# Corporate Rescue: A Critical Analysis of its Fundamentals and Existence

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The candidate confirms that the work submitted is his own and that appropriate credit has been given where reference has been made to the work of others.

# Acknowledgements

A number of years ago when I was studying for the LLB I remembered corporate Insolvency Law being briefly covered within company law – a common way of introducing and explaining in a few words the key concepts and what happens to a company when it is unable to pay its debts. It was during the course of these seminars that I began to realise the importance of Corporate Insolvency Law in particular the extent that it may affect local communities and the tensions that exist between the creditors and other interested parties. It was by chance after I had completed the LLM that an opportunity presented itself to study a LLM in Insolvency Law with Professor Andrew Keay, the same lecturer that had sparked my interest in the subject a few years earlier. It is difficult to explain exactly what it was that encouraged me to pursue a PhD in this field, other than to say that the intricacies of corporate rescue strategies and the breadth of research that was possible in this area fascinated me.

Normally it is perceived that most PhD students would thank their supervisor for the kind and tireless efforts that they have received over the course of the thesis. In my case, I would like to additionally thank Professor Andrew Keay for being the one that inspired me all those years ago.

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# Abstract

The current financial climate has created an unsympathetic environment for companies to trade. The economic shift has highlighted the fragility in which companies are financed, operate, and how they identify, analyse and attempt to neutralise financial distress. Given that the potential options available to a company are dependent on the conclusions drawn from the examination of the distress it has become imperative to determine at what point a company is in trouble. In conjunction with satisfying this point, effort must also be placed on defining "financial distress" and considering how this has had a bearing on the implementation of a rescue strategy. The array of problems that companies face do not all need to be fatal, and hence not all companies that have problems have to be liquidated. Corporate rescue is a variable term. How it is applied depends on a number of factors that range from the identity of the company to the philosophy and character of the insolvency practitioner. Currently corporate rescue follows a formal mechanism known as administration. This process is increasingly coming under challenge from an alternative model that addresses the fact that administration can be a lengthy and expensive process. This alternative model known as pre-packed administration ("pre-packs") offers to conduct "rescue proceedings" in secret and often result in selling the company to members of the existing management. How the pre-pack model operates and conflicts with many of the UK's traditional principles such as transparency and fairness highlights the tension within the profession as well as a lack of legislative guidance on the matter. This thesis aims to consider a number of issues: to assess the characteristics evident within the UK's corporate rescue model and determine whether they comply with the theoretical principles of rescue; to examine the relationship between corporate rescue theory and government policy and how this has developed within the current economic environment; to determine whether the UK's rescue model, when evaluated in light of the efficiency rule, can be classed as a true rescue model; and to ascertain whether pre-packs offer a viable and legitimate solution to the inadequacies of the current law governing corporate rescue. Chapter One will introduce the corporate rescue concept and set out the research questions and aims that will be examined in this thesis. The second chapter will take a closer look at the fundamental principles and characteristics that are essential to the UK's corporate rescue model and help shed light onto how the rescue regime came to being endorsed. Chapter Three is constituted by two parts. The first part sets out to examine how rescue is implemented in practice, taking a look at the different philosophical divides in

corporate rescue and the influence of the Cork report. The second part focuses on the role and duties of the insolvency practitioner, in particular the wide discretion afforded to them and how they may use this to their advantage. Chapter Four explores the theoretical concepts of efficiency and the relationship that this has with the UK's administration process. The penultimate Chapter introduces the alternative "rescue" measure which this thesis will class at the pragmatic response to the inadequacies of the current corporate insolvency legislation. Finally Chapter Six reflects on the research questions and aims set out in Chapter One and highlights any areas that would benefit from further research.

# Contents

## Table of Cases

*Associated Provincial Picture Houses Ltd v Wednesbury Corp* [1948] 1 K.B. 223

*Austinsuite Furniture Ltd, Re* [1992] B.C.L.C. 1047

*BNY Corporate Trustee Services Ltd v Eurosail-UK* 2007-3BL Plc Court of Appeal (Civil Division) [2011] EWCA Civ 227

*Brady v Brady* [1989] A. C. 755 HL

*Bramston v Haut* [2012] EWHC 1279 (Ch)

*Brook v Reed* [2011] EWCA Civ 331

*Buchler v Talbot* [2004] 2 A.C. 298

*Byblos Bank SAL v Al Khudhairy* [1987] BCLC 232

*Capital Annuities Ltd, Re* [1979] 1 WLR 170

*CE King Ltd, Re* [2000] 2 B.C.L.C. 297

*Cheyne Finance plc (no 2), Re* [2008] 2 All ER 987

*Clydesdale Financial Services v Smailes* [2009] EWHC 1745 (Ch) [2009] B.C.C. 810

*Cuthbertson & Richards Sawmills Pty Ltd. v Thomas* (1998) 28 ACSR 310

*Debtor (No 17 of 1966), Re* [1967] Ch 590, [1967] 1 All ER 668

*DKLL Solicitors v HM Revenue & Customs* [2007] EWHC 2067 (Ch), [2007] B.C.C. 908

*Douglas Griggs Engineering Ltd., Re* [1963] Ch 19

*C Evans and Sons Ltd. v Spritebrand Ltd. and Anor* [1985] BCLC 105 (CA)

*Flagstaff Silver Mining Co of Utah, Re* (1975) 20 eq 268

*Four Private Investment Funds v Lomas* [2008] EWHC 2869 (Ch), [2009] B.C.C. 632

*Great Northern Copper Co., Re* (1869) 20 LT 264

*Gregory v Wallace* [1998] IRLR 387 (CA)

*Greycaine Ltd., Re* [1946] Ch. 269

*Halliwells LLP v Bannon* [2010] EWHC 2036 (Ch)

*IRC v Lawrence and Anor* [2001] 1 BCLC 204 (CA)

*Kayley Vending Ltd, Re* [2009] EMHC 904 (Ch), [2009] B.C.C. 578

*Key2law (Surrey) LLP v Gaynor De'Antiquis (Secretary of State for Business, Innovation and Skills intervening)* [2011] EWCA Civ. 1567

*Lathia v Dronsfield* (1987) BCLC 321

*Lehman Bros International (Europe), Re; four Private Investment Funds v Lomas [2008] EWHC 2869 (Ch)*, [2009] B.C.C. 632

*Lewis's of Leicester Ltd, Re* [1995] B.C.C. 514

*Lewis v Doran* [2005] NSWCA 243; (2005) 219 ALR 555, NSW CA

*London & Manchester Industrial Association, Re* (1985) 1 Ch D 466

*Lyric Club, Re* (1892) 36 Sol Jo 801

*McAteer v Lismore* [2012] NI Ch 7

*Medforth v Blake* [1999] B.C.C. 771

*Mills v Birchall* [2008] EWCA Civ 385; [2008] B.C.C. 471

*Mirror Group Newspapers plc v Maxwell and Others* [1998] BCC 343

*National Livestock Insurance Co, Re* (1858) 26 Beav 153

*Odelola v Secretary of State for the Home Department* [2009] UKHL 25

*Powdrill v Watson* [1995] 2 AC 394 (HL)

*Revenue and Customs Commissioners v Portsmouth City Football Club Ltd (In Administration) Chancery Division* [2010] EWHC 2013 (Ch)

*Rowbotham Baxter Ltd., Re* [1990] BCC 113

*Sandell v Porter* (1966) 115 CLR 666, (1966) 40 ALJR 71

*Secretary of State v Tjolle* [1998] 1 *B.C.L.C.*, 333

*Solomons and Defty v Cheal, Huggins and Coster* [2011] EWHC (ch2543)

*T & D Industries Plc, Re* [2000] 1 All E.R. 333

*Transbus International Ltd, Re* [2004] 2 All E. R. 911

*Taylor Industrial Flooring Ltd v M & H plant Hire (Manchester) Ltd* [1990] BCLC 216, BCC 44, CA

*Trident Fashions Limited (No2), Re* [2004] 2 BCLC 35

*Tweeds Garages Ltd., Re* [1962] Ch 406

*Williams and Anor v Natural Life Health Foods Ltd. and Anor* [1998] 1 WLR 830 (HL)

*West Mercia Safetywear Ltd v. Dodd* [1988] 4 BCC 30, [1988] BCLC 250

*Whitaker, Whitaker v Palmer, Re* [1901] 1

*Yate Colleries Co., Re* [1883] WN 171

*Zegna III Holdings Inc., Re* [2009] EWHC 2994 (Ch)

# Table of Legislation

Insolvency Act 1986, Section 27

Insolvency Act 1986, Section 44(1)(a)

Insolvency Act 1986, section 72A, 72B-72G;

Insolvency Act 1986, Section 87

Insolvency Act 1986, Section 122(1)(f)

Insolvency Act 1986, Section 144

Insolvency Act 1986, Section 213

Insolvency Act 1986, Section 214

Insolvency Act 1986, Section 214 (2) (c)

Insolvency Act 1986, Section 214(3)

Insolvency Act 1986, Section 214 (6)

Insolvency Act 1986, Section 214 (7)

Insolvency Act 1986, Section 216

Insolvency Act 1986, Section 230(2)

Insolvency Act 1986, Section 238

Insolvency Act 1986, Section 239

Insolvency Act 1986, Section 240

Insolvency Act 1986, Section 240(2)

Insolvency Act 1986, Section 241

Insolvency Act 1986, Section 245

Insolvency Act 1986, Section 245(4)

Insolvency Act 1986, section 176A

Insolvency Act 1986 Sch. B1

Insolvency Act 1986, Section 14

Insolvency Act 1986, Section 40(2)

Insolvency Act 1986, Section 44 (1).

Insolvency Act 1986 Sch. B1 para. 3(1)

Insolvency Act 1986 Sch. B1 para. 3(2)

Insolvency Act 1986 Sch. B1 para. 4.

Insolvency Act 1986 Sch. B1 para. 12

Insolvency Act 1986 Sch. B1 para. 13

Insolvency Act 1986 Sch. B1 para. 14

Insolvency Act 1986 Sch. B1 para. 15

Insolvency Act 1986 Sch. B1 para. 16

Insolvency Act 1986 Sch. B1 para. 17

Insolvency Act 1986 Sch. B1 para. 18

Insolvency Act 1986 Sch. B1 para. 19

Insolvency Act 1986 Sch. B1 para. 20

Insolvency Act 1986 Sch. B1 para. 21

Insolvency Act 1986 Sch. B1 para. 22

Insolvency Act 1986 Sch. B1 para. 23

Insolvency Act 1986 Sch. B1 para. 24

Insolvency Act 1986 Sch. B1 para. 25

Insolvency Act 1986 Sch. B1 para. 26

Insolvency Act 1986 Sch. B1 para. 27

Insolvency Act 1986 Sch. B1 para. 28

Insolvency Act 1986 Sch. B1 para. 29

Insolvency Act 1986 Sch. B1 para. 30

Insolvency Act 1986 Sch. B1 para. 31

Insolvency Act 1986 Sch. B1 para. 32

Insolvency Act 1986 Sch. B1 para. 49

Insolvency Act 1986 Sch. B1 para. 49(2)(b)

Insolvency Act 1986 Sch. B1 para. 51

Insolvency Act 1986 Sch. B1 para. 52(1) (a)

Insolvency Act 1986 Sch. B1 para. 52(1) (b)

Insolvency Act 1986 Sch. B1 para. 52(1) (c)

Insolvency Act 1986 Sch. B1 para. 52(2)

Insolvency Act 1986 Sch. B1 para. 52(3)

Insolvency Act 1986 Sch. B1 para. 52(4)

Insolvency Act 1986 Sch. B1 para. 74

Insolvency Act 1986 Sch. B1 para. 75

Insolvency Act 1986, Sch. B1, para. 3(1)(b)

Insolvency Act 1986 (Prescribed Part) Order 2003 (SI 2003/2097)

Insolvency Rules 1986, rule 2.33(2)

Enterprise Act 2002, Sch.16, para.65

Enterprise Act 2002, Sch.16, para.250

Insolvency Practitioners regulations 2005

## Chapter 1

## Introduction

### 1. Overview

Finding solutions to arduous problems is and will remain an endeavour firmly associated with legal scholarship. As problems are systematically identified, isolated and sometimes rectified, inevitably eradicating some problems leaves the scope for new ones to materialise. It is within this evolving environment that a resourceful and pragmatic approach is required to ensure that the law remains progressive, whilst at the same time embraces and demonstrates a faithful understanding of the underlying principles that are firmly associated with a particular area of law. Invariably, tensions between conflicting interests and objectives cause the process to be scrutinised; producing a vacuum whereby development is almost entirely reliant on, and in some cases limited to, the ability of the participants to agree to compromises. Whilst most laws (and amendments) which govern aspects of our lives are discussed at great length through various consultations and formally begin life as a White Paper that follows a stringent process through Parliament before it officially becomes law, there are others that take a more unconventional route. Some are influenced by custom that is dictated by policy and motivated by best practice, aiming to create an alternative process to oppose undesirable and in most cases inefficient legislation. Whether informal processes should be sanctioned as legitimate is a debatable issue and beyond the scope of this thesis. The focus here is to assess whether informal models should be recognised even if they endorse principles that are contrary to their formal counterparts[1].

The temperament of this process can be transposed into any area of law; but it has particular relevance to the fast-moving pace of corporate and commercial law, especially so in recent years given the financial climate. The financial recession and the impact that this has had on the economy have raised many issues. With the occurrence of a second major recession in 2012 (double dip recession[2]), and with the economic buoyancy levels not expected to return

[1] Any reference to the law in this thesis is as stated at 1st May 2013.
[2] For a overview on the UK's economy that took place towards the end of 2011 see the discussion held by accountants BDO who state that the UK is at a serious risk of a double dip recession http://www.bbc.co.uk/news/business-15621916 (accessed 11th December 2011); for a market view on the economy see also a poll carried out by Deloitte, which revealed that CFOs now see a 38% chance of a double

to pre 2008 figures until 2013 at the earliest, questions are raised as to how best to deal with a financially troubled company. Whilst recent literature within the area has chosen to focus on the collapse of financial institutions such as banks[3], insolvency law despite its importance and proximity to collectively reducing potential financial risk has lacked extensive input from academics. However, given the relationship between a country's economy and how a particular jurisdiction deals with an economic downturn, the literature can only set to increase and this in turn will hopefully lead to more opportunities being created to provide more in-depth research on the subject of corporate rescue and related insolvency issues[4].

As far as corporate failure goes, it is an understanding that within a capitalist environment that some companies will face financial troubles[5]. But it must be emphasised that there is a clear distinction to be had between issues that have a bearing and are critical to the operations of a company and those which are viewed as minor events, something which is merely part of the lifecycle of a company competing in a volatile market. Given the wide range of potential problems that a company may face, not all financial troubles would lead to a company failing. Even if the problems were considered to be significant this does not automatically mean the end for the company; instead they can seek help from outside internal management to try to solve the problems before they become irreversible. It is this notion of attempting to restrain the failure and in turn rectify the problems that this thesis focuses upon. This conception, in its most basic form, will be referred to as corporate rescue. As a perception, corporate rescue presents itself as a model designed to help distressed yet salvageable companies. It provides the premise that if a company with financial problems seeks professional help before the troubles became overwhelming, then with a bit of luck a company could be restored to prosperity (which as it will be seen is often not the same thing

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dip, up from 33% in the first quarter of this year (2011), http://www.deloitte.com/view/en_GB/uk/news/news-releases/32c68bcdde2a9210VgnVCM100000ba42f00aRCRD.htm (accessed 11th December 2011).

[3] Banks are subject to a different insolvency regime which is not being considered in the thesis.

[4] For instance, see L. Manning, 'Review of the Insolvency and Restructuring Landscape in the UK', 10(1) *International Corporate Rescue*, (2013) which provides an overview on the increase of retail and corporate insolvencies that are happening in the UK and how the measures introduced by the Enterprise Act 2002 has transformed the options available to insolvency practitioners.

[5] However, the epithet "too big to fail" has come to epitomise one of the most serious challenges for policy makers revealed in the current financial crisis. It appears that the general consensus concedes that there is no alternative to bailing out big banks and other colossal financial institutions. But, it must be stressed that as critical as the issue of size is, it is not the crux of the matter; rather it is the complexity of the company in question, see E. Hüpkes, 'Complexity in Complexity: what to do about the 'too-big-to-fail' Problem', 9 *JIBFL*, (2009), 515; see also R. De Weijs, 'Too Big to Fail as a game of Chicken with the State: what Insolvency Law Theory has to say about TBTF and Vice Versa', *European Business Organization Law Review*, (2013), 201.

as a company returning to the same state as it was before the problems occurred) and given a second chance to continue to trade[6].

Assessing the corporate rescue procedure in the UK is an opportunity to advance knowledge within this area and contribute to the understanding of how rescue, in theory and practice has developed. It is interesting to note that most research, in general, is conducted with the intention of questioning the effectiveness of a particular legal principle and whether the law at present is adequate, or whether reform is required to address the outstanding issues. This thesis will venture off the conventional path and consider something more pertinent; research will be conducted with the intention of discovering the very heart of corporate rescue and with it pose the question: does corporate rescue in the UK actually exist?

Considering this question, it is worth commencing with an assessment of what is corporate rescue, what role does it have in society and how its usage may be affected by changes in the financial climate i.e. a recession[7]. Company survival is difficult enough to achieve in flourishing times when the economy is strong. Achieving this feat when there is a general hardship amongst companies makes the odds much higher. Despite this reservation, survival remains the key priority. Survival is a multifaceted term that demands a broad approach to be taken to determine the substance and extent of the problems and how best, if feasible, these can be solved as quickly as possible. Assessing what amounts to survival is a debateable issue, and one that will be discussed at length throughout the thesis. But it suffices to mention briefly as a preliminary introduction to the subject that the survival term is somewhat blurred because there are some commentators who believe that rescue amounts to only company rescue (as a whole), whilst others believe it can include business rescue as well (reorganisation)[8].

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[6] The origin of this term can be traced back to the influential white paper entitled, '*Productivity and Enterprise: Insolvency – A Second Chance'*, DTI, Cm 5234, (July 2001), see http://www.insolvency.gov.uk/compwp.htm (accessed 10th July 2010). The contents and importance of this report will be discussed in greater detail in Chapter Two.

[7] Governments have been keen to keep up with global, systematic and localised threats as the crisis has unfolded, but despite this they have come to realise that even where there were comprehensive and modern insolvency regimes in place, they were not fit for the often unique purposes to which they were needed. See N. Hood, 'Making up insolvency law in the recession – the world legislates on the hoof', 2 *Corporate Rescue and Insolvency*, (2010), 65. It is also accepted that in an era of recession job preservation is a critical factor, something which a rescue plan may help to tackle, see P. Okoli, 'Rescue Culture in the United Kingdom: Realties and the need for a Delicate Balancing Act', *ICCLR*, (2012), 61, at 61.

[8] Whilst the Enterprise Act 2002 gave a new emphasis to company survival, it did not make this the paramount concern (See *Productivity and Enterprise White Paper* (2001), para 2.15). It therefore follows that if the subject matter of what is being rescued is not clear it makes it difficult to assess in real terms, and to reach a general

In addition to this debate, there are other factors which need to be considered. As well as dealing with the internal working of a company, invariably external factors may have an influence on the way in which the rescue strategy is conducted. With this in mind it is worth highlighting something of a misconception about the relationship between the economy and the impact that this may have on a company. Contrary to popular belief, most companies do not experience major financial troubles at the onset of a recession[9]. The difficulties often arise after a recession, when a company has, in order to survive over this period, relied on its reserves to stay afloat but may now as this testing time is over face a new problem of surviving growth and stability in a competitive market[10]. With no resources to fund expansion, and with post credit-crunch lending being more restrictive, the pattern that emerges when examining the recessions that occurred in the 1980s[11], 1990s[12] alongside the most recent occurring in the last few years is that the peak of insolvencies arrives after the point when companies are attempting to return to growth. Observing the relationship between when a company is distressed and when it has reached the point of failure is a pedantic affair, but reviewing these concepts over a thirty year period demonstrates a notable change in attitudes and practice, revealing a deliberate move away from the use of liquidation; a procedure that was once the chosen option for companies that were in financial hardship. Liquidation is essentially a straight forward process that leads to a terminally ill company being wound up and its assets sold to satisfy, as far as possible, any debts outstanding. However, in most cases, having a choice on how to deal with a company is a luxury rarely afforded. In most cases there was no alternative, as it was often the case that the documents providing for security over a company's property demanded in return for finance by financial institutions such as banks were drafted to protect their own interests ahead of other creditors.

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consensus amongst academics and practitioners whether survival has been achieved at all. As it will be seen this dispute has serious implications on determining what are or what should be the aim or aims of corporate rescue.

[9] A recession is usually defined as a period of general economic decline; specifically two consecutive quarters of negative GDP growth.

[10] Contained within the R3's website, the journal entitled *'Insolvency Lag: Risks for 2010'*, provides "Evidence (which) suggests (that) from previous recessions...early recovery is a dangerous time for struggling businesses and individuals", https://www.r3.org.uk/uploads/documents/Insolvency%20Lag%20Briefing%20Paper%2026.01.2010.pdf (accessed 22nd February 2010).

[11] Ibid. Research compiled suggests that the 1980s recession lasted five quarters – from Q1 1980 to Q1 1981. Although there were a greater number of fluctuations than there were in the 1990s recession, the long term trend shows insolvencies rising throughout the recession and for a considerable period of time after. Although the figures do show some periodic falls, company liquidations never fell back to their pre-recession levels – there was a lasting "step up".

[12] Ibid. Though there were some minor fluctuations, the overall trend shows that liquidations continued to rise long after the official end of the recession, peaking at the end of 1992 – over a year after the recession's official end.

If a company could not satisfy its debts, it was generally the bank's right to place the company into receivership whereby it would be given priority to be reimbursed, irrespective of whether this led to other creditors receiving nothing or resulted in the liquidation of the company[13].

This outcome led some commentators and practitioners to question the fairness of such a process, especially for those companies that had the potential to be rejuvenated. In the early 1980s the government was increasingly becoming aware of the inadequacies of the law governing corporate insolvency and showed a desire to scrutinise the current legislation and investigate the possibility as to whether an alternative procedure could be proposed. A highly influential select committee, known as The Cork Committee was charged with looking into the matter, observed and noted that in some circumstances a company should be given a "second chance", that is, a viable business should be allowed to continue to operate; this laid the foundations for what would become known as the "rescue culture"[14]. It should be noted that the concept of rescue has been known in the UK for some time but has rarely been used because of the preference for receivership. Despite some major concerns regarding the intricacies of receivership, changing the habits of those who practice in this field will inevitably take time. In addition to facing some resistance to change within the profession, it is often the case that reformative measures are constrained by limited administrative resources and the demand on legislative bodies means that not all reform can occur speedily. It therefore should come as no surprise that the Cork Report took some time to be compiled and subsequently not all of its recommendations were enacted in the Insolvency Acts of 1985 and 1986. However, notwithstanding that some sections were omitted, its recommendation for the creation of a new procedure called the administration process which had the responsibility of not introducing, but promoting corporate rescue as a real alternative to liquidation for financially distressed companies, was followed through. Since the inclusion of this process, the procedure has gone on to become one of the integral elements of corporate insolvency[15].

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[13] A. Keay and P. Walton, *Insolvency Law: Corporate and Personal*, (Harlow: Pearson Education Limited, 2003), at 49. For an interesting analysis that challenges the much repeated proposition that secured claimants 'stand outside' liquidation, see R. Mokal, 'What Liquidation Does For Secured Creditors, And What It Does For You', 71(5) *Modern Law Review*, (2008), 699-733. For a discussion on funding liquidations, see J. Armour and A. Walters, 'Funding Liquidation: A Functional View', *Law Quarterly Review*, (2006), 295.

[14] The Cork Report (Insolvency Law and Practice: Report of the Review Committee), Cmnd. 8558, (1982).

[15] Despite this presumption, a question that will be later considered is whether since the Cork Report has the rescue culture continued to prosper and influence or has the influence steadily declined?

In spite of the optimism that the Cork Report seemed to offer, it was not until the Enterprise Act 2002 that effectively, but not completely, eradicated receivership[16]. Whilst receiverships may still continue to be of relevance depending on the time that the charge relied upon by a secured creditor was made[17] it was hoped that the administration process would in time become the preferred model, notwithstanding some reservations about whether it could effectively accommodate the wide ranging financial, legal and social needs of companies in a volatile economic climate. Exactly what these needs are will be examined later, but the question considered here is whether the insolvency legislation that governs corporate rescue adequately fulfils this role. Or to put it another way, have the theoretical characteristics contained within the UK's formal corporate rescue model become redundant in its ability to provide a working framework that can efficiently produce viable rescue strategies that could be entered into in order to save a financially distressed company?[18]

The question of whether corporate rescue can be delivered within its legislative framework depends on determining what amounts to a successful rescue. The issue rests with establishing the different ways in which success can be measured with divergences often depending on what question is asked and when the question is asked[19]. Early attempts to provide an insight into the level of success achieved may have the disadvantage of making data appear optimistic. Such an action could potentially leave the rescue attempt looking rather pessimistic causing unnecessary concerns amongst management and creditors in addition to complicating matters with an already distressed company. It follows that if the intended objective is to simply dispose of a wasteful company that has no chance of continuing to operate successfully, then liquidation should follow. If a distressed company shows signs of profit potential, and that with some professional assistance in its financial and operational affairs it could in the near future begin to trade successfully again, the assigned

[16] The Enterprise Act 2002 barred the right to appoint administrative receivers in any security created after 15 September 2003 (subject to certain specific exceptions). Any attempt to do so takes effect as a power to appoint an administrator.

[17] Note that there is a list of exceptions contained within sections 72B-72F of the IA 1986 (inserted by the EA 2002, s.250 (1)), which allows for certain specialised companies to be subjected to an administrative receiver even under debentures executed after the commencement of the EA 2002.

[18] Whilst many professionals and a variety of institutions, such as INSOL International, UNICITRAL, and The World Bank have spent much of the pre-recession decade pressing for progress and reform to facilitate restructuring of distressed, yet salvageable companies, the change required was hindered by the good economic health of the respective countries. It now appears as the global crisis has unfolded, insolvency systems that were inadequate have now taken rash emergency measures to try and address the fallacy of the law. See N. Hood, 'Making up Insolvency Law in the Recession – the World Legislates on the Hoof', 2 *Corporate Rescue and Insolvency*, (2010), 65.

[19] A. Belcher, *'The Economic Implications of Attempting to Rescue Companies'* in H. Rajak (ed.), *Insolvency Law Theory and Practice*, (London: Sweet & Maxwell, 1993), at 237.

administrator who is instructed to review the company's affairs would be inclined to implement actions that would strive to rescue the ailing company. The distinction sounds simple, and in a sense it is. But in practice doubts have been raised about the effectiveness of the corporate rescue regime. The concerns rest on the critical difference between actual successful rescues that help return companies to health and mere attempts which are fruitless. Reflecting on the current legislation in place, what is the likelihood that a company can be rescued? Delicately put, procedural developments often lag behind current trends evident within practice. It is therefore a real concern that the existing legal framework lacks the ability and there is a lack of confidence in it to meet all challenges that may confront a troubled company. Given the lack of initiative from the government to impose measures to address these shortcomings, one must ask whether it can rightfully be said that an effective corporate rescue model actually exists in the UK.

To determine whether a corporate rescue model has been effective, the core values and its intended aim must be analysed. The principles of corporate rescue in the UK, as noted above, were explored and consolidated for the first time in the Cork Report. The report considered the merit of a corporate rescue regime and how it would be beneficial to give distressed companies an alternative to being wound up. It recognised that there were many factors that could contribute to a company suffering hardship and that it was not necessarily improper actions carried out by the actors in charge of the company (management) that contributed to its position, but rather wider issues that were beyond its control. The report suggested that there were wider social implications to be considered besides maximising the wealth of the creditors; this in turn prompted a revision of the insolvency procedures and for the first time it was questioned whether a company should be saved as a going concern, and efforts to promote rescue rather than simply see liquidation as the automatic solution were made. Whilst there is the temptation to conduct a cross analysis of the various corporate rescue models in different jurisdictions and compare its characteristics in conjunction with the recent economic crisis, it must be realised that geographically, it is not technically a global crisis as new emerging markets will predominately be unaffected[20]. This is a deliberate self- imposed constraint to narrow the focus of this thesis in order to cover the UK's creditor- friendly

[20] N. Hood, 'Emerging Markets and the Capital Market Crisis', 6 *Corporate Rescue and Insolvency*, (2008), 81.

administration procedure along with other dominant rescue strategies such as the pre-packs adapted by insolvency practitioners (IPs)[21].

With the above in mind this brief introduction aims to establish what the core foundations to corporate rescue are, focusing on three main areas: the nature of companies; determining insolvency and the concept of rescue.

## 2. Understanding Companies

Recent statistical data compiled by the Insolvency Service shows that the majority of companies that enter an insolvent state in the United Kingdom fail[22]. This conclusion poses three fundamental questions: why is it the case that so many companies fail? Secondly, is there an effective legal mechanism in place to help companies that are in financial distress avoid liquidation? And thirdly, is the current legal framework efficient in rescuing a financially distressed company? For now the focus will be on the last question, which focuses on the procedural identity of corporate rescue. It is essential to understand what is at the heart of corporate rescue: what is being rescued? This question should be approached with caution. Not all companies should be viewed in the same way and as such should be treated as unique entities with their own identities. Each company has a different set of objectives (purpose of existence), structure (management) and provide different services. Despite these many differences, collectively companies interact in a complex network where their success and failure largely depends on the success and failure of other firms. In reference to this thesis success will refer to the ability of a company to operate in a competitive market and pay its creditors whilst at the same being able to generate a reasonable rate of profit for its shareholders.

With these deliberations in mind it is important to consider another aspect, namely that as a legal entity companies are multifaceted[23]. It is helpful when discussing the well-being of firms to refer to a company as if it were alive. Whilst a company is not sentient, it can relate to attributes that are familiar to functions of a living being. A company can be referred to as

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[21] When necessary, reference will be made to a system which in theory represents the opposing values, namely the more debtor friendly Chapter 11 system evident in the United States of America.

[22] Insolvency Service, http://www.insolvency.gov.uk/otherinformation/statistics/insolv.htm (accessed 24th February 2010).

[23] Whether a company has social responsibilities is debatable, especially from a contractarians viewpoint, who would argue that the sole purpose of a company is to generate profit. However, it could be argued that without having some responsibility at least in the loose sense then generating profit would be made more difficult.

being alive when it is at operational status, dead when it ceases to exist, with further reference being made to its health depending on its financial status. Professionals who are assigned to deal with corporate insolvency matters can easily be referred to as doctors who will use their technical knowledge and experience to see if they can "operate" on the company and nurse the company back to health. But like all surgeries there are a number of factors that need to be taken into consideration. With any type of intervention there is a question of timing and this is correlated with the level of risk that may be evident. Early intervention reduces the extent that the company is exposure to failure, but it of course does not eradicate it entirely. It remains that the most serious of cases will carry little chance of success but nevertheless the decision to not intervene is likened to the initial examination completed by a medical doctor; it has to occur to establish the extent of the problem. Only once this has been determined can the necessary course of action be decided. It will therefore come as no surprise that determining the extent of a company's financial problems is not an easy task. For this reason it is imperative to: appreciate how individual companies operate; understand the vast array of problems that a company may face; what help is available to a company in financial distress, and what is the likelihood of this help actually assisting the company back to health? In regards to the assistance that a company may expect it is critical to note the role that IPs play and what duties they owe to the company and its creditors. As the architects of corporate rescue processes they have wide discretion to dictate what is to happen without needing to wholly justify the actions taken. Whether the justification is based on commercial judgment or influenced by the lucrative nature of rescue proceedings over liquidation remains an issue that will be explored later on in this thesis.

Before these questions can be fully examined it must first of all be made clear that it is inevitable that some companies will fail and not all companies can be rescued[24]. It should also be stressed that even if a company was eligible to be rescued, other variables such as securing additional finance may prevent the company from doing so. Whilst the issues and concerns to prevent rescue are numerous, the end to a company's existence usually means that it has lost the ability to compete against other companies within the same line of business. This covers complications such as market pressure, investment shortages, and management failings. In addition to these sources special attention should be drawn to two technical insolvency tests set out in the Insolvency Act 1986, which state that if a company

[24] See R. Parry, *Corporate Rescue*, (London: Sweet & Maxwell, 2008), at 13.

can neither pay its debts as they fall due and/or its liabilities exceed that of its assets, then the company may be classified as insolvent[25]. These tests provide a legal framework to be applied to insolvency that act as benchmarks for creditors to assess whether their investment or money owed for services rendered will be recovered. If one of these tests is satisfied then the secured creditor(s) who have not received payment may decide in order to protect their own interests to put the company into administration. Upon this action taking place it removes the focus from the shareholders and ensures that they receive a reasonable rate of return and places the attention firmly onto maximising the wealth of the creditors, who the administrator will owe a duty towards[26]. Once a company has entered administration only three outcomes are possible: liquidation, straight dissolution or rescue, with the last option reserved for only a few.

Before examining corporate rescue in depth it is important to outline a distinction between the company and the business. A business plan aimed at turning around a troubled company may involve reorganising some aspects central to its operations. The changes implemented are often designed to improve the way in which the company conducts its business. This streamlining exercise is often associated with efficiency and to achieve this end cutbacks will have to be made. From altering the size of the firm to introducing redundancies the general aim is to refocus on identifying what elements of the company are profitable (if any) and discarding aspects that are not. It follows that a company having financial problems will rarely have any other option but to change in order to survive. Determining the extent of the changes required will inevitably lead to an audit being carried out across the firm to identity the possible ways to cut costs without affecting the core mechanics of the company which are essential for the company to exist. The outcome will usually result in a modified, leaner company that has been for all intents and purposes recycled. Why this distinction is important is because corporate rescue has over the years become associated with two models – pure company rescue and business reorganisation. The trouble however is that the terms have become interchangeable, causing some confusion as to what the aim of corporate rescue should be. It will be seen that most rescues for various reasons often fall into the reorganisation category; with the pure rescue concept only being applicable to those rare cases where the company largely remains unchanged. It is therefore suggested that as most companies which enter an insolvent state have to change to have at least a chance of

[25] The Cash Flow and Balance Sheet Tests will be discussed in Chapter Two.
[26] The role and function of administrators will be explored in Chapter Three.

surviving, corporate rescue in its purest form does not, and cannot, exist[27]. It is accepted that some commentators will dispute whether the distinction makes any real difference, but the fact that the two concepts exist means that that it must have some importance and as such they must be fully explored. For instances, in some cases partial rescue (reorganisation) will surely serve a greater purpose than liquidation. Likewise, proposing that one of the aims of corporate rescue should be to reduce/restrict the potential financial repercussions that a distressed company will have on the wider community is a consideration that would not look out of place in most insolvency models. But whilst these considerations appear integral to a sound rescue model, they do not define it nor do they shed light on what rescue should fundamentally be seen to do. It is a matter of perception often dictated by public policy that classifies what rescue is. This invariably means that a corporate rescue model should evolve and remain relevant to the environment in which it operates. Failing this then there is every chance that an alternative rescue mechanism will develop that caters to occupy the void - the legal vacuum for which the insolvency legislation does not provide. Applying this hypothesis to the UK, questions have arisen that enquires into the uncertainties created from the current legal framework as set out within the Insolvency Act 1986 and the Enterprise Act 2002. The debate considers whether because of the current legal inadequacies in providing clear provisions to aid a distressed company a new approach has been adopted by IPs that addresses these matters. The critical aspect of this approach is that not only does it operate outside the mainstream principles of administration, it is by its very nature an informal process not endorsed within the current insolvency law. This solution (pragmatic response) that appears to be gaining wider support will be referred to as pre-packed administrations ("pre-packs")[28].

### 3. The Concept of Rescue

The rescue culture is a concept born out of the ideology that calculated risk should be encouraged and if failure occurs then there should be a system in place to help minimise the

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[27] A recent decision delivered by Mr Justice Norris has offered some assistance on this matter. In his deliberations he considers the first objective ("rescuing the company as a going concern") and whether this had been achieved. He concludes that it does not seem to be so. He highlighted the distinction between the company and its business, and in this case how the terms have been confused. A much slimmed-down version of the business of the company has been sold as a going concern: but the company cannot be rescued as a going concern because it has creditors of some £400,000, fees and expenses of administration of some £68,000 and virtually no assets. Therefore he noted that this administration has achieved nothing. See *Solomons and Defty v Cheal, Huggins and Coster* [2011] EWHC 2543 (Ch), in particular para 14.

