts were often mindful of the serious impact of disqualification on an individual. More practical factors, however, reduce the protective effect of disqualification for unfitness. 305 The law requires no prior qualification for becoming a company director, 306 limited liability companies can be incorporated at minimal cost and it is not easy to find an ex post facto standard of competence for disqualification. 307 The disqualification process, moreover, only comes into play in cases where the incompetence (or ‘unfitness’) at issue is followed by insolvency (which may be a matter of happenstance). Routine investigations and the making of unfit conduct reports by the Official Receiver, administrators 308 or liquidators only follow entry into formal insolvency proceedings. 309 The conduct of

302 Ibid., p. 304.
304 Note (1997) 18 Co. Law. 56. For an argument that there is a ‘growing judicial intolerance of honest or uninformed incompetence’ see E. Ferran, Company Law and Corporate Finance (Oxford University Press, Oxford, 1999) p. 234.
305 See Hicks, ‘Can It Deliver?’, pp. 439–40 and Disqualification of Directors, pp. 68–9.
306 Lord Hoffmann made the point that it was difficult to find an ex post facto standard of competence for disqualification because the law does not require any qualification to become a director: Lord Hoffmann, ‘Sainer Lecture’ at p. 197.
307 Sch. 1 of the CDDA 1986 gives a definition of improper conduct but offers the well-intentioned director little guidance on standards of best practice to creditors.
308 Administrators, like other office holders, have a duty to bring potential unfit conduct to the attention of the Secretary of State under CDDA s. 7(3). The wording of CDDA s. 7(3)(c) was introduced by the Enterprise Act 2002 s. 248 and Sch. 17, para. 42 to reflect the fact that administration is no longer an exclusively court-based procedure. (Administrative receivers are also under a duty to report but since the Enterprise Act 2002 their appointment has been much reduced: see ch. 8 above.)
directors of companies that are merely struck off the register and dissolved is not investigated and, in 2003–4, for instance, 154,300 companies were struck off the register and dissolved but only 15,700 were subject to formal insolvency proceedings.\textsuperscript{310} Even when formal insolvency proceedings are involved, the IP or Official Receiver has to find sufficient evidence of unfit conduct to prompt reporting to the Secretary of State and the latter has to decide to proceed further.\textsuperscript{311}

Many incompetent directors, moreover, may escape disqualification due to good fortune or the skill of other parties. Another factor reducing the effectiveness of disqualification is the period of time needed to collect evidence for a formal hearing: this may be so considerable as to lead to a number of disqualifications being dropped because they are out of time.\textsuperscript{312} The majority of periods of disqualification, furthermore, tend to be relatively short (in 2006–7 around 700 disqualifications were from one to five years, around 400 from six to ten years and about 100 from eleven to fifteen years)\textsuperscript{313} and the enforcement of orders is difficult. In the case of self-employed directors, these individuals may avoid the impact of disqualification by setting up in their own name. It is, indeed, arguable that disqualification is a sanction that is most effective when applied to professional, employed executives but one that in practice is used more widely in relation to the self-employed individual with regard to whom it has less impact.\textsuperscript{314}

A further consideration reducing the


\textsuperscript{311} The indications are that the Secretary of State will proceed in less than a third of cases of unfitness reports: Williams, ‘Disqualifying Directors: A Remedy Worse than the Disease?’, p. 235.

\textsuperscript{312} See CDDA 1986 s. 7: the application for disqualification must be made within two years from the date the company ‘became insolvent’, but the court may, exceptionally, give leave to make a later application (s. 7(2)); \textit{Re Probe Data Systems Ltd (No. 3)} [1992] BCC 110 at 111: Scott LJ’s factors to be taken into account when considering whether to grant leave.

\textsuperscript{313} See Insolvency Service, \textit{Annual Report and Accounts} 2006–7, p. 16. Of course with most of the minor cases being disposed of via undertakings a significant number of the reported cases now feature unfitness at the 'upper end of the spectrum': see e.g. \textit{Re Vintage Hallmark plc} [2008] BCC 150 (fifteen-year ban imposed on directors of a public company); \textit{Re City Truck Group} (No. 2); \textit{Secretary of State for Trade and Industry v. Gee} [2008] BCC 76 (twelve-year ban on two directors); \textit{Kappler v. Secretary of State for Trade and Industry} [2006] BCC 845 (eleven-year ban): see D. Milman ‘Current Judicial Perspectives on the Managerial Role’ (2008) 237 \textit{Sweet & Maxwell’s Company Law Newsletter} 1, 3–4.

\textsuperscript{314} See Hicks, ‘Can It Deliver?’, p. 446.
The protective impact of the disqualification regime is that disqualification does not remove ill-gotten gains. If disqualification were to be relied upon significantly to boost the expertise of directors, then steps would have to be taken to overcome its inherent weaknesses. Enforcement costs and periods could be reduced further by establishing a specialist tribunal; sanctions could be made more severe and also more flexible; more rigorous policing could be directed at those who breach disqualification orders; more information could be given to directors and the public on disqualifications and a greater emphasis placed on protecting the public. More radically, there could be a rethinking of the conditions under which directorial conduct is the subject of reporting so that the current dependency on formal insolvency processes would be reduced and investigations could be instigated following such events as complaints or examples of errant behaviour that do not lead to insolvency. Another suggestion is that more use could be made of the court’s power to disqualify under section 10 of the CDDA 1986 following a finding of liability for fraudulent or wrongful trading under section 213 or 214 of the Insolvency Act – a course of action that could be facilitated by removing some of the procedural barriers that restrict the application of section 214.

It should not be forgotten that other approaches to improving directorial expertise can be considered. The criminal law has a role to play in limiting the worst forms of directorial misbehaviour and directors may be held to account by such mechanisms as fraudulent trading, which, as noted, the CLRSG considered a valuable weapon in countering crime. Laws providing for the personal liability of directors (for example, for wrongful trading) might also be said to encourage directorial expertise and standards. The use of criminal laws, however, demands that high standards of proof be satisfied and it has been pointed out that the criminal offences established in the Companies Acts are hugely

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315 As advocated by Hicks, ibid.
316 This might involve the issue of guidance to directors on their duties and responsibilities together with the expected standards of behaviour: see ibid., pp. 449–51.
317 See ibid.; Finch, ‘Disqualifying Directors’.
318 Though this offers no easy route to a solution: see the discussion in Williams, ‘Disqualifying Directors: A Remedy Worse than the Disease?’, pp. 239–41. On BERR investigations under the Companies Acts see Boyle and Birds’ Company Law, pp. 531–4 and 719–30.
319 See Griffin, ‘Accelerating Disqualification under s. 10 of the Company Directors’ Disqualification Act’.
underenforced. Hicks has, nevertheless, argued that evidential problems in the current law might be overcome and that ‘New, strict liability offences and civil penalties which preclude the misuse of corporate property to the detriment of creditors could be highly effective, being easier to prove than the broad and uncertain test of unfitness.\footnote{See Hicks, ‘Can It Deliver?’, p. 454.}

A potential route to raising standards lies through increasing directors’ awareness of their obligations in times of trouble. What is clear is the extent of work that has to be done. A 2001 survey of directors of companies with an average of over 700 employees and £167 million annual turnover revealed that they were ‘fundamentally ignorant’ about their duties and liabilities on insolvency.\footnote{Survey by Taylor, Joyson and Garrett, Legal Director magazine, reported in Financial Times, 1 November 2001.} Two-thirds of finance, legal and managing directors were unaware that their personal liability might be higher if they had above-average expertise and experience. The same proportion did not know that their company could continue to trade if it was insolvent provided that it had a reasonable prospect of avoiding liquidation.

The issue of information for directors has been considered by the Law Commission and the Scottish Law Commission\footnote{Law Commission and Scottish Law Commission, Company Directors, 1998.} as well as by the CLRSG.\footnote{CLRSG, Final Report, 2001, para. 3.9.} The CLRSG wanted ‘greater clarity on what is expected of directors’ and to make the law more accessible as well as to bring the law into line with modern business practice. It wanted ‘clear, accessible and authoritative guidance for directors on which they may safely rely, on the basis that it will bind the courts and thus be consistently applied’.\footnote{CLRSG, Final Report, 2001, pp. 42–5. See also CLRSG, Developing the Framework, paras. 3.12–3.85; CLRSG, Completing the Structure, ch. 3.} As noted already, however, the Companies Act 2006 statutory statement of directors’ duties provides no detailed blueprint regarding the duties of directors in the vicinity of insolvency and the courts must still be relied upon to give flesh to the rules.\footnote{On questioning whether the judges are equipped to review directors’ actions near insolvency, or to assess business risks, see T. Telfer, ‘Risk and Insolvent Trading’ in R. Grantham and C. Rickett (eds.), Corporate Personality in the Twentieth Century (Hart, Oxford, 1998) pp. 138–9; G. Varollo and J. Fukelstein, ‘Fiduciary Obligations of...}
be the brightest, best and most competent directors that make themselves aware of their duties, rather than the less able and less competent. The effect may be to polish the standards of directors who already perform well rather than to raise the standards of those who cause greatest losses to creditors. It can be pointed out, moreover, that knowledge of one’s duties is not the same as knowing how to turn around a company’s fortunes in times of trouble. It is only one of many expectations that we may have of directors in troubled times.\footnote{329} More rigorous standards, of course, might prompt directors to behave more responsibly but it can be argued that such steps have to be combined with new training initiatives to have real effects.\footnote{330}

Other proposals on raising directorial expertise relate to company direction in general, rather than to performance in the specific context of insolvency, and space does not allow a full review here.\footnote{331} Steps such as professionalisation and training\footnote{332} and the monitoring and regulation of directorial behaviour may, however, encourage higher standards of performance across the spectrum of corporate fortunes.\footnote{333} The market,

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\footnote{330} It can also be questioned whether directors are driven by the prospects of personal sanctions. There is survey evidence that only around a third of directors cite such sanctions as an important driver of their conduct: see R. Baldwin, ‘The New Punitive Regulation’ (2004) 67 MLR 351.

\footnote{331} See Finch, ‘Company Directors’.

\footnote{332} Ibid. The Institute of Directors (IOD) introduced the concept of a ‘chartered director’ in 1999. To achieve this status directors must have experience as a director, must pass an examination and must subscribe to the IOD’s Code of Professional Conduct: see further R. Esen, ‘Chartered Directors’ Qualification: Professionalism on UK Boards’ (2000) 21 Co. Law. 289. The IOD has also developed a Diploma in Company Direction and promoted a range of measures designed to improve directorial competence. Degrees in company direction are now available at various academic institutions. It is, however, questionable whether this burgeoning demand is not raising the standards of the most able and competent rather than the performance of those individuals most likely to underperform. On the issuing of guidance for directors and the need to deal with functions as well as duties, see Hitchens, ‘Directorships’, pp. 367–8. The CLRSG rejected the notion that company directors should be required to have formal qualifications or age limits (see CLRSG, Final Report, 2001, para. 3.49). The Companies Act 2006 provides for no formal directorial qualifications but s. 157 specifies a minimum age of sixteen for a person to be appointed as a director.

\footnote{333} The Combined Code recommends that on first appointment to be a director of a listed company directors should be given training on their role, but directors of listed companies are only a small minority of directors: see Hitchens, ‘Directorships’, p. 366; C. Riley, ‘The Company Director’s Duty of Care and Skill: The Case for an Onerous but Subjective Standard’ (1999) 62 MLR 697.
indeed, may supply incentives that may raise directors’ standards. Thus, banks may consider the training and track records of directors when assessing loan risks and may require personal guarantees in the case of less impressive directors. A straw poll at an INSOL conference, moreover, revealed that a ‘sizeable majority’ of delegates favoured a compulsory competence test that directors would sit (along ‘driving test’ lines) before being allowed to act as directors.\footnote{See Editorial, (2001) 17 IL&P 121.} Informational solutions are also being increasingly advocated. It has been suggested that the Government could prepare directors’ ‘information packs’ to advise new directors on their functions and obligations\footnote{Ibid. The suggestion is to fund such packs by a modest levy on companies each time a notice of appointment or change of directors is filed with the Registrar of Companies.} and, in practice, bodies such as R3 are taking information solutions forward with business ‘survival guides’ for directors.\footnote{See R3 (formerly SPI), Ostrich’s Guide to Business Survival (R3, London, 2002).}

Such approaches can, however, offer no guarantees that directorial expertise will save companies in a given situation: enterprise necessarily involves risks. What insolvency procedures should not do is discourage directors from seeking help or prevent directors from applying their skills in times of corporate troubles: for instance, by creating excessive incentives to depart from troubled companies or by excluding directors too fully from, or at too early a stage in, rescue or insolvency processes.

**Efficiency**

Do insolvency laws and processes induce directors, efficiently and economically efficiently, to balance the protection of creditor interests with needs to pursue rescue options and encourage enterprise?\footnote{This, it will be seen, is not a Jacksonian test of whether the law conduces to maximising the pool of assets available to all the company’s creditors. On the reasons for rejecting this test see ch. 2 above.} It has been pointed out above that certain insolvency processes (e.g. administration) can be criticised as offering directors too weak a set of incentives to apply their expertise to rescue or creditor protection objectives in times of trouble. That discussion will not be repeated, nor is there the space here to discuss how the law generally conduces to directorial skill and care.\footnote{On which see Finch, ‘Company Directors’; Riley, ‘Company Director’s Duty of Care and Skill’.

\footnote{335} Ibid. The suggestion is to fund such packs by a modest levy on companies each time a notice of appointment or change of directors is filed with the Registrar of Companies.
\footnote{337} This, it will be seen, is not a Jacksonian test of whether the law conduces to maximising the pool of assets available to all the company’s creditors. On the reasons for rejecting this test see ch. 2 above.
\footnote{338} On which see Finch, ‘Company Directors’; Riley, ‘Company Director’s Duty of Care and Skill’.
times. As a preliminary issue, then, the efficiency implications of imposing incentives and disincentives on directors, rather than corporations, should be noted. A first reason for targeting directors is that the total costs of sanctioning directors may be lower than the costs involved in controlling corporations so as to achieve the same reductions in wrongdoing.\(^{339}\) Personal liability, moreover, is less liable to impose costs on a firm that will either increase the likelihood of insolvency or worsen the position of creditors in an insolvency. Making directors liable may also provide an efficient way to raise standards of management as it assists investigators by providing them with levers with which to bargain with managers for information concerning other corporate failings.\(^{340}\)

Looking at economic efficiency, an advantage of holding directors liable is that this may leave risk evaluation and risk spreading to those individuals who are the best acquirers of information concerning corporate risks, levels of capitalisation, internal control systems and insurance. It thus permits managers to select the optimal strategies for dealing with risks.\(^{341}\) Finally, of course, personal liability improves the prospects of compensation by bringing the pocket of the wrongdoer within range of the victim, and where that pocket is deep, it may produce compensation for wrongdoing that is unavailable from the insolvent company.\(^{342}\)

A number of further points can be gleaned by examining a particular rule in more detail. Here it is worth looking at the wrongful trading provision and asking whether insolvency processes leave directors prone to undesirable diversion from the economically efficient and balanced pursuit of rescue or creditor protection objectives and whether the costs of ensuring that directors pursue such ends, rather than personal interests, are excessive.\(^{343}\)


\(^{340}\) As noted above, however, it may be easy to exaggerate the degree to which directors are aware of, or are driven by, prospects of personal liabilities: see Baldwin, ‘New Punitive Regulation’; Williams, ‘Disqualifying Directors: A Remedy Worse than the Disease?’.

\(^{341}\) See Kraakman, ‘Corporate Liability Strategies’, p. 874.


\(^{343}\) The wrongful trading section, Insolvency Act 1986 s. 214, it should be noted, does not attack the incompetence or mismanagement that may have brought a company to the verge of insolvency. It covers the taking of proper steps to protect creditors beyond the point when the company’s failure seems inevitable.
A central issue here, as has been pointed out, is one of agency costs. These costs relate to three main areas of potential directorial economic inefficiency. First, the managers of a troubled firm may expend assets in a desperate gamble to trade out of trouble and save their jobs. They will, in doing so, take inefficiently large risks because the risk bearers are in the first instance the shareholders (to be followed increasingly by the creditors as the firm declines). A second danger is that managers will act in ways that prejudice the interests of creditors who were granted loans at early stages of corporate life: by, for example, taking out later secured loans that involve draconian terms and are not justified by the chances of potential recovery. Third, directors may, in times of trouble, act in a manner biased towards their shareholders and they may be able to do so because their information is superior to that possessed by creditors.

It has been argued that shareholders and creditors would be likely to agree to an open-ended section 214 type of directorial duty as a way of dealing with such problems. They are likely to do so, the argument runs, because the economically efficient mode of applying the right incentives is for creditors to be allowed to decide on the efficient balance between, on the one hand, spending on control or monitoring activity, and, on the other, adjusting loan terms to take on board the risks of adverse actions by directors. Shareholders are likely to be content both that the company will pay the loan rates that are set in this manner and for directors to look to creditor interests as insolvency looms, because such a creditor-centred regime is cheaper overall than one in which shareholders and creditors seek, ex ante, to anticipate and agree all the steps that managers should take.


On the ‘perverse’ incentive for an insolvent company to continue to trade see Telfer, ‘Risk and Insolvent Trading’; Prentice, ‘Creditors’ Interest’. On excessive risk aversion see pp. 744–5 below.

Directors may tend to ally with shareholders because the latter hold equity, have voting rights and hold the power to appoint them. In the face of insolvency this may result in excessive distribution and undue and over-investment: see S. C. Myers, ‘Determinants of Corporate Borrowing’ (1977) 5 Journal of Financial Economics 147.

in troubled times.349 The company, after all, will pay interest rates that are reduced in reflection of the creditor orientation that comes with insolvency.

It may, however, be the case that, in certain circumstances, there are ways of reducing agency costs that are more economically efficient than a section 214 type of duty. In assessing these alternatives, it has to be borne in mind that, as noted, section 214 may be formulated and enforced in a manner that renders it a control device of low impact, low control effect, low deterrence and poor compensation. Under-deterrence may, indeed, occur because the wrongful actions of directors may produce losses to creditors that vastly exceed any sums liable to be forfeited by directors.350 The pessimistic view of personal liability rules generally is that they tend to be difficult to enforce because of organisational secrecy, the numbers of responsible parties involved and the evidential problems that are associated with attempts to isolate culprits and prove cases. In many cases, relevant knowledge (e.g. about the nature of the corporate decline) may, rightly or wrongly, be scattered across the management or firm and not held by one individual.351 Personal liability rules, moreover, may discourage the conscientious from acting as directors while failing to provide effective deterrence for, or remedies against, cavalier directors.352

As for the argument that personal liability rules will encourage intra-company monitoring of potential wrongdoing, the effects of such rules on non-executive directors may be undesirable.353 Executive directors tend to dominate corporate boards and possess considerable advantages over outsiders vis-à-vis their time, resources, quality of information and access to board policy-making procedures.354 The outsider faces severe obstacles in

352 See J. Freedman, ‘Limited Liability: Large Company Theory and Small Firms’ (2000) 63 MLR 317, who notes (at p. 344) that if the ‘device’ of making directors personally liable is to be relied upon, ‘it may be important for a clear and reasonably consistent body of case law to be built up in order to provide guidance and for principles drawn from this case law to be communicated to business owners prior to incorporation. Such reliance, however, presupposes a highly rational system of deterrence in which directors show a high level of understanding of detailed legal information.’
monitoring board activity and the prospect of being held personally liable for failing in such monitoring functions may prove an excessive deterrent to non-executive direction, notably when the economic benefits of non-executive direction are seen to be dwarfed by potential liabilities for damages. Companies may, in spite of such relevant factors, persuade non-executive directors to serve on their boards but the prospect of personal liability may result in such directors demanding high-risk premiums; perhaps excessive investment by the company in monitoring for offences; and the avoidance of conduct that is potentially profitable but gives rise to legal uncertainties.  

Alternatively, companies, when selecting outside directors, may seek to avoid such problems by choosing directors who are either non-risk averse or uncritical of risk taking. An incentive to select on such a basis would run counter to notions of outside directors constituting checks on corporate folly.  

The imposition of personal liability can have further cost and economic efficiency implications. Thus, the costs of compensating managerial risk bearers may be greater than the costs of deterrence by means of enterprise liability since directors bear risks of an undiversified kind. Unlike shareholders who can spread risks across a portfolio, the directors’ eggs are in the one corporate basket.  

It is preferable, say the Chicago school, to punish the corporation. This will create incentives for internal corrective action and the firm is better positioned than the state to deter misconduct by its employees and to do so efficiently.  

Another danger of personal liability is that those who are prepared to operate as company directors will become excessively risk averse, so much so that they are unwilling to take commercially justifiable risks for fear of triggering personal liability. Either such risks may be left untaken (an economically inefficient result) or those properly responsible may evade

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358 Incentives perhaps dependent on the firm itself facing high levels of punishment and probability of detection: see Stone, ‘Place of Enterprise Liability’, p. 30.
359 Where, however, the firm itself is unlikely to suffer sanctions, it may even endorse directorial wrongdoing: see J. Coffee, ‘“No Soul to Damn: No Body to Kick”: An Unscandalized Inquiry into the Problem of Corporate Punishment’ (1981) 79 Mich. L. Rev. 386 at 408.
their responsibilities. Risk avoidance can be achieved most readily by delegating legally awkward tasks to subordinates, closing companies down too early or by shifting risks to outside consultants. Economic inefficiencies may result in so far as managers shy away from decisions, fail to trade or assume responsibilities, desist from establishing effective lines of control and delegate decisions to parties less well positioned to decide relevant issues. Even where the right levels of risks are taken by directors, it may be the case that statutory regulation causes directors to spend an inordinate amount of time on compliance issues and that this may impose ongoing costs on the company that outweigh the value of any protections that ensue. In 1962 the Jenkins Report raised this issue, asking whether further statutory regulation would ‘to any significant extent hamper or impede the company in the efficient conduct of its legitimate business’.

Nor may directors find reassurance in judicial responses. Heavy reliance on personal liability places a good deal of faith in the courts as arbiters of the business decisions of directors. As has been seen above, however, the judges have left the wrongful trading law in an uncertain state that (if enforced) would be likely to chill efficient directorial risk taking. This uncertainty might make directors ‘likely to shy away from taking the sort of bold resolute decisions that are required to maximise profits’.

It may be the case, however, that the disciplines of the labour market will reinforce the wrongful trading and other insolvency provisions, so as to give directors incentives to behave properly during times of decline. The optimistic argument here is that a director’s value in the market will be influenced by his reputation for behaving reasonably: ‘He has an incentive to signal to the market that he is capable of effectively doing all that any reasonably competent manager would do to abate the damage done to the company’s creditors.’366 In response to such optimism, however, it can be said that even if a director was governed by the labour market, this would not necessarily demand that an appropriate balancing of creditor and shareholder interests was ensured by the director. Such a market might look to issues of basic competence, but a ‘balanced’ approach to different interests would only be valued by a market that itself reflected such interests. A labour market dominated by shareholder concerns would reward directors who favoured members’ rather than creditors’ interests.

As for the power of the labour market, this, like the market for corporate control, may encounter severe informational problems in assessing directorial behaviour, especially during periods of corporate difficulty when affairs move fast, data may not be collected efficiently, there is confusion and blame-shifting as ‘tracks are covered’. For all these reasons it is difficult to see the labour markets as making up for the deficiencies of personal liability rules in encouraging efficient company direction.

Economically efficient rules for influencing directorial behaviour must incentivise the taking of remedial actions at the right stage of a company’s troubles. In focusing on the wrongful trading rules it is, accordingly, relevant to ask whether these trigger the duty to have regard to creditor interests at the right stage in corporate decline. To recap, the objective of the provision can be seen as giving directors proper incentives to avoid taking unreasonable risks with creditors’ funds at the point in corporate decline at which duties to shareholders and shareholders’ (now diminished) equity interests no longer operate effectively to prevent excessive risk taking by the directors.367 Here it is worth emphasising again that insolvency is a precondition for liquidators enforcing section 214 duties but the duty to regard creditor interests arises at an

367 Davies, ‘Directors’ Creditor-regarding Duties’. 
earlier stage – when the director realises or ought to realise that there is no reasonable prospect of avoiding insolvent liquidation.\footnote{See the discussion in Davies, \textit{ibid.}, who argues that the English courts operate on the basis of a cash flow test of incipient insolvency, as in \textit{Re Purpoint [1991] BCLC 491.}} It is at that point that the directors must take reasonable steps to minimise potential losses to creditors. The precondition of insolvency will be returned to below but, focusing on the arising of the duty to regard creditor interests, could the formulation above be improved upon so as better to balance creditor protections with desires to encourage entrepreneurship and rescue? The CLRSG gave this matter much deliberation and, as noted above, canvassed the potential rule that directors should be required: ‘where they know or ought to recognise that there is a substantial probability of an insolvent liquidation, to take such steps as they believe, in their good faith judgement, appropriate to reduce the risk, without undue caution and thus continuing also to have in mind the interests of members’.\footnote{CLRSG, \textit{Final Report}, 2001, para. 3.17.} The Government, however, rejected this version as inconsistent with the promotion of a rescue culture and it is also likely that the courts would have been reluctant to have interfered with the judgements of directors on the basis of such a test.\footnote{Davies, ‘Directors’ Creditor-regarding Duties’, p. 318.} Three conclusions can, perhaps, be drawn from the CLRSG’s discussion: first, that it may be extremely difficult to produce a formulation of a rule that better encapsulates the relevant policy objective than section 214; second, that reliance on the judges to assess the particular circumstances of directors’ decisions to continue trading may be unavoidable; and, third, that any problems now encountered with section 214 (at least regarding the point at which the duty arises) may flow, in the main, from how it has been applied in different courts rather than its essential formulation.