[28] The term will be explored in Chapter Five, but it suffices to mention that it involves a pre-arranged sale of all or part of a distressed business or assets of the company, which will be executed immediately, or shortly after the appointment of an administrator.

adverse effects that it may have on affected parties. Whilst the law strived to address the changes that had occurred in society, the pace of these changes became too great and gradually rendered the law less effective in fulfilling its objectives. Part of the issue rests with the terminology adopted; to what extent do the management of a company understand the fundamental signs of distress and how has the concept of rescue been interpreted by IPs and related professionals?[29] In addition, it is important to understand the public's perception of insolvency and the stigma associated with a company in financial distress. The idea of giving a company a second chance is still viewed with some suspicion in the UK, unlike in the United States of America where it is encouraged and even sought after[30]. It appears that the unwillingness to be associated with failure is so inherent in the UK that it has the potential to hinder any plans that are designed to help a company recover. Instead of understanding and accepting financial distress as something that is natural in the lifespan of a company, it is often viewed as something that could and should have been prevented.

Whilst some reform was introduced in the Enterprise Act 2002 to enhance the importance of rescue, the chance for the UK's administration model to be tested did not really occur due to the economy remaining steadfast throughout the turn of the millennium up until about 2007/2008. This changed somewhat towards the end of 2011, and it has now become clearer that the current insolvency legislation has in some cases not been correctly used or at least not to its full potential. In essence, it is not understood whether the UK's corporate rescue model is equipped to accommodate these changes in commercial markets. It is only through actively measuring and assessing a particular model that allows for enough data to be compiled that a true picture can be revealed as to whether the law accommodates the realities that occur in practice. Within an area of law as complex as corporate insolvency, it is prone to being susceptible to many variables that are often beyond its control. A change to the economic climate poses a constant challenge to a model. These potential disputes only aim to highlight faults, lacunas, and ultimately to determine whether a better model can be adopted that deals with the issues in hand.

[29] For further discussions on the importance of insolvency practitioners and how directors are expected to act in a way that contributes to the success of the company see A. Keay, 'Office-holders and the Duty of Directors to Promote the Success of the Company', *Insolvency Intelligence*, (2010), 129.
[30] See L. Qi, 'Managerial Models during the Corporate Reorganisation Period and their Governance Effects: The UK and US Perspective', *Company Lawyer*, (2008), 131.

## 4. The Emergence of a Corporate Rescue Culture

As noted earlier, corporate rescue within the UK's legal system can trace its origins back to the Review of the Select Committee chaired by Sir Kenneth Cork in 1982. This report became highly influential for its substantial coverage of the issue of corporate rescue along with the aims and principles that should be promoted and adhered to by corporate rescue. The principles set out by the Cork Report reflected and embraced the customs and workings of the business world at the time and helped to address the lack of insolvency procedures that were in place to deal with failing companies. Therefore it should be noted that the Cork Report was a visionary piece with one of its aims to lay the foundations for making corporate rescue a real alternative to liquidation, and, hence, a working policy to be considered for legislation rather than just an idea embedded in theory. The Report was received with wide acclaim, with many of its recommendations entering legislation by way of the Insolvency Act 1986. The administration process became the mechanism that facilitates corporate rescue, with an emphasis on preserving companies as a going concern where possible and to protect the interests of the public and employees alike. A marked contrast to the administration process is Chapter 11 which is the United States primary version of corporate rescue and is contained within the American Bankruptcy Reform Act 1978. This rescue model differs from the UK's model as it permits the management of the debtor company to remain in control of the company and whilst under the protection of the Act to formulate a restructuring plan for the company, despite it being a possibility that the management was the source of the financial problems. The Insolvency Act 1986 differed fundamentally from the US approach in that some of the main aims of the Act were to: operate as deterrence against any wrongdoings of directors; raise awareness of the various options open to companies in financial distress; promote good practice. All of these factors were designed to ensure professional standards were enhanced and that technical knowledge was increased amongst management to highlight when intervention should be sought. Collectively it was hoped that overall this effort should contribute to the efficient implementation of corporate rescue proceedings and raise the profile of the rescue culture.

There were further reforms in the following years, such as the Insolvency Act 1994, the Insolvency Act 2000, and in more recent years the Enterprise Act 2002. The provisions in the latter Act were fundamental in that it aimed to address some shortcomings of the 1986 Act namely to make the insolvency procedure more accountable and transparent by: removing receivership; abolishing the preference for Crown debts; and attempting to implement a legal model that correlated more with the happenings of the business and financial world in the face of commercial realities, rather than being a model confined to theory alone. For these reasons the Act's full potential is yet to be realised, and for the purposes of this thesis these benchmarks for change will be revisited for direction and inspiration.

It must be understood that rescue should not be perceived as a mechanism that offers an absolute solution to a distressed company, but more often than not a partial response that temporarily relieves financial pressures. It may offer a solution to a problem, but whether that amounts to a temporary or a permanent one is difficult to conclude with the lack of research and cooperation from professionals within the field. With this in mind the questions remain numerous, including: whether temporary rescue is something that should be sought if it offers some respite from the full onset of distress; should there be a limit on the amount of times a company can be rescued; or is this irrelevant, despite the legislation inferring that a company should have the option to be able to continue as a going concern at the point of redemption? Some would say that the availability of rescue has to be assessed subjectively, with no reference being made to a company's history. However, it is only by looking at its past that it can be clearly determined whether a rescue plan is likely to work. This however prompts further questions as to whether rescues which are followed by subsequent rescues can be regarded as rescues? Are they not merely temporary measures that did not fully address the original problems? Whilst it is accepted that further problems may be unrelated to the first incident it has to be asked, if a company is continually having financial problems: should it not be terminated as it is clearly not a viable company? The questions are of course numerous without having a specific case to dissect but it demonstrates the complex nature of companies. It is therefore paramount to make clear that whilst early intervention is often cited as providing rescue strategies with the best chance of being successful, rescue does not equate to restoration, nor does it offer immunity from further distress in the future.
It will be seen that defining corporate rescue is problematic, especially since there are debates as to what it is and entails. Despite these difficulties a well-received attempt at offering some guidance on this matter is that it involves a major intervention to prevent eventual failure[31]. It will be appreciated that this definition does not offer an absolute insight into the practicalities

[31] A. Belcher, *Corporate Rescue*, (London: Sweet & Maxwell, 1997), at 12; A. Belcher, '*The Economic Implications of Attempting to Rescue Companies*', in H. Rajak (ed.), *Insolvency Law: Theory and Practice*, (London: Sweet & Maxwell, 1993); see also D. Brown, *Corporate Rescue: Insolvency Law in Practice*, (Chichester: John Wiley & Sons, 1996), Ch1; M. Hunter, 'The Nature and Functions of a Rescue Culture', *Journal of Business Law*, (1997), at 491; R. Harmer, 'Comparison of Trends in National Law: The Pacific Rim', 1 *Brooklyn Journal of International Law*, (1997), 139, at 143-8.

of applying this in reality.  For instance, what amounts to a "major intervention"?[32] Whilst it may intend to cover all bases it fails to assert with any clarity when and if intervention should take place? Exactly when can it be labelled satisfactorily as a mechanism that efficiently pursues the goal of rescue? Ultimately this begs the question what is "eventual failure"? When is failure classed as irresolvable failure? Does this just include the immediate foreseeable future or all issues that may be reasonably envisioned?

With this in mind it is suggested that a non-tangible, evolving framework is required that reflects and adopts contemporary issues; not just financial ones, but also cultural developments that have taken place in society. It is submitted that a Darwinian approach should be adopted which is based on economic considerations, whereby uncompetitive companies are allowed to die and in turn they are replaced by stronger rivals[33]. There has to be some casualties when it comes to dealing with distress, otherwise no company would ever fail, and this cannot be allowed to happen – a displacement exercise marked by success and dictated by the public interest to maintain wealth maximisation must take place[34].

**5. Research Questions**

This thesis endeavours to examine the developments in corporate rescue and the existing provisions made for rescue. As a result of the foregoing, this thesis poses the following questions:

- Have the characteristics contained within the UK's corporate rescue model become redundant so far as their ability to provide a framework that can efficiently produce a viable rescue package that could save a company?
- Does the corporate rescue model evident in the UK fulfil and reflect the aims set out in the government's policy?
- Can the model referred to as corporate rescue in the UK be accurately described as corporate rescue?

[32] In particular how does this differ from a normal managerial response to corporate trouble? See V. Finch, 'Corporate rescue Processes: the search for Quality and the Capacity to Resolve', *J.B.L.*, (2010), 502, at 504. See also P. Okoli, 'Rescue Culture in the United Kingdom: Realties and the need for a Delicate Balancing Act', *ICCLR*, (2012), 61, at 62.

[33] Similarly the approach has also been referred to as 'bankruptcy Darwinism' whereby only the fittest companies will survive financial problems. See K. Gross, 'Taking Community Interests into Account in Bankruptcy: An Essay', 72 *Washington University Law Quarterly*, (1994), 1031, at 1035.

[34] For example see J. Girgis, 'Corporate Restructuring, the Evolution of Corporate Assets and the Public Interest', 22(1) *International Insolvency Review*, (2013), pp 29-54.

- Is there a legal vacuum whereby the realities evident in practice are not accommodated for within the law on corporate rescue?
- What has been the response in practice to the corporate model that government has introduced?

### 6. The Aims of the Thesis

The purpose of this thesis as already stated is to determine whether the administration process is sufficiently efficient to meet its aims, and secondly, question whether the endorsement of an alternative "corporate rescue model", namely pre-packs is a legitimate and natural successor to the formal administration process[35]. In considering these aims, it will determine whether the increased usage of this alternative procedure has shifted the focus away from formal legal processes and in turn marked a clear move away from complying with the current legislation that governs corporate rescue. Ultimately the examination of the processes will reveal whether due to the fundamental lack of compliance, this has led to a procedure that is or is not fully compatible with the principles and ideology that governs corporate rescue in the UK. In conjunction with the research questions a theoretical framework can be developed and employed, which produces four aims:

- To assess the characteristics evident within the UK's corporate rescue model and determine whether they comply with the theoretical principles of rescue.
- To examine the relationship between corporate rescue theory and government policy and how this has developed within the current economic environment.
- To determine whether the UK's rescue model, when evaluated in light of the efficiency rule, can be classed as a true rescue model.
- To ascertain whether pre-packaged administrations offer a viable and legitimate solution to the inadequacies of the current law governing corporate rescue.

### 7. Methodology

Addressing the aims brings interesting questions as to how the research is to be conducted. This thesis aims to incorporate and adopt a trans-disciplinary approach. The entire thesis will

[35] The concepts will be discussed in greater detail in the next few chapters, but it suffices to mention that the term will be closely associated with fairness, and the premise that if something is not fair, it cannot be efficient. See A. Keay and H. Zhang, 'Incomplete Contracts, Contingent Fiduciaries and Director's Duty to Creditors', 32 *Melbourne University Law Review*, (2008), 141, at 164.

involve principally a doctrinal study adopting a desk-based approach to an examination of aspects of corporate rescue. As a matter of necessity the thesis will draw on the findings of some empirical studies that touch upon the area of corporate rescue, as well as some of the theoretical arguments that have been mounted in the area. The sources drawn upon will be cases, government reports (white papers, consultations, and committee reports), books, journal literature and relevant electronic sources such as websites for various organisations.

## 8. Thesis Structure

### Chapter 2: Corporate Rescue: Concept, Nature, and Purpose

The core traditional principles and terms within corporate rescue will be explored and analysed in this chapter. It will also draw upon emerging concepts within the field. It will be clear from the research that terms such as “financial distress” and “insolvency” are tentative terms that sometimes add confusion rather than help a troubled company address its problems. Exploring the theory of rescue and noting the key factors that are considered to be integral to a rescue model involves a closer examination of the historical practices of the jurisdiction in question. Whilst the focus will firmly be on the UK’s rescue regime a comparison will be made with the US model to explain how “path dependency” can influence differences, even if the reason for those differences no longer exist. It is through this understanding that it is explained why embracing change is sometimes a difficult process to achieve and why occasionally this may give rise to alternative models being sought. The objectives of corporate rescue will be considered in order to allow us to determine by whom and how a rescue process may be influenced. Ultimately, this chapter aims to provide an overview of the characteristics that are essential to the UK’s corporate rescue model.

### Chapter 3: Determining Corporate Rescue Policy and the Role of Insolvency Practitioners

Chapter Two sets out the theoretical principles of rescue. It is constituted by two parts.

#### Part I: Corporate Rescue Policy

This part of Chapter 3 seeks to draw attention towards how corporate rescue is implemented in practice. To begin an overview is required, exploring the philosophical aspect of rescue, in particular examining the divide that exists between proceduralist and traditionalist views in relation to the issue of - for whose interests should corporate rescue serve? This has important implications as it determines the overall flavour of the rescue model that a country will possess such as following a creditor bargain theory or a team production theory. Following this, attention will be directed to discovering the early development of the rescue culture in the UK, making reference to the Cork Report and how this has shaped the rescue regime that the UK has today. In conjunction with this the Report by the Review Committee ('*A Second Chance*') and the Enterprise Act 2002 will be reviewed to provide an indicator as to the direction the rescue culture has taken and whether the key policy factors have changed over time.

**Part II: Insolvency Practitioners: Function, Conduct and Abuses**

The role of the IP is critical to the wider understanding of how rescue procedures are implemented. They administer the process and determine the fate of the distressed company. The IP's function will be examined and will involve an examination as to how the IP's role has developed in the UK and the core skills, knowledge and professional qualifications that are required to be an IP. An emphasis will be placed on the self regulation of the profession and the role of the Recognised Professional Bodies (RPB). The main concern regarding the role of IPs is the apparent secrecy that surrounds their decision making process. There are requirements which dictate that they should record their "thinking" but in practice this is rarely comprehensively completed nor is it often successfully challenged, which raises serious questions regarding the transparency and accountability of the process. Whilst there are codes of conduct such as the Code of Ethics setting out five fundamental principles that should be adhered to when implementing their functions in addition to safeguards in place to help the IP to avoid conflicts with any of the five principles, any challenge to the non compliance of these measures often fail. The complaint procedure and the relationship between the court and the IP indicate that there is a lack of regulation within this area. The lack of action taken by the RPBs when abuse has been found also tarnishes the reputation of the process. Overall it will be examined whether this procedure allows IPs to manipulate the process for personal financial benefit.

**Chapter 4: Determining the Existence of a Corporate Rescue model within the UK when assessed in light of an Efficiency framework**

This chapter will examine the theoretical concepts of efficiency; why efficiency is considered more important than other notions; and the relationship that efficiency has with the notion of fairness. In turn the research undertaken in Chapter Two and Three will be scrutinised to assess whether the aim of rescue as stated in Schedule B(1), para 3(1)(a) of the Insolvency

Act 1986 has been correctly applied or whether the current law is inadequate in dealing with a financially distressed company in the current economic environment. An aim is to discover whether a correlation exists between inefficient legislation and an alternative rescue model emerging. The role that IPs have taken and how they may have contributed to this informal process will also feature. It will be suggested that the parameters dictated within the notion of efficiency has forced the concepts of corporate rescue to evolve and ultimately adapt according to the changing wants and needs of the business market.

**Chapter 5: Pre-Packaged Administration: The Pragmatic Response (The Compromise)**

The rescue model endorsed originally in the Cork Report, the Insolvency Act 1986, and Enterprise Act 2002 has given way to a new breed of rescue, namely pre-packed administration. The embracing of this informal process takes the direction of corporate rescue away from the foundational principles set out in the administration process. To understand this process the background to its origins will be observed and how the courts have approached the legitimacy question. The role of IPs and the discretion that they are afforded when considering a rescue strategy is critical to the understanding of how pre-packs operate. Focus will turn to Statement of Insolvency Practice (SIP) 16 and how this has demonstrated that the process needs to become more regulated. Whilst in some respects this falls short of offering assistance, it does codify what is best practice and offers a new guidance even if it is clear that the courts will refrain from interfering with “commercial judgements” made by IPs who they consider are best placed to make such decisions. Reference will again be made to the fundamental principles and safeguards examined in Chapter Three and how this has an impact on the pre-pack process, specifically how IPs make fair and accountable decisions. A few case studies will be explored to see how pre-packs work in practice as well as reflecting on the undesirable aspects such as professional fees of IPs and management buy-outs. Finally, proposals for change to the system will also be explored. Overall it will be established whether the lack of formality given to pre-packs has meant that the UK no longer has a corporate rescue model that is reflective of its principles as set out in its legislation. This chapter aims to understand more about this “pragmatic response” to rescue and whether it should be embraced or rejected as a serious, legitimate answer to helping distressed companies.

**Chapter 6: Conclusion**

A summary of the research conducted and any areas that would benefit from further research.

# Chapter 2

# Corporate Rescue: Concept, Nature, and Purpose

## I. Introduction

The way in which a financially distressed company is approached has changed over the years, in part because of fundamental shifts in the law and in financial markets. Examining the methods that have been employed to address these concerns involves a close exploration of the traditional and emerging principles that are evident within the United Kingdom's (UK) corporate rescue model. To achieve this end a number of issues will become apparent, namely the discovery that financial distress is a tentative term that often causes confusion and complicates matters as opposed to offering much needed clarity. Accepting that financial distress is something that cannot be fixed but rather takes on a form that seems to evolve, choosing to reflect the diverse and complex nature of the wider economic market, it should be stressed that distress and corporate death are not synonymous[1]. A company is unique; therefore distress will affect each company in different ways causing the value of the company to be depreciated in dissimilar fashions. It therefore follows that any attempt to apply or adopt a universal solution to distress would be a fruitless exercise. Each troubled company should be assessed on its own individual merits, even if this results in a break-away from what is considered normal practice.

Given the diverse nature of financial distress in conjunction with the tension that exists amongst creditors a picture emerges regarding the difficulty of dealing with a company that can be saved from liquidation. The benefits to be gained from a rescue process are often overlooked with commentators preferring to be pessimistic in relation to some aspects. To criticise a model is easier than to suggest reform measures that could aid the process, but this would be to ignore the fact that corporate rescue is anything but a straightforward procedure. With this in mind a comprehensive overview of the characteristics that make up the corporate rescue model in the UK are essential to the wider understanding of this subject.

[1] K. Wruck, 'Financial distress, Reorganization, and Organizational Efficiency', 27 *Journal of Financial Economics*, (1990), 419, at 420.

From extracting this information the rationale of what corporate rescue should aspire to do will be deduced. The rescue model has been designed to encompass a range of possibilities, but it cannot cater for every scenario. This is not the same as suggesting that there are shortcomings that should have been addressed, but rather acknowledging that there is a gulf between what the insolvency legislation says on the one hand and what practice deems to be necessary on the other. This thesis amongst other things will explore whether a "meeting of the minds" between the pragmatists and the theorists will occur, or whether the disparities will continue. Taking the opinion that the latter option is more likely, it will firstly be examined whether the administration procedure embraced in the UK coincides with the theoretical principles of rescue.

To explore this submission it will be necessary to separate this chapter into three distinct sections. The concepts involved within the process will be explored to shed light on the terminological difficulties that exist, particularly the point in time when a company is deemed insolvent; the difference between insolvent and in distress, and the various interpretations of rescue – is this company or business rescue - pure (keeping the company intact) or a reorganisation (saving only fragments of the company)? The second stage proposes to take a look at the nature of rescue; particularly the administration procedure and it is distinguishable from other models such as Chapter 11 of the US Bankruptcy Code. The last section questions the objective of rescue, examining the reasons behind why a company should be rescued and taking a closer look at the administration process.

As noted, corporate rescue has a complex personality. The principles of a corporate rescue model are based on an interdisciplinary[2] compliance between many formal and informal interpretations[3]; a reflection of how the corporate rescue idea has evolved through custom and contract law to produce an end product which contains a mixture of statutory and judiciary input.  It is this collaboration between various practices that provides a testament to the breadth and depth of corporate insolvency and in turn enhances the company's reputation as a complex legal entity. In truth it would be difficult to imagine an insolvency framework that contained aims which were isolated from the principles inherent in the jurisdiction's legal system. It is therefore paramount that the legal procedures adopted by a particular jurisdiction

[2] V. Finch, *Corporate Insolvency Law – Principles and Perspectives*, 2nd edn, (Cambridge: CUP, 2009).
[3] A. Belcher, *Corporate Rescue*, (London:  Sweet & Maxwell, 1997), at 87.

reflect and sit in harmony with the general overall thrust of existing legislation; unless of course the aim is one of reform.

Considering this, it begs the question: does the current insolvency framework provide adequate solutions for the contemporary issues that currently face companies? To answer this question a greater understanding of corporate rescue is required. The rescue concept presents itself as a complex legal mechanism which derives its identity from a mixture of inherent and external influences, including cultural impressions as well as economic pressures, voluntarily or not. Considering the various factors that can come into play, it will be of little surprise that developing a single idea as to what rescue should achieve has prompted much debate amongst academics. Apart from the difficulty in reaching agreement as to what "success" constitutes in the context of rescue, legal rules endure because they are efficient in their means[4]. If this submission is correct any legal procedure subjected to the efficiency test faces assessment whereby it must provide a plausible explanation as to why it should be, or deserves to be, recognised as the leading authority for the purpose it was designed[5]. Should it fail, attention must be drawn to alternative measures which address the issues. This in turn would be subjected to the same treatment to determine whether this provides the more adequate solution. Applying this to a company suffering financial distress, would it be better served if it entered the formal administration process or the informal alternative, pre-packaged administration (pre-packs)?

Part of the answer rests with identifying the various elements to efficiency and the different notions that they present. Critically there are some commentators who have suggested that efficiency cannot exclusively provide for any goals in the law itself[6]. Whilst this proposition will be explored in greater detail in Chapter Four it suffices to mention that this thesis argues to the contrary. In addition the research will demonstrate a necessity to review other factors such as fairness in conjunction with efficiency as these other notions are equally as important in providing justifications for why the law is as it is. Given the nature of corporate rescue the

[4] F. Easterbrook, 'Is Corporate Bankruptcy Efficient?', 27 *Journal of Financial Economics*, (1990), 411, at 411.
[5] Notions of efficiency will be explored in Chapter Four.
[6] R. Mokal, 'Review Article on Fairness and Efficiency', 66 *Modern Law Review*, (2003), 3.

focus will be on economic efficiency[7], but other factors such as path dependency will also form part of the critical analysis[8].

The path dependency theory will be used to explain the process of how certain rescue models are selected. However, to suggest that there is a choice in these matters is to misunderstand the theory. The premise is not based on a voluntary preference towards a particular trait or character evident within a rescue model but is often the result of following the historical development of a legal system that has been dictated over time. In other words there is a considerable lack of choice for the legislators to direct a rescue process in a way that is different from what has developed within the legal parameters of a particular jurisdiction. It is the case that implementing change will be difficult to achieve as the dependency to rely on traditional principles runs so deep within a legal framework that the differences between rescue processes will remain even if the reasons for those differences no longer exist[9]. Hence corporate insolvency regimes such as the ones evident in the UK and the US demonstrate how similar concepts can be interpreted differently and choosing one model over the other in these situations is prevented by a sense of belonging to one system as opposed to another[10].

It is however important to note another issue. If a jurisdiction is obliged to embrace a traditional approach to corporate rescue, would considering an alternative means that did not necessarily fit within existing practice be acceptable? Is it possible that this transition could be viewed as a rebellious act against the status quo or would it be demonstrating a willingness to adopt a practical response which would properly address the prevailing issues in commercial markets? An example of attempting to adjust to these changes has been the endorsement of the pre-packaged administration process which has gathered momentum in recent years by offering a less stringent approach for interested purchasers to buy a distressed

[7] M. J. White, 'The Corporate Bankruptcy Decision', 3 *Journal of Economic Perspectives*, (1989), 129, at 139.
[8] G. McCormack, 'Control and Corporate Rescue – An Anglo-American Evaluation', 56 *ICLQ*, (2007), 515, at 533.
[9] G. McCormack, 'Control and Corporate Rescue – An Anglo-American Evaluation', 56 *ICLQ*, (2007), 515, at 533.
[10] Further reading on 'path dependency' see R. J. Gilson, Corporate Governance and Economic Efficiency: When Do Institutions Matters?', 74 *Washington University Law Quarterly*, (1996), 327; M. J. Roe, 'Chaos and Evolution in Law and Economics', 109 *Harvard Law Review*, (1996), 641. For example the UK's insolvency regime has traditionally followed principles that have made it more inclined to embrace a creditor orientated approach, something which was noted in the highly influential Cork Report, and which made it distinguishable from other models like the United States Chapter 11 which follows a more debtor friendly approach.

company, without risking the value of the company disintegrating[11]. But even with these apparent advantages, would adopting this informal process go against everything that has been formulated in the past and render the formal administration procedure obsolete?

The prominence of the pre-packs can perhaps be explained by the lack of synchronisation between legislation and its practical application, which leads to one asking whether corporate insolvency legislation is simply one or more cycles behind current economic developments? If this is the case then the issue concerns itself with the restrictive parameters of the legal framework rather than the task of gathering the required support needed to implement change. That said the matter is rather more complicated than a mere theoretical dispute over how best to deal with a distressed company. The issues surrounding the legitimacy of pre-packs has been one of the most contentious matter that has resulted in much literature and has been the source for many heated debates regarding whether it can be seen as a genuine rescue process. Unfortunately any attempt to address these matters has suffered a setback as it was recently announced that the Government has scrapped any proposed consultation, concluding that that no changes will be made for the time being[12]. The Government was not convinced that the benefit of new legislative controls presently outweighed the overall benefit to businesses[13]. This has ensured that the tension between academics and insolvency professionals is to remain for some time creating a perfect opportunity to research the formal and informal rescue processes that currently exist in the UK[14].

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[11] Statistics compiled by the Insolvency Service will show that pre-packs now account for half of administrations, see The Insolvency Service, http://www.insolvency.gov.uk/otherinformation/statistics/201005/index.htm (assessed 20th January 2011).

[12] For example see, The Insolvency Service, *2011 Annual Review of Insolvency Practitioner Regulation*, (May 2012), at 9. It was as recent as June 2011 that the Insolvency Service (IS) led a short consultation on reforming the rules concerning pre-packed insolvency sales with the intention of implementing any potential new laws by October of the same year. However the statutory instrument outlining the proposed changes was removed from the IS website and the body announced in August 2012 that the planned regulatory changes would be delayed until April 2013 at the earliest. The changes drafted would have seen creditors given three days' notice if a company was to be sold to a connected party. Insolvency practitioners do not currently have to give notice of a pre-packaged sale to unsecured creditors although permission of secured creditors – for example, banks – is required.

[13] The Hon. Ed Davey, Minister for employment relations, consumer and postal affairs, said that the Government had listened to the views of "interested parties" and decided that it was better for small businesses not to impose further regulatory requirements on them. He said the Government was not prepared to introduce changes only applicable to larger firms. As much of the concern was related to small businesses, he did not consider that measures should be introduced just for businesses other than micro-businesses. It is for these reason that he announced that the Government would not be seeking to introduce new legislative controls on pre-packs.

[14] It will be noted that the commentary will not consider whether a model is right or wrong (morally or legally), the thesis will adopt a technical argument and assess whether Administration and pre-packs are so fundamentally different that they cannot co-exist as rescue models within the UK's insolvency framework.

## II. Structure of the Chapter

The purpose of this chapter is to provide an overview of the key principles and concepts that have contributed to the UK's corporate rescue regime. It is critical to the greater understanding of corporate rescue to firstly understand how insolvency laws have evolved over time and why certain aspects have remained whilst others have been discarded. Essentially a closer examination is required to determine the correlation, if any, between the policy decisions that have been made and the rescue model applied in practice and to see whether they sit in harmony or in conflict with each other.

The chapter will commence with an overview of the key concepts with an examination into the importance of how certain terms are interpreted and how this is critical to the greater understanding of corporate rescue. Defining financial distress is paramount to the successful application of a rescue model that heavily relies on management providing IPs with the correct information to allow them to intervene at the optimum time. The completeness of the information provided and any conflicts of interest between interested parties play a crucial role in establishing whether a distressed company can be rescued. The two legal tests for establishing insolvency - the Cash Flow and Balance Sheet tests - will form a focal point for this section. Distinctively the second stage will closely look at the nature of corporate rescue; focusing on the strategic development of rescue and observing the historical circumstances that have influenced the model, particularly how administration grew out of receivership which is essentially a creditor-orientated procedure and noting the findings of the Cork Report which set the foundations for the rescue regime that exists today. A brief historical overview of the fundamental differences between the UK and US insolvency laws will encapsulate the distinct identities of administration and Chapter 11 of the US Bankruptcy Code respectively, highlighting the tentative aspects of the models, such as who is in control of the company when the rescue/reorganisation process has been initiated. The divergence between the UK and US will show the complexity of corporate rescue and implicate a reliance on a wide range of circumstances. The third stage will look at the objectives of rescue. Cultural influences, the interests of society and the promotion of calculated risk as a means of encouraging entrepreneurial activity will be explored as a means of discovering the factors that have contributed to the UK's corporate rescue model. Discovering the parameters of the current insolvency legislation will assist in determining whether the rescue model in the UK is adequate in dealing with the needs of a distressed company. If the model is found to be wanting, can this be construed to mean that the UK lacks a formal rescue procedure? Ultimately it will be asked whether the alternative informal pre-pack model was inevitable.

## Part One: Corporate Rescue Concepts and Interpretations

### 1. Background

There are a number of different rescue models endorsed around the world that despite each having their own unique corporate rescue identity, share similar concepts and principles. To appreciate the foundations of corporate rescue it must firstly be understood how a legal system deals with a financially distressed company. Predominately the substance of a rescue model is highly dependent on the historical legal development that has occurred in a respective country[15]. It is therefore often the case that the direction taken by legislative bodies is nothing more than a mere echo that reflects old custom and practices that have existed for decades. This occurrence may be observed in the corporate insolvency and rescue regimes in both the UK and US; each being a product of their environment shaped by different circumstances. The intrinsic character of both models will be discussed with the greater focus being on the UK's administration procedure.

As a starting point it is critical to grasp what causes a company to become distressed and at what point does a company become insolvent? A key consideration when examining this is to be aware of the various parties that interact with a company, including creditors, shareholders, directors and managers of the company, employees, suppliers and customers. In addition it should also be noted the vital relationship between that of the insolvency practitioner (IP) and a rescue package, something which will be explored in greater detail in Chapter Three.

The purpose of corporate insolvency has many aspects, most designed to create opportunities for action rather than laying down consequences for stipulated states of affairs[16]. It is a system that is heavily reliant on the participation of those actors who operate within the circle of a distressed company's ambit to identify when action is required and what recourse is best suited given the circumstances. Rescue models endeavour to be associated with promoting a positive and proactive role, as well as a corrective and a punitive role. A system must be seen

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[15] This of cause has not prevented some commentators from drawing conclusions, see H. Hansmann and R. Kraakman, *'The End of History for Corporate Law'*, in J. Gordan and M. Roe, (eds), *Convergence and Persistence in Corporate Governance*, (Cambridge: CUP, 2004), at 33.

[16] V. Finch, *'Corporate Insolvency Law: Perspectives and Principles'*, (Cambridge: CUP, 2002), at 125.

to be accessible in providing readily available technical knowledge to those in charge of a company to inform and encourage them to seek help when distress has been identified and provide a level of confidence that the law will not penalise them merely for doing so.

However, identifying when a company is financially distressed is not a straight forward process, with part of the difficulty resting with how the initial assessment of the financial state of a company is conducted. The evaluation of a company's solvency state relies on somewhat rough benchmarks often referred to as the cash flow and balance sheet tests. The tests are not intended to be accurate mechanisms employed to determine the exact financial situation of a struggling company but used as a statutory rule to determine whether a company is insolvent for certain legal purposes. In some cases they have presented an over simplistic view of how distress is calculated when in fact the circumstances should be viewed in a wider context "constituted out of an assemblage of calculative technologies, expert claims and modes of judgment"[17].

Given the nature of how the point of insolvency is determined there is considerable room for discretion to be applied by the person who administers the affairs of the troubled company. This role can be assigned to a number of people who satisfy the requirements, but it is normally the case that a qualified accountant who is a trained insolvency practitioner (IP) will deal with the matter. To avoid any doubt, it should be noted that in the UK it is accountants rather than legal professionals who generally deal with insolvency related issues and this has influenced the way in which distress and insolvency are determined[18]. Often cited as being in the best position to make a sound decision, an IP may use his or her commercial judgment and have at his or her disposal, amongst other things, various data compiled from things such as accounting spreadsheets. Such is the reliance on IPs and familiarity in the way in which they conduct their affairs, the courts have demonstrated a willingness to leave insolvency related decisions in the hands of the IP and have refrained from interfering in the opinions that are formed.

[17] P. Miller and M. Power, 'Calculating Corporate Failure', in Y. Dezalay and D. Sugarman (eds.), *Professional Competition and Professional Power: Lawyers, Accountants and the Social Construction of Markets*, (London: Routledge, 1995), at 51.
[18] The negotiation process is not founded by legal pointers, but rather a process reliant on financial data subject to interpretation; it is purely the aftermath that is determined by insolvency legislation, see V. Finch, *Corporate Insolvency Law: Perspectives and Principles*, (Cambridge: CUP, 2002), at 126.

Once IPs have been instructed to act in the best interests of the distressed company they must decide what realistically can be done with the company. Despite the fact that IPs are held in such high esteem by the court and are given a wide berth to conduct their duties, obtaining the necessary information to allow them to do their job has always been problematic in some cases. Distress and insolvency are terms that are susceptible to wide interpretation. By allowing IP's to conduct their duties with discretion it has left a "legal space" where a company's financial status can be negotiated[19]. An IP may for instance successfully secure data relating to the financial situation of a company but in doing so he must keep an open mind accepting that accurate reports may be difficult to obtain due to the ease of manufacturing data to suit the required needs[20]. Given this difficulty, the eventual decision is based on opinion - does the IP "think" a company can survive as a going concern? Whilst this may occasionally result in errors, there is no real alternative. Audits and consultancy form an integral part of assessing the liquidity of a company and dominate the created market for insolvency administration and the extra-legal market for corporate rescue, and this method of deduction is here to stay[21]. That said, whilst financial measures are often adopted to assess corporate failure it will be seen that it is also a legal test that has received much attention from the judiciary and academics alike. However, before this analysis takes place it is necessary to provide an overview that examines the reasons why a company may become distressed.

### 1.1. Causes of Financial Distress

Before examining the terms distress and insolvency it is worth commencing with a brief introduction into what may cause a company to be subjected to financial hardship. The task of identifying events that have had an effect on a company's well-being is a troublesome affair as some companies can for a period of time be technically insolvent but not be in a position of financial distress; the alternative is also possible whereby a company can be technically in financial distress but not insolvent. Evidentially, distinguishing between the two positions is difficult but critical to how the troubled company is to be approached. Distress describes a moment of despair, an indicator that the company is having some

[19] P. Miller and M. Power, 'Calculating Corporate Failure', in Y. Dezalay and D. Sugarman (eds.), *Professional Competition and Professional Power: Lawyers, Accountants and the Social Construction of Markets*, (London: Routledge, 1995), at 58.
[20] The agglomeration of financial data can be perceived as a weakness of accountants especially when assessing the health of a company, see F. Clarke, G. Dean and K. Oliver, *Corporate Collapse: Regulatory, Accounting and Ethical Failure*, (Cambridge: CUP, 1997), ch17.
[21] V. Finch, *Corporate Insolvency Law: Perspectives and Principles*, (Cambridge: CUP, 2002), at 125.

problems. Insolvency is more of an absolute term used to describe an end result, and is a reflection of what has happened to the company.

Identifying causes of failure are essential for any attempt to rescue a company[22]. The difficulties should be categorised and systematically analysed to ensure that all the problems are properly accounted for as no rescue strategy will be able to prevail unless they are remedied. A detailed description of the internal and external factors that may contribute to the failure of a company is not at the heart of this thesis[23], but it suffices to mention what the most often cited causes of failure are attributed to.

It is generally understood that the most common cause of distress is acts committed (or omissions) by the management of the company[24]. Whilst it is understood that the management of the company cannot control all eventualities that may take place, such as prolonged strikes and business competition from a major group, it is nevertheless a necessity that a company is expected to take risks to stay competitive and, as a result, successful. The difficulty in taking risks that may not have necessarily reaped any immediate rewards is for the management to realise and accept that the financial difficulties that may be evident require an honest reflection and should not be merely dismissed as just a blip in a business plan but something that could become very serious. How this assessment is undertaken depends entirely on the management, but a word of warning should be noted as prolonging

[22] Whilst good accounting systems will provide for accurate cash flow forecasts and project projections, including checks against theft and fraud, there appears to be a lack of commitment to the provision of good quality accounting information, see J. Day and P. Taylor, 'Financial Distress in Small Firms: The Role played by Debt Covenants and other Monitoring Devices', *Insolvency Lawyer*, (2001), 97.