A further aspect of an economically efficient insolvency law is that it should render creditors well placed to police directors’ behaviour in times of trouble.\footnote{On the creditors’ ability to monitor directors and their role in controlling general directorial competence see Finch, ‘Company Directors’, pp. 189–95.} It is certainly the case that creditors possess significant power that is capable of being exercised at such times. Secured creditors can apply real pressure merely by threatening to exercise their legal rights upon default or even prospective default of debenture terms. Such creditor stances would impinge on directors’ reputations and prompt reappraisals of company plans and top management. Unsecured trade creditors are unlikely to exert the same broad influence
as financial creditors but, where a company fails to pay its debts, trade creditors may apply pressure by threatening to disclose this fact to other suppliers, the market and the public. As the company moves from financial difficulty to financial crisis, creditor power increases further. The company’s prospects of survival almost wholly depend on creditor co-operation. Financial creditors may be able and inclined to demand broad changes as conditions of assistance.

Threats cease and legal steps are initiated when rescue is deemed inappropriate. At this stage, creditors may replace the directors with a liquidator. At this time, actions potentially covering negligence may be brought against directors personally. Such actions, as we have seen, may be brought under a number of heads. First, like a shareholder, any creditor may bring a misfeasance action against past or present company officers for a breach of fiduciary or other duty in relation to the company. This action, however, demands a certain altruism on the petitioning creditor’s behalf. Such duties are owed to the company; thus, any contributions or compensation received from negligent directors will enter into the company’s assets and, as such, will be available to all creditors generally. These actions are, in addition, made less attractive because a misfeasance action can also be brought by the liquidator as the representative of the general creditors. Thus, liquidators, on behalf of creditors, can collect and evaluate the evidence for taking action against former directors, aided by investigative powers unavailable to individual creditors. Action by liquidators, however, is not always to be assumed even if the evidence of directorial negligence exists. Wheeler has noted the pragmatism of liquidators:

An important concern is with the location and realisation of saleable assets, from which their fees will be paid ... A fruitless but well-intentioned search for assets is unlikely to be a cost-effective use of time. An action of misfeasance, for example, becomes a reality only after a balancing exercise of factors such as cost, time involved, and the financial situation of the directors from which the recovery is sought.

373 Insolvency Act 1986 s. 212(1), (3).
374 See Insolvency Act 1986 ss. 131–4. See also ch. 13 above.
In the case of wrongful trading actions, we must return to the insolvency preconditions for enforcement. A central limitation of section 214 is that wrongful trading actions have to be instigated by liquidators after insolvent liquidation. This means that if directors breach their section 214 duty but the company is not liquidated, they will escape liability. In addition, if there is a dissolution of the company without a formal insolvency procedure (perhaps because the funds are lacking to support a formal procedure) the section 214 process is bypassed. Finally, if the insolvent company enters administration – the post-Enterprise Act preferred way of handling troubled companies – and the administrator effects a rescue, the directors who breached their section 214 duty will again escape liability. These factors all suggest that section 214 will greatly under-incentivise directors to have regard for the interests of creditors at times of corporate trouble. Those incentives might be increased by allowing individual creditors to bring section 214 actions where a company has been dissolved and no liquidator has been appointed – and by incentivising such creditors by allowing them to receive, as a first call, a portion of the directors’ contributions. Such a reform, however, possesses the limitations that the directors’ pockets have to be deep enough to encourage such actions and the creditors have to possess the time, resources and commitment to pursue such courses, as well as the information needed to evaluate the potential returns.

There are, thus, general dangers that enforcement difficulties in relation to such actions as wrongful trading and misfeasance may lead to under-deterrence. Under-deterrence may also occur because errant directors’ pockets may not be sufficiently deep to induce creditors to incur the expenses of enforcing their rights. Some lenders can resort to third-party security to make up for such deficiency. They may, accordingly, seek charges from shareholder-managers of closely held firms to cover personal property, even homes. Such actions may, however, only be feasible for powerful banks that are dealing with smaller companies in circumstances where third parties hold considerable assets.

In concluding, then, it can be said that the present law falls short in conducing to economically efficient company direction in times of

376 See Davies, ‘Directors’ Creditor-regarding Duties’.
377 See ibid.; Griffin, ‘Accelerating Disqualification under s. 10 of the Company Directors’ Disqualification Act’.
corporate trouble. A number of key difficulties can be identified. Enforcement problems may render actions such as wrongful trading suits a blunted and inefficient tool. Similarly, when liquidators or creditors face high costs in gaining relevant information about company affairs, inefficiency results. Such high costs may result from an excessive reliance on the use of outside professionals in insolvency processes and sets of incentives (or uncertainties) that lead directors to depart too early from the company scene. Legal uncertainties, as seen in the wrongful trading law, create inefficiencies both by chilling desirable risk taking by directors and by reducing the ability of shareholders and creditors to assess and manage risks at lowest cost. If it is asked whether the current statutory scheme would have been arrived at by allowing participants to negotiate, one thing is clear. Participants in such a discussion would have wanted a regime in which directors, creditors and shareholders could assess and allocate risks in as clear a fashion as possible. That is the precondition for maximising returns. From both technical and economic efficiency perspectives what matters is certainty, what is undesirable is the chill wind of unknown risks. From this point of view the current formulation of the law on directors’ duties fails to deliver.

Finally, the broad limitations of individual liability rules have to be returned to. The deterrence of sub-optimal behaviour requires not merely that legal rules are rigorously applied but that sanctions involve a correspondence between the assets that a director puts at risk and the potential losses that directorial actions may place on creditors or shareholders. This condition is rarely satisfied and, accordingly, responses such as improved directorial training, intra-company controls and accountability regimes have to be looked to.

**Fairness**

Directors might complain that, in a number of respects, they are treated unfairly by the laws and processes discussed above. Disqualification under the CDDA may have very serious implications for individuals but, as has been seen above, the courts have failed to offer clear guidance on the position of the director. Some judges have applied a ‘rights’ approach to company direction. Others have seen direction of a

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company incorporated with limited liability as a privilege. If the judiciary were to follow the logic of either of the above approaches in a consistent manner, directors might not be in a position to complain that it is unfair to subject them to a law that is incoherent and inconsistently applied. A single consistent judicial trend, however, is yet to emerge and decisions, as noted, often contain elements of both ‘rights’ and ‘privileges’ approaches.382

Before the Insolvency Act 2000, company directors might have complained that the disqualification process was so slow as to constitute an unfair regime. The Insolvency Service’s 2000 Report on Company Rescue and Business Reconstruction Mechanisms383 noted that:

There were strong arguments made that for many honest directors of failed companies, the length of time which it currently takes the Secretary of State … to bring on disqualification proceedings (or to reach a decision that proceedings will not be brought) acts as a considerable inhibition on any attempts they may wish to make to go back into business.384

The Review Group recommended that steps be taken to speed up the disqualification process and the Insolvency Act 2000 section 6 offered a response by developing the ‘fast-track’ procedure. As already noted, this procedure empowers the Secretary of State to accept consensual undertakings equivalent to disqualification orders without a full court hearing.385 Another potential complaint of unfairness, however, emerges with this process. The Institute of Directors, among others, has complained that a plea-bargaining culture may develop in which directors will be placed under undue economic pressure to accept disqualification rather than have their day in court.386 One commentator has argued that the new procedure ‘will do little to dissuade the rogue with deep pockets. The real danger is that directors with limited resources and no desire for

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382 See p. 730 above and, for example, Secretary of State for Trade and Industry v. Griffiths, Re Westmid Packaging Services Ltd (No. 3) [1998] BCC 836; Re Keypack Homecare Ltd (No. 2) [1990] BCC 117.
385 The Secretary of State may, however, require a statement of grounds for the undertaking: see Re Blackspur Group plc (No. 3) [2002] 2 BCLC 263.
386 See Walters, ‘New Regime’, pp. 92–3. See also M. Simmons and T. Smith, ‘The Human Rights Act 1998: The Practical Impact on Insolvency’ (2000) 16 IL&P 167 for suggestions (at p. 172) that it is a breach of Article 6 for the individual to face ‘such proceedings without proper legal representation’ and that if directors are unable to ‘contest the proceedings effectively due to financial considerations’ this too could amount to a breach of Article 6.
litigation against the Secretary of State will be persuaded to agree a disqualification undertaking with little or no professional advice.\textsuperscript{387}

Moving away from disqualification to the other personal liabilities of directors, the latter may again complain of unfairness on the grounds that uncertainty infuses a host of liability provisions. In relation to wrongful trading, for instance, it has been suggested that the key finding – whether the director knew, or ought to have concluded, that there was ‘no reasonable prospect’ of avoiding insolvent liquidation – poses a question that is ‘inherently elusive’.\textsuperscript{388} A director can ‘only speculate whether injecting more capital, cajoling other directors to take corrective action, tightening up accounting procedures, pursuing plans to achieve a turnaround, consulting an insolvency practitioner, or putting the company into liquidation will be sufficient’.\textsuperscript{389}

Such complaints of unfairness and demands for legal certainty are given added weight when it is remembered that, in times of corporate trouble, directors will very often be compelled to make decisions within short deadlines and under extreme pressure. The director’s difficulties are only added to by uncertainties in determining when a company is insolvent and which approach to accounting data should be used in making this calculation.\textsuperscript{390} English directors are not protected by a ‘business judgement rule’ as encountered in the USA and some commentators have questioned whether judges are qualified to strike the right balance in judging the performance of directors.\textsuperscript{391} A director has a duty to consider creditors’ interests at some stage in a company’s decline but whether this duty only operates when the company is insolvent or of ‘doubtful solvency’ rather than at some point earlier remains uncertain. The Companies Act 2006 left the judges to formulate the content of the

\textsuperscript{387} R. Tateossian, ‘The Future of Directors’ Disqualification’ (2000) Insolvency Bulletin 6 at 7. An editorial in the Financial Times (16 November 1999) suggested that prior to the Insolvency Act 2000 directors were faced with a Hobson’s choice: ‘either accept the ban, and be barred from business for at least two years; or run the risk of a long, extremely expensive court battle to try to clear your name’. Sir Richard Scott, the Vice Chancellor, argued to the Chancery Bar Association in 1999 that a solution might be to allocate costs under the ‘just and reasonable’ test of criminal cases, rather than the ‘loser pays all’ civil litigation formula: see (2000) 21 Co. Law. 90.


\textsuperscript{390} See Katz and Mumford, Making Creditor Protection Effective, part 5; ch. 4 above.

\textsuperscript{391} See Cheffins, Company Law, p. 543.
directors’ duties to creditors and, as indicated, the judiciary will enjoy a wide scope for judgement in shaping those duties as they are considered in relation to particular circumstances. The way forward here may be to hope, not that a blueprint set of rules is placed in statutory form, but that clear impediments are removed from enforcement processes and that the courts will use their judgement to produce rules and applications of these that are increasingly commercially operable and consistent.

**Conclusions**

The current regime of insolvency laws and processes fails to deal with company directors in a convincing manner. The sections above have identified deficiencies on the accountability, expertise, efficiency and fairness fronts. In many ways, the root cause of insolvency law’s failure is one that has been alluded to already. Present insolvency law is not underpinned by a conception of the company director, or the company director’s insolvency role, that is explicable in relation to a sustained set of values or principles. Instead, we see an institutional inconsistency in which company directors are sometimes seen as competent and trustworthy individuals with private rights to direct limited liability companies that are worthy of strong protection. On other occasions, directors are seen as fortunate individuals who exercise the privilege of directing limited liability companies and who should not be too surprised if, in the public interest, they lose that right in order to protect the public or to raise standards of direction as a matter of policy.

Recent governmental policy has sought to promote enterprise and competitiveness, and to control directors’ activities through a body of law that is as simple and accessible as possible. To this end the Companies Act 2006 statutory statement of directors’ duties has been developed but no guidance has been offered in that statement regarding the point at which a particular director should start to treat creditors rather than shareholders as the risk bearers whose interests are to be taken into account. The judges have to be relied upon to put flesh on such rules. What should be avoided are unexplained divergences of philosophy. Directors cannot rightfully complain if the judges produce laws that are complex; they can complain if the laws are philosophically confused.

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Employees in distress

The insolvency of a company may prove traumatic for employees, especially those who have invested years of effort and skill in the enterprise. A range of outcomes for employees may be triggered by insolvency, and the law, in some respects, seeks to minimise the negative consequences of insolvency for employees. Insolvency law, however, has other interests to look to, notably those of creditors and possibly those of shareholders and the state. Issues of fairness come to the fore, as do considerations of rescue and the design of rules that allow efficient transfers of enterprises.

This chapter begins by outlining how the law treats employees in an insolvency. It then moves to a now familiar set of issues by asking four questions. Do insolvency laws relating to employees lead to efficient rescue processes and corporate operations? Do these laws make best use of employee expertise? Are employees given an appropriate voice within the schemes of accountability that operate in insolvency? Does the law allocate rights to employees that are fair? A further, more general issue is then discussed: whether insolvency law’s conception of the employee evidences a coherent and appropriate philosophy.