[23] On corporate failure see C. F. Pratten, *'Corporate Failure'*, (Chartered Accountants in England and Wales, London, 1991); C. Campbell and B. Underdown, *Corporate Insolvency in Practice: An Analytical Approach*, (London: Chapman, 1991); H. D. Platt, *Why Companies Fail: Strategies for Detecting, Avoiding, and Profiting from Bankruptcy*, (Lexington: Lexington Books, Mass, 1985); J. Argenti, *Corporate Collapse: The Causes and Symptoms*, (London: McGraw-Hill, 1976); On high gearing see R. Hamilton, B. Halcroft, K. Pond and Z. Liew, 'Back from the Dead: Survival Potential in Administrative Receiverships', 13 *Insolvency Legal & Practice*, (1997), at 78, 80; On over expansion see J. Stein, 'Rescue Operations in Business Crises', in K. J. Hopt and G. Teubner (eds.), *Corporate Governance and Directors' Liabilities: Legal, Economic, and Sociological Analyses on Corporate Social Responsibility*, (Berlin: De Gruyter, 1985); On mismanagement see V. Finch, 'Company Directors: Who Cares About Skill and Care?', 55 *Modern Law Review*, (1992), 179, at 210; On Charging Markets and Economic Conditions see K. Dyson and S. Wilks, *'The Character and Economic Content of Industrial Crisis'*, in Dyson and Wilks (eds.), *Industrial Crisis: A Comparative Study of the State and Industry*, (Oxford: Blackwell, 1985).

[24] See a joint Smith Institute and R3 report on a summary of a roundtable debate and events at the Labour Party and Conservative Party Conferences (July and October 2009). The events focused on whether the existing insolvency regime was fit for purpose. The events looked at whether there was a case for reform and amongst other things stated that poor management is one of the primary causes of business failure, at http://www.r3.org.uk/media/documents/technical_library/Press,%20Policy%20and%20Press/Smith%20Institute_Bankrupt%20Britain.pdf (accessed 4th September 2012); see also J. Lingard, *Corporate rescue and Insolvencies*, 2nd edn, (London: Butterworths, 1989), at 3, para 1.12.

the waiting game, hoping the situation improves will reduce the chances for an administrator to do anything about it[25].

With this in mind it is imperative to understand how a company should operate. As a benchmark a successful company requires "competent management, a suitably motivated workforce and worthwhile products"[26] to survive in a competitive environment. Any element that affects any of these can negate a company's ability to generate profit. Whilst products may become obsolete and workforces cause disruption to productivity, measures can be taken to rectify these problems with relative ease if the management of a company is competent. However, if it is the management that is responsible for the demise of the company then any rectification becomes much more difficult[27]. The issues may become amplified depending on the size of the workforce, the experience and qualifications held by management[28], the extent of the problem and how quickly the distress has been identified. If management lacks the ability to deal with the issues and are not prudent enough to seek specialist help, it may continue to make poor strategies or preserve its control over the company by using superior information to make poor decisions[29]. Ultimately, management is in a position to make or break a company; the managers are the ones that run the company and make the key decisions on how that company should operate[30].

The vast number of reasons why a company may experience troubles can be broken down into five critical areas that if not monitored would affect the financial stability of the

[25] Unfortunately the chance has often been and gone before an administrator can do anything, see S. Frith and S. Davies, 'Clearing up the Mess: Applying the Basic Principle of Insolvency Law – A Review of Cases Decided in 2008 on the Theme of Administrators – Part 1', *Insolvency Intelligence*, (2009), 117, at 117.
[26] J. Lingard, *Corporate Rescue and Insolvencies*, 2nd edn, (London: Butterworths, 1989), at 1.
[27] ComRes conducted an online survey in May 2010 of R3 members in the UK. The survey was sent to 2082 IPs, of whom 329 responded. This means that approximately one in six of those eligible to take part did so. Their findings revealed that 'Incompetence or bad management' of company directors causes 56% of corporate failures, while nearly 40% of businesses could have been saved if professional advice had been sought earlier, according to a poll of insolvency experts carried out by insolvency trade body R3, see https://www.r3.org.uk/newsandpress/default.asp?page=1&i=525&id=446#PressArchiveStory (assessed 20th October 2010); See C. Campbell and B. Underdown, *Corporate Insolvency in Practice: An Analytical Approach*, (London: Chapman, 1991); J. Argenti, *Corporate Collapse: The Causes and Symptoms*, (London: McGraw-Hill, 1976).
[28] Most English Company Directors are in fact untrained and unqualified, see V. Finch, 'Company Directors: Who Cares about skill and Care?', 55 *Modern Law Review*, (1992), at 79. Recent reports suggest that the situation has not improved, see Smith Institute and R3 report, (July and October 2009), at http://www.r3.org.uk/media/documents/technical_library/Press,%20Policy%20and%20Press/Smith%20Institute_Bankrupt%20Britain.pdf (accessed 4th September 2012).
[29] K. H. Wruck, 'Financial Distress, Reorganisation and Organisational Efficiency', 27 *Journal of Financial Economics*, (1990), 419, at 424.
[30] In some firms that management will be stakeholders in the company as well.

company, and potentially lead to financial distress. The five[31] elements are not, it is submitted, exhaustive. Rather they are indicators of the core issues that may prevail. The first element covers issues regarding efficient production, a reference to the way in which the products are made. Sub categories cover whether the product has been made within a specified time-frame and at a competitive value. Any disruption to the set targets will invariably mean that the products are being made at a loss which will affect the profits of the company. Following on from this the second element requires skilful marketing (products that will be readily absorbed into the market). If there is no market for the product produced then the company will simply not be able to generate any turnover, and will operate its business at a loss. In conjunction with this, the third element should prevent obsolete products by insisting on stringent financial controls to show the outcome is profitable. But predicting markets and what will "catch on" involves risk assessments based on probabilities; there is always a risk that the market turns against the company. The fourth element covering the diversification of products aims to spread the financial risk of one product failing by having an interest in another profitable enterprise. But this is not always possible especially if the reason for the failure is something that has affected the market as a whole. To have the luxury of having an interest in products over a wide range of markets is a rare trait for many companies. The final element encourages a contingency plan (business plan for disaster management, and specifically one involving a financial climate change). This however is entirely dependent on the extent of the distress and whether the company can be salvaged.

The general list provides a clear message: – spread risk and adapt quickly to hostile conditions or risk being susceptible to harsh economic conditions either by way of consequence or subsequently through unforeseen influences, which may eventually lead to the company being unable to remain solvent. Consequential results are controllable through risk management and prudent analysis of company information; subsequent risks are rare, and ones that often affect the wider market as a whole rather than an individual business, such as a change in the financial climate on a global scale. It is the change in an economy that poses a continuous threat to all businesses. The change in the economic settings may be sudden and with little warning, such as the Government imposing exchange controls, hire purchase controls, tariff barriers or materially changing tax policies. The natural answer to this would be for the management to adapt quickly to the situation, but if it is on an

[31] J. Lingard, *Corporate Rescue and Insolvencies*, 2nd edn, (London: Butterworths, 1989), at 1.

unprecedented level with a lack of real experience from the managers in dealing with such an occurrence then this will prove a difficult task that may lead to the company being exposed to financial troubles far greater than it should have been. If it is the case that the company cannot survive such exposure then inevitably the company will fail. However there is a possibility for a company to be rescued as long as the signs of financial distress can be recognised and management is willing to admit to its mistakes[32]; its importance will also be determined by its ability to provide a timeframe where a rescue attempt would potentially prove more successful[33].

### 1.2. Financial Distress

As noted above there is a clear distinction between when a company is in financial distress and when a company is insolvent. Financial distress is a variable term that can be applied to a number of situations. It may apply to describe a recent internal or external event, or it may be part of a series of ongoing problems that have not been resolved. Distressed companies are those that require a major rethink in the way a firm's operations or structures are performed[34]. Such action will normally involve the reorganisation of the company's operations[35]. Distress normally arises in terms of default, when the company has failed to make a significant payment of principal or interest to the creditor[36]. Substantiating distress may also be achieved through assessing calculations based on a company's accounts, which can provide a breakdown of a company's financial profile, producing ratios to predict a range of events,

[32] It should also be noted that "Regardless of the economic circumstance, no business will survive with poor management in place. I have seen a good workforce let down and sometimes laid off due to management which do not admit and correct their mistakes.", see R3 press release by R3's President Steven Law: 'Bad management to blame for nearly 60% of corporate insolvencies', (9th July 2010), (assessed 20th October 2010) https://www.r3.org.uk/newsandpress/default.asp?page=1&i=525&id=446#PressArchiveStory

[33] Determining when a rescue strategy has been a success will often depend on when the question is asked. The timeframe is therefore open to scrutiny. See A. Belcher, *'The Economic Implications of Attempting to Rescue Companies'* in H. Rajak (ed.), *Insolvency Law Theory and Practice*, (London: Sweet & Maxwell, 1993), at 237.

[34] C. Foster, *Financial statement Analysis*, 2nd edn, (Prentice-Hall, Englewood Cliffs, N.J., 1986), at 61. See also J. Day and P. Taylor, ' Financial Distress in Small firms: The Role Played by Debt Covenants and Other Monitoring Devices', *Insolvency Lawyer*, (2001), 97. A. Belcher, *Corporate Rescue*, (London: Sweet & Maxwell, 1997), at 12; A, Belcher, *'The Economic Implications of Attempting to Rescue Companies'*, in H. Rajak (ed.), *Insolvency Law: Theory and Practice*, (London: Sweet & Maxwell, 1993). See also D. Brown, *Corporate Rescue: Insolvency Law in Practice*, (Chichester: John Wiley & Sons, 1996), ch1; M. Hunter, 'The Nature and Functions of a Rescue Culture', *Journal of Business Law*, (1997), at 491; R. Harmer, 'Comparison of Trends in National Law: The Pacific Rim', *Brooklyn Journal of International Law*, (1997), 139, at 143-8.

[35] C. Foster, *Financial Statement Analysis*, 2nd edn, (Prentice-Hall, Englewood Cliffs, N.J, 1986), at 61; A. Belcher, *Corporate Rescue*, (London: Sweet & Maxwell, 1997), ch. 3; See also V. Finch, *Corporate Insolvency Law: Perspectives and Principles*, (Cambridge: CUP, 2002), at 122 where the SPI Eighth Survey revealed that 71 per cent of businesses in its sample of formal insolvency cases experienced a break up sale of assets.

[36] See V. Finch, *Corporate Insolvency Law: Perspectives and Principles*, 2nd edn, (Cambridge: CUP, 2009), at 146. A technical distinction has been made by Belcher between "default proper" and "technical default", with the former referring to not a failure to comply with payment and interest obligations but rather a core principle in that the company has dipped below a certain level of net worth.

including long term solvency plans,[37] and the general financial well-being of a company[38].To address issues that arise generally leads to negotiations with at least one of the company's creditors. But depending on the provisions agreed within the contracts between the company and the creditors for dealing with debt default, providing a mutual outcome may be very difficult. Whilst this attempt at defining financial distress aims to bring some clarity, it will be of no surprise to learn that it has found no universal consensus[39].

Despite the differences some confusion is often caused because the word insolvent is often used as a synonym for financial distress[40]. A company in the UK may be classified as insolvent if it is unable to pay its debts[41]; this will mean that the distressed company has satisfied either the cash flow or balance sheet test (this is examined in the next section). There may be some room to distinguish the two and argue that it is only with the cash flow test where a company is unable to meet its current cash obligations. Examples of this includes unpaid debts to suppliers and employees, actual or potential damages from litigation and missed principal or interest payments[42].These can all be correctly referred to as signs of financial distress as there will usually be a clear breach of contract. This should be compared to a company that has outstanding liabilities that are greater than the value of assets, and as such it is not possible to discharge the liabilities. Whilst this may render a company legally insolvent if it is unable to pay its debts[43], unlike the cash flow test it will usually be the case that the creditors' claims are paid to date and so no breach of contract will arise[44]. Given the

[37] See A. Belcher, *Corporate Rescue*, (London: Sweet & Maxwell, 1997), at 40.

[38] A companies profile may be determined by a number of 'effectiveness ratios' which charter the profitability with the given resources; specifically liquidity ratios determine the ability to pay debts within deadlines, solvency ratios consider the firm's capital structure and its ability to meet long term financial commitments, see A. Belcher, *Corporate Rescue*, (London: Sweet & Maxwell, 1997), at 40. On further reading regarding ratios and how they are use to predict insolvency see A. Belcher, *Corporate Rescue*, (London: Sweet & Maxwell, 1997), ch 40; E. I. Altman, 'Financial Ratios, Discriminant Analysis and the Prediction of Corporate Failure', *23 Journal of Finance*, (1968), at 589; J. Pesse and D. Wood, 'Issues in Assessing MDA Models of Corporate Failure: A Research Note', *British Accounting Review*, (1992), 24, at 33; R. Taffler, 'Forecasting Company Failure in the UK Using Discriminant Analysis and Financial Ratio Data', *Journal of Royal Statistical Society*, Series A, (1982), 342.

[39] For a spectrum of potential indicators of distress see R. Morris, *'Early Warning Indicators of Corporate Failure'*, (Ashgate/ICCA, London, 1997); J. Day and P. Taylor, 'Financial Distress in Small Firms: The Role Played by Debt Covenants and Other Monitoring Devices', *Insolvency Law*yer, (2001), at 97.

[40] K. H. Wruck, 'Financial Distress, Reorganisation and Organisational Efficiency', 27 *Journal of Financial Economics*, (1990), 419, at 421.

[41] See A. Keay and P. Walton, *Insolvency Law: Corporate and Personal*, 2nd edn, (Bristol: Jordans, 2008), ch. 2.

[42] K. H. Wruck, 'Financial Distress, Reorganisation and Organisational Efficiency', *27 Journal of Financial Economics*, (1990), 419, at 421.

[43] R. M. Goode, *Principles of Corporate Insolvency Law*, 4th edn, (London: Sweet & Maxwell, 2011), at 110; J. Boyle, J. Birds, E. Ferran and C. Villiers, *Boyle and Birds' Company Law*, 4th edn, (Bristol: Jordans, 2000), at 638-40.

[44] See E. I. Altman, *Corporate Financial Distress*, (New York: Wiley, 1983).

difficulties in determining the legal point of insolvency, this matter has now received some much needed attention in the case of *BNY Corporate Trustee Services Ltd v Eurosail-UK*[45]. The significance of this case is realised in the clarity that it has brought in helping to define when a company was unable to pay its debts for the purposes of the Insolvency Act 1986 s.123 (2). The case held that this provision was satisfied when a company whose assets and liabilities, including contingent and future liabilities, were such that it had reached the “point of no return”[46].

In an attempt to encompass these technical assessments, the law has provided two tests to determine the point of insolvency. It should be noted that the mere consequence of a company entering an insolvent state does not necessarily trigger any legal consequences. If any wrongs have been committed it will depend on the present legal position of the company. For instance, wrongful trading will only become apparent after the initiation of formal proceedings of winding up. For anything short of this it is still possible for civil and criminal actions to be taken against certain individuals if for example during an investigation into the possibility of implementing a rescue plan wrongdoing is identified[47]. Despite initial thoughts that taking such action may damage potential rescue plans this consequential action may even go as far as easing the financial distress, particularly if wrongful or fraudulent trading is evident. But this would only prove beneficial if the funds could be restored, or if it could be proven that the cause of distress had been identified and resolved. Nevertheless the contribution that the confidence factor has in a rescue package cannot be understated; in essence it is perhaps the single most important factor that enables a company to take the necessary proactive steps to secure the necessary funds to finance its recovery plan. With this in mind it is imperative that these proactive steps are taken at the right time, which brings us to the next section on how insolvency is determined from a legal perspective.

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[45] 2007-3BL Plc Court of Appeal (Civil Division) [2011] EWCA Civ 227.

[46] *BNY Corporate Trustee Services Ltd v Eurosail-UK* 2007-3BL Plc Court of Appeal (Civil Division) [2011] EWCA Civ 227, paras 48-49. Within the judgment the term “point of no return” receives much attention. The concept originates from Professor R. Goode who used the description as a way of providing some guidance on assessing the ability of a company to pay its debts. However, the court conceded that it will invariably be the case that the court would have to form its own view to whether the company had reached that point, see para 61. It should also be noted that the Cork Report as its own term for the “point of no return” referring to the point when the “shutters should be put up”, see paras 54, 58, 80.

[47] Whilst acts like wrongful trading can only be determined at the point of insolvency, others such as a breach of directors duties will suffice. See Company Directors Disqualification Act 1986, section 2, or section 6 if the company went into liquidation or administration.

### 1.3. Determining Insolvency

As noted above, to determine whether a company is in financial trouble or on the verge of becoming insolvent the law provides, as a guideline two tests that if satisfied amounts to sufficient evidence for insolvency proceedings to be initiated. These tests are known as “cash flow” insolvency (commercial solvency) and “balance sheet” insolvency[48]. The two tests are very similar in the sense that they will usually be both passed or failed. It has been noted that:

There is a close link between cash flow insolvency and balance sheet insolvency in that where a company is a going concern and its business can be sold as such with its assets in use in the business, those assets will usually have a substantially higher value than if disposed of on a break-up basis, divorced from their previous business activity. So a company which is “commercially solvent has a much greater chance of satisfying the balance sheet test of insolvency than one which is unable to pay its debts as they fall due”[49].

Theoretically a company should have the necessary financial controls in place which would notify the management of any concerns before these tests could potentially be satisfied; but in practice this is not always the case due to imperfect information (misleading or incomplete), conflicts of interests and incompetence. The real problem therefore is determining which data to rely on after the point of distress – version (A) which shows resistance and signs of recovery, or version (B) which shows a permanent decline? As both scenarios may sufficiently be demonstrated based on the interpretation of data, one conclusion must nevertheless be chosen as the more convincing. This clearly presents a position where positive action to intervene in a distressed company is reliant on nothing more than a well educated prediction. The tests employed to determine insolvency should therefore be treated as guidelines since the meanings and the way that they may be applied, is in dispute[50]. For these reasons, calculating whether a corporate rescue procedure is a viable option can be time-consuming and very expensive, not to mention having the potential to direct attention to the management and the decisions that they have made. Although management does not

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[48] Alternatively they have been also referred to as commercial insolvency and absolute insolvency respectively, see R. M. Goode, *The Principles of Corporate Insolvency Law*, 4th edn, (London: Sweet & Maxwell, 2011), at 114 and Ch 4 generally.

[49] Ibid, at 115.

[50] As was noted by Nicholls L. J. in *Byblos Bank S.A.L. v. Al-Khudairy* (1986) 2 B.C.C. 99, 549 at 99, 563, where he observed that only three decisions had been found relevant to the point he had to decide; See also R. Goode, *Principles of Corporate Insolvency Law*, 4th edn, (London: Sweet & Maxwell, 2011), at 113. However some assistance has been provided in some recent case law, see *Re Cheyne Finance plc (no 2)* [2008] 2 All ER 987.

necessarily have to be the one which can raise the issue of insolvency[51], it is clear from the data interpretation exercise that this can lead to honest disagreement about the course of action that is to be taken. This in turn may contribute to a delay in taking proactive steps to address the dire state of a company's finances if it is later proven to be the case that the company's state of affairs were not improving and actually showed signs of sliding into further trouble.

If one of the legal tests is satisfied and it becomes apparent that the company is insolvent, then this may cause some creditors to take action against the company to recover the money that they are owed. In an attempt to prevent a raid on the company's assets, a company upon entering administration, is granted a moratorium whereby actions against the company are stayed. This allows the company a "breathing space", that is, time to properly assess the situation and decide on the best course of action to be taken without worrying about the creditors pulling the company apart. That said, despite the intentions of a moratorium it does not always prevent creditors from taking enforcement action for payment; it is a question of swiftness, with the fastest party gaining an advantage, something which may hinder a rescue attempt if the item (asset) "grabbed" with the intention to be sold to realise funds happens to be critical to the operations of the company[52].

To maximise the benefits obtained from an administration process it must be initiated at the first available opportunity. The process covers a number of key actions, amongst the list include: a winding up order made on creditors' petitions[53]; action against directors in the form of wrongful and fraudulent trading[54]; transactions carried out at undervalue or a preference[55]; and an administration order[56] against a company are a few but to name. The insolvency tests are used in legal proceedings as a way of determining the extent of the financial troubles within a distressed company. Despite the extent that these tests are integrated within insolvency related issues there is a question as to why there is a need for two tests? As previously noted the two tests do overlap so would it not be practical to combine them? Or

[51] See L. Qi, 'Managerial Models during the Corporate Reorganisation Period and their Governance Effects: The UK and US Perspective', *Company Lawyer*, (2008), 131.
[52] For example if certain core machines in a manufacturing company had to be sold. This may impact the production rate or even the ability to produce its product.
[53] Insolvency Act 1986, s.122(1) (f).
[54] Insolvency Act 1986, ss.214(6) and 216(7).
[55] Insolvency Act 1986, ss.213 and 214 respectively.
[56] Insolvency Act 1986, s.8.

are the distinctions justified? These are questions that have not received much attention; merely accepted as a natural consequence from adopting principles based on corporate insolvency's approach prior to the Insolvency Act 1985[57]. Further analysis is now required.

### 1.4. The Tests: Cash Flow and Balance Sheet[58]

#### 1.4.1. Cash Flow Insolvency

A company may be cash flow insolvent if it cannot pay its debts as they fall due[59]. This is the main ground upon which companies are liquidated. The fact that a company's assets exceed its liabilities is an irrelevant matter; if it cannot pay a debt as it falls due then there is no reason why a creditor should have to wait until the company can realise assets, some of which may not be in a readily liquidated form. But readily liquidatable assets may be taken into account. In respect to its statutory definition, the full legal definition of inability to pay debts is found within section 123 of the Insolvency Act 1986. The most important are:

(1) A company is deemed unable to pay its debts-

(a) if a creditor (by assignment or otherwise) to whom the company is indebted in a sum exceeding £750 then due has served on the company, by leaving it at the company's registered office, a written demand (in the prescribed form) requiring the company to pay the sum so due and the company has for 3 weeks thereafter neglected to pay the sum or to secure or compound for it to the reasonable satisfaction of the creditor, or

(b) if, in England and Wales, execution or process issued on a judgment, decree or order of any court in favour of a creditor of the company is returned unsatisfied in whole or in part, or

(e) If it is proved to the satisfaction of the court that the company is unable to pay its debts as they fall due.

Whenever this can be established, it will be deemed by the court that the company is insolvent, and the onus is then on the company to prove that it can pay its debts as they fall

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[57] R. Goode, *Principles of Corporate Insolvency Law*, 4th edn, (London: Sweet & Maxwell, 2011), at 111.

[58] It should be noted that there is in fact a third test which concerns itself with banks. Regulatory insolvency is not something that will be examined in this thesis due to its special relationship with banks which for all sense and purposes are not treated in the same as an ordinary company.

[59] Insolvency Act 1986, s.122(1) (f).

due[60]. The apparent ease in which the test can be followed is partially betrayed by the vagueness of what is meant by the term "debts". Further issues covering how are these debts paid and what can be included in the payment of these debts adds another dimension to the process. Given the wording of the provision there is also a question regarding the flexibility in making payments and whether there is a level of tolerance to be applied to payments made? It appears that these questions can only be applied on an individual basis and the potential merits discussed in accordance with the interested parties in that particular case. A general application does not seem to apply.

Section (e) quite simply covers any company that is unable to meet current demands[61], irrespective of whether the company had assets which, if realised, would enable it to discharge its liabilities in full. Inability to pay debts also covers scenarios whereby an invoice has been sent to the company, and if the amount has not been disputed but does not get paid within a specified time then this can amount to evidence of a company unable to pay its debts[62]. In addition to this it was the case until recently that prospective debt could not be taken into consideration[63], however this has now changed[64]. Whilst only the courts usually consider this matter, IPs may also take this into account as part of a broader measure to realise the full potential of a distressed company. The process does not need to be exact; rather it is a technique aimed to introduce flexibility when attempting to determine the solvent/insolvent state of a company.

Establishing whether a company can pay its debts, the courts must consider the current revenue of the company along with any possible monies that may be realised from selling assets. However, there is a condition placed on this valuation process in that the monies must be realised in a short time frame[65]. Whilst this may limit some actions to pursuing money, the company is not limited to its own cash that happens to be on hand in determining whether it has the ability to pay its debts. A company can rely upon money which might be obtained from the sale of assets or upon loan money where the loan was granted because of the amount

[60] See L. Doyle, and A. Keay, *Insolvency Legislation: Annotations and Commentary*, (Bristol: Jordans, 2007), at 150.
[61] *Re Capital Annuities Ltd* [1979] 1 WLR 170.
[62] *Taylor Industrial Flooring Ltd v M & H plant Hire (Manchester) Ltd* [1990] BCLC 216, BCC 44, CA.
[63] *Re London & Manchester Industrial Association* (1985) 1 Ch D 466 at 472.
[64] *Re Cheyne Finance plc (no 2)* [2008] 2 All ER 987.
[65] *Re Capital Annuities Ltd* [1979] 1 WLR 170, at 182, 188.

of the company's assets[66]. Where the sale of a major asset is certain, the realisation of these funds will be considered and taken into account[67]. But if it is a mere hope or an expectation that future funds may be realised then this will not be taken into account unless the hope or expectation was realistic[68].

Establishing whether a company is cash flow insolvent is a question of fact. If a company has a large amount of outstanding debts and unsatisfied judgments then this may be something that the court may take as evidence that establishes that a company cannot pay its due debts[69], when all of the company's assets have been considered[70]. If the company itself or its solicitors have admitted that they are unable to pay then this is also evidence[71], along with the absence of assets on which execution can be levied[72]. A company found to be unable to meet its debts as they fall due is considered insolvent for the purpose of winding up, and this permits an administration order or winding up order to be made[73].

### 1.4.2. Balance Sheet Insolvency

The alternative test for determining insolvency is the balance sheet (or asset) test which is satisfied if the company has total liabilities that exceed the value of its assets, therefore rendering the debtor with insufficient assets to discharge his liabilities[74]. The logic behind this is to emphasise that it is not sufficient for a company to realise its assets to satisfy its liabilities, if the ultimate liabilities would not be satisfied upon the realisation of the company's assets. The term "liabilities" has a much broader meaning than "debts"[75] and is defined for the purposes of winding up in r 13.12(4) of the Insolvency Rules 1986. Rule 12.12(4) states that it is immaterial whether the liability is present or future, whether it is certain or contingent, or whether the amount is fixed or liquidated, or is being capable of being ascertained by fixed rules or as a matter of opinion. A court may only take into account the assets of the company held at that time; so assets which are expected to be received in the

[66] *Sandell v Porter* (1966) 115 CLR 666, (1966) 40 ALJR 71; *Lewis v Doran* [2005] NSWCA 243; (2005) 219 ALR 555, NSW CA.
[67] *Cuthbertson & Richards Sawmills Pty Ltd v Thomas* (1998) 28 ACSR 310, at 319.
[68] *Byblos Bank SAL v Al Khudhairy* [1987] BCLC 232.
[69] *Re Tweeds Garages Ltd* [1962] Ch 406.
[70] *Re Lyric Club* (1892) 36 Sol Jo 801.
[71] *Re Great Northern Copper Co* (1869) 20 LT 264.
[72] *Re Flagstaff Silver Mining Co of Utah* (1975) 20 eq. 268; *Re Yate Colleries Co* [1883] WN 171; *Re Douglas Griggs Engineering Ltd* [1963] Ch 19.
[73] The administration process will be discussed in due course.
[74] Insolvency Act 1986, s.123 (2)
[75] *Re Debtor* (No 17 of 1966) [1967] Ch 590, [1967] 1 All ER 668.

future by the company or funds that it has on loan are both excluded from being taken into account[76].

The problem however with determining insolvency using the balance sheet test is the question surrounding the valuation of assets. For corporate rescue to prevail the valuation of assets is absolutely critical. The disparity between estimates can be startling; an example to emphasise is where there are valuations of works of art by a leading auction house and the actual sale price at auction realised as a reflection on how difficult it is to give an accurate valuation of assets not having an established market price[77]. Market rates, timing of the sale and available buyers[78] are all factors which contribute to the uncertainty of a definite figure; not to mention the difficulty in valuing some liabilities[79], notably unqualified existing liabilities and contingent liabilities[80]. It follows that it is particularly difficult to determine and assess the valuation of the items in question when the Act does not make clear whether it should be made on the basis of a "going concern" or as a "break up" sale[81]. It is understood that whilst the court may take into account contingent and prospective liabilities as determined in the *Cheyne Finance Plc* case[82], it cannot take into account contingent and prospective assets[83].

Exactly how the courts should determine whether a company can pay its debts has received much attention, particularly in the *Cheyne* and *BNY* cases. The two cases considered the scope of section 123(2) was to cover situations where, although it could not be said that a company was currently unable to pay its debts as they fell due, it was, in practical terms, clear that it would not be able to meet its future or contingent liabilities[84]. The ultimate aim is therefore to discover whether a company has reached the point of no return[85] or in respect of which the shutters should be "put up", notwithstanding that this is imprecise, judgement-

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[76] *Re National Livestock Insurance Co* (1858) 26 Beav 153; 53 ER 855; *Byblos Bank SAL v Al-Khudiary* (1986) 2 BCC 99, 549 at 99, 562-99, 563.
[77] R. Goode, *Principles of Corporate Insolvency Law*, 4th edn, (London: Sweet & Maxwell, 2011), at 115.
[78] Some particular difficulties may arise where specialist buyers cannot be determined, or there is no established market value for that commodity, see V. Finch, *Corporate Insolvency Law: Perspectives and Principles*, (Cambridge: CUP, 2002), at 123.
[79] See A. Belcher, *Corporate Rescue*, (London: Sweet & Maxwell, 1997)
[80] R. M. Goode, *The Principles of Corporate Insolvency Law*, 4th edn, (London: Sweet & Maxwell, 2011), at 134-137.
[81] V. Finch, *Corporate Insolvency Law: Perspectives and Principles*, (Cambridge: CUP, 2002), at 123.
[82] *Re Cheyne Finance Plc (In Receivership)* [2007] EWHC 2402 (Ch), at para 27.
[83] *Byblos Bank SAL v Al-Khudhairy* (1986) 2 BCC 99, 549, CA.
[84] For example see *Re Cheyne Finance Plc (In Receivership)* [2007] EWHC 2402 (Ch), para 58; *BNY Corporate Trustee Services Ltd v Eurosail-UK* 2007-3BL Plc Court of Appeal (Civil Division), paras 110, 117.
[85] *Re Cheyne Finance Plc (In Receivership)* [2007] EWHC 2402 (Ch), [2008] Bus. L.R. 1562.

based and fact-specific[86]. Whilst the process can appear to be relatively “mechanical”, the court is keen to stress that this “asset-based” approach has been around for some time, but has only recently attracted attention[87]. The process is sensitive to data interpretation and part of the exercise is to decide whether the audits that have taken place were said to convey a true and fair view of the company's position in the opinion of its directors. The test is therefore whether the directors truly believed in the facts and figures obtained and if this was the case then it should have real force and provide adequate justification in supporting the actions taken as honest, informed, and reasonable. However, in most cases the collected data would be historic, normally conservative, based on accounting convention and would rarely represent the only true and fair view. The court on this basis would have to complete its own investigations and form its own view as to whether the company had reached the point of no return[88]. Given the difficulties associated with compiling the relevant information it would be necessary in some cases to consider whether to depart from the recorded position and take into account other factors. These include substantial assets, the period over which its liabilities had to be met and the potential for significant change in the differences between the value of assets and liabilities.

Putting these considerations to one side, it should be noted that the balance sheet test can only be used with wrongful trading[89], but cash flow and balance sheet can be used for satisfying the grounds for a winding up[90], administration[91] or the avoidance of transactions at an undervalue[92], preferences[93] and certain floating charges[94]. In effect the balance sheet method is one of the tests that would be used to assess whether any potential action should be taken to disqualify directors[95] and also the point of identifying insolvent liquidation to see whether

[86] *BNY Corporate Trustee Services Ltd v Eurosail-UK* 2007-3BL Plc Court of Appeal (Civil Division), para. 58. For a summary of the BNY judgment see C. Cooke, ‘Balance Sheet Insolvency: A Commercial Approach’, 8(3) *Int. C. R.*, (2011), 228-230. Further assistance on the inability to pay debts see D. Henderson, ‘Inability to Pay Debts: Where are we now?’, 24(4) *Insolvency Intelligence*, (2011), 54-59; B. Jones, ‘Past the Point of no Return’, *4(2) C. R. & I.*, (2011), 43-44.
[87] *BNY Corporate Trustee Services Ltd v Eurosail-UK* 2007-3BL Plc Court of Appeal (Civil Division), para. 58.
[88] *BNY Corporate Trustee Services Ltd v Eurosail-UK* 2007-3BL Plc Court of Appeal (Civil Division), para. 61.
[89] The reason or this exclusiveness lies with the fact that there is no reason to impose liability of the delinquent directors to contribute to the assets of the company except where the assets are insufficient to meet the liabilities and the expenses of winding up.
[90] It should be stressed that there are other ways in assessing the inability to pay debts outside the use of insolvency; see R. M. Goode, *The Principles of Corporate Insolvency Law*, 4th edn, (London: Sweet & Maxwell, 2011), at 116.
[91] Insolvency Act 1986, s.8(1)(a).
[92] Insolvency Act 1986, s.238, 240(2).
[93] Insolvency Act 1986, s.239, 240(2).
[94] Insolvency Act 1986, s.245, 245(4).
[95] Company Directors’ Disqualification Act (CDDA) 1986 s.6(2).

there are to be any orders made against directors for wrongful trading[96]. However, this has not been made an easy task with additional conflicting pointers set out in other statutes besides that of the Insolvency Act 1986. The Company Directors' Disqualification Act 1986 for the purposes of disqualifying a director states that the test is whether the company's assets are insufficient for the payment of its debts and other liabilities together with the expenses of winding up, when it goes into liquidation, when an administration order is made, or an administrative receiver is appointed[97]. Furthermore the Employment Rights Act 1996 states that the point of insolvency, 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 of a charge and a voluntary arrangement has been approved under Part I of the Insolvency Act 1986[98].

It has been observed that defining insolvency is a task largely dependent upon the context in which it is being used. Given the wide berth that insolvency has been afforded this has had the unfortunate effect in surrounding the term with uncertainty, leaving its meaning, at best, vague and imprecise[99]. Another aspect that has not cleared up matters and certainly not something that cannot be ignored is that the "unable to pay debt" concept is a state of insolvency, not an absolute definition[100]. It is in the finer detail that the clinical image of corporate insolvency law is betrayed by a lack of a coherent path that brings consistency with the terms and approach dictated. In some respects it should not come as a surprise as the origins of failure and finding ways to control this within a legal framework has never enjoyed a smooth ride. It is an understanding that determining insolvency cannot be strictly bound by a legal definition; other values must be observed and applied where necessary to create a more accurate reading of the company's health status to allow a more informed decision be

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[96] Insolvency Act 1986, s.214.
[97] CDDA 1986, s.6(2).
[98] See R. M. Goode, *The Principles of Corporate Insolvency Law*, 4th edn, (London: Sweet & Maxwell, 2011), at 118; see also V. Finch, *Corporate Insolvency Law: Perspectives and Principles*, (Cambridge, CUP, 2002), at 124;
[99] D. Milman, 'Test of Commercial Insolvency Rejected', 4 *Co Law*, (1983), 231, at 232.
[100] R. M. Goode, *The Principles of Corporate Insolvency Law*, 4th edn, (London: Sweet & Maxwell, 2011), at 109-111.

made regarding what assistance the distressed company requires[101]. However even if a consensus was reached on how best to analyse the failure, determining when a company is in fact insolvent on a given day poses another troublesome matter[102].

### 1.5. The Relationship between Financial Distress and Corporate Rescue

It remains questionable whether the study of corporate insolvency law contributes to the understanding and avoidance of failure. The interpretation of financial distress in a legal context could be said to be irrelevant[103]. An examination focusing on the legal input will ignore the wider variables that have influenced this area of law. But if the general nature of corporate insolvency proceedings were observed, this could enhance the knowledge to be gained in the context of corporate rescue. Whilst the insolvency legislation may provide for a framework of codes and terms to be followed, giving rise to a general acceptance on how companies should be monitored, operated and audited, it also gives incentives and deterrents for certain actions. But whilst the rules exist, total compliance does not always occur and these principles cannot be expected to be followed rigidly by those who are not equipped to read legal documents such as the managers who run the company[104]. It is partly for this reason that difficulties exist with managers of companies failing to recognise when help is required. Whilst there are rules and tests in place to offer guidance and assistance it is often the knowledge that the law will be lenient with those who assist in promoting a proactive response, provided that they are not at fault for the demise of the company. But despite the initiative that the insolvency legislation provides, failure of companies is inevitable and whilst it could be suggested that there is no conclusive proof that rescue prevents eventual failure, there is perhaps a case to be made for a temporary measure that relieves the problems but only on the understanding that temporary measures do not amount to corporate rescue in the real sense. With this in mind, it is now time to explore the nature of corporate rescue.

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[101] Depending on the type of business and the extent of the financial problems, different remedies will be sought for various problems. If the financial distress is isolated to one particular business, rather than an industry this will affect how the IP deals with his attempt at rescuing the company, if he should choose this course of action.
[102] K. Chiah, 'Voidable Preference', 12 *New Zealand Universities Law Review*, (1986), 1, at 6.
[103] V. Finch, *Corporate Insolvency Law: Perspectives and Principles*, (Cambridge, CUP, 2002), at 140.
[104] This is probably more accurate in describing managers of smaller companies. For further reading see V. Finch, *Corporate Insolvency Law: Perspectives and Principles*, (Cambridge, CUP, 2002), at 140; for a discussion on the limit that corporate insolvency law has on the efficiency of corporate management see 'The Fourth Annual Leonard Sainer Lecture – The Rt Hon. Lord Hoffmann', reprinted in (1997) *18 Co. Law. 194*; see also V. Finch, 'Company Directors: Who Cares about Skill and Care?', 55 *Modern Law Review*, (1992), 179.

**Part Two**

## 2. The Development of Corporate Rescue Regime in the UK

Corporate law concerns itself with many issues regarding the welfare of a company. Of particular interest to this thesis is the law relating to the insolvency of companies. When a company becomes insolvent many questions may arise. Amongst them all, the most imperative question is, is the company capable of being rehabilitated or at least got into a better shape before liquidation?[105] In terms of evaluating the insolvency of companies, the process is relatively modern when compared with laws regulating the relationship between individual creditors and debtors. How these laws have developed in dealing with a person or a company who has been unable to pay his debts will vary according to the cultures and customs in question. The law relating to both personal and corporate insolvency are very distinctive and can be found in the Insolvency Act 1986[106]. The two different spheres have however not always coexisted in one statute and have developed at a different pace, subjected to different influences[107].

The origins of insolvency law derived from continental Europe, with UK's law adapting principles from statutes and ideas from Europe[108]. It is appropriate to refer to the UK's insolvency law as a combination of many other insolvency models giving it a truly European flavour[109]. It is part of its unique heritage that by adopting segments of other insolvency models and interpreting the rules and customs according to the needs of the jurisdiction it has created something of a model based on best practice. In this sense the model adopted does not follow a conventional pattern based on a single legal jurisdiction. It therefore raises the question whether this adopted corporate rescue system is reflective of what is required from such a model or has it become "path dependent", and unable to change from its inherent culture?

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[105] See R. Goode, *Principles of Corporate Insolvency Law*, 4th edn, (London: Sweet & Maxwell, 2011), at 9.
[106] A consolidated version of the Insolvency Act 1986 may be viewed through the Insolvency Service website at http://www.bis.gov.uk/insolvency/ (accessed 30th September 2012).
[107] Personal insolvency law will not be discussed due to the focus on companies. But it is worth noting out of interest that the law regulating the insolvency of individuals may trace its roots to the earliest days of common law, when there were no collective procedures for the administration of an insolvents estate and a disappointed creditor could seize the effects of his debtor and, at a later date, his person also. For further reading see E. Cooke, *An Enquiry into the State of Law of Debtor and Creditor in England*, (London: Butterworth, 1829).
[108] For a fuller review on the early years of bankruptcy see A. Keay, 'Balancing Interests in Bankruptcy Law', *CLWR*, (2001), 206, pp 221-226; E. Welbourne, 'Bankruptcy Before the Era of Victorian Reform', *Cambridge Historical Journal*, (1932), 51; R. Weisberg, 'Commercial Morality, the Merchant Character, and the History of Voidable Preference', *39 Stanford Law Review*, (1986), 3; V. M. Lester, *Victorian Insolvency*, (Oxford: Clarendon Press, 1995).
[109] With this in mind a distinction is drawn between English insolvency law and Scottish. The latter is not covered within this thesis.

The circumstances that dictate the makeup of the UK's insolvency law can trace its roots back to the 14th century where it was common practice for banks to deal with the economic fallout of financial crises. A key moment came in the form of a general crisis in banking involving most of the leading houses in Florence suffering from an overextension of credit[110]. Because of the lending agreements with these banks in England, the failure of the Bardi Bank in 1345 sent ripples to the heart of the financial stability of England[111]. It could be seen as one of the first examples of a financial failure occurring in another country affecting the stability of another; this certainly provided a "wake-up call" for legislation in relation to those who caused such a crisis. It was not until the reign of Henry the VIII[112] that the 1542 Statute of Bankrupts was enacted in England. There is a general agreement that the Act was based on the practice adopted in Italy[113], which itself was derived from Roman law origins.

It was not until the late 18th century that the UK began to create its own mark based on the needs that were now apparent with its business and financial links throughout the British Empire. The birth of corporate insolvency law goes back no further than 1844, when Parliament enacted the Joint Stock Companies Act 1844, the first general Act to provide the incorporation of a company as a distinct legal entity, albeit with unlimited liability for its members. This Act was later followed by the Joint Stock Companies Winding-Up Act 1848 and 1849, distributing general winding up jurisdiction on the Court of Chancery, a jurisdiction overlapping that of the Bankruptcy Court until the passing of the Joint stock Companies Act 1856 and Joint Companied Winding-Up (Amendment) Act 1857 which left the Court of chancery with exclusive jurisdiction and thus formally separated Bankruptcy and winding up procedure[114].

It follows that initially corporate insolvency had aligned its identity with bankruptcy law and did not assume a distinct status until the initiation of limited liability for members of a company with the enactment of the Limited Liability Act 1855. Equally important was the enactment of the Bankruptcy Act 1861 which abolished the distinction between traders and non traders; providing the foundation for a uniformed insolvency system to emerge. The first

[110] N. Davies, *Europe: A History,* (London: Pimlico Press, 1997), at 401.
[111] Le Cannu *et al*., '*Entreprises en Difficulté*' (Paris: Joly Editions, 1994), para.2027.
[112] (1509 – 1547).
[113] The etymology of bankruptcy is said to be from the Italian "*banca rota* " (broken bench), the punishment meted out to the insolvent trader, whose bench in the marketplace was ceremonially broken to deny the trader the ability to continue exercising his craft.
[114] L.C.B. Gower, *Principles of Modern Company Law*, 6th edn, (London: Sweet & Maxwell, 1997).

piece of legislation that can be described as containing the first modern company law statute was the Companies Act 1862, which amongst things contained the first detailed winding up provisions, including a provision of pari passu distribution[115]. Other notable provisions in the following years include section 10 of the Judicature Act 1875 which aligned rules as proof of debt in company liquidation with those applicable to bankruptcies[116]; section 4-6 of the Companies Act 1883 established categories of preferential debt for winding up and bankruptcy; Preferential Payments In Bankruptcy Acts 1888 and 1879, with the last Act establishing that claims secured by floating charge were subordinated to preferential debts[117]. Moving our attention to developments in the twentieth century the Bankruptcy Act 1914 aimed to consolidate the law on insolvency. The Act was however highly technical and completely out of touch with the needs and concerns of the time. Nevertheless, despite the law having many shortcomings it was not until pressure mounted in the form of the European Economic Community Draft Bankruptcy Convention in 1970 that law reform began to look likely. With Britain's entry to the EEC it meant that they would have to adhere to the Treaty of Rome, which in turn meant respecting and complying with the associated Treaties. With Britain's insolvency laws contrary to that of the Draft EEC Bankruptcy Convention, it brought considerable problems in the attempt to universalise the law, highlighting in particular the social and economic changes that have taken place in Britain but were not reflected in its legislation. Further advisory committees were instructed with the purpose to determine whether the laws could be harmonised, and the acceptability for the Convention to be applied in Britain[118]. It reported back many concerns, especially those that surrounded the unfairness of floating charges on other creditors in the company. Whilst reform occurred, the 1976 Insolvency Act is largely remembered as a wasted attempt at dealing with the issues in question. With the inadequacies of the law still remaining this led to the appointment by the Secretary of State for Trade of the Insolvency Law Review Committee in 1977 to:

(i) To review the law and practice relating to insolvency, bankruptcy, liquidation and receiverships in England and Wales, and to consider what reforms are necessary and desirable;

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115 Companies Act 1862, s. 133(2). Note that this was confined to voluntary winding up.
116 The scope of this section has proved controversial and it was not until 1901 that it was finally established by the Court of appeal that the bankruptcy priority rules were carried over into winding up; see *Re Whitaker, Whitaker v Palmer* [1901] 1 Ch.9.
117 Considered in *Buchler v Talbot* [2004] 2 A.C. 298.
118 Departmental Advisory Committee, chaired by Kenneth Cork, F.C.A, hence its popular title, 'Cork Mark I', as the author was a member of the committee, (1973-6).

(ii) To examine the possibility of formulating a comprehensive insolvency system, and the extent to which any existing systems might, with advantage, be harmonised and integrated;

(iii) To suggest possible less formal procedures as alternatives to bankruptcy and company winding-up proceedings in appropriate circumstances; and

(iv) To make recommendations.

Subsection three highlighted a general concern to develop an alternative measure to liquidation; something which later paved the way for what was to become the emergence of the corporate rescue culture in the UK. Eventual reform came in the form of the Insolvency Act 1985, which when it came into force was replaced by the Insolvency Act 1986 – a consolidating enactment which repealed and re-enacted the Insolvency Act 1985 and the Insolvency provisions of the Companies Act 1985. The 1986 Act, whilst it is largely based on the findings that materialised from the highly influential Cork Report five years earlier[119], it did not endorse all of the principles. The 1986 Act represented an attempt to address the flaws regarding corporate insolvency law up until that point and introduced a new procedure called administration, as a concept that could properly address rescue strategies aimed to prevent companies' needless entering liquidation.

### 2.1 Developments leading up to the Enterprise Act 2002

In the new millennia further reform occurred with the Insolvency Act 2000, which brought in new provisions on voluntary arrangements and moratoria and amended the Directors Disqualification Act 1986 on the disqualification of directors. Despite these steps taken to amend and clarify corporate insolvency laws, the focus has remained very much on addressing isolated provisions when there was a growing concern that the unfairness associated with the existing law was going unaddressed.

A significant aspect of the old law was the long established institution of administrative receivership. This practice was not designed to be a collective procedure, but rather a debt enforcement remedy available to a creditor holding a floating charge which, with any fixed charge, covers the whole or substantially the whole debtors' company property. This was an extremely powerful tool that could be utilised by one creditor to appoint a receiver to take control of the company and its assets, largely displacing directors, and to continue trading as

[119] The Cork Report (Report of the Review Committee on Insolvency Law and Practice), Cmnd 8558, 1982.

deemed agent of the company, sell off business/individual assets or hive them down to a new debt free company which could be sold off[120]. Given the ability of the receiver to dissect and deal with the company as he or she wished, there were particular concerns over the way in which a creditor could "select" a receiver and how the appointment seemed to be precipitate at almost no notice. Since the receiver owes his or her duty to the appointing creditor and not the general body of creditors there is a lack of incentive to keep the cost of the process down and to ensure that the assets are realised at the best price. In addition to these concerns there was also the ability for the creditor to block administration – a collective procedure designed for the benefit of creditors generally, by appointing a receiver before an administration order is made. This preventive measure was one of the critical reasons that were instrumental to the demise of the rescue culture after it was promoted in the 1990s[121].

Additionally, alternative measures such as the Company Voluntary Arrangements (CVA's) which were introduced in the 1986 Act proved to be ineffective as a rescue mechanism as the initiation of the procedure did not trigger a moratorium. This combined with the concerns mentioned above marked the start of a shift in opinion and a decision was taken in principle that all insolvency proceedings should be collective in character[122]. To achieve this end, the Enterprise Act 2002 prohibited the appointment of an administrative receiver by a floating charge holder[123]. The 2002 Act did however allow for such a holder to appoint an administrator, but this was on the acceptance that the making of distributions to the charge is not a legitimate objective if it is reasonably practical that the other aims of rescue (rescue of a company as a going concern and achieving a better result for creditors as a whole upon immediate winding up) is achievable[124]. The abolition of this option, along with the introduction of the prescribed part to allow a certain percentage of funds to be reserved for unsecured creditors (the "prescribed part") and the removable of Crown preference helped to reignite the rescue culture.

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[120] R. Goode, *Principles of Corporate Insolvency Law*, 4th edn, (London: Sweet & Maxwell, 2011), at 14.
[121] V. Finch, *Corporate Insolvency Law – Principles and Perspectives*, 2nd edn, (Cambridge: CUP, 2009), Ch 6, 7 and 9; L. Gullifer, '*The Reforms of the Enterprise Act 2000 and the Floating Charge as a Security Device*', in Wolf-Georg Ringe, Levine Gullifer and Philippe Théry (eds), *Current Issues in European Financial and Insolvency Law: perspectives from France and the UK*, (Oxford: Hart Publishing, 2009).
[122] There are a number of studies that support this view: P. Aghian, O. Hart and J. Moore, 'A Proposal for Bankruptcy Reform in the UK', 9 *I. L & P*., (1993), at 103; and 'Insolvency Reform in the UK: A Reused Proposal', 11 *I. L. & P*., (1995), at 103. For government input see 'Second Chance Report', '*Productivity and Enterprise: Insolvency – A Second Chance*', DTI, Cm 5234, (July 2001), see http://www.insolvency.gov.uk/compwp.htm (accessed 10th July 2010); '*A Review of Company Rescue and Business Reconstruction Mechanisms*', Report of the Review Group, Insolvency Service, DTI, (2000).
[123] This applies to floating charges created on or before September 15 2003.
[124] R. Goode, *Principles of Corporate Insolvency Law*, 4th edn, (London: Sweet & Maxwell, 2011), at 15.

### 2.2. Freedom of contract and the Creditor Based Regime

The background to corporate insolvency law demonstrates that corporate rescue has developed at a steady pace with traditional values embedded in English contract law forming the basis for the type of corporate rescue system in the UK[125]. The UK system has basically been regarded as creditor based and this stance is exemplified by three key features[126]; the first being the entitlement of a creditor. Since the creditor has an outstanding amount that has not been repaid by the debtor, the creditor on the failure of the debtor to fulfil his contractual duties is entitled to take steps to retrieve his due amount by way of a winding up or a bankruptcy order, notwithstanding the adverse consequences that this may have on the creditor. This has somewhat been amended by the Insolvency Act 1986 where a moratorium can be obtained to permit the debtor to have more time to save the company, through a number of avenues such as raising further funds, selling assets or reaching an agreement with the creditors. The second feature is the entitlement of the secured creditor to enforce his security irrespective of the consequences to others, considering nothing but his own interests. This has been slightly weakened with the Insolvency Act 1986 and weakened further by the Enterprise Act 2002, but nevertheless it remains one of the critical factors that an IP must consider. The final feature, which the courts often consider is the pari passu principle, which permits the equal distribution of the debtor's wealth amongst the unsecured creditors. This is not an absolute principle and is subjected to the availability of funds. If such funds exist then it is possible that the liquidator, administrator or receiver may make a prescribed part of the company's net property available for the satisfaction of unsecured creditors[127].

With these three features in mind, it is important to emphasise and grasp the importance of the relationship between contractual obligations and the expectations it is capable of producing. The concept of reasonable and legitimate expectations[128] is the substance that fuses the principles together. It is within this line of thinking that enables us to consider what provisions we would reasonably wish to see in a contract if we drafted it[129]. The concept is

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[125] R. Goode, *Principles of Corporate Insolvency Law*, 4th edn, (London: Sweet & Maxwell, 2011), at 19.
[126] G. Lightman, 'Attitudes and Values: Developments in Insolvency Law: Part 1', *Insolvency Intelligence*, (2001), 57, at 58.
[127] See Insolvency Act 1986 ('Prescribed Part') Order 2003 (SI 2003/2097). This effectively 'top slices' a certain part of the net proceeds (net property) from the realisation of the property covered by floating charges for unsecured creditors. For a comprehensive overview of the section see L. Doyle and A. Keay, *Insolvency Legislation: annotations and Commentary*, (Bristol: Jordans, 2007), at 218.
[128] See A. Keay, 'Directors' Duties to Creditors: Contractarian Concerns Relating to Efficiency and Over-Protection of Creditors', 66 *Modern Law Review*, (2003), 665, at 679.
[129] L. Mitchell, 'The Fairness Rights of Bondholders', 65 *New York University Law Review*, (1990), at 1225.

crucial as it has a bearing on the efficiency of the agreement and the terms it produces. It also has the effect of creating a consensual obligation that brings an element of fairness to all parties concerned. It is suggested that the principles of corporate rescue and the model endorsed in the UK fail to meet such expectations, partially because a creditor oriented system cannot truly be expected to take into consideration all of the parties concerned, in particular the debtor. However there is room for scope in suggesting that because insolvency has occurred the debtor foregoes that right, in that the company may enter administration which will to an extent protect any action occurring until the company's financial status has been assessed.

### 2.3. The Cork Report

The official title given to the Cork Report is the Report of the Review Committee on Insolvency Law and Practice (Cmnd. 8558, 1982). This Report contributed more to the area of insolvency law and practice than any other that has been formulated since. The report, which devoted a chapter to administration[130], drew particular attention to the change in attitudes that had occurred. The Committee sought to define the characteristics of a good modern insolvency law[131], by looking at the existing procedures in place and seeing how they could be amended to address the fallacies in the law. The Report drew attention to these problems and proposed a procedure by which the court could appoint an administrator to manage the company, with the same powers as a receiver and manager. The Report was keen to promote the idea that the grant of an administration order would have the effect of freezing the enforcement of rights against the company, whether secured creditors or otherwise, thus facilitating the simple regime of voluntary arrangements proposed in the report. It must be noted that the Cork Report does not set out the aims of a corporate rescue model. Rather it is necessary to take a holistic approach whereby all the aims contained within the passage should be reviewed as a whole and once they have been collectively understood, it reflects, between the lines its ideology, what has been described as the rescue culture[132], a philosophy of restoring companies to profitability and avoiding liquidation[133]. Whilst there are a few options provided within the report to achieving this end, the focus in this thesis is on

130 Insolvency Law and Practice, Chapter 9.
131 Insolvency Law and Practice: Report of the Review Committee Cmnd. 8558 (London: HMSO, 1982), para.198.
132 The phrase has now passed into English jurisprudence. See the speech of Lord Browne-Wilkinson in *Powdrill v. Watson* [1995] 2 A. C. 394 at 442, 445, 446.
133 Paragraphs 191-8; 203-4; 232; 235; 238-9; See also R. M. Goode, *Principles of Corporate Insolvency Law*, 4th edn, (London: Sweet & Maxwell, 2011), at 57-59.

administration[134]. It must be stressed that despite the introduction of the rescue culture, many companies still end up in liquidation. Nevertheless, notwithstanding this potential shortcoming rescue proceedings have played a vital role even if it was just to increase the value received on the sale of assets before the company entered liquidation.

The Report recognised the pessimistic approach of the law towards rehabilitation and accepted that liquidation should not be the only option[135]. It found that when compared with other systems the UK's position was unfavourable as others had procedures that promoted rescue[136]. As such one of the aims to emerge from the discussions was how to develop a corporate insolvency system that embraced a rescue culture. To this end a group of objectives were created, which gave the new system a sense of direction as well as allowing the flexibility to add further if required[137]. The objectives set out in the report are intentionally vague to capture an array of situations, yet contain enough substance to protect specified interests. The objectives are set out below; once listed, closer attention will be paid to dissecting the nature and purpose of each. The aims are:

(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;
(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[138];
(f) To ensure that the processes of realisation and distribution are administrated 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

[134] The other options been CVA under Part 1 of the IA 1986; s. 425 of the Companies Act 1985; and the contract –based "workout" an arrangement concluded outside any statutory framework, such as the "London Approach".
[135] See D. Milman, 'Moratoria on Enforcement Rights: Revisiting Corporate Rescue', *Conveyancer and Property Law*, (2004), 89, at 91.
[136] See USA, Chapter 11 of the Federal Bankruptcy Code.
[137] It will also be noted how these objectives may come into conflict with each other, see S. Frisby, 'In Search of a Rescue Regime: The Enterprise Act 2002', *Modern Law Review*, (2004).
[138] On the importance of fairness to creditors given the mandatory, collective nature of proceedings, see also para 232.

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[139];

(h) To recognise and safeguard the interests not merely of insolvents and their creditors but those 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 of the community[140];

(i) To preserve viable commercial enterprises capable of contributing usefully to national economic life[141];

(j) To offer a framework of insolvency law commanding respect and observance, et 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
    (v) To ensure due recognition and respect abroad for English insolvency proceedings.

An important aspect to derive from these objectives is the importance of preserving viable economic enterprises which contribute to the economic prosperity of the country. Conversely it also recognises the intertwined relationship that failure has on a community; the so called "ripple effect" that will financially unsettle people and companies beyond the distressed company[142]. Paragraph (h) and (i) when combined together illustrate the significance of preserving communities that are dependent on a core company by implying that is not just about saving companies which are economically viable, but also the possibility the company enjoying economic success at a later stage if it is in the interests of the community[143]. The objectives collectively recognise that the law cannot exist in ignorance of the wider

[139] See para 198(h) and amplification in paras 235 and 238.
[140] See para 198(i) and amplification in paras 203-4.
[141] See para 198(j) and amplification in para 204.
[142] Cork Report, para. 204.
[143] See M. Hunter, 'The Nature and Functions of a Rescue Culture', *Journal of Business Law*, (1999), 491, at 497-9; and on the social costs see B. G. Carruthers and T. C. Halliday, *Rescuing Business: The Making of Corporate Bankruptcy in England and the United States*, (Oxford: Clarendon Press, 1998), pp 69-70.

implications; it must endeavour to do its best to consider all eventualities in the interest of maintaining wealth in what would otherwise become deprived areas (jobs and local wealth).

Taking account of these wider issues, corporate rescue must strive to bridge the divergences between theory and application. Achieving this aim however involves understanding that corporate rescue was embraced in a politico-legal dimension, thereby providing a trans-disciplinary flavour to the concept[144]. Whilst this approach may assist in greater knowledge being obtained about how rescue operates and increase awareness in how corporate insolvency is integrated in everyday life, it can invariably lead to and cause confusion[145]. A clear example of this can be found with the approach the court took[146] in *Powdrill v Watson*[147], which stated:

...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 and run a business, it is unlikely that Parliament would have intended to produce a regime as to employees' rights which render any attempt at such rescue either extremely hazardous or impossible[148].

Amid this tension between providing a stable insolvency system for a rescue strategy to occur against the reputation that insolvency receives in the UK, political forces have been keen to promote a rescue model based loosely on that of the United States (Chapter 11). The aim for adopting the characteristics of another model would be to eradicate the stigma that is associated with insolvency in the UK and replace it with a confident system that encourages risk taking for the promotion of enterprise[149]. The importance of sustaining the attitude of

[144] See Insolvency Service, '*A Review of Company rescue and Business reconstruction Mechanisms, Report by the Review Group*', (DTI, 2000), (IS 2000), at 12-23.
[145] The failure to formulate a limited number of core principles to which others may be treated as subservient has in some ways caused confusion regarding the direction in which the law should take, see *The Justice Report, 'Insolvency Law: An Agenda for Reform'*, (London, 1994).
[146] And notably the British Banks Association endorsed corporate rescue in their 1997 paper, *'Banks and Business Working together'*, (London, 1997), para 3 which states that: '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'. Whether this statement remains accurate after the financial troubles that were manifested by the Northern Rock episode in 2009 remains to be seen.
[147] [1995] 2 AC 394.
[148] [1995] 2 AC 394, at 442; quoted in V. Finch, *Corporate Insolvency Law: Perspectives and Principles*, (CUP, Cambridge, 2002), at 191; and M. Hunter, 'The Nature and Functions of Rescue Culture', *Journal of Business Law*, (1999), 491, at 511.
[149] Peter Mandelson then the Trade Secretary in 1998 went to great lengths to discuss with the hope of reassessing business perception on failure and move it towards risk taking; see M. Hunter, 'The Nature and

taking risk and encouraging unsuccessful entrepreneurs to try again has been an imperative stance that the government has been eager to promote[150], and something which the Enterprise Act 2002 seeks to strengthen. In essence the new regime was about providing the necessary framework to permit "a culture in which companies that can be rescued, are rescued"[151]. The reality of the situation however means that the problem is not the law, or even the means to implement change, but the inherent attitude that failure is something that could and should be avoided[152]. This attitude has been critical to presenting the type of corporate insolvency model that has developed in the UK. Little distinction has been made between a company that has become distressed due to extrinsic events that were not foreseen ("honest failure")[153] and cases where the failure was the result of poor management decisions[154]. Depending on how the difference has been interpreted creates either a management displacement rescue regime or one that permits the management to remain in control of the company. The latter will now be explored.

### 2.4. A Comparison with Chapter 11 of the US Bankruptcy Code

The research conducted within the historical overview section above notes that different perspectives on bankruptcy exists, and it is perhaps nowhere better demonstrated than observing the corporate insolvency laws that exist on both sides of the Atlantic. The US approach could be best described as endorsing an optimistic view, characterised as recognising that failure does not need to rule out future successes of incumbent

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Functions of a Corporate Rescue Culture', *Journal of Business Law*, (1999), 49, at 519; see also a comment by the Parliamentary Under-Secretary of State for Trade and Industry, Melanie Johnson who stated that 'the insolvency reforms will help address the fear of failure that is a significant barrier to enterprise and help prevent companies in difficulty from going under unnecessarily. Together, the reforms will help make the UK become a better place to do business...', HC Deb. April 10, 2002, col.111; see also V. Finch, *Corporate Insolvency Law: Perspectives and Principles*, (Cambridge: CUP, 2002), pp.127-34, 284-86; A. Keay, 'Balancing Interests in Bankruptcy Law', *CLWR*, (2001), at 225.

[150] Patricia Hewitt, the Trade and Industry Secretary, House of Commons Debate, second reading of the Enterprise Bill, April 10th, (2002), col. 44.

[151] Insolvency Service (IS), 'An Update on the Corporate Insolvency Proposals', (January 14, 2002), see http://webarchive.nationalarchives.gov.uk/+/http://www.dti.gov.uk/enterprisebill/index.htm (accessed 9th February 2010), at 1. The IS have made the objective of the EA, particularly the purpose of the administration process as "to facilitate the rescue of viable companies and, if this is not reasonably practical, a better return to the creditors"; see J. Alexander, 'The Enterprise Act 2002', 3 *Insolvency Law & Practice*, (2003), para.2.7.

[152] See B. G. Carruthers and T. C. Halliday, *Rescuing Business: The Making of Corporate Bankruptcy in England and the United States*, (Oxford: Clarendon Press, 1998), at 246.

[153] This term shows a gradual move away from old ideology to a more open and forgiving commercial system that would encourage fairness and reduce the penalties for hard strapped companies, see HM Treasury Press release, 8th June 2001 as presented by the then Chancellor Gordon Brown; see also the second reading of the Enterprise Bill, where the Trade and Industry Secretary, Patricia Hewitt stated that the aim of reform was to 'strengthen the foundations of an enterprise economy by...establishing an insolvency regime that will encourage honest but unsuccessful entrepreneurs to try again', HC Deb. (April 10, 2002), col.44.

[154] See N. Martin, 'Common-Law Bankruptcy Systems: Similarities and Differences', *American Bankruptcy Institute Law Review*, (2003), 367, at 374.

management[155]. Bankruptcy law constitutes a way for creditors to sort out their claims collectively by liquidation of the debtor's assets or by reaching agreements with regards to an outcome. There are various options that a failed company can take. This thesis is interested in the most well known of the reorganisation provisions, namely Chapter 11 of the US Bankruptcy Code for it represents the preferred mode for US public corporations[156]. The proceedings are usually initiated by management, but can also be initiated by creditors as well[157]. The advantage to be gained from voluntary bankruptcy petition (initiated by management as opposed to creditors) is that it appears to favour reorganisation, despite incumbent management remaining in post as well as sustaining the value for the company. What the US model acknowledges is the value of human capital – management should stay in place if their value adds to the firm. Assessing positive valuations on human capital is a difficult process but the Chapter 11 model at least gives the option of whether to keep it or not.

Observing the UK's rescue regime it has remained more favourable towards the treatment of insolvents, at the expense of perhaps the treatment of true economic delinquents[158]. Who exactly are the true economic delinquents entirely depends on the model being researched and when and who is asked. Unlike the "Debtor in Possession" (DIP) model evident in the US which allows for the existing management to remain in control of the ailing company during the reorganisation period, the UK with its management displacing model opts for an external administrator – an IP often appointed by a secured creditor with security over the whole of the assets of the company[159]. It would appear that the UK by adopting a creditor driven regime has provided a highly unsympathetic stance against the notion of corporate rescue.

This is further emphasised in the divergence between how the two systems treat failure, with the element of penalty becoming associated with the UK's insolvency regime. This has not only been fundamental in contributing to the creditor friendly type of rescue model that we

[155] M. Brouwer, 'Reorganization in US and European Bankruptcy Law', *European Journal of Law & Economics*, (2006), 5, at 11.
[156] S. Gilson, *Creating Value through Corporate Re-structuring; Case studies in Bankruptcy, Buyouts and Breakups*, (New York: John Wiley and Sons, 2001), at 23.
[157] Petitions filed by management made bankruptcy proceedings voluntary. Involuntary bankruptcy petitions filed by creditors are overwhelmingly chapter 7 (liquidation) petitions, see S. Block-Leib, 'Why Creditors file so few Involuntary Petitions and why the Number is not too small', 57 *Brooklyn Law Review*, (1991).
[158] M. Hunter, 'The Nature and Functions of Rescue Culture', *JBL*, (1999), 491, at 498.
[159] See Insolvency Act 1986, para 64.

have today, but it has also ensured that failure would be classed as something undesirable by the general public which in turn has had the effect of ensuring that management displacement was the only option[160]. Despite the apparent friction between the two models as to which is the preferable notion neither is able to produce a clear and more convincing argument. Notwithstanding this stalemate, what is clear is that some of the mutual characteristics that they share can be viewed as embracing an equal understanding in that they are both dedicated to saving viable companies; preserving jobs, satisfying creditor's claims and to produce a return for its owners[161]. Essentially assessing which model offers the best outcome is impossible to certify as there are some commentators who will suggest that it is inevitable that the UK will eventually come to resemble the US[162], whilst others, will suggest, equally robustly, that the US model will tilt towards the British system given the increasing influence that creditors are enjoying in Chapter 11 by means of provisions in DIP financing agreements[163].

Whether any alteration or morphing of legal systems will occur is academic. That said if the US was to adapt the UK's model it would involve a change in attitude. The traditional principles in the UK dictate that debts must be paid; insolvency is morally wrong and culprits should be punished[164]; that on the failure of the debtor to satisfy its contractual obligation, in order to make sure the debt is paid, the company should be wound up[165]. In addition the US would have to consider the meaning of certain concepts. In the UK there has been much debate surrounding the two mechanisms of rescuing and liquidating, with some commentators suggesting that these are in conflict with the goal of keeping businesses in operation[166], stating that this has been highlighted as a separate goal to that of insolvency

[160] For further reading on the history of Insolvency law in England see P. Omar, 'The Mutual influence of French and English Commercial Laws in Insolvency', *International Company and Commercial Law Review*, (2008), 136, at 136.

[161] See E. Warren, 'In Bankruptcy policymaking in an Imperfect World', 92 *Mich L Rev*., (1993), 336, 354-5; and for a UK perspective see *Powdrill v Watson* [1995] 2 AC 394, 442.

[162] See J. Armour, B.R. Cheffins and D.A. Skeel Jr., 'Corporate Ownership Structure and the Evolution of Bankruptcy Law: Lessons from the United Kingdom', 55 *V and L Rev*., (2002), at 1699.

[163] G. McCormack, 'Control and Corporate Rescue – An Anglo-American Evaluation', 56 *ICLQ*, (2007), 515, at 516.

[164] As previously noted there is a presumption in the UK that when a company becomes insolvent it is due to the failure of the management and those who were last in control, see R. Goode, *Principles Of Corporate Insolvency Law*, 3rd edn, (London: Sweet & Maxwell, 2005), at 328.

[165] The DIP regime has been likened to leaving 'an alcoholic in control of a pub', see G. Moss, 'Chapter 11: An English Lawyer's Critique', 11 *Insolvency Intelligence*, (1998), 17, pp 18-19.

[166] The aim of rescuing a distressed company and keeping a company in operation should be seen as two distinct paths which do not necessarily lead to the same outcome. The question entirely depends on substance – the extent that the company survives intact from a rescue strategy. Substantial changes to a company's operations invariably means the company will also change, but this will not reflect rescue in the true sense of the word.

law[167]. But on the other hand the Cork Report has always advocated that rescue is part of insolvency.

### 2.5. A Distinction between Rescue and Restoration

Rescue procedures go beyond the normal managerial responses to financial distress and may take on the appearance as a formal or informal process. In any meaningful discussion involving corporate rescue a distinction must be drawn between two different objectives - rescuing the company and rescuing the business[168]. Both should not be viewed as alternative options that can be selected on preference. The primary option of administration, which is set out in the next section is to rescue the company as a going concern[169]. The term has received much attention and has been held to mean "the survival of the company itself together with all or part of its undertakings as a going concern, an outcome which was incapable of being achieved through...hiving down the company's business into a new company"[170]. Further guidance has indicated that it should be construed to mean "the company and as much of its business as possible"[171], with any proposal resulting in nothing more than a "shell" company not constituting rescue[172]. Determining whether this threshold has been achieved depends largely on what constitutes a successful rescue. Whilst this question may be self-defeating given the array of interested parties with different objectives, measuring success depends on who is asked, with creditors and employees likely to have conflicting interests.

The main objective of corporate rescue is illustrated as a process that is associated with a company that can be said to have substantially remained intact, with the emphasis on the continuity of its practices, employees and management remaining in charge[173]. Whilst it is accepted that there may be some changes, these will be minimal and the emphasis is on the

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[167] T. H. Jackson, *The Logic and Limits of Bankruptcy Law*, (Cambridge, Mass: Harvard University Press, 1996), chapter 9; D. G. Baird, 'The Uneasy Case for Corporate Reorganisations', 15 *Journal of Legal Studies*, (1986), at 127.

[168] R. Robinson, 'Proposals, Proceedings and Preferential Status', *Recovery*, (2002), 25, at 78.

[169] Insolvency Act 1986, Sch. B1, s.3(1) (a).

[170] See Harman J in *Re Rowbotham Baxter Ltd* [1990] BCC 113 at 115E-F.

[171] See DTI's Explanatory Notes, (1999), para 647.

[172] See DTI's Explanatory Notes, (1999), para 649.

[173] There is some disagreement with what extent of a company has to remain intact. For instance Frisby suggests that many 'pure' rescues are far more complex but states that the emphasis is that the entity remains functional, see S. Frisby, 'In Search of a Corporate Rescue Regime: The Enterprise Act 2002', *Modern Law Review*, (2004). This however should be contrasted with the wording employed in *Re Rowbotham Baxter Ltd* [1990] BCC 113 at 115E-F, which finds support in para 647 of the DTI's explanatory notes which indicates that rescuing a company as a going concern "is intended to mean the company and as much as the business as possible", which appears to be much more than just the functionality of the company as suggested by Frisby.

continuation of the corporate identity and a return to its former state. This will be described as close to "pure rescue" that can be achieved.

On the other hand a major change may occur to the company that results in the company being reorganised. This will result in a change to the company's form and once the proposed change has been implemented it cannot be said to resemble its former state. This may be referred to as corporate recycling or restructuring as it does not fulfil any of the attributes associated with "pure" rescue and it has been described as a process which is not corporate rescue at all[174].

Both objectives require different strategies, for instance saving a "corporate shell" may not be the better option for creditors who could get a better result if the business were to be sold[175]. Conversely, a company may be liquidated, but steps can still be taken to retain the business by selling it to bidders and it continuing (even if only in a reduced form) to employ workers and contribute to the economy[176]. These factors of satisfying secured creditors, taking measures to preserve employment and satisfying some unsecured creditors to enable business to continue should not be ignored[177].

Pure rescue is exceptionally rare[178], but it is the term that best describes the primary objective of administration. Whilst full restoration to its former state might pose some interesting questions, particularly if the distress was as a result of bad management, it is accepted that in some cases their removal may result in a different outcome for the company[179]. But this presumption is open to the possibility that another management group would not act in the same way. The act of removing management would therefore only work if it could be shown that the incompetence was so fundamental to the troubles of the company.