A preliminary issue, however, has to be dealt with: the scope of the term ‘employee’ for the purpose of insolvency protections. A starting point here is that, in order to claim priority as an employee, a person must be employed under a contract of service with the company rather than, say, operate as an independent contractor.\(^1\) The courts, moreover, will consider a number of factors in assessing whether a person is an employee or not, factors that include: whether the person is under the control of another or an integral part of another organisation; whether they are in business on their own account; and the economic reality of the relationship with the

alleged employer. As for the status of a director, it appears that a non-executive director who acts on his own account cannot be a company employee but that an executive director may be. In the Bottrill case, it was said that where a director held a controlling interest in the company, this did not rule out his being an employee but was merely one factor to be taken into account. Directors who were controlling owners have been held not to be employees in certain instances but, in the Nesbitt decision of the Employment Appeal Tribunal, a husband and wife with written employment contracts, salaries, a 99 per cent shareholding and a history of managing the company were held to be employees. The Tribunal stated that a majority shareholding and directorship did not affect a person’s status as an employee unless the company was a ‘mere simulacrum’. Further guidance from the Employment Appeal Tribunal came in Clark v. Clark Construction Initiatives Ltd when the Tribunal pointed to three sets of circumstances in which it might be legitimate not to give effect to an allegedly binding contract of employment: where the company was a sham; where the contract was entered into for an ulterior reason (e.g. to secure a statutory payment); and where the parties did not in fact conduct their relationship according to the terms of the contract. Clark also listed factors that might be considered in deciding whether to give effect to a contract of employment and emphasised: that the onus rested on the party seeking to deny the contract; that a controlling shareholding, or role as founder of, lender to, or guarantor of the company, did not rule out a contract of employment; and that a history of acting in accordance with the contract was a strong indicator of its validity. Factors that militated against attributing the status of employee included: not acting in accordance with the alleged employment contract and a failure to reduce the terms of the contract to writing.

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2 Ivey v. Secretary of State for Employment [1997] BCC 145, 146. Other relevant factors mentioned in Ivey are whether there is mutuality of obligation between the person and the alleged employer and the respective bargaining powers of the person and the alleged employer. (In Montgomery v. Johnson Underwood Ltd (The Times, 9 March 2001) the Court of Appeal indicated that an employee must be under the control of the employer.)

3 Keay and Walton, Insolvency Law, p. 470.


7 See also Lee v. Lee’s Air Farming Ltd [1961] AC 12 PC (NZ).

Protections under the law

At common law, employees are merely unsecured creditors of a company but a company’s directors may be entitled to consider employee interests when dealing with corporate troubles. Thus, in *Re Welfab Engineers Ltd* 9 the directors of a troubled company sold it on terms that they hoped were conducive to the business’s survival as a going concern and the court held that, in doing so, it was lawful for the directors to take such employment considerations into account.10

The Insolvency Act 1986 provisions on preferential debts are also of some assistance to employees.11 In chapter 14 it was noted that these provisions give preferential priority to unpaid wages and accrued holiday pay owed.12 The effect is that such payments are payable out of the available assets of the company in advance of unsecured claims and claims secured by floating charges but after relevant insolvency expenses and other secured claims. In addition, however, two pensions debts are treated as preferential.13 Unpaid employee contributions are preferential to the extent of sums deducted from pay by the employer in the last four months but not yet paid to the pension scheme. There is no ceiling limit set on the amount that can be preferential under this heading. In the case of unpaid employer contributions, the preferential status is limited, firstly, to amounts owing in the last twelve months to a contracted-out occupational pension scheme14 and, secondly, to the amount of the national insurance rebate applicable. The preferential amount is thus restricted to a percentage of relevant earnings.15

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9 [1990] BCC 600.
10 See also the Court of Appeal decision in *Re Saul D Harrison & Sons plc* [1994] BCC 475.
11 Insolvency Act 1986 s. 386 and Sch. 6.
12 Insolvency Act 1986 Sch. 6, Category 5 (limited, in the case of pay arrears, to payments due regarding the four months before the relevant date (up to a maximum of £800) under Sch. 6 para. 9(b)); Insolvency Proceedings (Monetary Limits) Order 1986 (SI 1986/1996).
14 The preferential status thus does not attach to sums owing to personal pensions or non-contracted-out schemes.
15 Pollard and Carruthers (‘Pensions as a Preferential Debt’) thus calculate that, on 2003–4 figures, the maximum preferential amount per employee would be £1,240 – if the employee had earned over the upper earnings limit of £30,940.
A second, and often more productive, source of statutory protection flows from employment law and the social security system. Employees of a company which has entered insolvency proceedings are entitled to claim against the state National Insurance Fund on the terms set out in the Employment Rights Act 1996 ss. 166–70 and 182–90. These provisions enable employees to claim in respect of unpaid arrears of wages (for up to eight weeks at up to £330 per week), notice pay, holiday pay, the basic award for unfair dismissal compensation, any statutory redundancy pay and any award made by an industrial tribunal for failure to consult with representatives of the workforce. The effect is that if the Secretary of State/National Insurance Fund makes any payments to employees the National Insurance Fund is then subrogated, by statute, to the rights of the employees against the insolvent employer (including their rights as preferential creditors).

From the employee’s point of view, the advantages of the National Insurance Fund route are that National Insurance Fund entitlements are guaranteed as opposed to preferred. Employees are thus certain to be paid such entitlements in full (up to the statutory limit) even if the insolvent employer has no funds. They are also spared the delays involved in allowing insolvency processes to run their full course in meeting their preferential claims and they avoid the danger that the claims of fixed charge security creditors will exhaust the insolvency estate before the preferential claims come to be dealt with.


17 Employment Rights Act 1996 s. 186(1)(a); Employment Rights (Increase of Limits) Order 2007 (SI 2007/3570), increasing, inter alia, the maximum compensatory award for unfair dismissal to £63,000 and the maximum amount of a week’s pay (for calculating the basic or additional award for unfair dismissal or redundancy payment) to £330.


19 Claimants on the National Insurance Fund do, however, have to establish their redundancy claims before a tribunal: see R. Morgan, ‘Insolvency and the Rights of Employees’ [1989] Legal Action 21.

20 See Clarke and Rajak, ‘Mann v. Secretary of State’, p. 89, who also noted the danger that increasingly wide drafting of fixed charges tended to reduce the value of statutory preferential status; see further ch. 9 above.
Employees are also protected by a series of laws that conduce to the continuation of their paid employment. When the employer company becomes insolvent, prospects of payment diminish. If the company remains the employer during rescue attempts, the employees’ claims for wages are protected by the priority rules already noted. Where, however, an administrator becomes their employer, in relation to adopted contracts, sums due regarding ‘wages or salary’ are payable ahead of the claims of secured creditors and even ahead of the administrator’s own remuneration and expenses.\(^{21}\) The administrator will be indemnified by the secured creditor and the effect is to give retained workers ‘super-priority’ for their wages. Under the Insolvency Act 1986, Schedule B1, paragraph 99(5) no account is taken of actions taken in the first fourteen days of the administration when assessing whether the administrator has adopted a contract. This provision gives fourteen days of grace in which an administrator can decide whether and how to effect a rescue. Adopting employee contracts preserves employment and makes the administrator the guarantor of the wages but the ‘super-priority’ rule also means that the administrator risks his expenses.

What the phrase ‘wages or salary’ covers for the purposes of paragraph 99(5) has been considered by the courts. In *Re Allders Department Stores Ltd*,\(^ {22}\) Lawrence Collins J stated that, when contracts of employment were terminated after adoption, redundancy and unfair dismissal payments were not ‘wages or salary’ under paragraph 99.\(^ {23}\) This was not the view taken at first instance in *Huddersfield Fine Worsted*\(^ {24}\) but the Court of Appeal, in the same case,\(^ {25}\) ruled that, in spite of the changes to the wording of section 19 of the Insolvency Act as it was transformed into

\(^{21}\) I.e. secured creditors holding floating charges: Insolvency Act 1986 Sch. B1, para. 99(3)(b) and 99(4)(b). Para. 99(6) states that ‘wages or salary’ includes sums due regarding holiday pay (or in lieu of holiday pay), illness or good cause absence, periods that would be treated as earnings under a social security enactment, and contributions to occupational pension schemes. For a discussion of employee claims and the respective legal liabilities of companies and insolvency practitioners see D. Pollard, ‘Personal Liability of an Insolvency Practitioner for Employee Claims’, Parts 1 and 2 (2007) 10 Insolvency Intelligence 145, (2008) 11 Insolvency Intelligence 7.


paragraph 99 of Schedule B1, there was no significant change of priorities regarding employment liabilities and that protective awards under section 189 of the Trade Union Labour Relations (Consolidation) Act 1992 were not payable in priority to the expenses of the administration. Such awards were not sums covered by the term ‘wages or salary’ per paragraph 99(6).

It was clear that, in taking this view, the Court of Appeal was mindful that a construction of the statute that rendered the adoption of employment contracts more expensive would undermine the rescue culture by tending to lead the administrator to dismiss workers during the first fourteen days of the administration rather than to keep them on and seek to implement a strategy of continued trading.

26 Notably, introducing (in para. 99(6)(d)) the reference to liabilities ‘treated as earnings under an enactment about social security’. For a critique of the revised (and confused) wording resulting from the transposition of s. 19 to paragraph 99 see Neuberger LJ in Re Huddersfield Fine Worsted and Lyons and Roberts, ‘Administration Expenses – Friday Afternoon Drafting and the Rescue Culture’.

27 In Day v. Haine [2007] EWHC 2691 (Ch) the High Court stated that employees who become entitled to a protective award after the onset of liquidation cannot claim against their employer or liquidator. Their only remedy is against the Secretary of State for BERR under the Employment Rights Act 1996: see R. Nicolle, ‘Employee Rights in a Restructuring’ (2008) Recovery (Spring) 37.

28 The respondents failed on another front also. The court stated that there were two conditions for super-priority: the sum had not only to be ‘wages or salary’, it had also to be a ‘liability arising under a contract of employment’. A protective award under the employment protection legislation at issue did not, according to the court, arise from a contract of employment.

29 Echoing the approach of Lord Browne-Wilkinson in Powdrill v. Watson [1995] BCC 319, 330; [1995] 2 AC 394, 443–4, who spoke of not impeding the rescue of viable businesses through ‘imponderable liabilities to employees’: see Lyons and Roberts, ‘Administration Expenses – Friday Afternoon Drafting and the Rescue Culture’. See also A. Walters, ‘The Impact of Employee Liabilities on the Administrator’s Decision to Continue Trading’ (2005) 26 Co. Law. 321: ‘It is plausible to suggest that the decisions in Allders and Huddersfield are entirely in tune with the spirit of the insolvency legislation’; cf. R. Parr and N. Bennett, ‘The Rescue Culture v. Collective Employment Rights’ (2005) 18 Insolvency Intelligence 156: ‘A victory for common sense? Well, yes, if you are a supporter of the rescue culture. But there will be those who support the European approach to the enhancement of collective employment rights who wouldn’t agree. They will see [the Court of Appeal Huddersfield] decision as giving administrators the green light to ride roughshod over the rights of employees of an insolvent company. (In Powdrill v. Watson the Court of Appeal had given ‘super-priority’ not only to wages payable for the period for which notice of termination of employment should have been given, but also for holiday pay for the period before the appointment of the administrator. The Insolvency Act 1994 quickly amended s. 19 (the predecessor to para. 99) to limit administrators’ liabilities to wages or salary or occupational pension payments in respect of services rendered wholly or partly after the adoption of the contract (s. 19(6)–(8)) (holiday and sick pay were deemed wages or salary for such purposes).) See also ch. 9 above.
Another set of laws covers the situation in which there is a sale of the company or part of the business: a sale that might be made as part of a rescue operation or the realisation of assets by the liquidator, administrator or receiver. Employees in such scenarios may be faced with new owners who wish to vary terms of employment, close down some units or downsize by dismissing a portion of the workforce. General employment laws cover workforce reductions and variations of contract and will not be discussed here.\textsuperscript{30} Mention must, however, be made of the Transfer of Undertakings (Protection of Employment) Regulations 1981 (hereafter ‘old TUPE’) which implemented the European Acquired Rights Directive 77/187\textsuperscript{31} and the Transfer of Undertakings (Protection of Employment) Regulations 2006 (hereafter ‘TUPE’) which replaced and revoked the old TUPE Regulations and came into force on 6 April 2006.\textsuperscript{32}

The original Acquired Rights Directive of 1977 was designed to preserve the contractual rights of employees on a transfer of their employing business\textsuperscript{33} and, as a result, the old TUPE regulations were introduced by a ‘reluctant’ government.\textsuperscript{34} They affected transfers in insolvency and non-insolvency situations. Before the introduction of old TUPE, a

\textsuperscript{30} See generally Collins et al., Labour Law.


\textsuperscript{34} See David Waddington MP, Under-Secretary of State for Employment, HC Debates, vol. 14, col. 680.
business transfer terminated all employment contracts under the common law\textsuperscript{35} and employees of insolvent companies that were involved in a transfer were able to rely only on their preferential claims or their access to the National Insurance Fund. The purchaser of a going concern sale of an insolvent business was, accordingly, not liable for the acquired rights of its employees. Following old TUPE, matters were different. Under Regulation 5 of old TUPE (now TUPE Regulation 4) a transfer of an undertaking passed contracts of employment over to the transferee and previously employed persons became employees of the transferee under the same terms and conditions as were set out in their initial contracts.\textsuperscript{36} Unsatisfied liabilities of the transferor also passed to the transferee.

The TUPE Regulations of 2006 keep in place the rights and obligations of old TUPE but some revised wordings are used (in efforts to clarify the law and in reflection of post-1981 case law) and some changes are effected by TUPE 2006 – notably to widen the scope of the Regulations to cover cases where services are outsourced, insourced or assigned by a client to a new contractor.\textsuperscript{37} A stated purpose of the new regulations is to provide some relief from the transfer of liabilities in a formal insolvency so that some liabilities will be met by the National Insurance Fund instead of passing to the transferee.\textsuperscript{38} New provisions thus make it easier for insolvent businesses to be transferred to new employers and new rules set down the ability of employers and employees to agree to vary contracts of employment where a relevant transfer occurs.\textsuperscript{39} A new duty is also imposed on the old transferor to supply information about the transferring employees to the new transferee employer.\textsuperscript{40} Fresh provisions also set down the circumstances in which it is unfair for

\textsuperscript{35} Nokes v. Doncaster Amalgamated Collieries [1940] AC 1014.

\textsuperscript{36} Under Regulation 7 of old TUPE and Regulation 10 of TUPE, an employee’s right to participate in an occupational pension scheme does not carry over to the transferee under Regulations 5 and 6 of old TUPE or Regulations 4 and 5 of TUPE. See generally D. Pollard, ‘Pensions and TUPE’ (2005) 34 Industrial Law Journal 127 and the discussion below on the protections for employees offered by the Pensions Act 2004.

\textsuperscript{37} See TUPE Regulation 3.

\textsuperscript{38} See TUPE Regulation 8 and below. The effect is that the state subsidises transfers in potential rescue situations: see R. Dhindsa, ‘The Draft TUPE Regulations and Insolvency’ (2006) 19 Insolvency Intelligence 8; Sargeant, ‘TUPE – The Final Round’.

\textsuperscript{39} See TUPE Regulation 9. A person’s contract of employment will not transfer if the individual informs the transferor or the transferee that he or she objects to being so transferred: see TUPE Regulation 4(7); Hay v. George Hanson [1996] IRLR 427; New ISG Ltd v. Vernon and Others [2007] EWHC Ch 2665; J. McMullen, ‘The “Right” to Object to Transfer of Employment under TUPE’ [2008] 37 Ins. LJ 169.

\textsuperscript{40} See TUPE Regulations 11 and 12.
employers to dismiss employees for reasons connected with a relevant transfer.

TUPE has, however, been roundly criticised as being badly drafted and ‘bringing confusion to new heights’. A core difficulty concerns the definitions of different kinds of insolvency proceedings – upon which much depends. Transfers that are effected in the context of a formal insolvency are governed by two sets of provisions depending on the type of insolvency procedure involved. Regulation 8(1)–(6) deals with insolvency proceedings ‘opened in relation to the transferor not with a view to the liquidation of the assets of the transferor and which are under the supervision of an insolvency practitioner’. In these ‘relevant insolvency proceedings’ certain of the transferor’s debts to employees will not pass over to the transferee but will be satisfied out of the National Insurance Fund. Thus, regarding employees who pass over to the transferee, and notwithstanding the non-termination of their employment, the National Insurance Fund will meet payments due under the insolvency provisions of the Employment Rights Act 1996. In the case of employees who have been dismissed by reason of the transfer – and therefore dismissed unfairly – the debts that the National Insurance Fund will meet are those payable as statutory redundancy pay by the Secretary of State under the insolvency and redundancy provisions of the Employment Rights Act 1996.

In the case of proceedings that (in the terms of TUPE Regulation 8(7)) have been ‘instituted with a view to the liquidation of the assets of the transferor and are under the supervision of an insolvency practitioner’ Regulations 4 and 7 do not apply and there is, accordingly, no automatic


42 See TUPE Regulation 8.

43 The Employment Appeal Tribunal has ruled, in Secretary of State for Trade and Industry v. Slater [2008] BCC 70 that, for Regulation 8(6) or 8(7) to apply, the transfer must take place after the date on which the insolvency proceedings have commenced (which was to be identified with reference to the statutory provisions governing the start of the particular process) and, also, when those proceedings have come under the supervision of an insolvency practitioner – which, in the case at issue, was not until he was appointed liquidator.

44 That is (according to the Guidance of the Redundancy Payments Directorate): arrears of pay, holiday pay, sums due for failures to give statutory minimum periods of notice, and basic awards for unfair dismissal, subject to statutory limits under the Employment Rights Act 1996 s. 182.

45 These provisions give effect to Article 5(2) of Directive 23/2001.
passing of rights and obligations under employment contracts to the transferee. Nor are dismissals made by reason of the transfer automatically deemed to be unfair.

Regulation 9 of TUPE enlarges the scope for the transferor and/or transferee varying the terms of employment contracts before or after the transfer takes place. Thus, variations can be allowed where the sole or principal reason is the transfer itself or a reason that is connected with it which is not an economic, technical or organisational reason and is designed to safeguard employment opportunities by ensuring the survival of the whole or part of the undertaking. Such variations must be agreed with representatives of the employees.

As for dismissals of employees because of the relevant transfer, TUPE Regulation 7 takes the place of Regulation 8(1) of old TUPE and states that employees will be deemed to have been unfairly dismissed if the sole or principal reason for dismissal is the transfer, or a reason connected with it that is not an ‘economic, technical or organisational’ (ETO) reason entailing changes in the workforce of the transferor or transferee ‘before or after the relevant transfer’.

The insolvency implications of old TUPE depended a great deal on the courts. One central issue was whether the purchaser of an insolvent business could avoid inheriting employee liabilities if the IP, acting as agent of the transferor company, effected dismissals prior to the transfer. Matters here turned on the construction of the phrase ‘employed immediately before the transfer’ in old TUPE Regulation 5(3) (a phrase repeated in TUPE Regulation 4(3)). An opportunity to avoid employee-related obligations was provided by the Spence case where the Court of Appeal held that an employee dismissed three hours in advance of a transfer was not employed ‘immediately before’ that event. The House of Lords, however, took a different view in Litster.

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46 Regulation 9 responds to the inflexibility of the old TUPE Regulations: in Wilson v. St Helens Borough Council [1999] 2 AC 52 the House of Lords held that if employees were transferred on a relevant transfer under (old) TUPE, their terms and conditions could not be varied lawfully for a reason connected with the transfer, regardless of their consent or the period of time between the transfer and the variations of terms. See further Dhindsa, ‘Draft TUPE Regulations and Insolvency’.

47 TUPE Regulation 7(2).

48 Secretary of State for Employment v. Spence [1986] ICR 651. But see Bork International A/S v. Foreningen 101/87 [1988] ECR 3057, [1990] 3 CMLR 701 (ECJ rules that if a worker is dismissed before transfer at the behest of the transferee, and in breach of Article 4(1), the worker is regarded as being employed at the time of transfer).

where there was an hour’s gap between dismissal and transfer. Their Lordships focused on the purpose of the Acquired Rights Directive – which they said was to ensure the protection of the acquired rights of employees – and accordingly read old TUPE Regulation 5(3) in the light of old TUPE Regulation 8(1). The effect was to add to the words ‘employed immediately before the transfer’ the phrase ‘or would have been so employed if he had not been unfairly dismissed in circumstances described in Regulation 8(1)’. The new TUPE Regulation 4(3) follows Litster (only dropping the word ‘unfairly’ and renumbering the referenced regulation) by using the phrase ‘or would have been so employed if he had not been dismissed in circumstances described in Regulation 7(1)’.

A further complication flows from Regulation 7(2) of TUPE, which (like old TUPE Regulation 8(2)) offers the employer a defence. The dismissal will not be unfair if, as already noted, there was an ‘economic, technical or organisational reason’ for it (the ETO defence). The courts have held, regarding old TUPE Regulation 8(2), that improving the price of a sale will not constitute such a reason and have tended to look for a justification connected with the prospects of operating the business as a going concern. The courts have thus developed case law relevant to TUPE Regulations 4 and 7 but, from the IP’s point of view, a concern is

50 See Frisby, ‘TUPE or not TUPE?’, p. 256; Lord Oliver in Litster [1990] 1 AC 546 at 563A–B. Cases subsequent to Litster, such as Re Maxwell Fleet Facilities Management Ltd (No. 2) [2000] 2 All ER 860, also indicated that where a hive-down had taken place in an effort to avoid the transfer of employment liabilities, the courts would treat the device unsympathetically and apply the Litster approach. The courts would thus ensure that where dismissals were made prior to the eventual transfer of the hive-down vehicle, the employment liabilities would pass through to the ultimate transferee. (In a hive-down it is usual to transfer the viable parts of the business to a subsidiary of the insolvent company and to seek to sell that subsidiary as a ‘clean commercial package’: see Davies, ‘Acquired Rights’, pp. 32–3.)

51 See, for example, Eldridge, ‘TUPE Operates to Damage Rescue Culture’, p. 20.

52 See Pollard, ‘TUPE and Insolvency, II’; Whitehouse v. Charles A. Blatchford & Sons Ltd [2000] ICR 542 (CA); Wheeler v. Patel and J. Goulding Group of Companies [1987] IRLR 631 (EAT); Gateway Hotels Ltd v. Stewart [1988] IRLR 281 (EAT). See also Dynamex Friction Ltd and Ferotec Realty Ltd v. Amicus and Others [2008] EWCA Civ 381, where the Court of Appeal held that dismissals of staff made by an administrator because of lack of funds were made for a genuine economic reason, and not a reason connected with a transfer, notwithstanding that the business was subsequently sold to companies controlled by the former director. On the approach of the ECJ see Abels v. Administrative Board of the Bedrijfsvereniging voor de Metaal-Industrie en de Electrotechnische Industrie (Case C-135/83) [1987] 2 CMLR 406; Jules Dethier Equipment SA v. Dassy (Case C-319/94) [1998] ICR 541.

53 See, for example, Frisby, ‘TUPE or not TUPE?’; Pollard, ‘TUPE and Insolvency, I and II’; Collins et al., Labour Law.
that this is bedevilled by uncertainties on a number of points: for instance, regarding the ETO defence and the connection between a dismissal and the transfer.\textsuperscript{54} Such a practitioner would, in an ideal world, be able to calculate the reliability of any TUPE-avoiding measures and his or her exposure to potential employee claims. The DTI/BERR, moreover, has not decided to determine precisely the extent to which TUPE will apply to different insolvency procedures and this means that insolvency practitioners have to rely on uncertain developments in case law. It should also be stressed that whether TUPE will apply to a process will be an important factor in selecting which procedure to follow and will impact considerably on the practitioner’s ability to attract a purchaser of the troubled company or business. On present evidence, that practitioner is faced with a legal state of affairs that is uncertain and far from ideal.\textsuperscript{55}

Turning to TUPE and the position of pension rights following a transfer, Regulation 10 stipulates that rights and obligations relating to occupational pensions schemes do not carry forward to transferees. The Pensions Act 2004 sections 257 and 258, however, introduced new pension protections with respect to transfers of employment that come within the terms of TUPE.\textsuperscript{56} Regarding transfers after 6 April 2006 to which TUPE applies, transferees are required to offer transferred employees a minimal level of pension provision if they had, immediately before the transfer, enjoyed access to an occupational pension scheme with an employer contribution element. The transferee may choose whether to offer a defined benefit scheme of a defined standard or a money purchase scheme to which the employer contributes at a specified rate.\textsuperscript{57} Immediately before the transfer the transferring employee must be either an active member of the scheme; eligible to be such a member; or potentially such a member if employed by the transferor for a longer period. The 2004 Act protections, however, only apply to future benefit accruals – they do not protect benefits that relate to service before the

\textsuperscript{54} Frisby, ‘TUPE or not TUPE?’, p. 259, for instance, asserts: ‘Both insolvency practitioners and transferees will never be entirely certain whether “financial constraints” dismissals will be adjudged to be unconnected to a transfer.’


\textsuperscript{57} See Transfer of Employment (Pension Protection) Regulations 2005 (SI 2005/649) for stipulations regarding the minimal standards of schemes.
transfer, the rights and obligations regarding which remain with the transferor. What the 2004 Act does involve, for prospective purchasers of troubled companies, is the prospect of having to bear a minimum level of future pension obligations and the need to investigate, before purchasing, the transferor’s pension schemes, the contribution levels of employees and the relevant waiting periods. Obligations to match the contributions of the employee up to a maximum of 6 per cent of the employee’s salary will have to be factored into financial plans.\textsuperscript{58}

For employees, the Pensions Act 2004 brought not merely the above TUPE-related protections but also those offered by the Pensions Regulator and the Pension Protection Fund (PPF). The latter fund became operational on 6 April 2005 and provides compensation to employees who are members of eligible defined benefit schemes if the employer becomes insolvent and the scheme is underfunded.\textsuperscript{59} To be covered by the PPF the scheme must be an eligible one and must not have commenced winding up before 6 April 2005; the employer must be insolvent, its scheme funded below the PPF level of benefits, and the IP must have issued a scheme failure notice stating that a scheme rescue is not possible. In the alternative, the trustees of the fund must have applied to the Board of the PPF to assume responsibility for the scheme because it appears that the employer is unlikely to continue as a going concern; or the Pensions Regulator must have notified the Board that the employer is unlikely to continue as a going concern.