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[174] Finding commentators to agree or even suggest that this is the case is troublesome, but see S. Frisby, 'In Search of a Corporate Rescue Regime: The Enterprise Act 2002', *Modern Law Review*, (2004), who whilst implies that this may be the case, quickly provides evidence to the contrary, but only because little evidence currently exists to suggest strongly otherwise.
[175] V. Finch, 'Re-invigorating Corporate Rescue', *Journal of Business Law*, (2003), 527, at 531.
[176] V. Finch, *Corporate Insolvency Law: Perspectives and Principles*, (Cambridge: CUP, 2002), at 188
[177] N. Davis, 'The Rescue Culture in the United Kingdom', 2 *Insolvency Litigation and Practice*, (1997), 3, 4.
[178] See S. Frisby, *'A Preliminary Analysis of Pre-Packaged Administrations'*, (R3: Association of Business Recovery Professionals, 2007), which reveals that only a few cases that are pursued through administration will lead to corporate rescue. Most are in fact Business rescues.
[179] This belief is held strongly amongst creditors, see G. Moss, 'Comparative Bankruptcy Cultures: Rescue or Liquidation? Comparisons of Trends in National Law – England', 23 *Brooklyn Journal of International Law*, (1997), 115.

It is unfortunate, but by the time the administrator is appointed pure rescue remains a distant possibility at best, unless the company had acted speedily to instruct an external expert when any signs of distress were perceived. Restructuring the business will often ensure that the company survives in some form or another[180]. It will be appreciated that a company that goes through a company rescue will more than likely have to change, even if this is partial, which most of them are[181]. There are many outcomes to a corporate rescue[182]. But not all of them would be classed as adhering to a true corporate rescue model as some companies are modified and changed into another entity by means of reorganisation, refinancing, or a takeover[183]. Establishing the correct circumstances in which the terms can be used is a troublesome affair[184]; nevertheless analysing the divisions is necessary if corporate rescue is to be fully understood and appreciated. With the efficiency of a process becoming as important as the result it produces, attention turns to exploring the function of corporate rescue.

## 2.6. The Function of Corporate Rescue: One Interest or Several?

To answer this question attention should be drawn to the literature produced in the United States where, unlike the UK, scholars they have debated the philosophy of the law of bankruptcy for some time. Whilst it is not surprising given the way in which the UK's law has developed that the focus has not been on its identity, the UK is now beginning to see the need to gain a greater understanding about insolvency, its impact and the complex policy issues that surround regulating failure. The literature on this matter is quite extensive, but it suffices to restrict the examination and focus on the more prominent views. The likes of Professors Baird, Jackson and Scott will be referred to as those whose theories suggest that it is not for insolvency law to concern itself with employment protection or with the wider

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[180] R3's Ninth Survey of Business Recovery (2001) suggests that nearly one in five businesses survive insolvency and continue in business in one form or another.

[181] A. Belcher, *Corporate Rescue*, (London: Sweet & Maxwell, 1997), at 23; R. Harmer, 'Comparison of Trends in National Law: The Pacific Rim', *Brooklyn Journal of International Law*, (1997), 1, 139.

[182] A. Belcher, *Corporate Rescue*, (London: Sweet & Maxwell, 1997), at 24-34; D. Brown, *Corporate Rescue: Insolvency Law in Practice*, (Chichester: John Wiley & Sons,1996), chapter 1; R3's Ninth Survey of Business Recovery (2001) which suggests that nearly one in five businesses survive insolvency and continue to operate in one form or another.

[183] For further details on corporate control see J. Franks and C. Mayer, 'Capital Markets and Corporate Control: A Study of France, Germany and the UK', 10 *Economic Policy*, (1990), at 191-231; C. Bradley, 'Corporate Control: Markets and Rules', 53 *Modern Law Review*, (1990), at 170; J. Fairburn and J. Kay (eds.), *Introduction to Mergers and Merger Policy*, (Oxford: Oxford University Press, 1989).

[184] It is accepted that the majority of corporate rescues are not full company survivals, which brings into question the efficiency of the UK's corporate rescue regime as a rescue model. For a flavour on the change that has occurred see M. Phillips and J. Goldring, 'Rescue and Reconstruction', 15 *Insolvency Intelligence*, (2002), 75, at 76.

community interests. The function of insolvency law, according to them, has one overriding goal: to allocate the common pool of assets in such a way as to maximise benefits for creditors as a whole[185]. Any threat to this goal, particularly if an individual creditor wished to take unilateral action which would interfere with the interest of other creditors is considered a harmful act and so as a protective measure insolvency law should impose a collective procedure to protect all the interests[186]. For a collective procedure to exist two principles must be observed. First, there must be rigid adherence to the absolute priority rule, i.e. that shareholders receive nothing until creditors have been paid in full[187]. Secondly, insolvency law must respect the pre-insolvency ordering of entitlements. In regards to corporate rescue the principles are of direct relevance, especially the consideration of the latter whereby it is the function of insolvency law to translate pre-insolvency assets and liabilities into an insolvency forum with minimal dislocation[188]. The justification for the principles rest with the knowledge of protective rights, in that the redistribution of rights on insolvency would create an incentive for individual creditors to opt for insolvency proceedings even if this was not in the interest of the other creditors. In addition there needs to be assurance that certain actions will occur when a company becomes insolvent. In particular that secured creditors and their pre-insolvency entitlements would not be reduced and distributed amongst the unsecured creditors[189].

It is worth mentioning that the normative debates on insolvency philosophy and policy tend to be contested between two schools of thought that can be characterised as "Proceduralist" and "Traditionalist"[190]. The importance of these concepts is realised in its ability to elicit and dominate normative insolvency debates by often posing the questions: what is the legitimate

[185] See T.H. Jackson, 'Bankruptcy, Non-Bankruptcy and the Creditors' Bargain', 91 *Yale Law Journal*, (1982), at 857; T. Jackson, The Logic and Limits of Bankruptcy Law; D.G. Baird and T.H. Jackson, 'Corporate Reorganisations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors,', 51 *Chicago Law Review*, (1984), at 97; T.H. Jackson and R.E. Scott, 'On the Nature of Bankruptcy: An essay on Bankruptcy Sharing and the Creditors' Bargain', 75 *Virginia Law Rev*., (1989), at 155.
[186] See R. Goode, *Principles of Corporate Insolvency Law*, 4th edn, (London: Sweet & Maxwell, 2011), at 58.
[187] D.G. Baird and T.H. Jackson, 'Bargaining after the Fall and the Contours of the Absolute Priority Rule', 55 *University of Chicago Law Review*, (1988), at 738.
[188] T. H. Jackson, 'Translating assets and Liabilities to the Bankruptcy Forum', 14 *Journal of Legal Studies*, (1985), at 73.
[189] Whilst some commentators have argued that the only concern that insolvency proceedings should have is to maximise returns to creditors and it is not the function of insolvency law to alter relative pre-insolvency entitlements, see E. Warren, 'Bankruptcy Policy', 54 *University of Chicago Law Review*, (1987), at 775. This of course is now subjected to the 'Prescribed Part' scheme, see above.
[190] D. G. Baird, 'The Uneasy Case for Corporate Reorganization', 15 *Journal of Legal studies*, (1986), 127, at 133. See also R. Goode, *Principles of Corporate Insolvency Law*, 4th edn, (London: Sweet & Maxwell, 2011). These concepts will be discussed in more detail in the next chapter.

province of insolvency law and whose interests should insolvency law serve? The questions intend to stimulate discussions on who should benefit from a distressed company. Assessing this will usually go hand in hand with determining how efficient a rescue process is. This will depend on what agenda is to be satisfied, with one method used to measure its capacity to ensure that capital flows to those locations where it will be put to best wealth-creating use[191]. Again, whether the results realised and the methods used are capable of reaching agreement it remains to be seen; different parties will inevitably wish to pursue different goals. Legalists will hope to see processes that respect the procedural and substantive rights of affected parties. Political scientists may incline to emphasise the need for rescue processes to be shaped by representative institutions. In the face of all such different expectations regarding rescue, it is difficult to produce an "uncontentious yardstick for quality"[192].

Turning attention to the literature in the US, there are commentators who claim that implementing reorganisations save firms that ought to have been shut down and that the direct costs of these often lengthy proceedings are high[193]. It is suggested that the alternative to this is to accept that market based insolvency procedures are more efficient and that financially distressed firms should be "auctioned" in the open market instead of being reorganized[194]. The aim is therefore to achieve maximum valuation, by obtaining the highest value for the assets. This premise however rests on one fundamental issue - can one trust the markets?[195] Various reports have concluded different findings, but as relevant to the circumstances that match our current economic climate it may be suggested that valuations

[191] For example see D. G. Baird, 'The Uneasy Case for Corporate Reorganization', 15 *Journal of Legal Studies*, (1986), 127. The preservation of viable businesses will be a more important concern in such a philosophy than saving the company *per se*.

[192] V. Finch, 'Corporate Rescue Processes: the search for Quality and Capacity to resolve', *Journal of Business Law*, (2010), 502, at 505.

[193] See M.J. White, 'The Corporate Bankruptcy Decision', 3 *Journal of Economic Perspectives*, (1989), 129-151; and M.J. White, 'Corporate Bankruptcy as a Filtering Device: Chapter 11 reorganizations and Out-Of-Court Debt Restructurings, 10(2) *The Journal of Law, Economics & Organization*, (1994), 268-295 for an analysis of how reorganization provisions may delay liquidation of inefficient firms. For empirical evidence supporting the view that many inefficient firms are allowed to reorganize and continue to operate in the U.S, see E. S. Hotchkiss, 'Post-Bankruptcy performance and Management Turnover', 50 *Journal of Finance*, (1995), 3-21.

[194] See D. G. Baird, 'The Uneasy Case for Corporate Reorganization', 15 *Journal of Legal Studies*, (1986), 127-147. M. Bradley and M. Rosenzweig, 'The Untenable Case for Chapter 11', *The Yale Law Journal*, (1992), 101, 1043-1095. T.H. Jackson, *The Logic and Limit of Bankruptcy Law*, (Cambridge: Harvard University Press, Massachusetts, USA, 1986).

[195] S. Sundgren, 'Does a Reorganization Law improve the Efficiency of the Insolvency Law? The Finnish Experience', *European Journal of Law & Economics*, (1998), 177, at 177.

are particularly low during periods of time when an industry or the whole economy suffers from financial distress[196].

As it will be seen, recent reform in the UK's corporate insolvency law has made the predominant objective to rescue, where possible, the company as a going concern. Whilst the legal duties invested in the IP is to consider the interests of the creditors as a whole, to limit this scope to just creditors and not the wider community runs the risk of over-simplifying the nature and purpose of the insolvency law proceedings[197]. A question that arises is can theoretical models influence how policy-makers think? Unfortunately answering this question will prove problematic as there has been a lack of research in providing a link between justifying the policy taken and the theory upon which it is based[198]. Despite this limitation it suffices to conclude that whilst the protection of the interests of existing creditors is rightfully a primary function, it should by no means be viewed as the sole function of corporate rescue.

### 2.7. Further Influences: Interests, Values and Visions

Accepting that there are other interests beside that of creditors which should be observed, attention is then turned to determining whether these should qualify at the expense of others? To what extent these influences are felt is entirely dependent on the design of the rescue model. Legal systems will often attempt to interlink a number of distinct influences to produce a result which is more reflective of the competing needs that companies in administration require. But ultimately the UK's corporate rescue regime allows the IP to determine what should be considered, thereby leaving the selection process susceptible to the prejudices of the IP with no general application applying across the profession. The extent of an IP's discretion and function within the role is something that will be considered in the next chapter; for now what remains is an examination of these influences.

#### 2.7.1. Cultural Influence – Social Network Adapting to the Circumstances or Social Evolution?

The repercussions of a company in distress are felt beyond the boundaries of the company itself. It is therefore essential to adopt a model that incorporates shared values as part of the

[196] A. Schleifer and R. Vishny, 'Liquidation Values and Debt Capacity: A Market Equilibrium Approach', *The 67 Journal of Finance*, (1992), 1343-1366.
[197] E. Warren, 'Bankruptcy Policy', 54 *University of Chicago Law Review*, (1987), at 800.
[198] See E. Warren and J. Westbrook, 'Searching for Reorganization Realities', 72 *Washington University Law Quarterly*, (1994), at 1257.

legal framework. The importance of this is to be understood in the relationship between the way in which the law operates in implementing the principle of collective maximisation of returns for creditors and how this directly relates to its social and economic policy[199]. In essence it is a combination of law and practice that dictates the boundaries and what is considered as a priority; it is therefore inevitable that some social factors will materialise, embedded in the foundations of the given jurisdictions' legal system. Applying this notion it is plausible to suggest that by introducing alien concepts within an established legal system brings doubt as to whether the focus can be shifted. It has previously been discussed that most models are "path dependent" and introducing change is something that may be contrary to the very foundations of a given legal system. Some principles are so integrated into a legal model that it is almost impossible to extract this without attacking the entire concept. Applying this to the UK's insolvency system, whilst the regime has concerns regarding the effect of insolvency, the focus rests on the belief that "society has no interest in the preservation or rehabilitation of the company as such, though it may have a legitimate concern in the preservation of the commercial enterprise"[200]. This act of preservation recognises that in some circumstances a priority could be given to other interested parties, such as employees whereby they are ranked above other unsecured creditors, simply because their wages is the only source of income[201]. Whilst this demonstrates some legal flexibility to be responsive to the wider issues, this should be read as an exception since secured creditors will, and expect to, take the first bite of the cherry and it is circumstantial whether any remains for the other creditors[202]. This is not to imply that social norms should be considered on the same level as the rights of secured creditors, but rather it is expressing the fact that the interests belonging to secured creditors should not be viewed in isolation or in a vacuum.

Given the impracticalities in pursuing corporate rescue as opposed to business rescue, the focus has firmly shifted onto the rehabilitation process – a procedure designed to tweak the working of a business by providing for the reorganisation of it in order to somehow allow it to continue to operate as a going concern. It will be seen that the rehabilitation mechanism, due to its invasive nature, will inevitably interfere with pre-existing entitlements. The extent

[199] J. M. Garrido, 'The Distributional Question in Insolvency: Comparative Aspects', 4 *I. I. R.*, (1995), at 25.
[200] Report of the (Cork) Review Select Committee, Insolvency Law and Practice, para. 193.
[201] R. Goode, *'Principles of Corporate Insolvency Law'*, 4th edn, (London: Sweet & Maxwell, 2011), at 250. It has also been said that they deserve this special protection, see V. Finch, *Corporate Insolvency Law*, 2nd edn, (Cambridge: CUP, 2009), Ch 17.
[202] However see the Insolvency Act 1986 a.176A; Insolvency Act 1986 (Prescribed Part) Order 2003 (SI 2003/2097).

of this interference is in constant conflict with the legislation's goal in protecting the creditor's substantive rights, however enforcement of such rights are temporarily suspended when the company enters administration[203]. This action thereby provides a blanket of protection and a much needed breathing space for negotiations and a rescue package to be deployed if possible. But the suspension of rights and the extent of flexibility that can be negotiated around these rights to include socially driven considerations is a point that remains controversial and in essence dependent on the views of the IP who has been assigned the role. If the IP wished to consider and justify the inclusion of these wider social norms he or she would have to do so on the basis that it enhanced the chances of the primary goal in saving the company; whether this would be allowing social constructed norms "in through the back door" remains to be debated.

With these difficulties it begs the question whether the socially inclined issues should be dealt with outside the field of corporate insolvency as a separate function, or is it to be suggested that the UK is ready for a socio-economic driven corporate rescue model? The question warrants some further analysis. For something to be socially accepted its views must be reflected in the inherent nature of a particular subject. As already noted any measures taken that conflict with the norm will result in a fundamental shift in the way in which they operate and are governed; causing a movement away from routine decision making processes[204]. Of course the obstacle remains, that despite the willingness that may be shown in adopting those views the enactment of the new approach is ultimately a matter for the views of the judiciary and the views of the IP's[205]. In essence any inroads into the development of this issue may be hindered by the legislators' lack of commercial awareness and hence ability to recognise that legal reform is required. Conversely, it must also be recognised that in order for these considerations to have a chance to become part of the legislation the connected parties who participate in a distressed company must acknowledge its effect and pay heed to the rules[206]. Acceptance of these rules along with any incentives for furthering self interest[207] will influence not only the outcome, but also the way in which that objective is to be achieved.

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[203] Insolvency Act 1986, ss. 10, 11.
[204] J. Alexander, 'The Enterprise Act 2002', 3 *Insolvency Law & Practice*, (2003), para 22(1).
[205] S. Davies, '*Insolvency and Enterprise Act*', (Jordans, Bristol, 2003), at 71; J. Alexander, 'The Enterprise Act 2002', 3 *Insolvency Law & Practice*, (2003), para. 29.
[206] H. Rajak, 'The Enterprise Act and Insolvency Law Reform', 24 *Company Lawyer*, (2003), at 3.
[207] For interest theories see C. Hood, *Explaining Economic Policy Reversals*, (Buckingham: Open University Press, 1994), pp.4-10, 20–26; R. Baldwin and M. Cave, *Understanding Regulation*, (Buckingham: Open University Press , 1999), pp.19-26.

Those interested parties wanting to have an input will be very concerned to protect their interests against others; in this sense this rule is described as having a non-mechanical working[208], choosing to work on an evolving basis to meet the interests of the actors who have an investment in the result. However, as identified above, it will be seen that as there are many interests to satisfy, and this inevitably means that there will be competition as to which are chosen and who will miss out. It is therefore inevitable that those who are able to exert the most influence will be able to do so at the expense of the weaker party by undermining what it can demand[209] and signifying the lack of importance that the party has in the insolvency process; whereby its "capabilities as shapers of action" is limited[210]. Addressing this matter can only be overcome if it is acknowledged that besides the maximisation of creditors' returns, it is possible that by additionally protecting the interests of local communities then this could enhance the creditors' interests overall[211]. To target a specified group or a network that would allow some survival of the business to operate within a community would prove not only beneficial in the long term for the local economy but would protect the workforce. A procedure like this, given the extent of change required would be more associated with rehabilitation rather than rescue since the bare minimum of the original identity would remain intact.

Essentially, whilst these interests can be considered they are often seen as taking precedence at the expense of the interests of the secured creditors. An alternative to this would be to suggest that if these parties wished to be protected and their interests fell outside the common pool, then they should look at pursuing their claim outside the insolvency proceedings and not be concerned with creating new special entitlements within insolvency law[212]. It seems that by maintaining this division it ignores the wider concerns and the realisation that some of the problems that face the creditors outside the common pool only happen because of the initiation of the insolvency proceedings in the first place[213].

[208] V. Finch, 'Re-invigorating Corporate Rescue', *Journal of Business Law*, (2003), 527, at 528.
[209] M. Grindle, *Getting Good Government*, (Harvard: Harvard University Press, 1997).
[210] P. Sabatier and D. Mazmanian, *'The Conditions of Effective Implementation: A Guide to Accomplishing Policy Objectives'*, Policy Analysis, (1979), 481.
[211] R. Goode, *Principles of Corporate Insolvency Law*, 4th edn, (London: Sweet & Maxwell, 2011), at 73.
[212] T. H. Jackson, *The Logic and Limits of Bankruptcy Law*, (Cambridge, Mass: Harvard University Press, 1986), pp.31-32.
[213] R. Goode, *Principles of Corporate Insolvency Law*, 4th edn, (London: Sweet & Maxwell, 2011), at 73.

**Part Three**

## 3. The Objective of Corporate Rescue

It will be appreciated that the objectives of a corporate insolvency system must contain provisions for a comprehensive corporate rescue model. In addition to the objectives set out by the Cork Report in Section Two, the administration procedure sets out a list of objectives that should be pursued where a company is in financial distress. The three objectives are designed to put an emphasis on the rescue of the company as a going concern, failing which, the second objective may be reviewed to see if a better result can be achieved for the company's creditors as a whole than would be likely if the company were wound up[214]. If neither the first nor the second objective is achievable then the objective of realising property in order to make a distribution to one or more secured or preferential creditors will be pursued.

Whilst these objectives must be followed by an IP the main outcome following administration is a fundamental shift in the way in which the company is managed, financed and staffed, which invariably means that change will occur[215]. The type of change that can be expected is dependable on the financial position of the troubled company. If the company is in a bad shape then the provisions to be agreed are often drastic and depending on the scheme to be implemented, it will also be time consuming and expensive[216]. These are important factors and it will be explored in the next chapter that the length of time it takes to resolve the distress (if this is possible) and the expenses incurred by the IP will have a bearing on the success of a rescue strategy, particularly as this cost has to be satisfied before creditors are paid out.

As noted above, most rescues are in fact business rescues. Circumstances as they are often mean that the only way in which the distressed company will generate immediate cash flow is the sale of profitable parts of the business, or even selling subsidiaries of the company. This restructuring process is not "pure rescue", which would only qualify if, after such disposals, the rump of the group remains viable and can be profitable – in essence the core business

[214] See Insolvency act 1986, para 3, Sch. BI.
[215] V. Finch, '*Corporate Insolvency Law: Perspectives and Principles'*, (Cambridge: CUP, 2002), at 188.
[216] Under the Companies Act 1985, s. 425, schemes of arrangement are exceptional difficult to negotiate as not only do they require court approval, but each class of creditors must hold a separate meeting. It is no surprise that with so many parties involved, they tend to be very time consuming and expensive. Under the Insolvency Act 1986, ss3 and 5 states that all creditors vote together at the same meeting, but anyone who feels that they have been unfairly prejudiced may appeal to the court under s6 provided that he does so within 28 days.

must be identified and saved[217]. As such company rescues will remain rare and will become more difficult to achieve as the choices to be made by IPs become more strenuous in times of a recession. Corporate rescue is a process concerned with efficiency and of discarding unsuccessful businesses, which can be applied to any size of corporation; the only viable test is, is it worth saving as a going concern? If not the resources should be directed to more worthy uses[218], but if the main objective is not achieved then the other options are not concerned with rescuing the company but rather saving the business.

Determining what the objectives of rescue are is not the same as speculating what they should be. One of the aims of this thesis is to determine whether or not there is a sufficient linkage between the theoretical cornerstones of corporate rescue and what occurs in practice to conclude whether the UK has an efficient corporate rescue model. Whilst this notion will be explored in greater detail in Chapter Four, what needs to be discussed here is the premise that administration has become the new liquidation process. Corporate rescue involves much more than satisfying a number of tests, if there is/are no buyer(s) for the business, irrespective of whether it is potentially profitable the company will fail without further funding. The company has to remain attractive and relevant to the market it operates in. IPs may have the skills required to conduct a rescue strategy but they cannot make the company anything more (as a whole) than what it was when they were initially introduced.

The conduct of IPs and how they go about fulfilling the objectives will be explored in the next chapter where it will be submitted that insolvency proceedings provide a profitable business venture for accountants/IPs and so rescue packages are an ideal instrument which can be exploited to the benefit and needs of the IP when assessing the best course of action to be taken with a particular company in financial distress. For this reason it will be of no surprise that transparency is a critical problem in rescue packages, a problem that has contributed to rescue packages being branded as mistrusted mechanisms that seems to benefit the selected few[219].

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[217] J. Lingard, *Corporate Rescue and Insolvencies*, 2nd edn, (London: Butterworths, 1989), at 5.

[218] G. Lightman, 'Voluntary Administration: The New Wave or the New Waif in Insolvency Law', 2 *Insolvency Law Journal*, (1994), 59, at 62; M. J. White, 'The Corporate Bankruptcy Decision', *Journal of Economic Perspectives*, (1989), 129.

[219] For an interesting discussion on the matter, and something that will be examined in more depth in Chapter Three, see the report compiled by The Office of Fair Trading, *'The Market for Corporate Insolvency Practitioners: A Market Study'*, June 2010 http://www.oft.gov.uk/shared_oft/reports/Insolvency/oft1245 (assessed 19th January 2011).

It is imperative to keep in mind the objectives set out within the Cork Report[220], and how they paved the way for what was two major strands of corporate insolvency law reform: namely those of providing a regulatory framework to prevent commercial malpractice or the abuse of insolvency procedures themselves[221], and of providing a formal legal procedure for business rescue[222]. Before the report considered the wider implications of corporate insolvency there were no explicit statements in regards to the purposes of insolvency law.

The question therefore remains: does the Cork Report coupled with the objectives set out in Schedule B1 of the Insolvency Act 1986 present itself as a useful statement of objectives for a modern corporate insolvency law? With this in mind, what now needs to be explored in more detail is what is at the heart of a company.

### 3.1. What is being Rescued?

Various distressed companies may fulfil the criterion which makes them eligible for rescue, but ultimately they may not be a viable entity that can realistically expect to be rescued within the market in which it operates. Nevertheless, despite this caution rescue is conventionally reserved for those companies that can survive if they are given a “second chance”[223]. What qualifies under this heading is based on a fact-gathering exercise whereby the entire structure of the company along with its finances and operations are broken down into numbers. If there are positives to be gained that can be achieved with a proportionate amount of effort in the form of financial assistance and time and this would be more beneficial in the long run than taking the swifter response and terminating the company immediately, then there is a chance that the company may be saved. It may seem that even with all of the relevant information gathered the facts portrayed from this exercise provide nothing more than a prediction, but one that is well informed. This nevertheless still leaves open the danger of taking a swift approach resulting in the company’s assets or business being sold cheaply. There is no denying this is a risk, but as the next chapter will demonstrate there is a duty on the IP to secure the best price possible given the circumstances.

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[220] See above, s. 2.3.
[221] Insolvency Act 1986, ss. 214, 238-41, 230(2).
[222] Insolvency Act 1986, ss. 8-27.
[223] Government white paper, *‘Productivity and Enterprise: Insolvency – A Second Chance’*, DTI, Cm 5234, July 2001, see http://www.insolvency.gov.uk/compwp.htm (assessed 10th July 2010).

The act of rescuing a company is an attempt to protect the company from further losses, but a rescue package will only be implemented if it is financially sound and efficient to do so. For whose benefit a rescue is undertaken can take multiple forms. It may be an attempt to protect or minimise the losses for creditors, or to prevent further losses occurring beyond the company itself, such as a reduction in the number of employees and the effects it would have on the local community[224]. As mentioned above, due to the nature of insolvency law and its perception by the general public, rescue packages are predominately seen as bail outs for companies that have only themselves to blame for their financial woes. What must be clarified here is the justification for giving companies a second chance, and why should a company be given this option? The fact highlighted above is that a company is much more than just one business - its actions or inactions cannot be said to affect solely its own interests. As a mere economic concern, the corporate rescue mechanism cannot thrive as it would be restricted to the analysis of cold financial data without seeing the far-reaching consequences that a rescue would have on a particular business and the community in which it operates. But by adopting a socio-economic approach it would enable corporate rescue to be considered in a broader way, opening the mechanism up to a wider selection of possibilities in relation to its objectives, values and visions[225]. These objectives can be realised in their various forms through adopting and incorporating a framework based on efficiency. The efficiency principle as it will be seen in Chapter Four is a fundamental concept that when combined with social norms, can enhance and help produce a number of goals that otherwise would have been neglected in a corporate rescue process[226]. The importance of social concepts cannot be understated as they are the variables that produce the parameters in which the law operates. In other words they provide justification for acting, and refraining from acting, in a certain way, which is reflective of custom in society. However, with competing objectives they are bound to produce a possible “trade off” between social compliance and the costs on various parties[227]. Whilst social aspects enhance the law in a beneficial way towards socially acceptable norms, they invariably may demand that creditors

[224] V. Finch, *Corporate Insolvency Law: Perspectives and Principles*, (Cambridge: CUP, 2002), at 189.
[225] For widening the scope of objectives by seeing beyond the economic approach see V. Finch, *Corporate Insolvency Law: Perspectives and Principles*, (Cambridge: CUP, 2002), at 190.
[226] On the social costs of corporate rescue see B. G. Carruthers and T. C. Halliday, *Rescuing Business: The Making of Corporate Bankruptcy in England and the United States*, (Oxford: Clarendon Press, 1998), pp 69-71; E. Warren, ‘Bankruptcy Policy’, 54 *U. Chic. L Review*, (1987), at 775, and the reply, D. G. Baird, ‘Loss Distribution, Forum Shopping and Bankruptcy: A Reply to Warren’, 54 *U Chic. L Review*, (1987), at 815.
[227] B. G. Carruthers and T. C. Halliday, *Rescuing Business: The Making of Corporate Bankruptcy in England and the United States*, (Oxford: Clarendon Press, 1998), at 155.

make certain concessions in complying with the above, but this cannot be fulfilled due to implications of efficiency[228].

Furthermore, it should be noted that a company depends on a particular market in which it operates to financially sustain its existence[229]. A company's existence relies on the needs/ raw materials/goods that enable the company to trade and ultimately conclude business. If the sources that enable the company to trade do not exist then it will not make money, and if it has no money it cannot pay its debts which will cause a "ripple effect" through the wider network in which it operates, causing financial and social problems for a large number of people. Rescue therefore aims to reduce the ripples rather than alleviate the full impact of where the problems originated; further supporting what seems to be a shift of focus from ex post responses to corporate distress, to that involving influencing how the actors of companies manage the risks of insolvency ex ante[230]. It is therefore critical that the internal members of a company proactively assist in the survival of the company; early intervention helps the prevention or onset of insolvency[231] or its worsening. If distress is identified and acknowledged at an early enough stage this can aid the rescue process to be swifter and potentially more successful, especially when external expertise is requested in the form of rescue specialists. We have already seen above the "tests" for determining insolvency, what now must be explored is the best time when a company should get help.

### 3.2. Enterprise Act 2002 and the Purpose of Administration

The Enterprise Bill was published on 26th March 2002 with the intention of removing administrative receivership and substituting the process with a more efficient model that would be better suited to rescuing a distressed company[232]. To ensure that this end was realised[233], the EA 2002 first of all had to change a number of provisions that governed

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[228] For administrative efficiency see G. Dal Pont and L. Griggs, 'A Principled Justification for Business Rescue Laws: A Comparative Perspective, Part II', *International Insolvency Review*, (1996), 47, at 47.
[229] J. Lingard, *Corporate Rescue and Insolvencies*, 2nd edn, (London: Butterworths, 1989), at 4.
[230] V. Finch, 'The Recasting of Insolvency Law', 68 *Modern Law Review*, (2005), at 713; V. Finch, 'Corporate Rescue in a World of Debt', *Journal of Business Law*, (2008), 756, at 575.
[231] Cork Report, Ch. 9.
[232] For further reading on the matter see: M. Hunter, 'The Nature and Functions of a Rescue Culture', *Journal of Business Law*, (1999), 49; A. Belcher, *Corporate Rescue*, (London: Sweet & Maxwell, 1997); V. Finch, *Corporate Insolvency Law: Principles and Perspectives*, (Cambridge: CUP, 2002); B. Carruthers and T. Halliday, *Rescuing Businesses: the Making of Corporate Bankruptcy Law in England and the United States*, (Oxford: Clarendon, 1998).
[233] On administration as a rescue procedure see I. Fletcher, 'UK Corporate Rescue: Recent Developments – Changes to Administrative Receiverships, Administration Company Voluntary Arrangements – The Insolvency

rescue[234]. Amongst a number of newly appointed provisions it permitted the commencement of administration extra judicially[235] and turned the focus to those in control of distressed companies to think more about insolvency risks before they became unsalvageable[236]. Under the old system, the administration order would prescribe one or more of four statutory purposes. The first of these was "the survival of the company, and the whole or any part of its undertakings as a going concern"[237]. Whilst this, as it will be seen shortly, shares some similarities with what was to become part of the new system, it is fair to say that this option was rarely used or considered as the primary purpose of an administration[238]. The main focus, as earlier iterated, was the "better realisation of the company's assets than would be effected on a winding up", which amounted to the trading of the company's business until its sale as a going concern or the sale of its assets[239].

When administrative receivership was reviewed amid concerns regarding the fairness of the process, there was a general consensus that the "rescue culture" had been slowly ebbing away until it was merely an afterthought. The new system introduced by the EA 2002 ensured that "survival" of the company could not be relegated in this way. Whilst the disagreements may continue regarding the distinction between company and business rescue, arguing that the only the former is truly corporate rescue, the reform was a much needed step in the right direction[240]. The law sets out one purpose of administration with a hierarchy of three objectives. Under para 3 of Sch. B1 the administrator is under a mandatory duty to perform his or her functions:

(a) with the objective of rescuing a company; or

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Act 2000, The White Paper 2001 and the Enterprise Act 2002', 5 *E. B. O. R*, (2004), 119; V. Finch, 'Re-invigorating Corporate Rescue', *Journal of Business Law*, (2003), 527.

[234] See section 2.1.

[235] Insolvency Act 1986, ss. 2A, 72B-72G.

[236] For an interesting discussion on the rise of pre-packed administrations as a pre-emptive force to be reckoned with, see S. Frisby, '*A Preliminary Analysis of Pre-packaged Administrations*', Report to The Association of Business Recovery Professionals, (August 2007); V. Finch, 'Pre-Packaged Administrations: Bargains in the Shadow of Insolvency or Shadowy Bargains?', *Journal of Business Law*, (2006), 568.

[237] Insolvency Act 1986, s. 8(3)(a).

[238] J. Goldring and M. Phillips, 'Rescue and reconstruction', Insolvency Intelligence, (2002), 75, at 76.

[239] Ibid.

[240] As noted above, according to the DTI's Explanatory Notes in para. 647, "rescuing the company" means "the company and as much as its business as possible". Thus, rescuing the company's business alone will not satisfy that objective.

(b) where it is not reasonably practicable to rescue the company, with the objective of achieving a better result for the company's creditors as a whole than would be likely if the company were wound up (without first being in administration), or

(c) where it is not reasonably practicable to rescue the company or achieve the result mentioned in paragraph (b), with the objective of realising property in order to make a distribution to one or more secured or preferential creditors.

The purpose of administration should therefore be viewed as a mechanism aimed at rescuing the corporate entity. Only when this objective cannot be achieved (not reasonably practicable) is the administrator permitted to consider the second objective and seek to achieve a better result than would be likely in a winding up, albeit also considering the company's creditors as a whole[241]. The final objective as stated above which was the primary focus of administrative receivership is now only opened to the administrator if none of the above objectives are reasonably practicable.

### 3.3. Routes to Administration: Court Appointment Procedure and out of Court Procedure

It was not enough to just consider the wording of the legislation in order to make the administration process efficient; the route to appointing an administrator had to change. The old law dictated one way, namely through the presentation of an administration petition and making, by the court, an administration order. Whilst this is still permissible, the new regime permitted the appointment of administrators without a court order by either a holder of a floating charge holder,[242] by the company or by its directors[243]. The duty and functions of the administrator will be considered in Chapter Three.

#### 3.3.1. Appointment by the Floating Charge Holder

As noted above, unless the charge was made before 15th September 2003, the appointment of an administrator, rather than an administrative receiver is now the key means by which a floating charge holder may enforce its debt[244]. This entitlement is considered within the current law with the objective of "realising property in order to make a distribution to one or

[241] This is supported in paragraph 3(2), Insolvency Act 1986, Sch. B1.
[242] See Insolvency Act 1986, Sch. B1 paras 12 to 19
[243] See Insolvency Act 1986, Sch. B1 paras 20 to 32
[244] Enterprise Act 2002, s. 250.

more secured or preferential creditors"[245] recognised as one of the three objectives of administration, albeit the lowest form. Therefore priority would be given, where feasible, to rescuing the company, or if not achievable, to realising a better outcome for the company's creditors as a whole than would be achieved in an immediate liquidation[246]. It is still important to realise that before reform occurred, receiverships flowing from a breach of a loan agreement secured by a floating charge did lead to a form of rescue. Whilst this is still possible if the date in which the agreement was entered is within the allocated timeframe there are questions as to the value of this rescue at the expense of the other creditors. Nevertheless, a rescue process did exist in a diluted format which satisfied a few creditors who were in a strong position.

### 3.3.2. Floating Charge

Businesses operate on a credit basis to fund their activities and loans are granted against collateral (usually assets), which would be forfeited or sold off if they failed to fulfil their contractual obligation to the creditor. This collateral that usually has a higher monetary value than the debt owed belongs to the creditors upon failure by the debtor to honour the terms of the contact. There are two types of creditors, those that are secured and those that are unsecured. One way to be secured is to have a charge over company property; a specific example of this is the floating charge. It is a form of security that was recognised by the UK's courts in the 19th century as a way of dealing with the business and financial circumstances at the time[247]. A floating charge will usually give the creditor a priority right over other creditors to take over the debtor's undertaking and run, sell it, dismantle it as he or she thinks fit by way of securing repayment of his debt. This concession to the freedom of contract is the defining moment where the UK's law departed from the laws of the USA and Continental Europe; the advantage that a floating charger has over other creditors seems to the USA as not only unfair but contrary to the idea of capitalism and enterprise, believing such a move would hinder progress. Nevertheless, it remained throughout much of the Commonwealth a tool of preference, with most creditors seeking a mixture of a fixed and a floating charge (a hybrid charge). It is worth pointing out that the creditor holding a floating charge need not consider the adverse effects that it may have on the wider community or the employees. Whilst in limited situations it may aid the process of rescuing a company as the creditor may

[245] Insolvency Act 1986, Sch. B1 para 3(1)(c).
[246] See R. Parry, *Corporate Rescue*, (London: Sweet & Maxwell, 2008), at 44.
[247] See R. R. Pennington, 'The Genesis of the Floating Charge', 23(6) *The Modern Law Review*, (1960), 630, at 640.

consider the option to preserve the company and sell it as a going concern (the first viable signs of a corporate rescue option), it may also decide to terminate the business affairs and initiate insolvency proceedings. With the seemingly unfair advantage that floating charge holders possessed, it was only a matter of time before the desire to review the law became apparent. The opportunity eventually arose in 1982 with the Cork Report.