The Pensions Regulator became operational on 6 April 2005 also and is responsible, \textit{inter alia}, for protecting pension benefits, reducing the risk of claims on the PPF and promoting the good administration of pension schemes.\textsuperscript{60} The powers of the Pensions Regulator include measures designed to reduce the ‘moral hazard’ whereby employers may seek to avoid their pension obligations at the expense of the PPF. Thus, the Pensions Regulator is able to require employers to make contributions or

\textsuperscript{58} See Pollard, ‘Pensions and TUPE’, p. 139.


\textsuperscript{60} Since 30 December 2005 it has been the case that each scheme has to meet a statutory funding objective – as detailed in the relevant regulations (the Occupational Pension Schemes (Scheme Funding) Regulations 2005 (SI 2005/3377)). The Regulator also issued a code of practice, ‘Funding Defined Benefits’, in December 2005.
give financial support to a scheme\textsuperscript{61} and to issue financial support directions that are designed to prevent employers avoiding pension debts by using group structures.\textsuperscript{62}

Insolvency practitioners are obliged to give various notifications in order to assist in the operations of the Pensions Regulator and the PPF. The IP must, thus, notify the Board of the PPF, the Regulator and the trustees of the relevant pension scheme of his appointment and his ceasing to act.\textsuperscript{63} Under section 120 of the Pensions Act 2004, the IP must notify the same parties when an ‘insolvency event’ occurs in relation to an employer who operates an occupational pension scheme.\textsuperscript{64} After such an event, the IP must also inform these parties about the status of the scheme – including his view on whether a rescue of the scheme is possible. For such purposes, an ‘insolvency event’ means, in essence, the commencement of any insolvency process other than a members’ voluntary liquidation.\textsuperscript{65} The IP who acts within his duties is not, however, subject to the Pensions Regulator’s power to require contributions or financial support.

**Efficiency**

In assessing whether the law’s treatment of employees leads to efficiency in insolvency processes, it is necessary to keep the efficiency question

\textsuperscript{61} S. 38 of the Pensions Act 2004 empowers the Pensions Regulator to issue a contribution notice requiring a person to make good a shortfall under a scheme – and for such purposes a person made liable may be an employer or a person connected with, or an associate of, the employer. The circumstances allowing the use of this power include those where the Regulator is of the opinion that the person was party to an act (or deliberate failure to act) the main purpose of which was to prevent the recovery of a debt which might become due from the employer in relation to the scheme. On 15 April 2008 the Government announced that it would strengthen this power by, inter alia, removing the need for the Regulator to prove intent to avoid properly funding the scheme, taking away the employer’s ‘good faith’ defence and allowing reference to the resources of the group of companies in judging whether a financial support direction should be made (see R3 Members’ News, 17 April 2008).

\textsuperscript{62} Occupational Pension Schemes (Scheme Funding) Regulations 2005, Regulation 6.

\textsuperscript{63} See s. 22 of the Pensions Act 1995 (as modified by the Pensions Act 2004).

\textsuperscript{64} The notice must be given within fourteen days of the event or the date when the IP becomes aware of the scheme. The notice will trigger an ‘assessment period’ during which the Board of the PPF will determine whether the PPF will cover the scheme. On the low number of s. 120 notices and the growing problem of ‘orphan pension schemes’ see D. Toms, ‘Pensions: Another Ticking Time Bomb for Insolvency Practitioners’ (2008) Recovery (Spring) 36.

separate from the issue of fairness or distributional justice. Central fairness questions (to be returned to below) are whether employees’ acquired employment rights should be recognised and, if so, whether creditors, the state or other parties should bear the associated costs. Key efficiency questions are whether the law conduces to low-cost rescues or realisations (and distributions) of the insolvent company’s assets and whether the law creates economically inefficient distortions in the allocation of resources. In answering these questions it is necessary to bear in mind the broad array of employees’ protections outlined above, though this discussion will focus centrally on the TUPE regulations.

A first point to make is that the changes made with the TUPE Regulations 2006 can be seen as rescue friendly in so far as they leave the social security system to pick up a portion of the debts that the transferring company owes to employees. Such a state funding of some transfer costs will, however, not be an option under Regulation 8(6) when there is a mere liquidation of assets of the transferor, and this consideration may incline creditors and insolvency practitioners towards rescue. Where the social security system does take on some of the transferor’s liabilities, this can be expected to make the transferred business more valuable and attractive to a purchaser and, again, to encourage creditors and administrators to look more favourably on rescue options than they would otherwise do. The costs of effecting rescue may, moreover, be lowered overall if it is assumed that a clear legal undertaking to pay certain debts out of the National Insurance Fund will involve lower transaction costs than would be incurred by leaving the parties to contest liabilities of this kind.

It can be said, secondly, that employee protections may in some circumstances conduce to the efficient negotiation of insolvency solutions. As indicated, the system of employee ‘super-priority’, the rules on contract adoption, the set of employment protections and, in particular, the TUPE regulations, will sometimes operate to encourage key employees to stay with a troubled company and to help it out of its troubles. This may prove more efficient than a position in which employees rush for the door and companies that might have been turned around and rescued are liquidated. As commentators have argued: ‘The first step to assist a corporate rescue is to induce the retained workforce to continue to work. Employees will be reluctant to help, however, unless they receive a better assurance that they will receive their wages than a promise from an insolvent company.’

66 Collins et al., Labour Law, p. 1034.
Protections for employees may also help to shore up morale. It has been noted that office holders tend to fear that employees who feel that a business is doomed will have a propensity to withdraw co-operation or will be likely ‘to develop mysterious illnesses’ or simply be liable not to apply very much effort once they know that they are certain to be made redundant. Similarly, some protective rules, notably those on employee consultation, may encourage the successful pursuit of solutions. As Armour and Deakin have commented: ‘On the positive side, TUPE provides a basis on which a designated representative of the employee – either the recognised trade union or unions in the enterprise concerned, or the default representatives provided for by statute – has the power to enter into negotiations with the employer over the terms on which the restructuring may take place.’

Contrary to this optimistic view, however, are ranged a number of objections. In response to the argument that TUPE encourages rescue by shielding the transferee from liabilities, it can be cautioned that the reforms under discussion are modest and that much more could have been done to encourage rescue. TUPE provides that basic awards for unfair dismissal are paid out of the National Insurance Fund but compensatory awards for unfair dismissal (which will often dwarf other liabilities) will still pass over to the transferee – a situation that may deter the potential purchasers of troubled companies who are likely to fear not merely the quantum of such compensatory awards but their indeterminacy.

Uncertainties in the law may be another concern because they tend to raise transaction costs, produce solutions inefficiently and render rescues more difficult. Present TUPE regulations, as indicated above, are uncertain in so far as it is difficult for a transferor or a transferee to judge whether redundancies made pre- or post-transfer in order to reduce a

70 Ibid., where it is suggested that in a typical case (of average earnings and ten years of service) the quantum of liabilities that do not transfer under TUPE is likely to be exceeded tenfold by that of transferring liabilities. Collins notes the role of Regulations 11 and 12 in seeking to control the uncertainties confronting potential purchasers through mandating the notification by the transferor to the transferee of information regarding potential liabilities to employees: Collins et al., Labour Law, para. 10.44.
wage bill will produce costs to transferees following the application of Regulations 4 and 7.71 Special difficulty, as indicated, attends the definitions of different kinds of insolvency proceedings – which are crucial in deciding whether transfers of rights occur. The source of the difficulty with TUPE on this point is that the definitions of procedures used are derived from the imprecise language of the Directive and it is not certain which UK procedures are referred to – or even whether reference should be made to the type of procedure involved or the outcome of the given procedure that is anticipated in a particular context.72 Not only that, but the BERR Guidance Note on TUPE does not take the same view on these points as the 2006 DTI Redundancy Payments Directorate’s Guidance.73

A second issue is whether (leaving uncertainties aside) shifting acquired rights costs onto the purchasers of insolvent companies does indeed obstruct rescues and thereby impede efficiency. Here much depends on the particular circumstances.74 In cases where there is no prospect of rescue, acquired rights have no effect. In instances where there is a clear case for a going concern sale, acquired rights are likely not to affect the rescue although purchasers will discount the price paid in reflection of their expected liabilities to employees (a solution principally raising issues of fairness rather than efficiency). In some cases, however, the transfer of acquired rights will mean that an office holder will raise more through a break-up sale than by selling as a going concern to a buyer who will make an offer that is acquired rights discounted. Armour

72 See Rollins, ‘Technical Update’; M. Sargeant, ‘More Flexibility for Insolvent Transfers: The Amended Acquired Rights Directive’ (1999) 15 IL&P 6. (For example, even administration can be embarked upon with a view to liquidation of some, or all, of the assets of the company: see ch. 9 above.)
73 See R3, Technical Bulletin, No. 77, November 2006. The view of the DTI Redundancy Payments Directorate (Guidance of 8 June 2006) is that Regulations 4 and 7 will not apply to compulsory liquidations and creditors’ voluntary liquidations but (contrary to the statement contained in the BERR Guidance of March 2007) will apply to members’ voluntary liquidations (since these are not insolvency proceedings). In administrations, administrative receiverships and voluntary arrangements, the NIF will meet payments owed to transferring employees under the insolvency provisions of the Employment Rights Act.
and Deakin thus quote as ‘largely representative’ the following comment from a party experienced in the conduct of administrations and administrative receiverships: ‘The Acquired Rights Directive I think is bad news for employees because it makes businesses harder to sell and therefore jobs harder to rescue … [A]t the margin I’m sure there are cases where the businesses didn’t sell because of the burdens that the purchaser would have had to take on.’

The 2006 reforms of TUPE were designed to make transfers more attractive to purchasers but, as noted, liabilities for unfair dismissal compensatory payments continue to pass to transferees and this may mute the rescue-enhancing effects of the 2006 regulations. Whether the process of protecting acquired rights actually impedes rescue rather than merely reduces sale price may, again, depend on a number of considerations, such as the number of employees involved, the length of their service and the quality and timing of information possessed by the potential purchaser.

A further issue alluded to above is whether the overall effect of TUPE is economically inefficient when the National Insurance Fund pays out for redundancies in circumstances where continuing employment for some of the workforce would have lowered net costs. On this point, the DTI consultation of 2001 argued that the benefits of rescue-enhancement were ‘expected to outweigh the relatively modest additional “deadweight” costs’ in insolvency payments from the National Insurance Fund. A danger, however, is that, since employees, under TUPE, will not be able to recover unfair dismissal compensation from the National Insurance Fund and will carry this forward to the transferee, this may induce IPs to engage routinely in pre-transfer dismissals. On this last point, however, something may turn on the information possessed by the IP. If the quality of information is high, it might be hoped that the IP would assess the need to dismiss or retain on the (acceptable) basis of the employee’s value to the

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75 Ibid., p. 31. The European Court of Justice considered this issue in the case of Abels v. Administrative Board of the Bedrijfsvereniging voor de Metaal-Industrie en de Electrotechnische Industrie (Case-135/83) [1987] 2 CMLR 406.

76 Frisby, ‘TUPE or not TUPE?’, p. 265.

77 Ibid., p. 264.

78 DTI, TUPE: Government Proposals for Reform: Public Consultation Document (DTI, 2001, URN 01/1133), para. 30. (Some costs would be offset by savings in benefit payments to employees who lost their jobs on liquidation.)

79 A concern expressed by Frisby, ‘TUPE or not TUPE?’, p. 268. Cost to the state would, however, be limited in the DTI’s proposed regime as the National Insurance Fund only pays up to statutory limits.
ongoing business. On grounds of certainty there may be a case for this version of state-funded acquired rights rather than one in which proof of an ‘objective’ case for dismissal is a precondition of the National Insurance Fund’s paying for acquired rights costs rather than the transferee.80 A more pessimistic view of the IPs’ motivation might, however, suggest a tendency to take advantage of ‘tactical’ dismissals: which might involve, for example, the shedding of senior staff and replacing them with more junior personnel possessing fewer acquired rights.

**Expertise**

The law would contribute to the best use of employee expertise at times of trouble if it induced loyalty on the part of those employees whose expertise is necessary to ensure an efficient sale or rescue. As the law stands, however, the employees of a troubled company are confronted by all of the uncertainties described above and they will tend to be far less well equipped than transferors, IPs or transferees to assess their levels of job security or the financial risks they would run if they decided to stay with the company. From the narrow perspective of employee expertise, therefore, the case for measures to increase certainty can be made with special force. Here, again, therefore, there may be an argument for the state to bear acquired rights costs. Such a set up would, as noted, allow IPs and other involved parties to assess whether there is a case for dismissal on legitimate economic grounds. There is liable to be far greater consistency between that process of reasoning and the employee’s deliberations on his or her value to the firm than between the latter deliberations and an employee’s assessment of the security that he or she is likely to derive from the statutory and case law on acquired rights.