### 3.4. Administration

Based on the above it is easy to see why administration has been described as a "hybrid procedure" combining the exceptional powers of a floating charge receivership with an altered set of objectives, based on a collective approach with a rescue-orientated mission[248]. The key aspirations of the new process were to introduce efficiency in the rescue process, specifically to encourage early participation by the controlling members of companies to seek help and enhance the success of a rescue occurring, as well as to reduce costs associated with court appointments. To achieve this end, provisions within the EA requested that the administrator must present proposals to creditors within eight weeks of his appointment and must convene a creditors' meeting within ten weeks of the administration's start[249]. This requirement is intended to bring an element of accountability to the proceedings by making the process more transparent[250]. The timeframe required to obtain all of the relevant information is dependent on the relationship that exists between the IP and the directors or financial institutions such as banks[251], as they will be in the best position to know what is going on with the business and report this back to the IP. The difficulty with this managerial displacement model is that there are questions as to whether accountants are the correct candidates to be running the company[252]. Administration does appear at odds with what appears logical, in the sense that surely the management is in the best position with its specialised knowledge to continue the firm's operations, as opposed to another person/body who gains control after an interruption in the affairs[253]. This of course poses another problem

[248] See I. Fletcher, 'UK Corporate Rescue', 5 *European Business Organization Law Review*, (2004), 119, at 125.
[249] See para 52 of Sch. B1 to the Insolvency Act 1986. Para 52 (1) sets out exceptions from these requirements.
[250] Assessing whether or not this has been achieved is something that will be reserved for the next chapter.
[251] That will usually have a qualifying floating charge: see para 14 of Sch. B1. After the EA 2002 there are three methods by which a 'new' administrator can be appointed: by the court on the application of the company, its directors, one or more of the company's creditors or by a combination of these parties – para 12; out of court on the application of the holder of a qualifying floating charge – paras 14-15; and out of court on the application of the company or the company's directors – para 22.
[252] Comparisons with the US DIP model are unavoidable, see D. Hahn, 'Concentrated Ownership and Control of Corporate Reorganisations', 4 *JCLS*, (2004), 117, at 146.
[253] See R. Posner, 'Foreword' in J. Bhandari and L. Weiss (eds.), *Corporate Bankruptcy: Economic and Legal Perspectives*, (Cambridge: CUP, 1996).

highlighted above in that is it a wise decision to leave those in charge who potentially caused the problems in the first place. The administration process aims to restore confidence in the company by discarding the old management, at least for a period of time. Whilst obtaining the relevant information may prove an obstacle, the EA has prompted a culture of supervision and monitoring, where readily available information can be assessed quickly and an administrator can be appointed on short notice. This not only attempts to promote efficiency but also a wider awareness of the issues involved[254]. So whilst it is noted that some responsibility has been placed on the financial providers to monitor and report any distress, the question remains for whom does the administration process cater?

The 2002 Act is explicit in its motives stating that administrators must act in the interests of the company's creditors as a whole[255]. These different interests or values are the factors which makes rescue a sensitive and delicate matter to handle[256]. But there is a far more pressing matter before the interests are to be considered and that is whether on the information that has been provided, the company would be best suited for administration or liquidation? The answer to this rests with the IP who must consider whether or not "in his opinion the purpose of the administration is reasonably likely to be achieved"[257]. Applying this to the premise that there is an emphasis on the preservation of the business as opposed to the preservation of company, if the IP concludes that a sale of assets would achieve a better result for creditors than preserving the company there will be little scope for challenging this assessment. However a creditor may apply to the court to challenge the decision[258], and may succeed if the creditor can prove the administrator has acted so unfairly to harm his interests. The IP would have to explain why the rescue objective cannot be achieved[259]. But any suggestion made that the courts will usually intervene or second guess "commercial judgments made by IPs is far off the mark"[260].

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[254] V. Finch, 'Corporate Rescue in a World of Debt', *Journal of Business Law*, (2008), at 758.
[255] Insolvency Act 1986 Sch. B1 para 3(2)
[256] V. Finch, *'Corporate Insolvency Law: Perspectives and Principles'*, (Cambridge: CUP, 2002, Chapter 6; M. Hunter, 'The Nature and Functions of a Rescue Culture', *Journal of Business Law*, (1999), 491; Insolvency Service, *'A Review of Company Rescue and Business Reconstruction Mechanisms'*, Report of the Review Group, Department of Trade and Industry, (2000), pp.12-23. See Enterprise Act 2002, Sch.16, para 65.
[257] Act 1986 Sch.B1 para 18.
[258] Insolvency Act 1986, Sch. B1 para 74
[259] Insolvency Act 1986, Sch. B1 para 49(2)(b)
[260] Hansard, HL Deb, vol 638, col 768 (29 July 2002); See also G. McCormack, 'Control and Corporate Rescue – An Anglo-American Evaluation', 56 *ICLQ*, (2007), 515, at 530.

Needless to say that if the IP is not provided with a full account of the company's affairs, which will allow them to evaluate the prospects of achieving the purpose of the administration then they will refrain from making such a statement[261]. The purpose of this process is to assess risk and identify potential risks. It was hoped that by introducing this "new" awareness of insolvency risks it would increase proactive steps to be taken before the position became terminal. But this in some respects ignores the more technical arrangement of finances: what if a shift in the financial climate occurs?[262] It would seem that despite the intention to increase the monitoring and supervision of companies, there has to be a distinction between a perceived risk and an actual risk. It would be uneconomic for any company to endeavour to see every risk. The only thing that companies can do is to take the steps that they think are necessary to prevent the greater risk as assessed from their reports.

In seeking these anticipatory steps to safeguard their interests, measures from creating and gathering in depth information about the companies going concerns has manifested itself into a vehicle striving to detect and manage risk early, rather than making its primary mission to repay debt. The EA 2002 took a decisive step to introduce new timeframes for action, creating incentives to monitor a greater urgency[263]. The shift in focus has created a new direction, more reflective of modern business practice, whereby calculated risk is to be encouraged and at the same time actively monitored to minimise the extent of financial distress if it occurs, which in turn increases the chances of a successful corporate rescue being carried out. This anticipatory, rather than reactive, policy[264] has been duly noted to apply to the way banks approach funding rescue packages.

This revamp in thinking has done much to making rescue packages possible. While in the pre-Enterprise Act regime banks could rely on receiverships and therefore never had to be proactive in assessing and reducing risk because they had greater control in receivership and the IP owed them duties, the newly adopted regime now means they are, in theory and

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[261] The Enterprise Act 2002 created new objectives for administration: Para 3(1) – 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 being in administration), or (c) realising property in order to make a distribution to one or more secured or preferential creditors. See L. Doyle and A. Keay, *Insolvency Legislation: Annotations and Commentary*, (Bristol: Jordans, 2006), at 1583.
[262] The term will be associated with economic events that happen on a large scale, affecting the economy as a whole rather than a systematic attack on individual sectors.
[263] V. Finch, 'The Recasting of Insolvency Law', 68(5) *Modern Law Review*, (2005), at 715.
[264] For an overall flavour on the change in insolvency law philosophy see V. Finch, 'The Recasting of Insolvency Law', 68(5) *The Modern Law Review*, (2005).

depending on priority and who has got it, on the same footing as other secured creditors, so it is imperative they act with haste to reduce the distress and increase what they recover. In sharp contrast to the position with receivership, the IP is now to consider the interests of the company's creditors as a whole[265], whilst at the same time ensuring that the procedures and enforcement provisions set down by the new Act delivered on its intention to protect their interests when the IP took decisions or made judgments about the company's prospects. These two aims changed the face of corporate rescue proceedings. Firstly, it dictated the overriding objective of rescue, and secondly it has changed the way in which investors choose to provide funds to companies. Why the latter change is important is worth emphasising because it has the potential to set a dangerous precedent. Naturally all companies need investment to operate. The next questions would be to ask: how are companies funded? Followed by: why is this important? The two questions can be answered simultaneously. Finance providers who wished to protect their investment before the enactment of the EA found the answer to be straight forward by initiating receivership with the floating charge they held giving them priority.

However, post EA it has created a re-think. With the uncertainties causing banks to shift their lending practices away from using floating charge securities and more towards lending via fixed asset security[266]. Why this point is imperative to rescue is because it will have a profound effect on its overall success. If there is a shift in security away from floating charges to fixed assets, there is a diversification of risk on the investment and ergo less of an urgency and tendency to monitor companies[267]. By providing a method in which a creditor may protect his investment, there is less concern about securing repayment and so less attention dedicated to ensuring the company is in a healthy state[268]. It would seem that that whilst the intention of the EA was to increase transparency and the availability of company information through monitoring, it has adversely diminished the process which would have allowed rescue to be a more prominent force than it is currently. Continuing with the concerns associated with monitoring, it is worth briefly exploring the introduction of the Operating and Financial Review (OFR)[269], which has now been replaced by the Business

[265] Insolvency Act 1986, Sch. B1 para 3(2).
[266] D. Prentice, 'Bargaining in the Shadow of the Enterprise Act 2002', 5 *EBOR*, (2004), at 153.
[267] See J. Armour and S. Frisby, 'Rethinking Receivership', *Oxford Journal of Legal Studies*, (2001), 20, at 23.
[268] Whilst all investors will pay attention to the company of interest, there would be a variation on how much time is dedicated to monitoring a company if their investment is not as strong as say one that is.
[269] See Company Law Review Steering Group (CLSRG), *Modern Company Law for a Competitive Economy: Developing the Framework*, Final Report (London: DTI, 2001) ch 5; DTI, Draft Regulations on the Operating

Review (BR) under section 417 of the Companies Act 2006. The importance of this is apparent when considered with corporate rescue proceedings as its effect was to further the process in which company directors not only manage serious risks but also disclose to stakeholders how they manage such risks[270]. The responsibility for maintaining this internal control system is fundamental to the potential success of any rescue procedure. If the system does not substantiate in detail the way that particular risks are to be dealt with, or overlooks others, then the company will not be equipped with the necessary skills to avert distress. However, it is hoped that the BRs[271] will have a more positive response, promoting transparency to be undertaken when dealing with insolvency risks and rescue. But on reflection does it make any difference? Does transparency really prevent or limit failure? Or would further research be more inclined to suggest that it has nothing to do with preventive methods, but rather accountability, increasing the sale of assets before the inevitable decline of the company and finding those parties responsible for the failure? This highlights the potential conflicts in the legislation: is administration a measure to prevent liquidation or is administration the new liquidation?

Whilst at one time financial distress was permitted to run its course because banks had priority, they now may be too hasty in placing the company into administration rather than putting trust and confidence into the management of the company, in that they can work through the glitch and return the company to a healthy state financially. It would now seem that the banks have criteria, not set in stone but rather guidelines that offer something approaching a good practice when faced with such a situation. Firstly they should observe and detect early warning signs of distress,[272] determine the quality of the management and its ability to deal with a company in distress,[273] and the company's performance in steering through the troubled times. Whilst it may sound like they are taking on responsibility, they are in fact taking steps to protect their investment. If success is to be assessed based on these proactive steps then success is an indirect product of self-interest. If corporate sustainability

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and Financial Review and Directors' Report – A Consultative Document (May 2004). See also L. Roach, 'The Legal Model of the Company and the Company Law Review', 26 *Company Lawyer*, (2005), at 98.

[270] V. Finch, 'The Recasting of Insolvency Law', 68(5) *Modern Law Review*, (2005), at 717.

[271] This only applies to large quoted companies; see s. 417 Companies Act 1985.

[272] See bank strategies see British Bankers' Association (BBA), A Statement of Principles: Banks and Micro-enterprises – Working Together (2008): http://www.bba.org.uk/media/article/bba-launches-revised-statement-of-principles (as of 30th October 2010)

[273] Ibid.

is to prevail as the one true motive for initiating rescue at an early stage is this to be considered detrimental for the direction of the corporate rescue?

### 3.5. When Rescue Fails – Rescuing Rescue

As previously stated, a company can suffer a second failure as there is nothing to suggest that previously rescued companies are more immune to financial distress than a non-rescued company. However, it may raise questions as to whether the company should have a third chance given that the decision to take that failed second chance did not prove effective[274]. Of particular attention will be the timeframe that has elapsed since the first rescue and what measures were taken to address the problems that faced the company. If new problems have materialised that were not evident in the first rescue is it correct to label any further attempt as a rectification process in conjunction with the first or a separate process unrelated to the previous one? Part of the difficulty with assessing this question is clearly the lack of data compiled on this subject. Statistics are not recorded by many administrators because firstly they are not required to file material and secondly there is little distinction to be had between first and second rescues. It would be interesting to quantify whether multiple rescue attempts just delay the inevitable process of liquidation. Or can it be simply said, as already mentioned, that administration is the new liquidation?[275] The question warrants further investigation and will be examined towards the end of this thesis.

The importance of which approach is taken reflects on the rights held by various parties associated with a company; when a healthy company is operating the directors are seeking to benefit the shareholders[276], and when the company is distressed the attention will be turned to aiding the interests of the creditors[277]. It therefore can be argued that it is beneficial to offer companies a number of different routes to rescue, but on the condition that they work

[274] But it must be recognised that the law cannot transform a non-viable business into a viable one, see E. Fennell, The Times (Law Section, Times 2), April 2003, at 9.
[275] This will be examined throughout the next chapters.
[276] For the views on shareholders as the owners of the company see, for example: H. Butler, 'The Contractual Theory of the Corporation', 11 *Geo. Mason UL Rev*., (1989), at 99; R. Sappideen, 'Ownership of the Large Corporation: Why Clothe the Emperor', *King's College LJ*., (1996-7), 7, at 27. On the nature of a shareholder's interest see E. Ferran, *Company Law and Corporate Finance*, (Oxford: Oxford University Press, 1999), pp.131-3. The Company Law Review Steering Group took the view that the basic duties of directors will still be to maximise shareholder wealth though this will be subject to a more 'inclusive' responsibility to have regard to other shareholders: See Modern Company Law for a Competitive Economy: Completing the Structure (November 2000) ch. 3.
[277] See *West Mercia Safetywear Ltd v. Dodd* [1988] 4 BCC 30, [1988] BCLC 250, per Dillon LJ.

together and not in conflict[278]. Achieving this goal naturally depends entirely on the individuals and the circumstances, and the fact is that reconciling them is not always possible.

### 3.6. Afterthought on Rescue Ideology

Despite the number of competing objectives, it is clear that corporate rescue must remain a selective mechanism aimed at only sustaining the companies that are economically viable[279]. It has aptly been described as embracing a Darwinian approach whereby a capitalist economy will acknowledge that a certain level of corporate failure is both inevitable and necessary to the efficient functioning of the market[280]. This theory of embracing a Darwinian approach can be expanded to include a Socio-Economic Darwinian approach, whereby it is accepted that rescue is not an automatic right[281], but the parameters in which it is judged should perhaps be widened to include as the name suggests socio-economic issues. Whilst this may be interpreted too widely, it is intended to highlight other issues that should be considered when discussing the benefits of rescuing a distressed company. The intended aim is to strengthen the result of a rescued company, rather than widen the scope which may weaken the process.

On a final note, if failure is a product that is inevitable and necessary why do we have rescue models? The answer to this is simple: not all companies in distress are beyond help. Some companies can be rescued and some can be restructured. There is the temptation to suggest that no company is too big to fail, but this will depend on the company, what it does and what would the consequences be to the wider economy if it was allowed to fail[282]. Whether the UK has a model that is efficient in its purpose will be explored in the next chapters. Like the Darwinism approach a model's strength is to be found in its willingness to adapt and evolve to deal with the circumstances in existence. From the research conducted in this chapter it has been highlighted that there is a divergence between insolvency legislation and what companies require in practice. Invariably it appears that sometimes change has to develop outside of the formal process and operate as an alternative to what the legislation dictates if it clear that the law is redundant in its purpose. If a rescue model does not effectively rescue companies then it cannot be said to be a rescue model at all.

[278] V. Finch, *Corporate Insolvency Law: Perspectives and Principles*, (Cambridge: CUP, 2002) at 358.
[279] *A Review of Company Rescue and Business Reconstruction Mechanisms: Report by the Review Group*, The Insolvency Service (London: HMSO, 2000) (The 2000 Report), para. 24.
[280] J. Argenti, *Corporate Collapse: The Causes and Symptoms*, (London: McGraw, 1976), at 170.
[281] S. Frisby, 'In Search of a Rescue Regime: The Enterprise Act 2002', 67 *Modern Law Review*, (2004).
[282] For instance see RBS. For further reading see E. Hüpkes, 'Complicity in Complexity: What to do about the 'too-big-to-fail' Problem', 9 *Journal of International Banking and Financial Law*, (2009), 515.

## 4. Conclusion

The Corporate rescue model in the UK has developed over the years with various notable inputs ranging from the Cork Report to the Insolvency Act 1986 and the Enterprise Act 2002. It was with the latter Act that aimed to secure the rescue concept as a dominant force within insolvency proceedings. It was hoped that the rescue culture that emerged would devise a structure which enabled distressed companies to easily seek the intervention that they need to remedy the problems that they faced. The difficulty with the legislation is that it assumed that the concepts of financial distress and insolvency could be defined with ease. Whilst there is case law and annotations within statute books to provide assistance they remain unclear and open to interpretation. The flexibility does offer some benefits by allowing a distressed company to easily demonstrate the financial state of its affairs, but despite the tests formulated the actual point of insolvency has never fully been determined. It has only broadly been stated to apply where cash flow is insufficient to cover current obligations, or if the company has outstanding liabilities that are greater than the value of assets, and as such it is not possible to discharge his liabilities. The asset valuation process has been the source of much controversy, partially because it is purely an estimation that can have far reaching consequences on a company's solvency state. The inaccuracy combined with the tension of having a model that has a dual accountancy and legal personality has in some ways allowed for the UK's corporate rescue form to be pulled in a number of directions.

The features evident within the UK's model have been significantly shaped by the Cork Report which intended to define the characteristics of a good modern insolvency law. It not only highlighted the flaws and recommended amendments, but it more importantly paved the way for the rescue culture to emerge. When the majority of the Cork Report's recommendations were enacted by way of the Insolvency Act 1986 this marked a new direction in policy – a new philosophy of restoring companies rather than automatically putting them into liquidation. However, despite changes in the field corporate rescue proceedings are thwarted with inherent conflicts associated with companies that are financially distressed. These attitudes have ensured that the model has become "path dependent"; it has refrained from endorsing natural change because the differences that make it so are echoed in its identity. To accept change would therefore be to acknowledge that it was inefficient in producing its desired outcome.

The research conducted shows that there is a pattern emerging whereby corporate rescue procedures have simply been used as substitutes for liquidation. This was not intentional. The intention was to provide a real alternative to liquidating companies, but what seems to have been created is a new mechanism that ultimately leads to the former, certainly in effect. The creditor friendly orientation of the UK's system along with the preference for enduring a management displacement model has ensured that it would remain distinct from the US's Chapter 11 model. The divergences are many, but a critical aspect is the role that the IP's play in the process. The role and duties will be something that will be explored in the next chapter.

This thesis accepts that rescue procedures cannot exist in isolation; whilst creditors' interests as a whole take priority in a rescue process it must also consider the wider consequences that occur due to a company being in financial distress. In conjunction with exploring wider interests, it should also be noted that the stigma associated with insolvency in the UK does, to a degree, hinder potential rescues as well as having the ability to inflate the causes of the insolvency to something greater than they should have been. Encouraging entrepreneurs to take risks on the scale of American counterparts is still something that needs to be addressed in this country. Some measures have been taken in giving a "second chance" to a distressed company, but questions still remain as to whether both the company and its business can be correctly associated with rescue? It has been suggested that only the former can as the latter is more likened to a recycling process. With this in mind it is submitted that the majority of distressed companies that do enter administration are not "rescued" in the true sense of the word. They are partially rescued companies that have been subjected to a major intervention to save them and in return they have been significantly streamlined, reduced in size and operate in a small capacity than they did before they sought help.

The new administration process that was introduced in the 1986 Act and reinforced in the Enterprise Act 2002 aimed above everything to introduce fairer corporate insolvency laws. What remains to be seen is whether due to the current corporate insolvency law and practice not synchronising an alternative informal process was developed outside of the main insolvency procedures to address the fallacy in the current legislation. It will be seen whether the increasingly popular pre-packaged administration process can correctly be referred to as a rescue model at all and whether this by proxy makes the formal administration process redundant.

# Chapter 3

# Determining Corporate Rescue Policy and the Role of Insolvency Practitioners

## Part I: Corporate Rescue Policy

### 1. Development of the Corporate Rescue Culture

In the previous chapter the UK's corporate insolvency laws were analysed to determine what essential principles have contributed to the UK's corporate rescue model. This chapter aims to use that information to determine whether a correlation exists between what the theoretical principles provide and how a distressed company is dealt with in practice.

It has been a long campaign to reform the insolvency laws in the UK to endorse and promote a fairer corporate rescue model[1]. This gradual push towards change has involved politicians actively encouraging a move towards a more US-style philosophy of enterprise that traditionally is less censorious of business failures and more dedicated to finding solutions to the problems[2]. Despite the reservations raised in the previous chapter regarding "path dependency"[3], the distinct cultural and economic nature of the two jurisdictions should not be viewed as a deterrent to adopting some aspects of another model. Policy makers and governments should actively review their legislation to determine whether it is operating

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[1] The need to deal with troubled companies has been long endorsed by politicians and legislators as well as the judiciary and bankers, see M. Hunter, 'The Nature and Functions of a Rescue Culture', *Journal of Business Law*, (1999), 491; R Harmer, 'Comparison of Trends in National Law: The Pacific Rim', *Brooklyn Journal of International Law*, (1997), 139, at 143-148.

[2] Peter Mandelson then the Trade Secretary in 1998 went to great lengths to discuss with the hope of reassessing business perception on failure and move it towards risk taking; see M. Hunter, 'The Nature and Functions of a Corporate Rescue Culture', *Journal of Business Law*, (1999), 49, at 519; see also a comment by the Parliamentary Under-Secretary of State for Trade and Industry, Melanie Johnson who stated that "the insolvency reforms will help address the fear of failure that is a significant barrier to enterprise and help prevent companies in difficulty from going under unnecessarily. Together, the reforms will help make the UK become a better place to do business...", HC Deb. April 10, 2002, col.111; see also V. Finch, *Corporate Insolvency Law: Perspectives and Principles*, (Cambridge: CUP, 2002), pp.127-34, 284-86; A. Keay, 'Balancing Interests in Bankruptcy Law', *Anglo American Law Review*, (2001), at 225.

[3] For further reading on 'path dependency' see R. J. Gilson, Corporate Governance and Economic Efficiency: When Do Institutions Matters?', 74 *Washington University Law Quarterly*, (1996), 327; M. J. Roe, 'Chaos and Evolution in Law and Economics', 109 *Harvard Law Review*, (1996), 641.

efficiently[4]; anything deemed to be falling short of the required standard would begin to cause concerns and action should be taken to establish how best to rectify any shortcomings[5].

In such circumstances the issue(s) may be addressed by exploring different approaches to the same question. In this case it was widely considered that the US model, specifically its Chapter 11, could offer valuable guidance as to how the UK's corporate rescue model could be improved to be more reflective of the needs that face modern businesses[6]. This insight has gained considerable support and provided the foundations for numerous reports and consultation papers[7]. More recently, the Enterprise Act 2002 has modified and addressed a few aspects that were considered to be unfair; notably replacing administrative receivership with a new way of initiating the administration procedure and ring fencing a set portion of funds for the benefit of unsecured creditors[8]. But whilst these legal developments have occurred at a steady pace, other contemporary factors appear to have been omitted from that analysis. Issues concerning the overall effect that insolvent companies have on local communities and the economy[9], the lack of technical compliance and transparency within the formal administration procedure have collectively had the undesirable effect of making the law appear out of touch and unresponsive to adopting changes required specifically to help a distressed company.

Since the EA 2002 the corporate rescue ideology has been to encourage pre-emptive strategies to prevent the onset of financial distress; placing the onus of ensuring that the financially distressed company seeks help at the right time firmly on the shoulders of those in

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[4] This term will be explored in more detail in the next chapter.

[5] The design of rescue regimes relies heavily on how efficient the corporate insolvency process eliminates those firms that are economically inefficient, see generally, A. Belcher, *Corporate Rescue*, (London: Sweet & Maxwell, 1997). This will be discussed in more depth in chapter four.

[6] See R. Parry, *Corporate Rescue*, (London: Sweet & Maxwell, 2008), at 262.

[7] See Department of Trade and Industry, *'Our Competitive Future: Building the Knowledge Driven Economy'*, (December 1998), Cm.4176, paras 2.12 to 2.14; Insolvency Service, *'A Review of Company Rescue and Business Reconstruction Mechanisms'*, Interim report (DTI, September 1999); Insolvency Service Report (2000); see also HM Treasury Press release, 8th June 2001 http://webarchive.nationalarchives.gov.uk/20100407010852/http://www.hm-treasury.gov.uk/ent_chal_index.htm (accessed 7th April 2011).

[8] See Insolvency Act 1986 ss72A, 72B-72G; Insolvency Act 1986 Sch. B1; Insolvency Act 1986 s.176A; Insolvency Act 1986 (Prescribed Part) Order 2003 (SI 2003/2097). For further reading see A. Keay, 'The Prescribed Part: Sharing around the Company's Funds', *Insolvency Intelligence*, (2011), 81.

[9] For a socially responsible company, it is important to ensure diversity in the workforce and provide suitable conditions for employees; it is also crucial to maximise the positive impact of the companies' operations through support for and involvement in the local communities where it operates; see R. Smerdon, *A Practical Guide to Corporate Governance*, 2nd edn, (London: Sweet & Maxwell, 2004), pp.250-251.

charge of the company[10]. The change marked a philosophical transformation in the way in which a troubled company was approached and how its predicament was to be addressed. Persistent audits and risk management became key mechanisms to detect any potential problems with creditors keen to regularly monitor their investment to know the true financial position of the company[11]. If any concerns were to be raised a company would be expected to comply with best practice for furthering the aim of rescue[12], and seek intervention from outside of the company at the earliest opportunity if internal measures were insufficient in dealing with the matter. This shift from "debt collection" to "risk management" encouraged those involved in the process to think about insolvency risks in advance of the final crisis[13]. This proactive measure which aimed to manage and restrict the extent of the distress, led to further intervention measures from the government to audit how management performed in such circumstances and whether directors should be held accountable for any wrongdoing committed[14]. Introducing accountability into the equation altered how financial distress was interpreted, in particular increasing awareness amongst management as to what measures may be adopted to avert possible dangers.

In conjunction with promoting a better understanding about how the affairs of a financially distressed company should be tackled, modern business practices dictate that real alternatives to winding up a company should be considered[15]. Amongst the list of alternative models to develop the controversial pre-packed administration procedure (pre-packs) is gaining in popularity[16]. The nature and issues surrounding pre-packs will be discussed later in Chapter Five but it is important to make clear that whilst there is no doubt that the idea of rescue is entrenched in the UK's insolvency legislation[17], the informal pre-pack procedure represents

[10] Identifying distress and ensuring that early intervention is sought has enabled many companies to recover successfully, but of course this does not always work so the emphasis will remain on the conduct of directors' in particular asking the question have they been proactive in assessing and responding to the difficulties? See R. Parry, *Corporate Rescue*, (London: Sweet & Maxwell, 2008), at 14.
[11] For further reading see A. Arora, 'The Corporate Governance Failings in Financial institutions and Directors' Legal Liability', *Company Lawyer*, (2011), 3, at 5.
[12] See the Cork Report: Report of the Review Committee on Insolvency Law and Practice (1982), Cmnd 8558, Ch 9; see also V. Finch, 'Corporate Rescue Processes: The Search for Quality and the Capacity to Resolve', *Journal of Business Law*, (2010), 502, at 506.
[13] See generally V. Finch, *Corporate Insolvency Law: Perspectives and Principles*, 2nd edn, (Cambridge: Cambridge University Press, 2009), Chapter 6.
[14] See M. Power, '*The Audit Explosion*', (London, Demos, 1994); A. Walters, 'Directors' Disqualification after the Insolvency Act 2000 – The New regime', *Insolvency Law*, (2001), 86.
[15] L. Hornan, 'The Changing Face of Insolvency Practice', *International Accountant*, (March 2005), 24, at 24.
[16] Pre-packs now account for over a half of administrations, see S. Frisby, 'Conclusion on Pre-Packs: Part 1', *Recovery*, (Winter 2009), 30.
[17] See at V. Finch, 'Corporate Rescue Processes: The Search for Quality and the Capacity to Resolve', *Journal of Business Law*, (2010), 502, at 507.

an approach that generally operates outside what is contained within the UK's insolvency related legislation and regulations[18].

The intention of this chapter is to evaluate the philosophy that has significantly contributed to the UK's rescue procedure, taking a closer look at the characteristics that have helped define corporate insolvency policy and with it to evaluate the path that corporate rescue has taken in recent years.

## 2. The Philosophy Divide: Proceduralist and Traditionalist

As soon as a company is assessed as being insolvent, or when it is realised by others that the company is in financial distress, interested parties will start to compete for what they consider to be their rightful financial claim in the debtor company. How best to deal and resolve these conflict of interests has been the point of debate in countless academic and practitioners articles[19]. The normative debates on insolvency philosophy and policy have taken numerous forms, but there now seems to be some consensus that it consists of two main schools of thought, namely proceduralist and traditionalist[20]. How to distinguish between the two is quite straightforward. The divergence between the theories becomes apparent when the following question is posed: whose interests should corporate rescue serve?

### 2.1. Proceduralists

In the way proceduralists form their opinion, they would say that corporate rescue exists primarily for the benefit of creditors. They see the core element of insolvency law as a mechanism to maximise the extent of recoveries for parties with non-insolvency legal entitlements relating to financially distressed debtors. The basis of this contention rests with the comparison of insolvency law satisfying the interests of a debtor's creditors and suggesting that this is very much of the same nature as to how civil procedure vindicates the interests of parties with legal entitlement, namely those who seek judicial relief or satisfaction via civil litigation[21]. On the legitimate provenance of insolvency law, proceduralists state that it should limit itself to issues arising in insolvency only. It is submitted that the debtors'

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[18] It should however be noted that in most cases, even for what is a brief moment, pre-packs enter administration to allow the deal to go ahead. Further discussions on this will take place in Chapter Five.

[19] For example see S. E. Etukakpan, 'Business Rescue and Continuity of Employment: Analysing Policy through the lens of Theory', *Company Lawyer*, (2011), 99, at 100.

[20] D. G. Baird, 'The Uneasy Case for Corporate Reorganizations', *15 Journal of Legal Studies*, (1986), at 127, 133; R. Goode, *Principles of Corporate Insolvency Law*, 3rd edn, (London: Sweet & Maxwell, 2005), at 41-42.

[21] C. W. Mooney Jr, 'A Normative Theory of Bankruptcy Law: Bankruptcy Law As (Is) Civil Procedure', University of Pennsylvania Law School, *Institute for Law and Economics Research Paper No.03-27*, (2003), at 43, at http://ssrn.com/abstract id=425120 (accessed 11th October 2011).

property or value worth should only be allocated to the holders of claims and interests in the property[22]. In effect they believe in the individual pursuit of claims as opposed to any collective measures aimed at distributing wealth over a broader range of interested parties[23]. The issue seems not to be with these other interested parties per se, but the fact that they see the insolvency system as a poor vehicle to be used to achieving broader social goals such as the preservation of employment and restricting the insolvency effects on the local economy[24]. They insist that the wider issues should be considered outside insolvency proceedings, and that the only reason why they should be modified or overridden is if this would maximise value for the creditors.

However, these wider interests (interests not concerning the primary issues arising from insolvency) can be considered on limited occasions, but only on the condition that these stakeholders have enforceable rights against assets outside of the provisions contained within the insolvency law[25]; in other words the rights exist and can be pursued outside the main insolvency proceedings. The critical point that the proceduralists argue that taking into account extraneous interests (such as those of the employees) may be detrimental to the interests of holders of private law legal rights (the right to have contracts performed or to be compensated for breaches by the debtor) and this in the insolvent company would be "prima facie theft"[26] and constitute a "corruption of civil justice"[27]. Critically they see insolvency law being concerned with determining the affairs of those who have a contractual relationship to the company, and mot merely fulfilling a role to satisfy a communitarian approach[28].

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[22] C. W. Mooney Jr, 'A Normative Theory of Bankruptcy Law: Bankruptcy Law As (Is) Civil Procedure', University of Pennsylvania Law School, *Institute for Law and Economics Research Paper No.03-27*, (2003), at 44, at http://ssrn.com/abstract id=425120 (accessed 11th October 2011).

[23] The notion derives from the understanding that a collection of assets is sometimes more valuable together than the same assets would be spread to the winds. Therefore the advantage of having a collective system of creditors' collection is to make sure that creditors, in pursuing their individual remedies, do not actually decrease the aggregate value of the assets that will be used to pay them. See T. H. Jackson, *The Logic and Limits of Bankruptcy Law*, (Cambridge, MA: HUP, 1986), at 14.

[24] S. E. Etukakpan, 'Business Rescue and Continuity of Employment: Analysing Policy through the lens of Theory', *Company Lawyer*, (2011), 99, at 100.

[25] T. H. Jackson, *The Logic and Limits of Bankruptcy Law*, (Cambridge, MA: HUP, 1986).

[26] C. W. Mooney Jr, 'A Normative Theory of Bankruptcy Law: Bankruptcy Law As (Is) Civil Procedure', University of Pennsylvania Law School, *Institute for Law and Economics Research Paper No.03-27*, (2003), at 28, at http://ssrn.com/abstract id=425120 (accessed 11th October 2011).

[27] C. W. Mooney Jr, 'A Normative Theory of Bankruptcy Law: Bankruptcy Law As (Is) Civil Procedure', University of Pennsylvania Law School, *Institute for Law and Economics Research Paper No.03-27*, (2003), at 29, at http://ssrn.com/abstract id=425120 (accessed 11th October 2011).

[28] The current political interest in corporate law and governance should not be underestimated. It has been suggested that there could be a shift in the division between the private world of the economic actor and the public world of societal action through the creation of new regulatory spaces and community-based discursive processes, see G. Wilson, 'Business, State and Community: Responsible Risk Takers, New Labour and the

In relation to the analysis of corporate rescue, proceduralists' prefer to rely on economic models and market trends to determine resolutions for distressed companies[29], as opposed to the use of judicial discretion determined on the basis of case law. The reliance on extrapolative formulas is not a precise process and given its dependence on a wide number of variables, it means that it has a tendency to employ solutions to problems, which does not necessarily correlate with legislation. This raises concerns as to whether such a system can be cost effective and efficient? Proceduralists nevertheless proclaim that the model is centred on the aim of reducing waste, by controlling investment capital that is reserved for distressed companies and allowing the natural failure and liquidation of financially distressed companies that are beyond redemption.

This follows the sentiments set out in Chapter Two, which identified customs and concepts that have led corporate rescue being compared to an instrument which endorses a Darwinian approach. That the process permits (even encourages) uncompetitive companies to fail, and stronger competition to take its place. This approach adopts a displacement action, whereby distressed yet viable companies take the place of companies that have exhausted all lines of potential recovery. The displacement model maintains a continual presence within the business world that is never redundant and should be considered as a natural remedy to failure as opposed to something that is undesirable. Whilst proceduralists endorse what seems to be a corporate answer to nature's natural selection, they do so with the knowledge that the liquidation of distressed companies fulfils a fundamental aim by ensuring that assets are liquidated for the benefit of the creditors[30]. This model attempts to provide the freedom and flexibility of a contractarian model while also being attentive to communitarian sentiments. Whether this approach is compatible with the UK's corporate insolvency legislation requires further analysis, starting with an examination of the alternative philosophy that promotes a wider approach.

### 2.2. Traditionalists

Contrary to proceduralists, traditionalists believe that insolvency law is not a tool solely reserved for the creditors in which they can pursue their own interests. Broadening the scope

Governance of Corporate Business', 27 *Journal of Law and Society*, (2000), 151, at 152. Whether this "space" has emerged is debatable and has been made particularly more difficult given the global financial difficulties.