**Accountability**

Are employees given an appropriate voice within the schemes of accountability that operate in insolvency procedures? Insolvency law, together with employment law, protects that voice in a number of respects.81 First, the law on unfair dismissal requires a ‘reasonable’

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80 Frisby, ‘TUPE or not TUPE?’, p. 269, suggests that uncertainties involved in distinguishing ‘objective’, or justifiable, dismissals from others can be reduced by introducing a rebuttable presumption that a dismissal is not justifiable.

employer to engage in consultation with an individual employee prior to dismissal and, where the employee is represented by an independent union recognised by the employer, that reasonable employer will also give as much warning as possible to the union and consult the union as to the best way to achieve the desired result with minimum hardship to employees. \(^{82}\)

The law on unfair dismissal thus can collectivise worker participation in decisions about economic dismissals, but this depends on there being a relevant union and an employee may not enjoy such rights if the tribunal is satisfied that the outcome would not have differed had consultation been conducted. \(^{83}\) A second protection derives from the Trade Union and Labour Relations (Consolidation) Act 1992 ss. 188–98 which provide that if an employer proposes to dismiss twenty or more workers at one establishment for economic reasons, he or she must consult in good time with representatives of the workforce \(^{84}\) with a view to agreeing ways of avoiding or reducing dismissals or mitigating the consequences of dismissal. Failure to comply with this requirement may result in a tribunal making a protective award \(^{85}\) to the dismissed employee.

A third source of employee process rights covering the sale of a business is TUPE. The TUPE Regulations 2006 oblige the employer (transferor and transferee) to inform affected employees’ representatives in advance about a transfer and its implications. \(^{86}\) The employer must consult and consider representations from a recognised trade union or (in the absence of a union) other workforce representatives with a view to seeking their agreement on intended measures affecting employees. Failure to observe these requirements to inform and consult may mean that the employer has to pay ‘appropriate’ compensation to affected employees. \(^{87}\) TUPE Regulation 5 also states that collective agreements shall be preserved in effect across a company transfer where those

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83 Where an employer fails to act in a reasonable manner procedurally and this does not affect the outcome, the unfairly dismissed employee will often, at the discretion of the tribunal, receive no compensation in excess of the redundancy payment (Polkey v. A. E. Dayton Services Ltd [1988] ICR 142 (HL)). This development ‘subverts the procedural protections dramatically, because the employer can usually argue extremely plausibly that workforce reductions were inevitable’: Collins et al., Labour Law, p. 1063.
84 Who may be the recognised trade union or (in the absence of one) elected representatives. For an example of an award for failure to consult on redundancies as required by s. 188 see Hutchins v. Permacell Finesse Ltd (UKEAT/0350/07/CEA).
85 Consisting of wages for the period during which proper consultation should have taken place.
86 TUPE Regulation 13.
87 TUPE Regulation 15.
agreements are made by or on behalf of the transferor and a trade union recognised by the transferor in respect of an employee whose contract of employment is preserved by TUPE. Trade union recognition is similarly preserved by Regulation 6.

Overall, the effect of these provisions is to give employees a voice – but, perhaps, only a modest one – in insolvency.88 As has been stated: ‘The notion that the workforce should routinely participate in managerial decisions that might affect their livelihoods seems like a distant peak on the horizon of British industrial relations ... The culture of British management seems to be one of preferring to keep strategic decisions confidential and to regard business reorganisations as part of the managerial prerogative.’89

Employee rights, then, hardly impinge on the governance of insolvency processes90 but they may have some effects. The TUPE obligations of consultation are backed up by potentially punitive provisions and this creates an incentive for managers to collectivise negotiations in troubled times. This may lower the cost of planning and implementing new strategies,91 which may bring a number of further advantages.92 It may facilitate planning reorganisations. It may increase employee loyalty, by offering reassurance, and help avoid the destructive effects of industrial action. A further gain from listening to the worker voice may be that expertise and knowledge within the workforce may be tapped, so that more efficient or fairer ways of realising reorganisational objectives may be arrived at. The co-operation of the workforce may also result in financial assistance: where, for example, employees make wage concessions in an effort to make a turnaround work. Finally, there may be social gains from consultation. If employees are given advance notice of reorganisations, they may find new jobs, retrain, retire or take other steps that will lower the overall impact of an insolvency on society.

Such advantages suggest that (assuming transaction costs can be kept modest) there is a case in efficiency terms for strengthening the voice of

89 Collins et al., Labour Law, p. 1066.
91 Collectivising negotiations may lower costs in so far as employers can deal with the unions or worker representatives rather than engage in protracted individual negotiations.
92 See Collins et al., Labour Law, p. 1060.
employees within insolvency processes and reorganisation procedures. With reference to fairness also it can be argued that it is socially just to increase the voice of those parties who have committed their efforts and working lives to the enterprise.93 It is, indeed, to issues of fairness that we should now turn.

Fairness

Is insolvency law’s application of employee rights fair? In answering this question we may ask whether the acquired rights of employees should be recognised and, if they are to be recognised, who should bear the cost of compensating the employees of insolvent companies. (In this discussion we might note that the issues are similar whether the transfer is made via a liquidator, a receiver or an administrator.)94 On the recognition issue, responses may vary according to different ways of conceptualising the employee. One vision of the employee sees him or her as merely another unsecured creditor. As was seen in chapter 14, however, there is a case, even within such a vision, for giving employees rights that are superior or preferential to those of other unsecured creditors. It would be unfair, for instance, not to recognise that employees are especially high-cost risk bearers who tend to enjoy modest levels of information and have very limited abilities to adjust rates or negotiate terms so as to reflect risks.95 Such protections as are offered by the Insolvency Act 1986 section 175’s preferential treatment for employees’ accrued wages and the ‘super-priority’ given to employees’ wage and payment claims in administration under the Insolvency Act 1986 Schedule B1, paragraph 99, are, for the time being, on this view, justified.

Another approach, however, might treat the employee not as some species of unsecured creditor but as a stakeholder who has an entitlement to rights and protections that derives from his or her contribution to the assets of the company.96 That contribution, it could be argued, is

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94 See Davies, ‘Acquired Rights’.


different in kind from that of an individual who supplies finance or goods to the company. Labour and working commitment, on this view, are factors that create superior moral claims based on desert and contribution as well as need.97 A similar argument can be made in implied contractual terms. Employees, it could be said, are engaged with the company on the basis of implicit expectations of careers, continuing prospects and pensions and these expectations should be recognised by insolvency law.98

A comparative perspective on these issues can be achieved by looking across the Channel. In France, a series of reforms followed the election of Mitterand’s socialist government in 1981. These promulgated a strong participatory model of the employee.99 This model fully recognised the employee as a ‘participant’ in the company, in good times as well as bad. Indeed, the more a company experienced difficulties, the more the employee representative institutions enjoyed a voice and powers of action. Employees possessed rights not only to be informed and consulted but to influence decision-making. The judges, moreover, endorsed this vision so that employee representatives in France have been treated as an organ comparable to the board of directors or the general meeting.100 In 1985 the legislature made employees’ interests part of the ‘interests of the company’, and employee representative institutions were entitled to intervene very extensively as participants in insolvency procedures.101


99 See Armstrong and Cerfontaine, ‘Rhetoric of Inclusion?’.100 Ibid., p. 42.

Employee participation is firmly entrenched in France but it has not proved a panacea for troubled companies since insolvency tends to be a small company problem and to occur where employee representation is non-existent.\textsuperscript{102} It may be the case that further steps are required to assist SMEs but proponents of the French system urge the strong ethical basis of the participatory model, as ‘social justice has an imperative quite independent of efficiency rationales’.\textsuperscript{103}

If it is accepted that employees have acquired rights that should be recognised in an insolvency, who should pay? When such acquired rights are passed onto transferees who discount the prices that they pay for troubled firms, the costs of acquired rights are, as noted, liable in practice to be borne by the secured creditors of the insolvent company.\textsuperscript{104} These creditors are the parties who stand to take the lion’s share of the residual estate and they will be the first to suffer from a strict transfer of acquired rights. If, on the other hand, rights do not transfer, the state and taxpayer (through the National Insurance Fund) will compensate those employees who lose their jobs (though payments are subject, in practice, to limitations). In discussing efficiency we saw that (if low levels of ‘tactical’ dismissals can be assumed) there may be a case for state funding of acquired rights protections on the grounds that this will reduce uncertainty. Is such a solution fair to the taxpayer though?

A risk-based analysis might raise difficult questions here. It is arguable that the state is an involuntary creditor who may find it easy to spread risks but who is very ill-placed to monitor and influence risk taking and who will not reap the benefits of risk taking. It could be argued that it would be unfair to burden taxpayers for these reasons and that it would be more equitable to burden creditors with employee-related costs. Creditors, especially the banks, are, after all, not only efficient risk spreaders but they are parties who advance loans voluntarily, can adjust

\textsuperscript{102} Armstrong and Cerfontaine, ‘Rhetoric of Inclusion?’, p. 44.

\textsuperscript{103} Ibid. It should be noted, though, that a shift towards strengthening the position of creditors has taken place in France: see Law 94–475 of 10 June 1994 and Omar, ‘French Insolvency Law and the 2005 Reforms’.

\textsuperscript{104} And by unsecured creditors if assets are sufficient to satisfy secured creditors’ claims and leave a fund.
their terms to perceived risks, are well informed and stand to benefit (at least through interest mechanisms and sales of ancillary bank services) from the profits made by the enterprise. There are, however, some reasons why the state can be said to enjoy the benefits of risk taking and should be prepared on grounds of fairness to fund acquired rights. Entrepreneurial risk taking will be encouraged by such funding and this will conduce to wealth creation which in turn will benefit the state in many ways.\textsuperscript{105} It would allow rescues and redistributions to occur in a lower friction manner than would be possible under a regime demanding that creditors should bear such costs. This may prove fair to taxpayers in so far as there is a return to the state for its efforts: the lower friction regime of enterprise would be likely to produce, overall, greater wealth for the state.

On both efficiency and fairness fronts, it seems there is a case for state funding of acquired rights in two situations.\textsuperscript{106} First, if the anticipated incidence of abuse through ‘tactical’ dismissals is reasonably small – and outweighed by gains in net wealth creation – it would be sensible to fund all insolvency-related dismissals from state sources. If, however, the likelihood of such abuse is high, it will be necessary to distinguish, at lowest cost, between objectively necessary dismissals (which would be state funded) and unjustifiable or ‘tactical’ dismissals (which would not be paid for by the National Insurance Fund). Guidance on these choices can best be derived from research into the severity of risks that state funding might be abused and into the potential of new laws and processes (such as reversals of proof)\textsuperscript{107} to reduce the uncertainties and transaction costs that flow from efforts to separate economically necessary from unjustifiable dismissals.

Conclusions

Employees are in some ways the lost souls of insolvency law. Their working contributions are the lifeblood of companies, yet the law does remarkably little to involve them in insolvency procedures. This is

\begin{footnotesize}
\begin{enumerate}
\item[105] Amongst other things there would, as noted above, be savings on National Insurance Fund benefit payments where rescues are effected.
\item[106] On the (attractive) case for socialising employee claims, see Davies, ‘Acquired Rights’, p. 53.
\item[107] See Frisby’s suggestion (noted above) of lowering costs by applying a rebuttable presumption that a dismissal is not objectively necessary where dismissal and re-engagement occurs pre- and post-transfer: Frisby, ‘TUPE or not TUPE?’, p. 269.
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because the law has failed to develop on the basis of a coherent and appropriate conception of the employee. On the one hand, insolvency law sometimes sees the employee as a creditor who merits a certain amount of protection. On the other, he or she is occasionally treated in a manner consistent with the rhetoric of stakeholding. Policies on employees, moreover, are driven, in relation to some issues, by considerations of economic efficiency yet on others they are shaped by reference to ethical and social justice arguments. The way to resolve such difficulties is, first, to develop a solid informational and research base so that the implications of dealing with employees in different ways can be calculated rather than guessed at. Some of the works referred to in this chapter offer evidence that the foundations of such research are now being laid. Much more work needs to be done, however, before reliable judgements can be made on issues such as the role of employee loyalty within rescues; the quality of information that tends to be available to potential parties to rescue; or the role played by employee representatives in designing and achieving turnarounds. Second, there needs to be greater clarity not merely about the objectives of insolvency law as a whole, but about the conception, nature and extent of employees’ rights in the corporation. Finally, and building on these developments, there needs to be a greater openness (even political honesty) regarding the trade-offs of risks, values and interests that are involved in insolvency law.\(^{108}\) This means that tensions between the interests of shareholders, creditors, employees, the state and other stakeholders have to be confronted rather than hidden away.

\(^{108}\) See, for example, Armstrong and Cerfontaine, ‘Rhetoric of Inclusion?’, p. 45 and the authors’ attack on (the then) DTI approaches as ‘tinkering’.
Conclusion

In some ways corporate insolvency law has come a long way since the Cork Report.¹ Numerous statutes, court decisions and administrative reforms have sought to develop the law so as to remedy deficiencies and secure newly appreciated needs. In the new millennium, the UK Government has shown a renewed desire to attune insolvency laws to the requirements of enterprise while, at the same time, avoiding abuses and injustices. In other ways, however, corporate insolvency law can be seen, to date, as an area marked by missed opportunities and modest achievements. It has, first, failed to develop as an organised, consistent and purposeful body of rules and processes. This has been a legal sector in which Cork’s prescriptions were cherry-picked and where, subsequently, particular issues have been dealt with piecemeal by both legislators and judges. Corporate insolvency law has, secondly, been developed without close co-ordination with relevant legal sectors and processes. It has not been linked sufficiently tightly with company law – in spite of its relevance to the ongoing needs of healthy companies – nor has it been tied in with an analysis of the arrangements for providing finances for companies that are found in the UK. As was made clear in chapter 3, corporate insolvency law is faced with a pattern of corporate funding that is dictated very largely by the legal frameworks that govern the provision of credit, notably those relating to security and quasi-security. To design insolvency law without looking at those arrangements is to cut the cloth without measuring the client.

A third deficiency is that this has been an area of law that has developed without a consistent guiding philosophy. As was stressed in chapter 12, different procedures have been developed on the basis of inconsistent assumptions not only about the values and objectives that are properly to be pursued, but also about the potential and roles of the different actors that are involved in insolvency processes. Directors and

¹ Report of the Review Committee on Insolvency Law and Practice (Cmnd 8558, 1982).
employees are central figures in corporate insolvency law and processes, but the law is based on notions of directorial roles and employee rights that are multiple, inconsistent and competing. This has led to a host of confusions, uncertainties, inefficiencies, unfairnesses and misplaced accountabilities. The broad end-product has been a system of corporate insolvency law that has offered, for much of the period since Cork, not so much a choice of processes that pull together harmoniously as an ill-organised array of procedures that, in many respects, have undermined each other.

There may be signs, though, that matters have improved in recent years. The Enterprise Act 2002, for instance, went some way to harmonise processes when it ended the potential for deploying receivership so as to ride roughshod over other corporate insolvency mechanisms such as administration and company voluntary arrangements. UK insolvency law has, moreover, embraced the rescue culture as a framing objective of insolvency law and it has espoused a generally collectivist approach to insolvency processes with the establishing of the post-Enterprise Act administration procedure.

The challenges facing insolvency lawyers and practitioners are, however, as acute now as they have ever been and a host of rapid changes has altered the nature of insolvency practice. As noted in the Introduction, much more ‘insolvency work’ is now being carried out prior to the institution of any formal insolvency process and the growing use of devices such as the ‘pre-packaged’ administration demand that we pay increasing attention to the quality of informal procedures for dealing with corporate troubles. New and acute questions have arisen concerning the efficiency, accountability and fairness of those procedures and actors that are encountered in the ‘twilight zone’ of insolvency. A related concern may be the level of expertise that is brought to bear by the new corporate distress specialists who operate in the shadows of insolvency.

The development of the ‘new capitalism’ has also imposed new strains on the world of insolvency. As sources of credit have become more disparate, and as the ever more complex packaging of debt has lowered the transparency of lending, it has become increasingly difficult to rely on the old assumptions that have traditionally underpinned insolvency processes. Thus, it can no longer be assumed that a dominant bank lender will be present to monitor and organise a company’s attempts to turn its affairs around. Similarly, the ‘London Approach’ to rescue has been taken to breaking point by the difficulties of securing essential undertakings across ever larger numbers of lenders with increasingly
divergent natures and interests. In such a world of change, the unavoidable danger is that the rules of insolvency law – even if they are coherent and satisfactory – will not be able to exert real control in those areas of activity where the real decisions are being made. Nor can it be assumed that such a danger will be less acute after the credit crisis has passed. The credit crisis of 2007–8 and aftermath may stimulate the taking of steps to increase the transparency of credit-related transactions. There may be new regulatory reforms that are designed to render the credit markets more stable, but such responses are unlikely to reduce the number and variety of parties who provide financing in the ‘new capitalism’.

To return to insolvency law’s need to mesh with other legal domains, consistency of philosophy means not only that insolvency law has to be characterised by purpose and direction but that company and employment laws need to be both internally coherent and consistent with insolvency law. The chapter 16 and 17 discussions of directors and employees give an indication of the dangers and challenges being confronted here. To give a simple example, it is of little value to design insolvency laws that are rescue friendly if laws on employment protection offer strong disincentives to the corporate transfers that are necessary to keep businesses alive.

The returns from philosophical consistency are, moreover, important. At various points throughout this book it has been argued that legal uncertainties produce high costs, inefficiencies and unfairnesses. It might be responded, though, that laws can never be certain, that judges have to apply rules to differing circumstances, and that judges need to adjust criteria, standards and rules to cope with changes in such matters as business practices and ways of setting up commercial relationships. There is, however, an important distinction to be drawn between the unavoidable uncertainties that flow from the factors just noted and the unnecessary uncertainties that arise because inconsistent philosophies are vying with each other in driving legal developments. If, for example, punitive approaches to company direction are sustained in competition with public protection philosophies (or if rescue-oriented and creditor protection responses are set against each other) a great deal of uncertainty will unnecessarily arise if there is no set of overarching principles that indicates which of the competing approaches will prevail in which circumstances, or what balance between the approaches is appropriate.

It is philosophical consistency – within and across the areas of insolvency, company and employment law – that offers such guiding principles. This, it should be emphasised, does not mean that a single
substantive blueprint has to be laid down – in a changing world such blueprints rapidly pass their sell-by dates. What is required is an approach that confronts competitions between values and objectives and explains how these can be understood and argued out. It is the ability to explain – and so to understand and predict – that reduces uncertainties.

This book has set out to respond to these questions of philosophical deficiency. It has done so, first, by making out the case for an ‘explicit values’ approach to the design and evaluation of corporate insolvency processes. This is an approach that is applicable to all corporate insolvency procedures and encourages the development of mechanisms that are consistent in so far as they link to a common philosophy and to a limited number of identifiable values. Second, this book has set out to examine not merely the formal rules of corporate insolvency law but also the procedures, actors and institutions that give substance to the law as an aspect of corporate life and decline. The law, after all, does not achieve a great deal if formal rules are harmonious but confusions and inconsistencies of approach pervade the processes and institutional structures that are needed to implement these rules. Attending to procedures, actors and institutions means that difficult questions have to be tackled concerning not merely the substantive and procedural rights of individuals, groups and firms but also the capacities and incentives of these parties to deliver the appropriate levels of managerial skill and commitment to rescue or winding-up processes. The return from coming to grips with these issues is that corporate insolvency law can be assessed and redesigned with an eye to operational matters and not merely to the formal rules.

A third way of responding to the current problems that are encountered in the law has been to examine whether the assumptions that underpin existing laws, procedures and institutions need to be challenged so that new ways of conceiving rules, processes and actors are necessary if an explicit values approach is best to be served.

The chapters above have presented arguments in favour of a number of changes that seem likely to lead to gains in efficiency, expertise, accountability or fairness without unduly negative side-effects. On the financing of corporate organisations, current arrangements involve significant dangers that transfers of insolvency wealth will be effected from unsecured to secured creditors and to parties who are well equipped to make use of quasi-security devices. Such transfers, where they occur, may prejudice healthy companies’ needs as well as the interests, in
insolvencies, of certain creditor classes (notably the unsecured trade creditors). Procedures could and should be adopted to allow unsecured creditors to inform themselves more easily about the risks they are running when they provide credit. This is not a complete answer for all unsecured creditors but it is a step that will help reduce inefficiencies and unfairness with regard to certain parties.

As for the system of priorities that insolvency law establishes, this is rendered uncertain and confused by the capacity of ‘creditors’ to employ quasi-security devices such as retention of title clauses. Steps could be taken to reduce such confusions and, in turn, to lower general transaction costs. Thus, for example, a more rigorous approach to the registration of retentions of title would increase transparency and reduce the costs of borrowing by lowering the levels of financial uncertainty that creditors face when providing funds.

Turning to the major actors in corporate insolvency processes – the IPs – it has been argued above that there is no strong case for reforms to replace IPs with court officials or civil servants. There may be good grounds, however, for tightening the mechanisms used to regulate IPs, for rethinking the breadth of the duties that IPs owe in insolvency procedures and for subjecting IP regulation to more rigorously independent oversight. Where, moreover, much insolvency work is being undertaken informally by non-IPs there is a need to monitor, on an ongoing basis, the activities of turnaround specialists and those other parties who impact on corporate troubles. The hanging question is whether it makes sense for the law to control IPs tightly and yet leave unregulated a series of practitioners who engage in work of a similar nature and impact.

Current governmental endorsements of a rescue orientation in corporate insolvency procedures are to be welcomed but the discussion of rescue in chapters 6 to 12 revealed considerable scope for improvements in present arrangements. First, there is a need for harmonisation so that different rescue procedures do not undermine each other – so that, for instance, the use of ‘pre-packs’ does not allow the sidestepping of those procedural protections and balances that are established by the law governing post-Enterprise Act administrations. Efficiency in rescues may also be served by giving directors greater incentives and capacities to resort to rescue procedures before the company’s chances for turnaround have evaporated. Thought should be given, for instance, to ending the requirement, in the Insolvency Act 1986 Schedule B1, paragraph 11(a) that a court must be satisfied that a company is, or is likely to become, unable to pay its debts before it can make an administration
order. Consistent assumptions ought also to be made across rescue procedures concerning the roles of different actors such as directors or IPs. Such assumptions, moreover, should be based not on traditions of deference or unexplored notions of culpability but on a considered analysis of factors such as informational position; training; incentives; specialist knowledge of the relevant market; ability to assess financial options; and commitment to rescue.

Accountability within rescue procedures should, again, be ensured in reflection of a philosophy that is consistent across procedures. To this end, the use of pre-packs, again, may prompt the observer to ask whether such processes allow vulnerable creditors properly to hold decision-makers to account and to bring an appropriate voice to bear on proceedings. There may also be a case for reconsidering whether shareholders should be excluded from the approval process in Schedule B1 administrations when insolvency is merely likely. Such an exclusion may not be fairness-enhancing and it may, similarly, be argued that fairness demands that the interests of employee stakeholders should be reflected in greater access to, or recognition in, the decision-making processes governing administration.

As far as the substantive principles governing post-insolvency contributions are concerned, it is collectivity and the _pari passu_ principle that have long occupied centre stage as regards residual assets. _Pari passu_ has, however, been subjected to a variety of exceptions and bypassing arrangements. The Crown preference has been abolished but the case for revising the rules on set-off is one not to be dismissed. It is difficult to support proposals for giving consumer creditors increased priority – largely because it is so difficult to distinguish ‘consumer’ from ‘trade’ creditor vulnerability – but employees can, for the moment, be identified as the creditor group most deserving of special treatment because of their status as non-adjusting, high-cost risk bearers. On replacing the _pari passu_ principle with another approach to distribution of the residual assets, it has been argued that alternatives that involve assessing the individual position or merits of the creditor would give rise to much uncertainty and would involve both inefficiencies and unfairnesses. New approaches to the definition of creditor classes face severe difficulties in dealing with heterogeneities within the memberships of such redefined classes and there would be problems in showing why such newly favoured classes would have claims that are stronger than those of competing classes.

It has been emphasised in chapter 15 that _pari passu_ only comes into operation once the relevant, residual, insolvency estate has been
constructed. Values such as efficiency and fairness have, accordingly, to be pursued in constructing the estate more generally and in establishing protections for ‘vulnerable’ risk bearers in the form of: procedural requirements (of information provision and disclosure); substantive protections (such as setting the ‘prescribed part’ at the appropriate level); ways of reducing overall risks of insolvency (for example, by improving directorial standards and training); and ways of spreading insolvency risks and, thereby, lowering risks borne by vulnerable parties.

The position of employees needs to be clarified not merely for the sake of employed persons but so that parties buying and selling companies can do so without excessive costs. A way forward, in the corporate transfer area, may lie through building on the TUPE 2006 Regulations by increasing further the state funding of employees’ acquired rights costs in corporate transfers post-insolvency. The law should also move towards a conception of the employee that recognises his or her participatory rights and contributions to the company. The relationship between this conception of the employee and the dictates of economic efficiency should be set out clearly in the law and such a relationship sustained in a consistent manner by the judiciary. As an underpinning to such developments in the law, more research should be undertaken (and state funded) on such matters as the potential role of the employee in rescues. Only against a reliable background of research can legislators, policy-makers, judges or others make informed judgements on implications for employees, other creditors or the variety of affected parties when they are shaping corporate insolvency processes or deciding issues.

As a final conclusion, a return should be made to the nature of the corporate insolvency law philosophy that is being argued for here. The ‘explicit values’ approach, it should be emphasised, is one that seeks to embrace both the public and private dimensions of corporate insolvency law. It is always difficult to reconcile public interests with those of private contractors, especially where private contractors vary sharply in their economic power, information levels, expertise and so on. A way to effect a ‘least-worst’ reconciliation, and to argue out the merits of this, is, however, to identify the values that are sought to be furthered within corporate insolvency processes. This, in the first instance, helps us to identify the ways in which different rules, processes and institutional arrangements affect various parties in divergent ways. Greater transparency is thus given to decisions about trade-offs. We can be clearer, for instance, on how much a new statutory requirement might affect small trade creditors compared to large secured bank lenders. Such
an approach also helps us to identify more easily the contradictory effects and assumptions that are associated with different processes and arrangements.

If corporate insolvency law is to move forward as a coherent, consistent and purposeful set of rules and processes, it is necessary to rethink a number of its elements in the light of such transparency. Some of those elements have been identified here and one route towards greater clarity of design and evaluation has, I hope, been mapped out in this book.

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