[29] J. Argenti, *'Corporate Collapse: The Causes and Symptoms'*, (London: McGraw-Hill, 1976), at 170.

[30] S. E. Etukakpan, 'Business Rescue and Continuity of Employment: Analysing Policy through the lens of Theory', *Company Lawyer*, (2011), 99, at 100.

of interest that should be considered in insolvency proceedings, traditionalists believe that stakeholders in general who have an economic interest in the company should be included[31]. They believe that there should be a wider distribution of wealth, with equal weight given to the interested parties[32]. However, caution should be applied when referring to the term "equal". This is not intended to mean "equality" in the general sense, but should be read to mean that equal respect and concern will be afforded to each claim. Similarly, however equal respect and concern does not mean the same thing as equality of treatment of those issues[33]. With this in mind, traditionalists are keen to demonstrate that insolvency law is created to take both the economic and non-economic values of all parties affected by financial distress into consideration[34]. Unlike the proceduralists they do not abide by economic models to analyse corporate insolvency, but choose to promote and highlight the wider concerns that should be considered and that the realised wealth should be distributed accordingly[35]. It follows that what they are most concerned with is providing alternatives to liquidation; namely providing solutions to financial distress and addressing the issues regarding the preservation of companies[36], protection of employment[37], furthering the interests of the community[38] and promoting equity amongst the creditors of the insolvent company[39]. This in other words can be described as seeking to foster distributive justice.

The two philosophies provide alternative means to establishing what should be the priority in insolvency. Given the technical nature of insolvency and the way that it addresses the interests of creditors and the economy in general, it is of no surprise that the theories present different ways in analysing how best to deal with financial distress and this in turn has generated difficulties[40]. The real purpose and legitimate provenance of insolvency has failed

[31] D. R. Korobkin, 'Contractarianism and the Normative Foundations of Bankruptcy Law', *Tex. L. Rev*., (1993), 554.
[32] See R. J. Mokal, *Corporate Insolvency Law: Theory and Application*, (London: OUP, 2005).
[33] For a further discussion on this issue, see R. J. Mokal, 'Contractarianism, Contractualism and the Law of Corporate Insolvency', *Singapore Journal of Legal Studies*, (2007), 51 at http://ssrn.com/abstract=1074745 (accessed 2nd January 2011).
[34] See Korobkin's *'Value-Based Account' on Corporate Insolvency* in D. R. Korobkin's, 'Value and Rationality in Bankruptcy Decision Making', 33 *William and Mary Law Review*, (1992), 333, at 335.
[35] E. Warren, 'Bankruptcy Policy', 54 *U. Chi. L. Rev*., (1987), 775, at 777.
[36] D. R. Korobkin, 'Rehabilitating Values: A Jurisprudence of Bankruptcy', 91 *Colum. L. Rev*., (1993), 717, 745
[37] E. Warren, 'Bankruptcy Policymaking in an Imperfect World', 92 *Mich. L. Re*., (1993), 336, 354-355.
[38] K. Gross, 'Taking Community Interests Into Account in Bankruptcy: An Essay', *Wash. U. L. Q*., (1994), 1031. However, it should be noted that there is some concern about how this element can come into conflict with other interests, see B. S. Schermer, 'Response to Professor Gross: Taking the Interests of the Community into Account in Bankruptcy: A Modern-Day Tale of Belling the Cat', 72 *Wash. U. L. Q*., (1994), at 1049.
[39] K. Gross, '*Failure and Forgiveness: Rebalancing the Bankruptcy System*', (New Haven, CT: YUP, 1997), 19.
[40] J. Pottow, 'Procedural Incrementalism: A Model for International Bankruptcy', John M. Olin Centre for Law & Economics, *University of Michigan*, (2006), at 943.

to create any agreement. This has had an unfortunate affect on the reputation of corporate insolvency law, often being cited as a non-stimulating area of law that has little regard for the wider social concerns of its actions. This is an unfair conclusion that disregards the tension that exists between different parties in an insolvent/distressed company with the realisation that not every creditor can be satisfied. The development of corporate insolvency law and rescue has somewhat been restricted partly due to a lack of time dedicated to the cause[41]. But even with this in mind the aspect that really needs to evolve is the opinion held by the general public that corporate failure is something that can always be avoided. It is inevitable that there will always be distressed companies. It seems that given the prevailing thoughts on the subject there will always be some disagreement as to how best to deal with them[42].

### 2.3. Two Distinct Models

Following on, the two theoretical ideologies can be further diluted with one theory dictating an "inclusive" approach to be taken with the interests to be considered, whilst the other approach is restrictive choosing to exclude certain parties from the proceedings. Despite these differences there is some consensus on the direction that corporate rescue should and has taken. On a foundational level there has to be a list of rules that interested parties would hypothetically agree to be included in a contact that would regulate any contentious matters arising in insolvency situations, and be accepted by interested parties as conditions for entering such contracts[43]. Noting the two philosophies, the divergences can be further diluted to represent two theories, namely the Creditor's Bargain Theory (CBT)[44] and the Team Production Theory (TPT)[45]. Both theories have had an important role in shaping the way in which legislation has developed, but particular emphasis will be given to the CBT, as the UK

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[41] This is of particular significance in relation to pre-packs. See Chapter Five.
[42] In 1999 Stephen Byers MP, the then Secretary of State for Trade and industry recognised the importance of cultural attitudes in attaining the optimum form of business governance for the welfare and prosperity of the nation in his key speech, stating: "...shifting British culture onto a more enterprising and less risk-averse track will take time. But we must all aspire to change the national mood if we are to create an outward looking, confident society, fit to take on the 21st century", London Business School, (21st July 2009).
[43] S. Freeman, *Justice and the Social Contract*, (Oxford: Oxford University Press, 2007), at 17.
[44] T. H. Jackson, 'Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain', 91 *Yale Law Journal*, (1982), at 857.
[45] L. M. LoPucki, A Team Production Theory of Bankruptcy Reorganization', *UCLAW Law School, Law and Econ Research Paper 3-12* (2003). This theoretical theory is by no means the only other beside CBT. Other theories which could also be used are the Communitarian Theory which considers a range of constituent interests and takes on a more public law focus; and what has come to be referred to as the Multiple Values approach, which states that there are other values beside the maximisation of the interests of creditors and efficiency that warrant consideration. See generally A. Keay and P. Walton, *Insolvency Law: Corporate and Personal*, (Essex: Pearson Education Limited, 2003), at 26.

arguably followed the pattern set out in this model in the period before the Insolvency Act 1986[46].

With these theories it is critical to be aware of the tension that exists between these models and how the variations between the two have resulted in different policy outcomes. Whilst the CBT was considered to be pivotal to corporate insolvency proceedings before the first major insolvency law reform in 1986, it is not free from criticism. The "success" of the model has somewhat attracted unwanted attention for whilst there are a number of different models, CBT constitutes the only sustained attempt at a principled analysis of the law governing insolvency[47]. But that said, the importance of the model is realised in the fact that despite the criticism, the development of other models have not been so coherent or focused[48]. Whether it is elegant principles that are sought or it is considered more desirable to have analyses which are "dirty, complex, elastic, interconnected", which can "neither predict outcomes nor even articulate all the factors relevant to a policy decision"[49], the divisions amongst critics will continue to exist.

There has always been an uneasy struggle between the various concerned parties and their different interests in a distressed company[50]. Whilst the IPs and the courts have traditionally attempted to address each case on its individual merits, with technical precision conjoined with their discretion they have managed (deliberately or not) to disregard interests that were not afforded any consideration within the insolvency legislation.

### 2.4. Creditor Bargain Theory

The CBT reflects the views endorsed by proceduralists, which states that the existence of insolvency law is for the exclusive benefit of the creditors of the insolvent. Whilst the theory acknowledges that there may be other interested parties in the insolvent company, the interests of the creditors should prevail[51]. Other interests should only be considered to the

[46] See Insolvency Act 1986, Sch. B1 para 3; see also *Brady v Brady* [1989] A. C. 755 HL.
[47] R. J. Mokal, *Corporate Insolvency Law: Theory and Application*, (London: OUP, 2005) at 34.
[48] E. Warren, 'Bankruptcy Policymaking in an Imperfect World', 92 *Michigan LR*, (1993), 336, at 338.
[49] E. Warren, 'Bankruptcy Policy', 54 *U Chicago LR*, (1987), 775, at 811.
[50] Different parties tend to "see quality through the lens of their own particular preferences", see C. Radaelli and F. De Francesco, *Regulatory Quality in Europe*, (Manchester: Manchester University Press, 2007), at 39.
[51] The identity of the creditors within the Bargain has been held to be critical to understanding the theory. Whilst the bargain is said to be hypothetical, the creditors on the other hand are quite real, see D. Gauthier, *Morals by Agreement*, (Oxford: Clarendon Press, 1986), at 9. It is from this premise that lends support to the suggestion that an hypothetical bargain would demonstrate, even if indirectly, what concepts would be agreed in the real

extent that these members are creditors with legal enforceable rights against assets of the company outside insolvency law[52]. Endorsing and justifying this theory is becoming increasingly problematic as it would only consider rights as negotiated pre-insolvency, thereby ruling out the employees who in all fairness have contributed in a human resource capacity to the company and deserve as much recognition to their claim as the creditors[53]. Any action to distinguish between finance capital and human capital would lead to the failure to recognise that both must exist to ensure the continuation of any company[54]. But as noted in Chapter Two, the way the UK's insolvency law has developed it has meant that when a debtor company defaults on payment of its debts as when due and is legally insolvent, the shareholders' interests are usually supplanted by the creditors' interests. It would seem that this understanding is so deeply embedded in the conscience of the legislators and evident in their actions that any intervention to the contrary would have to be in exceptional circumstances[55].

### 2.5. Team Production Theory

The TPT on the other hand differs in a fundamental way to CBT, submitting that the justification for the existence of a company is to organise team production. The theory dictates that the production effort within a company is the result of contribution from many sources, creating one joint effort as opposed to separate inputs belonging to one person[56]. It acknowledges that the creditors are not the only ones that contribute to the positive value of the company, nor are they the only ones who take the risk of investment in companies; they

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world, see J. H. Jackson and R. Scott, 'On the Nature of Bankruptcy: An Essay on Bankruptcy Sharing and the Creditors' Bargain', 75 *Virginia LR*, (1989), 75, at 160. It follows that by integrating actual people into the hypothetical bargain this introduces choice which in turn makes outcomes uncertain, R. Posner, 'The Ethical and Political Basis of the Efficiency Norm in Common Law Adjudication', 8 *Hofstra LR*, (1980), 487, at 499. This means that participates in the CBT are of the same character as those in real life, with different skills setting them apart, T. H. Jackson, *The Logic and Limits of Bankruptcy Law*, (Cambridge, MA: HUP, 1986), at 59.

[52] T. H. Jackson, *The Logic and Limits of Bankruptcy Law*, (Cambridge, MA: HUP, 1986), at 58.

[53] Ibid, see Jackson's "fish in the lake" example, at 57; see also S. E. Etukakpan, 'Business Rescue and Continuity of Employment: Analysing Policy through the lens of Theory', *Company Lawyer*, (2011), 99, at 101.

[54] The human contribution to the company in the form of employees' wages is given preferential treatment. Priority is given to employees under under s. 175, IA 1986. If employees are not retained, employees' wages up to £800 and sums due into employees' pensions, are to be paid.

[55] This is another example of the corporate rescue regime being constrained by what is often referred to as "path dependency", a term used to describe how a system may follow and embrace traditional norms even if the original reason for doing so has become extinct. For further discussions regarding path dependency see G. McCormack, 'Control and Corporate Rescue – An Anglo-American Evaluation', 56 *ICLQ*, (2007), 515, at 533.

[56] A. A. Alchian and H. Demsetz, 'Production, Information Costs, and Economic Organization', 62 *American Economic Review*, (1972), at 777.

should therefore be given equal weight[57]. The insolvency law process is dedicated and based on a collective basis where the rights of all interested parties are considered[58]. This theory unlike the CBT acknowledges the importance of the human capital contribution to a company and on that basis believes it is necessary and fairer to consider the broader interests[59].

### 2.6. Practical Application

With the theoretical discussion complete, applying these philosophies in practice reveals further divergences. The American model of insolvency legislation embraces the argument for considering other interests deserving of protection in insolvency[60]. The premise for this statement is to be found within the Bankruptcy Code, which allows, even if quite rare, the court to appoint a trustee in place of the "debtor in possession" (DIP) where the management commits wrongdoing. This model allows other "interests of the estate"[61] to be considered, beside that of the creditors. However, this is highly misleading to imply that just because the UK does not follow the DIP model it therefore must not wish to consider other interests but that of the creditors. Whilst the administrators once appointed are technically the agents of the company and must therefore conduct their duties in the best interests of the creditors as a whole, they must also consider the possibility of rescuing the company as a going concern[62]. The duty of attempting to save the company whilst clearly of a benefit to the creditors does mean that other interests would be considered as part of the process. This change in attitude marks a fundamental shift in the priority of interests and objectives in the UK's insolvency law[63], with the focus switching from liquidating a company to maximising the value for creditors to considering the sale of the company as a going concern which offers a genuine measure to enhance the protection of employees[64].

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[57] M. M. Blair, *Ownership and Control: Rethinking Corporate Governance for the Twenty First Century*, (Washington: Brooking Institute, 1995), at 239.
[58] See generally M. M. Blair and L. A. Stout, 'A Team Production Theory of Corporate Law', 85 *Virginia Law Review*, (1999) 247; L. A. Stout, 'Bad and Not-So-Bad Arguments for Shareholder Primacy', *75 Southern California Law Review*, (2002), 1189.
[59] See A. Rahmani, 'Shareholder Control and its Nemesis', *ICCLR*, (2012), 12, at 19.
[60] Bankruptcy provides a way to override the creditors' pursuit of their own remedies and to make them work together. This position reflects the kind of contact that creditors would agree to if they were able to negotiate with each other before extending credit. It is interesting to note that this is an application of bargaining in the "original position" behind a "veil of ignorance" in J. Rawls, *A Theory of Justice*, (Cambridge, MA: Harvard University Press, 1971), 136-42, in T. H. Jackson, *The Logic and Limits of Bankruptcy Law*, (Cambridge, Mass: Harvard University Press, 1986), at 17.
[61] Title 11 of the United States Code s.1104 (b) (2).
[62] Insolvency Act 1986, Sch. B1, para 3(1).
[63] P. Davies, 'Employee Claims in Insolvency: Corporate Rescues and Preferential Claims', 23 *I. L. J.*, (1994), 141.
[64] S. E. Etukakpan, 'Business Rescue and Continuity of Employment: Analysing Policy through the lens of Theory', *Company Lawyer*, (2011), 99, at 103.

Which model is preferable remains a contentious issue[65]. It will therefore be of little surprise that reaching a universal consensus on the design of an insolvency framework has not yet been achieved[66]. It must however be conceded that any suggestion that this outcome could be achieved would be to ignore the unique relationship between a jurisdiction's identity (noting the cultural and historical influences prevalent in the legal framework) and how this usually determines the philosophy it endorses[67]. In practice the decision will have been conceded many years ago.

For instance, in very general terms the UK has historically had a creditor friendly insolvency system whereas the US has endorsed a debtor friendly model. And as mentioned above, these legal systems are heavily reliant on custom and practice and doing things the way "it always has been done"[68].

The administration procedure and Chapter 11 are both products that have been in development for many years and it could if required be possible to trace their origin to a time when the circumstances were much different and the basic concepts within their legal framework had a slightly different meaning[69]. Whilst insolvency models have acknowledged the need to change and adapt to the environment they operate in, they can only evolve within set boundaries; they are as much subject to the mercy of the laws within their respective country as they are to the economy in general[70]. Thus creating a new identity that functions differently to the old model would inevitably cause friction as it would often fail to

[65] The solution to the financial distress of a company will depend on an array of issues, such as the nature of the problems; their severity; and the means available of resolving them. See R. Parry, *Corporate Rescue*, (London: Sweet & Maxwell, 2008), at 13.
[66] This has already been attempted but was declared impossible to achieve, see UNCITRAL Model law on Cross Border Insolvency (1997), which states that the Model Law respects the differences among national procedural laws and does not attempt a substantive unification of insolvency law, http://www.uncitral.org/uncitral/en/uncitral_texts/insolvency/1997Model.html (accessed 12th May 2011).
[67] See "path dependency" as discussed in Chapter Two.
[68] Ibid, see the importance of continuity.
[69] Whilst differences may have evolved over time, the main question appears to be not so much about whether bankruptcy law should exist at all but about how much it should do, see T. H. Jackson, *The Logic and Limits of Bankruptcy Law*, (Cambridge, Mass: Harvard University Press, 1986), at 7.
[70] "Institutions (laws) are the rules of the game in a society or, more formally, are the humanly devised constraints that shape human interaction (…). That institutions affect the performance of economies is hardly controversial. That the differential performance of economies over time is fundamentally influenced by the way institutions evolve is also not controversial". See D. C. North, *Institutions, Institutional Change and Economic Performance*, (Cambridge: Cambridge University Press, 1990), at 3.

complement the existing principles and values[71]. When this situation occurs and the legislation provides no remedy an informal (non legislative) alternative will usually surface.

In this particular case some IPs, pre Enterprise Act 2002, considered administration as a tardy and expensive process that more often than not hindered any attempt to rescue the company as a going concern. To address these issues they took it upon themselves using the discretion afforded to them to adapt a more pragmatic solution to the problems faced by financially distressed companies[72]. It will be seen that the IPs in developing alternative "rescue processes" such as the pre-packs have demonstrated that they are in fact the principal policy makers of corporate rescue. This raises some serious concerns however that as a result the current law no longer seems to draw a parallel with the intent of Parliament, rendering the rescue culture endorsed in the UK not rescue per se.

**3. Early Development: the Birth of the Rescue Culture in the UK**

As stated in Chapter Two, the Cork Report has had a fundamental role in shaping the UK's corporate rescue regime. This report was and remains the most comprehensive research project on the subject; with its legacy firmly embedded in the way it helped to change attitudes on how an insolvent company should be dealt with. It was clear that alternative measures to financial distress, other than liquidation was required. The Report acknowledges aspects of communitarianism in stressing not merely that insolvency affects interests in society beyond insolvents and their creditors, but that the insolvency process is about preserving viable commercial enterprises capable of contributing to the economy[73].
Within this idea of preservation, the Report recognised the importance of the benefits to be had both by secured creditors and by the community, if businesses and jobs were conserved. These initiatives were repeated nearly twenty years later in a report that examined the business reconstruction mechanisms evident in UK insolvency law and noted that

[71] "The past influences the present and the future...with any institutional change affecting the nature of path dependency". Ibid, particularly see Chapter 11.
[72] But he must act rationally and reasonably in exercising this discretion. See, e.g. G. Lightman and G. Moss, *The Law of Administrators and Receivers of Companies*, 4th edn, (London: Thomson/Sweet & Maxwell, 2007), at 246; R. Mokal and J. Armour, 'The New UK Rescue Procedure -- the Administrator's Duty to Act Rationally', 1 *Int. Corp. Rescue*, (2004), 136, 137-138; V. Finch, *Corporate Insolvency Law – Principles and Perspectives*, 2nd edn, (Cambridge: Cambridge University Press, 2009), pp.446-449.
[73] See Cork Report, para 198(i) and (j).

administrative receivership made a valuable contribution to the rescue culture[74]. Most significantly the process allowed rapid and effective action to prevent further deterioration in businesses' viability, particularly in those cases where fraud was evident or suspected. However despite the popularity of this process given the relatively low cost of initiating the procedure, the process was considered unfair to unsecured creditors as the appointed administrator owed a duty only to the appointing creditor[75].

### 3.1. Role of Administrative Receivership

In practice the banks were the principal providers of debt finance to smaller firms in the UK and at the same time represented the largest group responsible for administrative receivership appointments. For the banks whilst appointing receivers marked the best way to secure debt owed[76]; they remained open to suggestions that would increase the support that can be offered to a distressed company as long as it still ultimately protects their own commercial interests[77]. However concerns remained by those who were outside this privileged relationship leading to fears that the floating charge holder under administrative receiverships had too much power. This gave rise to a number of disadvantages with granting power to the floating chargeholder, namely[78]:

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[74] See Banking Law sub-Committee of the City of London Solicitors Company, Department of Trade and Industry, *'A Review of Company Rescue and Business Reconstruction Mechanisms: A Report by the Review Group'*, Insolvency Service, (2000), at 48.

[75] Opinion appears to be divided on the development of the rescue process in the UK. Some state that the administrative receivership process was one of the factors that caused an underdevelopment of the rescue culture in the UK. Others on the other hand have disagreed suggesting "...the UK, far from lagging behind in developing a rescue culture have probably developed a far more satisfactory system than any other in the world", but whilst it does provide a workable corporate insolvency framework they do concede "we accept that it may need improvement". See Insolvency law sub-Committee of the City of London Law Society, ibid at 49.

[76] Receivership, without question offered the most efficient enforcement procedure for banks, see R. Calnan, 'The Insolvency White Paper 2001: Substance or Procedure', 10 *JIBFL*, (2001), 449, at 450.

[77] The changes that occurred in the Enterprise act 2002 brought new challenges to how banks secured its interests. The administrator's statutory objectives confirmed that the inclusive protection of the banks interests was not going to be achievable given the collective creditors voice. The banks had to adapt to the new administration process and instead of "debt collecting" when a company has become insolvent, they had to ensure that they actively monitored the company's state of affairs, in other words "manage insolvency risks". See generally V. Finch, 'The Recasting of Insolvency Law', 68(5) *Modern Law Review*, (2005), at 715; for further regarding banks taking pre-anticipatory steps 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), 3; for an insight into how banks may be induced to shift their lending practices away from floating charge securities to mending via fixed asset security see D. Prentice, 'Bargaining in the Shadow of the Enterprise Act 2002', 5 *EBOR*, 153. The conclusion drawn from this is that this may result in a mixture of lending arrangements, an act that may spread the risk of investment and reduce the need for monitoring, or at least reduce the level required, for further reading on bank monitoring see J. Armour and S. Frisby, 'Rethinking Receivership', 20 *Oxford Journal of Legal Studies* (2001).

[78] Department of Trade and Industry, *'A Review of Company Rescue and Business Reconstruction Mechanisms: A Report by the Review Group'*, Insolvency Service, (2000), at para. 49.

- It can lead to unnecessary business failures, and undermine the rescue culture, particularly when the relationship between the 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;
- In making such decisions the floating charge holder had no incentive to consider the interest(s) of any other party;
- It can be unfair to other creditors, as the floating charge-holder will be taking decisions (such as whether to appoint an administrative receiver or to support an alternative response to insolvency) which can have a significant impact of the returns to the creditors without any requirement that their consent be obtained;
- It could also be unfair to other creditors that an administrative receiver owes his or her duty of care principally to the floating charge-holder and not to creditors in general; and that, unlike in other procedures, the cost of administrative receivership will fall on unsecured and preferential creditors if there are surplus funds over and above the amount needed to discharge the secured creditor's debt (but if the company is not at the time in the course of being wound up, its preferential debts (within the meaning given to that expression by section 386 in Part XII) are to be paid out of the assets coming into the hands of the receiver in priority to any claims for principal or interest in respect of the debentures[79]); and
- 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.

To address these imbalances it is necessary to make reference to a number of principles, which when read together provide a sound overview of what a corporate rescue model should aim to achieve.

### 3.2. The Eight Principles

These principles cover a broad range of considerations that aim to reflect all aspects of a corporate rescue strategy. They include:

(a) Fairness (as opposed to equality) – is, and is seen to be fair to all parties concerned, but recognises that not all claims can be equal;

[79] See Insolvency Act 1986, s. 40(2).

(b) Adaptability – it can respond quickly to the urgent needs of business and adopt to the sensitive nature of the financial market;

(c) Simplicity – it is a system that can be easily administered;

(d) Cost – it is accessible to all who need and use it[80];

(e) Efficiency – it achieves intended outcomes – the returns to creditors are maximised, and businesses that are viable in the long term are not liquidated[81];

(f) Timeliness – it encourages proactive risk management of companies;

(g) Transparency – makes the application of the law more assessable;

(h) Accountability – provides for a dedicated procedure to be utilised for parties seeking resolution where any of the above seven principles have been contravened[82].

It follows that any action taken to dilute these principles would be an act against the spirit of making an effective corporate rescue model. By embracing these as a whole there is a strong case to be made that they can actively encourage the evolution of corporate rescue. However the limitation with applying this method is that whilst these principles are designed to persuade practice to reflect modern requirements, it is the case that this often goes beyond what is contained within the legislation and so change must rely on influences outside Parliament, namely the wide discretion afforded to IPs to shape the law to suit the needs of businesses.

Notwithstanding the need for change, an obstacle to reform was that despite the popularity of receivership amongst secured creditors and government, it was not an available option for companies which had not granted a floating charge to a lender. Part of the solution for those

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[80] The issue regarding administration expenses should also be including within this sphere. It should be noted that when it comes to the treatment of expenses the court must work within the proper confines of the legislation and should not interpret it perversely simply to satisfy those administrators who adopt their practices on the basis of a very optimistic interpretation of the law, see D. Milman, 'Judicial Reflections on the Administration Process: a 2010 Perspective', *Company Law Newsletter*, (2010), 1, at 4.

[81] This will be discussed in Chapter Four.

[82] Accountability in this sense is to be taken in conjunction with the audits expected within a company. Audits are now chiefly viewed as a mechanism which has impacted the way in which a corporation is structured. It must be designed in such a way that its system may be audited and the data compiled becomes a way of reducing risks through the review of control systems. Whilst the purpose was to maximise rescue opportunities, it appears to have not only removed the human element out of the process, choosing to discard professional judgment or trust in favour of cold statistics, but it also has resulted in audits become dual purposed – measuring performance on the one hand and dictating accountability on the other. For an overview on how audits are "an emerging principle of social organisation" see M. Power, *The Audit Explosion*, (London: Demos, 1994); *The Audit Society: Rituals of Verification*, (Oxford: OUP, 1997); *The Risk Management of Everything*, (London: Demos, 2004).

who did not have a floating charge was to create a new fairer process; this became known as the Administration procedure. This new mechanism however had a limited impact as it was regarded, when first developed in the 1986 legislation, as a secondary option to receivership, as this alternative was only an option if there was no floating charge owner or if he or she chose not to embrace administration receivership[83]. This criticism must be put into context. The issue was not necessarily with the function of receivership per se, but rather with the fact that certain creditors could take security and gain an advantage over unsecured creditors[84]. This raises the question as to whether the focus should be on analysing the law of security, and not attacking a model that has provided the most effective method of enforcing security[85].

Despite the effectiveness of receivership, it often pursued the goals for a few individual creditors at the expense of other interested parties[86]. This unfair practice led to the credibility of corporate insolvency law being questioned and those who worked within the profession gaining an unsavoury reputation. Administration went some way to addressing the imbalances between secured and unsecured creditors, but it quickly became apparent that old practices continued with administrative receivers protecting the instructing party and disregarding the concerns of the creditors as a whole[87]. This had the undesirable effect of distressed, yet salvageable companies failing unnecessarily. But it should be remembered, whether this was desirable or not, corporate insolvency is based on contract law and is more concerned with protecting contractual rights than enforcing what is perceived to be right by the general body of creditors[88].

[83] Department of Trade and Industry, *'A Review of Company Rescue and Business Reconstruction Mechanisms: A Report by the Review Group'*, Insolvency Service, (2000), at 41.
[84] The purpose of the proceedings was therefore to provide the maximum prospect for the secured creditor and as such the concept of corporate rescue formed no part of the original blueprint, and neither were the appointing creditor or the appointee under any duty towards the company. See I. F. Fletcher, 'UK Corporate Rescue: Recent Developments - Changes to Administrative Receivership, Administration, and Company Voluntary Arrangements - The Insolvency Act 2000, the White Paper 2001, and the Enterprise Act 2002, *E.B.O.R.*, (2004), 120, at 123.
[85] Receivership, without question offered the most efficient enforcement procedure for banks, see R. Calnan, 'The Insolvency White Paper 2001: Substance Or Procedure, 10 *JIBFL*, (2001), 449, at 450
[86] G. McCormack, 'Control and Corporate Rescue – An Anglo-American Evaluation', *I.C.L.Q.* (2007), 515, at 534.
[87] It was advocated that rescue remedies were a superior alternative to liquidation and administrative receivership, evident from the following extract of Sir Kenneth Cork's autobiography: "We sought … to provide the means by which an insolvent business could be continued and disposed of as a going concern so as best to preserve jobs for employees and preserve the nation's assets", K. Cork, *Cork on Cork* (London: Macmillan, 1988), at 189
[88] See G. Lightman, 'Attitudes and Values: Developments in Insolvency Law: Part 1', *Insolvency Intelligence,* (2001), 57, at 58.

There is no denying that the administration process is in comparison a far more expensive procedure than receivership, which often involves arranging creditor meetings but this factor inevitably attracts attention and questions whether it can be an efficient mechanism that offers value for money in accordance with maximising recoveries. These concerns formed the basis for a review conducted by the Insolvency Service which explored whether on the grounds of equity and efficiency insolvency proceedings could become more effective and accessible[89].

**4. Proposals for Reform: a Change in Policy?**

It was widely advocated that reform was necessary to bring a fairer system into play; a system that owed a duty of care to all creditors and allowed them all, to some degree, to participate in the process. Above all change was directed to help maximise economic value by aligning incentives properly and ensuring that companies in distress do not "go to the wall" unnecessarily. This proposition was put forward by the Department of Trade and Industry in its 2001 influential report entitled '*Insolvency – A Second Chance*'[90], which amongst other things, aimed to streamline the administration procedure so that it become a fully effective procedure in all circumstances[91]. The report was aware as mentioned above that there was too great a tendency to treat administration as a second rate option when compared to receivership. The report also documented the fact that further measures were required to endorse effective legislation, which aimed at improving the ease and speed in which rescue proceedings could be initiated and concluded[92]. This, as the report recognised, was a trend that was on the increase, a hope for many that there was a viable solution other than liquidation[93].

Essentially the report was thorough with its investigations and had the intention to provide a procedure that was as flexible and as cost effective as administrative receivership, whilst at

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[89] In particular the main focus of the research was to "further the development of the rescue culture", see Department of Trade and Industry, *'A Review of Company rescue and Business Reconstruction Mechanisms: A Report by the Review Group'*, Insolvency Service, (2000), at para 17.

[90] Department of Trade and Industry, *'Productivity and Enterprise: Insolvency – A Second Chance'*, Insolvency Service, (2001).

[91] Ibid, see executive summary.

[92] See generally A. Keay, 'The Enterprise Act 2002: Pioneering a Brave New World in Insolvency Law in the United Kingdom, 11 *Insolvency law Journal*, (2003), 163, at 175-176.

[93] Department of Trade and Industry, *'Productivity and Enterprise: Insolvency – A Second Chance'*, Insolvency Service, (2001), at para 2.7

the same time remedying the major defects of that procedure[94]. There is no disputing the effectiveness of administrative receivership, but it is not a system that endorsed collective rights. Therefore one of the issues that it considered to be paramount was the need to rectify the old problem associated with IPs only owing a duty to the floating chargeholders in administrative receiverships. This was seen to be an outdated and unfair concept, with only a duty to all creditors being seen as a truly reformative measure, allowing unsecured creditors the opportunity to participate in the process and to let their voices be heard[95]. This could be considered a big enough step towards satisfying the demands of modern practice, along with the equally important steps to ensure that the overall control of the procedure and any disputes that arise will be dealt with by the courts who will direct it in a public and transparent fashion[96]. The transparency factor is something that is considered in more depth in the next section as it is mainly in reference to how the actors carry out the proceedings. It had contributed to the downfall of receivership as it was not a requirement for administrative receivers to make clear exactly how the decisions were made. The secrecy only increased suspicions, particularly amongst unsecured creditors, regarding the affairs of distressed companies, secured creditors and IPs. The process had reached a stage where it did not matter what was the eventual result of the company or the outcome this had on the unsecured creditors or other stakeholders.

It was necessary for reform to occur so that the option of rescuing distressed companies was kept alive. It was important to get the message across that liquidation should be the last option and that salvaging financially distressed companies, when possible, should be the norm. A change to allow this and ensure receivership was overlooked was if the law removed this as an option, and made it mandatory that the creditors' interests should be considered as a whole, rather than just fulfilling the interests of the creditor who had a floating charge[97].

Whilst the report dictated ways in which rescue could be achieved, it merely tried to readdress the imbalance that has existed for so long between rescue and liquidation. It is worth examining in greater detail the Report by the Review group which scrutinised the

[94] Executive summary, para 2.12
[95] Executive summary, para 2.12
[96] Executive summary, para 2.12
[97] The real question is whether administration is better than receivership at saving businesses? This will for some time remain a moot point. See R. Calnan, 'The Insolvency White Paper 2011: Substance or Procedure?', 10 *JIBFL*, (2001), 449, at 450.

problems with the Insolvency Act 1986 and why they believed that amendments contained within the Enterprise Act 2002 represented the best way forward.

**5. The Report by the Review Group: A Review of Company Rescue and Business Reconstruction Mechanisms**[98]

It is interesting to note the foreword of the report, which contains a statement composed by the Chancellor of the Exchequer and the Secretary of State for Trade and Industry, stating that the aim of the research is:

To review aspects of company insolvency law and practice in the United Kingdom and elsewhere relating to the opportunities, and the means by which, businesses can resolve short to medium term financial difficulties, so as to preserve maximum economic value; and to make recommendations[99].

The interesting aspect of this aim is the need to identify all the possibilities that can help lead to resolving a company's problems. As long as the economic value is preserved at a reasonable rate it does leave scope for the method which is to be applied to reach that goal. It poses the question whether retaining the economic value is more important than other factors such as ensuring that transparency within the process is employed. The findings of the report led it to believe that corporate rescue was not efficient and needed further development to address the unbalanced rights that existed between secured and unsecured creditors. Having identified the issues, the report conceded that in some cases the rescue of a business through administrative receivership could provide a better result than other procedures[100]. In truth the lack of empirical research in this area would make any statement suggesting whether one method was better than another open to criticism. But this does not dismiss the fact that urgent reform was not necessarily aimed at providing the better option in financial terms, but rather making the process fairer and more transparent.

Insolvency law attempts to embark on an ambitious project to somehow merge private rights, which supports the freedom of contract, and the collective approach. Whether they can be

[98] Department of Trade and Industry, *'A Review of Company Rescue and Business Reconstruction Mechanisms: A Report by the Review Group'*, Insolvency Service, (2000)
[99] Department of Trade and Industry, *'A Review of Company Rescue and Business Reconstruction Mechanisms: A Report by the Review Group'*, Insolvency Service, (2000), at 5.
[100] Department of Trade and Industry, *'A Review of Company Rescue and Business Reconstruction Mechanisms: A Report by the Review Group'*, Insolvency Service, (2000), at para 19.

merged is open to debate. Corporate insolvency law provides a mechanism to deal with situations where the company is having financial trouble. This will usually translate to meaning that not all of its contractual or legal obligations have been or can be fulfilled. Whilst contracts can be entered to protect interests and be enforced by private parties when necessary, there has been a steady wave of support growing to consider other parties which may have not be so fortunate to have such security[101].

Research compiled on this matter by the Insolvency Service has resulted in a new approach. It concludes that the pursuit of individual interests has been shown to increase the likelihood that equal distribution of wealth amongst creditors will fail[102]. It should be appreciated that whilst characteristically corporate rescue can be construed as a collective mechanism based on one of the fundamental principles, namely pari passu, it is subject to the creation of class or classes of preferential creditors[103]. These classes are reflective of, and responsive to, social objectives. The extent that relevant social norms override the more traditional considerations is open to debate, but the primary objective of corporate rescue is in no doubt – to facilitate the survival of the company and its business in order to maximise the value of the available assets[104]. This in theory should provide the best option for all creditors, but it is subject to the possibility that some interests can be enforced outside of such proceedings[105]. Nevertheless the emphasis is strongly on the disposal of inefficient companies that are no longer economically viable, and refraining from providing debtors with a permanent blanket of protection against creditors. Only a temporary stay can be given for the purposes of enhancing a rescue plan by giving a company the necessary and crucial breathing space to facilitate a plan[106].

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[101] It should be noted despite the perception that most will act only in their own self interests, in general it has been observed that people will behave in a cooperative fashion over time even if it appears contrary to their short-run interest, see generally R. Axelrod, *The Evolution of Cooperation*, (New York: Basic Books, 1984).

[102] Department of Trade and Industry, *'A Review of Company Rescue and Business Reconstruction Mechanisms: A Report by the Review Group'*, Insolvency Service, (2000), at para 23.

[103] Described as a communication issue and who would be preferred within a given situation, see V. Finch, 'Corporate rescue: who is interested?', *Journal of Business Law'*, (2012), 190, at 205.

[104] As set out in para.3 of IA 1986 Sch.B1 (which include rescuing the company)

[105] These are schemes of arrangement under s.895 of the Companies Act 2006 and Company Voluntary Arrangements (CVAs) as provided for in Pt 1 and Sch.A1 to the Insolvency Act 1986.

[106] The moratorium is initially lasts for a maximum period of 28 days and during this time meetings of the company and creditors must be held to consider the restructuring proposal. There is room to extend this period but the majority of creditors must agree subject to an absolute time limit of two months from the date on which the meetings are first held, see Insolvency Act Sch.A1 para 32. See generally G. McCormack, 'Rescuing small Business: Designing an 'Efficient' Legal Regime', *JBL*, (2009), 299, at 303.

But are these aids genuinely helping companies address the issues or is it merely delaying the inevitable? It was observed in Chapter Two, how a Darwinian approach has been taken with distressed companies. Competitive companies will prevail at the expense of weaker competitors. Companies are complex entities whereby legal principles alone cannot govern corporate rescue; socio-economic variables must also be considered[107]. This will be explored in the next section in conjunction with the discretion that is afforded to IPs who administer corporate rescue to analyse how rescue strategies operate in practice.

The Review Group noted that the use of administration had moved away from the intended purpose set out in the Cork report, from filing a gap that existed where no creditor had a floating charge, to becoming a mechanism that provided an efficient means of managing the affairs of an insolvent company[108]. In some ways it highlights a willingness to seize opportunities that coincide with the reality of what an insolvent company required. Essentially it has to be remembered that the people who operate in finance and business are opportunists who predominately understand risk, and that salvaging something, which can be guaranteed, is better than running the unnecessary risk to gain more at further financial expense[109]. This position was supported by some research contained within the Review Group, which shows that a growing preference for administration was evident even when there was a floating charge holder who could have invoked his right to opt for an administrative receivership[110]. However this was conditional on the banks approving the appointed administrator. This request has ensured that certain individual administrators are chosen by floating chargeholders with knowledge of how they tend to operate, which usually would mean that they are former receivers who tend to generally act in favour of the banks. It would seem that the strongest/ influential creditor(s) will always seek a way to gain an

[107] Contained within the meaning of “rescue culture”’ the socio-economic tag is understood to include the welfare of the country, the region, the town, the unit. Those entities are made up of persons (human or artificial), whose activities, products and services make up our national wealth. The destruction or the disablement of any part of those potentially wealth-producing activities may, and often must, impoverish the nation as a whole and many, possibly all, of its citizens. See M. Hunter, ‘The Nature and Functions of a Rescue Culture’, *Journal of Business Law*, (1999), at 491, 499.
[108] Department of Trade and Industry, *‘A Review of Company Rescue and Business Reconstruction Mechanisms: A Report by the Review Group’*, Insolvency Service, (2000), at para 70.
[109] Understanding risk involves assessing complex data that requires training, it should not be approached lightly and may require external expertise, see M. Sweeney-Baird, ‘The Role of the Non-Executive in Modern Corporate Governance’, *Company Lawyer*, (2006), 67, at 80. In addition it should be noted that even a majority decision taken honestly can involve poor strategies that are harmful to companies, see R. Harry, *Source Book of Company Law*, (Bristol: Jordans, 1995), at 530.
[110] Department of Trade and Industry, *‘A Review of Company Rescue and Business Reconstruction Mechanisms: A Report by the Review Group’*, Insolvency Service, (2000), at para 71.

advantageous position at the cost of other interested parties and it is perhaps in accepting this behaviour that makes it paramount to corporate rescue that reform is implemented.

**6. Evaluation of the Enterprise Act 2002 – The Way Forward?**

After many years of debate, deciding which direction corporate insolvency policy should take, the efforts finally took shape in the form of the Enterprise Act 2002[111]. There is no need to repeat aspects already mentioned in Chapter Two; instead a few points are worth mentioning. The Act allowed for four main options: administration, administrative receivership, compulsory liquidation, and voluntary liquidation. The first two options potentially allow for the rescue of a company or the business, whilst the latter two options do not. The second option, due to the concerns raised above has effectively been terminated as a choice, unless the charge was created before the 15th September 2003 or is covered by certain exceptions. The prevailing policy therefore represents the favoured way for dealing with a distressed company[112]. The circumstances cover a company that is facing severe cash-flow pressure but still has a good business model to preserve; in situations where it has been identified that there is a requirement to sell on the business of a technically insolvent company; and where the creditors are not willing to agree to an alternative course of action (such as restructuring) or agreement is not possible within a manageable timescale[113].

It follows that if administration is the tool to be used to rescue a company the role of the IPs becomes critical[114]. It became apparent that for these professionals to implement the necessary measures to help a company as a whole, an instrument was required to increase the chance of these rescues. To this end a "protective cloak" known as a moratorium, which comes into place when an administration commences is granted is absolutely crucial to the idea of rescue[115]. It is a shrewd device that prevents anyone presenting a petition to wind up

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[111] See generally P. Okoli, 'Rescue Culture in the United Kingdom: Realities and the need for a Delicate Balancing Act', *International Company and Commercial Law Review*, (2012), 61.

[112] See generally I. F. Fletcher, 'UK Corporate Rescue: Recent Developments - Changes to Administrative Receivership, Administration, and Company Voluntary Arrangements - The Insolvency Act 2000, the White Paper 2001, and the Enterprise Act 2002, *E.B.O.R.*, (2004), 120. S. Frisby, 'In Search of a Rescue Regime: The Enterprise Act 2002', *67 Modern Law Review*, (2004), 247. S. Rajani, The Enterprise Act 2002: Outline of Changes to Insolvency Law', *Insolvency Law and Practice*, (2003), 160.

[113] See L. Conway, *'Administration – Corporate Insolvency'*, House of Commons, (15/12/08), http://www.parliament.uk/briefingpapers/commons/lib/research/briefings/snha-04915.pdf (accessed 11th May 2011)

[114] See J. Black, 'Enrolling Actors in regulatory Processes: The Example of UK Financial Service Regulation', *Public Law*, (2003), 62.

[115] See s.895 of the Companies Act 2006 and Company Voluntary Arrangements (CVAs) as provided for in Pt 1 and Sch.A1 to the Insolvency Act 1986.

the company, prevents any creditor from enforcing security over the company's property or to repossess good in the company's possession under any sale or hire agreement, and no other proceedings, execution or legal process may be commenced or continued and no distress many be levied against the company or its property[116]. The moratorium is a clear example of how the policy makers have accepted that other interests should be considered, not just the creditors and that these other rights should be protected[117]. The fact remains that the window of opportunity to rescue a company is short and efficient methods need to be employed to enhance the likelihood of it occurring.

As far as the outcome of administration there are a few options that are worth mentioning. If the company is to be rescued then it may: enter into a Company Voluntary Arrangement (CVA); a formal scheme of arrangement under the Companies Act; or an informal arrangement. Also administration could lead onto the company entering a Creditors' Voluntary Liquidation (CVL), or being dissolved[118]. As it is to be seen the choice and alternatives offer wide scope, each with a very different objective. In some senses administration makes rescue a very appealing and credible option, whilst in others, as it will be seen in the next section, provides too much discretion to the IPs to conduct the affairs of the company as they please. This presents difficulties not only with concerns regarding the lack of accountability and transparency within corporate insolvency proceedings but also whether the actions sanctioned by the IP are within the boundaries of the law. The result of this, and the pressures faced by IPs to maintain value – both for creditors and in some respects prospective purchasers trying to restart a business - has partially led to a practice known as "pre-packed administration". This will be discussed in Chapter Five, but there are serious concerns whether this can be endorsed as a legitimate option for rescuing a company and whether given the characteristics evident within its scope it can be correctly associated with rescue when placed within the legal template devised by policy makers in the UK.

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[116] See L. Conway, *'Administration – Corporate Insolvency'*, House of Commons, (15/12/08), http://www.parliament.uk/briefingpapers/commons/lib/research/briefings/snha-04915.pdf (accessed 11th May 2011).

[117] See Insolvency Act 1986, paras 3(2), 49, 51-57)

[118] For a discussion on the importance of CVA in the post 2004 rescue culture brew see J. Tribe, 'Company Voluntary Arrangements and Rescue: a New Hope and a Tudor Orthodoxy', *JBL*, (2009), 454. For other options such as CVL see G. Todd, 'Administration post Enterprise Act – what are the Options for Exits?', *Insolvency Intelligence*, (2006), 17.

## 7. The Role of Directors in Corporate Rescue

It is imperative to understand that whilst IPs administer insolvency procedures and are responsible in some respects for interpreting the legislation, the actions of a director determine the viability of any rescue attempt[119]. When a distressed company comes to the attention of an IP, the financial state of a company's affairs is predominately reliant on the director's behaviour after it is verified that the company is in trouble[120]. There are a number of provisions that govern and encourage directors to act in a certain way; either by providing professional support to aid the company in distress or insinuating that misbehaviour, which contributes to the woes of the company, can attract serious repercussions. If this delicate balance is not observed it will be detrimental to promoting an entrepreneurial environment where calculated risks are encouraged to increase the number of people starting up businesses[121]. In essence there is a continuous need to inject business growth into the economy, whilst at the same time ensuring that there are sufficient safeguards and regulations in place to protect creditors and provide a guarantee that an insolvent company is processed efficiently to limit the possible damage that it could inflict on the wider community. With an emphasis on early intervention and taking pre-emptive measures to avert potential danger[122], the focus retains an element of acute business awareness with the ability to manage risk effectively[123]. But even if this diversification of risk was successfully negotiated, it is not feasible for some industries that must decide to either take further risk or perish[124]. It is within

[119] The board of directors is responsible for forging, reviewing and overseeing the implementation of corporate strategy and risk policy. It is imperative that they have the skill and experience to meet the needs of the business. However, the recent global financial troubles have revealed a startling lack of management practices, defective due diligence and imprudent business judgment. In some cases no strategies to identify and effectively deal with risk, see G. Kirkpatrick, 'The Corporate Governance Lessons from the Financial Crisis', *Financial Market Trends*, (2009), at http://www.oecd.org/dataoecd/32/1/42229620.pdf (Accessed 12th October 2010)

[120] See R. Parry, *Corporate Rescue*, (London: Sweet & Maxwell, 2008), at 14.

[121] See generally G. Wilson, 'Business, State and Community: Responsible Risk Takers, New Labour and the Governance of Corporate Business', 27 *Journal of Law and Society*, (2000), 151, at 161.

[122] This represents a fundamental philosophical change, moving away form on ex post responses to corporate crises to influencing ways which corporate actors manage insolvency risks ex ante, see V. Finch, 'Corporate Rescue Processes: The Search for Quality and the Capacity to Resolve', *Journal of Business Law*, (2010), 502, at 506.

[123] By diversifying risks/interests it can be seen that each debt is only a reflection of a small rather than a large exposure with the impact of default felt only slightly, see C. Cheffins, *Company Law: Theory, structure and Operation*, (Oxford: Clarendon Press, 1997), at 3. However some commentators have argued that this idea is not sustainable on a general level; see F. H. Easterbrook and D. R. Fischel, 'Limited liability and the Corporation', *52 University of Chicago Law Review*, (1985), 89, at 101.

[124] M. Whincop, 'Taking the Corporate Contract More Seriously: The Economic Cases Against, and a Transaction Cost Rationale For, the Insolvent Trading Provisions', *5 Griffith Law Review*, (1996), at 23.

these fundamental decisions that directors are assessed and hence it is critical to investigate how they operate in these circumstances[125].

Whilst there is a stigma associated with failure, the law in the UK allows directors to restructure without generating too much negative publicity[126]. The understanding is that directors will not attract criticism or be subjected to any civil or criminal action, if the company were to end up in liquidation, if it can be substantiated that "they took every step with a view of minimising the potential loss to the company's creditors as...he ought to have taken"[127]. Exactly what this "every step" means requires further analysis. In terms of how influential directors can be on the potential success of any rescue proceedings, there is a general expectation that they should not only be able to identify any threats to the company's well-being but also, if required, to take all the necessary proactive steps to ensure that the correct professional help is sought at the earliest opportunity[128]. This is not to say that directors' are prohibited from attempting to trade the company out of its difficulties; they must simply not endeavour to indulge in these actions to any degree if they had assessed the situation and concluded that there was no reasonable prospect that the company was going to avoid going into insolvency liquidation[129]. The difficulty with maintaining this position is that even if the director had acted in what would be generally described as diligent and in a manner that was consistent with what would be deemed as reasonable, this can only be determined by the court after they have deliberated over the actions taken in conjunction with

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[125] There has been growing public and media concern about directors' performance and the failure of systems of governance that rely on directors monitoring each other; See generally, A. Belcher, 'What makes a Director Fit? An Analysis of the Workings of Section 17 of the Company Directors Disqualification Act 1986', *Edinburgh Law Review*, (2012).

[126] S. Parbery, 'Loosen Rules to Save Firms', *The Australian Financial Review (Sydney)*, (8 August 2008), at 55. The standard expected from directors is expected to be a high one and the courts will no longer refrain from making imposing long periods of disqualification. The purpose of these proceedings is not penal, but to ensure that the public are protected against those directors of insolvent companies who have shown that they are a danger to creditors and others. See G. Lightman, 'Attitudes and Values: Developments in Insolvency Law: Part 1', *Insolvency Intelligence*, (2001), 57, at 60.

[127] Insolvency Act 1986, s. 214(3).

[128] See J. Armour and S. Frisby', Rethinking Receiverships', 20 *Oxford Journal of Legal Studies*, (2001), at 94. However, despite the authors caution due to the lack of qualitative data on this issue The Royal Bank of Scotland's specialised Lending Service Division which focuses on restructuring, rescue and intensive care claim that any at one time more than 1000 companies are in the unit's care and they manage to turnaround 80% of businesses back to good health (Financial Times, 31 January 2005, 24) http://www.ft.com/cms/s/0/410a1b4e-732f-11d9-86a0-00000e2511c8.html#axzz1NqCCm2n8 (accessed 30th May 2011).

[129] Insolvency Act 1986, s. 214(2)(b). Directors' must also ensure that a company does not incur more credit when it was apparent that the distress was irreparable, see *Re Austinsuite Furniture Ltd* [1992] B.C.L.C. 1047; and *Secretary of State v Tjolle* [1998] 1 *B.C.L.C.*, 333.

the threat posed to see whether the actions were sufficient[130]. This vagueness[131] has caused considerable confusion and has caused frustration amongst directors. They face growing concerns in trying to ascertain whether they are operating within the legal boundaries when they are trying to save the company, and determining when the correct time to ask for help is[132]. But it should be noted that those who continue to trade without seeking professional advice are at risk of being disqualified from acting as a director in the future[133]. Despite these concerns it must be said that whilst the existence of pure rescue is doubted, these principles along with some good luck have ensured that UK regime has partially delivered in providing a rescue model that fundamentally resembles rehabilitation.

**8. Summary**

Historically the corporate rescue policy in the UK has followed a CBT approach, which has developed to reflect more of a socio-economic stance. The UK could now be described as having a communitarian rescue model, which follows a traditionalist philosophy. The rescue idea has evolved from automatically liquidating distressed companies to focusing on the preservation of companies. The exact nature of rescue and what it should entail remains in dispute. Assistance on the matter can be found within Schedule B1, para 3(1) of the IA 1986, but questions are raised as to whether rescue should simply be reserved for the pure rescue of companies rather than the preservation of viable businesses. If this is the case then pure rescue as company rescue should be defined, is a very rare occurrence and as such would go some way in providing some justification to suggest that the idea of rescue is theoretical and severely lacks any real ability to be applied or have any practical application. The fact that many companies appear to be systematically selected for a rescue strategy only to be subjected to a laborious process that leads to liquidation provides further ammunition to imply that the notion of rescue is merely a temporary state that reveals its true identity as the new liquidation process. The eight principles aimed at promoting the integrity and effectiveness of a rescue model provide a steady framework where a proposed rescue model

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[130] It has also been referred to the 'moment of truth' test, see I. Fletcher, *The Law of Insolvency*, 4th edn, (London: Sweet & Maxwell, 2009), at 859.

[131] A. Keay and M. Murray, 'Making Company Directors Liable: A Comparative Analysis of Wrongful Trading in the United Kingdom and Insolvent Trading in Australia', 14 *International Insolvency Review*, (2005), 27, at 45.

[132] However, there are some commentators who suggest that the test is too easily satisfied as all directors have to do to avoid liability is to show that there was some reasonable prospect of the company avoiding liquidation, see S. Sharples, 'Directors Defence for Insolvent Trading Posed', *Lawyers Weekly (Sydney)*, 21 July 2009, at 6.

[133] Or liable to pay sums by reason of wrongful trading. For further reading see A. Keay, *Company Directors' Responsibilities to Creditors*, (Abingdon: Routledge-Cavendish, 2007).

can be quality checked on its substance and procedure to reveal whether it would be compatible with the cultural and economic aspects of the jurisdiction in question. Despite the changes contained within the Enterprise Act 2002, such as reiterating the importance on taking pre-emptive measures to tackle and counter financial distress, risk management even if monitored does not prevent the failure and it is only with the help from insolvency specialists that the extent of the situation can be determined. With a new emphasis on IPs to assess the situation and to consider the interests of the creditors as a whole, it is now seen that collective proceedings is a deliberate move away from the individual pursuit of interests as was seen under receivership.

The amendments in the EA intended to enhance the reputation of insolvency law, but many aspects of the old law remained. The actions of directors continue to heavily influence the outcome as to whether rescue would be ultimately successful as the extent of the financial distress largely depends upon how proactive the management have been in documenting and reporting the problems in addition to its ability to provide accurate and updated information when required by an IP. This, along with securing finance to aid a rescue attempt, particularly the ability to negotiate a debt-subordination scheme, proves critical and will not always be successful. Despite these concerns, the main factor that has contributed to the questioning of the existence and efficiency of rescue has been the involvement of the IPs and the wide discretion that they have been afforded under the relevant codes endorsed by respective regulatory bodies and the principles contained with the corporate insolvency legislation.

The increasing difficulty in dealing with a distressed company in light of dire economic conditions has contributed to alternative corporate rescue routes being sought. Pre-packed administrations despite proving highly controversial seems to have found some acceptance within the market as its usage is on the increase. However, before this is explored the role of the IP and the duties that they have within a rescue strategy needs to be examined.

## Part II

## Insolvency Practitioners: Function, Conduct and Abuses

### 1. Background

The previous section dealt with the policies surrounding corporate rescue, and this section will examine the actors that are charged with carrying out insolvency proceedings, and, in particular, the corporate rescue process. These professionals, known as Insolvency

Practitioners' (IPs) are the office-bearers in administration who have been assigned the duty to decide the best course of action in dealing with a distressed company[134]. It should be made clear that there is a definite distinction to be made between turnaround specialists and IPs with the former not being subject to any mandatory regime of training, experience or qualification and they do not have to comply with a system of accreditation[135]. The decision made by IPs in relation to the work that they implement can be multi-dimensional. They are influenced by a number of factors, including individual and team experience, technical knowledge, availability of accurate company audit reports in order to determine the extent of the distress, and what action would result in achieving the most beneficial outcome for the creditors as a whole[136]. Beside these personal attributes they are also under an obligation to adhere to the hierarchy of objectives set out in legislation for administration. The primary focus is on rescuing the company as a going concern, but achieving this is a delicate and problematic task given the nature of corporate rescue proceedings and it is inevitable that difficult decisions will have to be made, leaving some interested parties dissatisfied with the outcome[137]. It is often the case that unrealistic expectations are placed on the IP to deliver a better result than is possible. He or she must disregard any external influences and examine each case on its own individual merits, drawing on his or her, and that of his or her team's experience to make sure that informed, financially sound decisions are made[138].

This section seeks to examine the role that IPs have played in corporate rescue and to demonstrate how they have steadily evolved corporate rescue proceedings into something that could be described as non-reflective of the policy values dictated in the previous section. It is submitted that a new mechanism has been developed, which is strictly not a corporate rescue procedure at all, but a solution adopted as a pragmatic response to address the needs of businesses in a weakened economy. This procedure commonly referred to as pre-packed

[134] In corporate insolvency, IPs are invariably installed as agents of the company (for confirmation of this with regard to administrative receivers and administrators see for example Insolvency Act 1986 s. 44(1)(a) and Sch.B1 para 69). Significant modern authorities confirming this position in the case of receivers include *Mills v Birchall* [2008] EWCA Civ 385; [2008] B.C.C. 471.

[135] V. Finch, 'Doctoring in the Shadows of Insolvency', *Journal of Business Law*, (2005), 690, at 696.

[136] See S. Frith and S. Davies, 'Clearing up the Mess: Applying the Basic Principles of insolvency Law – A Review of cases Decided in 2008 on the Theme of Administrations - Part 1', *Insolvency Intelligence*, (2009), 117, at 117.

[137] But the extent of a decision being unfair, whether one or a class of creditors were satisfied would depend entirely on the circumstances. See *Revenue and Customs Commissioners v Portsmouth City Football Club Ltd* (In Administration) Chancery Division**,** [2010] EWHC 2013 (Ch), para 41.

[138] For example he must be able to provide valid reasons for his decisions, especially if the company cannot be rescued as a going concern or a better than winding up result cannot be achieved, see IA 1986 Sch.B1 para 49(2)(b). See further V. Finch, 'Control and Co-ordination in Corporate Rescue', 25 *Legal Studies*, (2005), 376.

administrations will be discussed in Chapter Five, where it will be argued that pre-packs signals the beginning of the end to the existence of corporate rescue in the UK.

## 2. Function: Personal Attributes and Qualifications

Prior to the introduction of the rescue culture, there was a level of distrust regarding the competence, suitability and effectiveness of liquidators and receivers[139]. The perception of these office holders by the general public was at an all time low and action designed to change these attitudes was drastically required[140]. The first step taken to address these concerns was to make it a necessity that IPs should be qualified[141] and regulated to reflect modern practices[142]. It was essential that the UK's corporate insolvency laws were overhauled as it became recognised that corporate rescue in the UK may have become something of a misnomer, as many companies that were rescued still ended up in liquidation[143]. What was required was a uniformed approach to corporate rescue that could hold IPs' accountable for their actions as well as keeping them informed of best practice and developments within the field[144].

### 2.1. Membership: Accountants or Lawyers?

The overall membership of the authorised IP club is very small, consisting primarily of a mixture of accountants and solicitors. Whilst both may take insolvency appointments, in reality accountants and the associated firms have a virtual monopoly on such matters[145]. This has had an important impact in the way in which corporate insolvency proceedings had developed at the beginning of the 20th century[146], and it is worth briefly exploring how this has contributed to the current model that exist in the UK today. There has always been some stigma associated with insolvency related work, something which solicitors were already

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[139] *Re Greycaine Ltd.* [1946] Ch. 269 illustrates this well; a commission of 5% had been drawn by the receiver for no more than the receipt and cashing in a cheque for £500,000, in settlement of a war-damage claim.
[140] P. Arnold, C. Cooper and P. Sikka, *'Insolvency, Market Professionalism and the Commodification of Professional Expertise'*, (2003) at 7, see http://aux.zicklin.baruch.cuny.edu/critical/html2/8018arnold.html (accessed 11th June 2011).
[141] Cork Report, Part2, Chapter 15.
[142] IA 1986, part XIII.
[143] See A. Katz and M. Mumford, *'Study of Administration Cases'*. Report to the Insolvency Service, (October 2006).
[144] See further V. Finch, 'Controlling the Insolvency Professionals', *Insolvency Lawyer*, (1999), 228.
[145] Around 40% of the UK's insolvency practitioners operate from major accountancy firms and of these most are implicated in major audit failures and have been the subject of DTI inquiries, see P. Sikka and H. Willmott, 'Illuminating the State-Profession Relationship: Accountants Acting as Department of Trade and Industry Investigators', 6(4) *Critical Perspectives on Accounting*, (1995), pp 341 – 369.
[146] C. Napier and C. Noke, *'Accounting and law: A Historical Overview of an Uneasy Relationship'*, in M. Bromwich and A. Hopwood, *Accounting and the Law*, edn, (London: Prentice Hall, 1992), at 34.

conscious of, given their ambivalent moral and social position[147]. Accountants on the other hand could not afford to turn down such an opportunity, given the slow growth of business despite the introduction of the Joint Stock Companies Act 1844. Despite this apparent reluctance, corporate failure provided a massive fillip to the businesses of some accountants and the related professional bodies[148]. It was not long before the majority of the fees billed by accountancy firms were from the fees they charged on these insolvency related cases[149]. This new found respect was partially through the acceptance that accountants were better placed and qualified than solicitors to deal with insolvency matters as they were "men of business"[150] who apparently acted in the public interest[151].

Within this understanding it appears that IPs have assumed that his/her primary role as accountants is to analyse data, which involves the process of inspecting, cleaning, transforming, and modelling data with the goal of highlighting useful information, suggesting conclusions, and supporting decision making based on these findings. In other words statistical analysis becomes the overriding factor effectively relegating legal considerations to afterthought. This approach has had a fundamental impact in helping to shape the profession's work ethics[152]. However, assessing exactly what should be expected from an IP should be approached with caution[153]. There seems to now be a growing reliance on the IP's creative problem solving skills, and this is particularly evident where there is a regulatory void not addressed by legislation[154]. In cases where the legislation is clear, actions taken by an IP such as taking over the day-to-day control and management of the company, as well as the continuous task of formulating proposals to rescue the company should not be viewed in a negative way but seen as positive obligations designed to help distressed companies[155]. The

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[147] W. R. Prest, *'Introduction'*, in W. Prest, *Lawyers in Early Modern Europe and America*, edn, (London: Croom Holm, 1981).
[148] See P. Arnold, C. Cooper and P. Sikka, *'Insolvency, Market Professionalism and the Commodification of Professional Expertise'*, (2003) at 9-12, see http://aux.zicklin.baruch.cuny.edu/critical/html2/8018arnold.html (accessed 11th June 2011).
[149] See E. Jones, *Accountancy and the British Economy 1840-1980: The Evolution of Ernst and Whinney*, (London: B. T. Batsford Ltd, 1981).
[150] Certified Accountants' Journal, 'Are lawyers Business Men?', *Certified Accountants' Journal*, (1910), No37, 105-107, at 105.
[151] W. N. Bubb, 'The Accountant and the Community', *Accountancy*, (1939), 456, at 456.
[152] See J. Flood and E. Skordaki, *'Insolvency Practitioners and Big Corporate Insolvencies'*, ACCA: Research Project 43, (1995), at 6, whereby it is suggested that an IP's role is dual purpose, with the majority accepting that their administrative role is secondary to their primary identification as accountants.
[153] Not all attempted rescues can be expected to succeed, see H. Anderson, 'Insolvent Insolvencies', 17(3) *Insolvency Law and Practice*, (2001), at 87.
[154] J. Flood and E. Skordaki, *'Insolvency Practitioners and Big Corporate Insolvencies'*, ACCA: Research Project 43, (1995), at p iii. It is on this premise that pre-packs developed, see Chapter Five.
[155] For example see Insolvency Act 1986, s. 144.

intervention by IPs should be seen as not only necessary but a legal requirement to assess what has happened, the extent of the distress, whether any wrongdoing has been committed, and what can be done to rectify the identified issues. As such the mere presence of IPs should not indicate or prompt a reaction from creditors that a rescue strategy can be achieved; they are not miracle worker and there are countless documented interviews which suggest that the life of an IP is anything but an undemanding job[156]. That despite the very long hours that the work demands, often involving working closely with those affected, they are expected to detach themselves from the suffering of those associated with the company. But any notion portraying these professionals as irrational, illogical and distant from the "inner experience of people"[157] is not a truthful account. Decisions involving the wider implications that will inevitably have an effect on businesses reliant on the core company and the workforce are issues that invariably weigh heavily on IPs' shoulders and should be considered and not ignored even if they are eventually dismissed.

With the responsibility to determine the fate of a company, there are questions raised regarding the suitability of these professionals to identify and deal with all of the issues that may be presented in a distressed company. Simply being an accountant who only bases conclusions on statistical data is no longer enough. Wider issues such as the ability to interpret legal provisions and possessing the necessary interpersonal skills to manage the affairs of all parties involved demonstrates the need for a high level of skill to be expected of the IP and this is demonstrated in the qualifications that are now required of people wanting to work in this profession[158].

### 2.2. Qualifications

The critical qualification that an individual must pass before he/she can carry out any insolvency related work is the Joint Examination Insolvency Board (JIEB)[159]. The JIEB exam is a practical exam that tests the knowledge and skills that IPs will rely upon whilst

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[156] Several interviews with IPs reveals a world of sleepless nights, hard drinking and heart attacks, see J. Flood and E. Skordaki, '*Insolvency Practitioners and Big Corporate Insolvencies'*, ACCA: Research Project 43, (London: ACCA, 1995) at 24-25.
[157] R. Hines, 'Accounting: Filling the Negative Space', 17 *Accounting, Organisations and Society*, (1992), at 313.
[158] However the bulk of those who work within this field remain accountants, see generally see J. Flood and E. Skordaki, '*Insolvency Practitioners and Big Corporate Insolvencies'*, ACCA: Research Project 43, (London: ACCA, 1995)
[159] For more information see: http://www.icaew.com/en/technical/insolvency/qualifying-as-an-insolvency-practitioner (accessed 8th March 2011).

completing his or her work. Whilst the professional paper provides for a comprehensive knowledge of insolvency-related matters to be gained, the exam remains technical and there are concerns that IPs are not fully prepared for the intensity and the human dimension of the tasks ahead.

Additionally it is important to note that the technical aspect of the qualifications should not be confused with the professional status that they enjoy as a result of his/her occupation[160]. An IP must not only pass the relevant qualifications, he/she must also be a member of one of the professional bodies. Therefore an IP is someone who is licensed and authorised to act in relation to an insolvent individual, partnership or company, and is regulated by one of the Recognised Professional Bodies (RPB) to ensure that he or she is, in a sense, supervised, and acts within the law[161].

### 2.3. An Overview of the Rescue Objectives

Paragraph 3, Schedule B1[162], provides that the objectives that an IP should consider in the performance of his/her functions. They are:

- Company rescue (as a going concern) is primary.

- If that is not possible (or if the second objective would clearly be better for the creditors as a whole), then the administrator should try to achieve a better result for the creditors than would be obtained through an immediate winding-up of the company

- Only if neither of these objectives is possible should the administrator realise property to make a distribution to secured and/or preferential creditors.

Collectively the changes made by the Enterprise Act 2002 represent a move towards embracing Cork's vision of including early rescue efforts[163], and a slight move towards

[160] T. Jones, 'Understanding Management Accountants: the rationality of Social Action', *Critical Perspectives in Accountancy*, (1992), 225, at 230.
[161] There are seven bodies: Institute of Chartered Accountants in England & Wales (ICAEW); Insolvency Practitioners Association (IPA); Law Society of England & Wales; Institute of Chartered Accountants of Scotland (ICAS); Association of Chartered Certified Accountants (ACCA); Institute of Chartered Accountants in Ireland (ICAI); Law Society of Scotland.
[162] Insolvency Act 1986.

Chapter 11 found in the US Bankruptcy Code[164]. Given the importance of these three objectives it is worth exploring them in greater detail to determine how the contents within each have been interpreted and what issues, if any, have arisen for each.

### 2.3.1. Company Rescue: Paragraph 3(1)

Of the three objectives the meaning behind ‘rescuing the company as a going concern’ demonstrates how technical the matter has become. In the process of deciphering this term comparisons can be made to the former s. 8(3)(a) which referred to “the survival of the company, and the whole or any part of its undertaking, as a going concern”[165]. It is understood that the wording employed in paragraph 3(1)(a) should be construed as having the same meaning as that of the former s. 8(3)(a) as interpreted in *Re Rowbotham Baxter Ltd*[166]. Support for this can also be found in para 647 of the DTI’s Explanatory Notes which indicates that the objective of rescuing the company as a going concern “is intended to mean the company and as much of its business”[167]. The threshold of what constitutes “much of its business” or what percentage is required to satisfy the test is not entirely clear[168]. Nor does the legislative text make the point of distinguishing company and business rescue; in fact it implies that an element of both must be present[169]. It does however explicitly acknowledge that when a company survives intact, but with no subsisting going concern undertaking, this would not fall within the scope of para 3(1)(a) since, in line with para 649 of the DTI’s Explanatory Notes, a proposal resulting in nothing more than a “shell” company does not constitute rescue[170]. Such an outcome would more than likely fall within the ambit of para 3(1)(b)[171].

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[163] Cork Report, para 198.
[164] Chapter 11 is the relevant chapter of the US Bankruptcy Code which provides for reorganisation under the bankruptcy legal regime of the US.
[165] *Re Rowbotham Baxter Ltd* [1990] BCC 113, at 115E-F.
[166] *Re Rowbotham Baxter Ltd* [1990] BCC 113, at 115E-F.
[167] See L. Doyle and A. Keay, *Insolvency Legislation: Annotations and Commentary*, (Jordans: Bristol, 2007), at 622.
[168] However, when considering the prospects of achievement of any of the sub-purposes contained with the three objectives it will be critical to provide evidence for the court to assess, mere assertions are insufficient for substantiating any claims. See for example *Doltable ltd v Lexi Holdings Plc* [2005] EWHC 1804 (Ch); [2006] 1 BCLC 384.
[169] See generally para 3(1)(a)-(c).
[170] L. Doyle and A. Keay, *Insolvency Legislation: Annotations and Commentary*, (Jordans: Bristol, 2007), at 623.
[171] For further notes see L. Doyle and A. Keay, *Insolvency Legislation: Annotations and Commentary*, (Jordans: Bristol, 2007), at 621-624

Assessing the distinction between company and business rescue is a fine one, but should nevertheless be appreciated. The rescue of the company itself will be a rare occurrence. In most cases the process is designed to highlight aspects of the company that are not operating efficiently. When a distressed company is investigated it will be inevitable that some part of the company, hopefully not all, will be discarded to permit the company to attempt to continue as a going concern. This streamlining exercise is more associated with business rescue, not necessarily rescue as intended by schedule B1, para 3(1), but more reflective of a restructuring process.

### 2.3.2. Better result or the Last Resort: Paragraph 3(1)(b) and Paragraph 3(1)(c)

This amended sub-paragraph encapsulates the previous duty on IPs whereby the receiver primarily owed duties to the appointing charge holder. The effect of para 3(1)(b) and 3(2) is that an administrator must perform his functions in the interests of the company's creditors (i.e. unsecured, secured and preferential creditors) as a whole[172]. Amongst the creditors he is required to perform his functions with the interests of unsecured creditors weighing equally with those of preferential and secured creditors. This is a significant step and one by which the new legislation has substantially altered the IP's position as it was (and remains) under the general law governing receivership. The new provision makes it compulsory for the administrator to consider objectives 3(1)(a) and (b) in all cases, even where the level of secured indebtedness exceeds the value of secured assets.

Given the conflict between the interests of secured and unsecured creditors generally where a company is or is likely to become unable to pay its debts it remains a concern whether in "the interests of the company's creditors as a whole", in the context of administration, is sufficient in itself in providing a workable basis for disgruntled unsecured creditors. The most obvious method to mount a challenge would be under para 74, to question the actions or proposed conduct of an administrator, and in particular one appointed by a floating charge holder whose appointee appears disinclined to pursue either of the objectives in para 3(1)(a) and (b) without justification[173].

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[172] Subject to sub-paragraph (4), which provides the administrator the scope to act as he wishes as long as he does not unnecessarily harm the interests of the creditors of the company as a whole.

[173] Despite the fact that administration is seen as attractive, see D. Milman, 'Judicial Reflections in the Administrative Process: a 2010 Perspective', 2 *Co. L.N.*, (2010), 283; it appears that the liberal regime of the EA has promoted a tendency to embrace administration as "an exit route from over indebtedness" without any correlational entrepreneurial effort, see P. Cranston, 'Fearful Silence', 24(2) *Insolv. Int*., (2011), 32. This highlights concerns that the process is still open to abuse, see P. Okoli, 'Rescue Culture in the United Kingdom:

Whilst the IP does not have to provide in great detail his/her intentions he/she is required under, r2.33(2)(m) of the Insolvency Rules 1986 to compile a statement of proposals under para 49(1) containing a statement of how it is envisaged the purpose of administration will be achieved whilst, more specifically, para 49(2)(b) required an explanation to be included within the statement as to why the administrator thinks that the objective in para 3(1)(a) or (b) cannot be achieved. Support for this can be found in the DTI's Explanatory Notes from paras 650 and 651, which envisages the IP reporting to creditors and explaining why the achievement of any particular objective was not reasonably practicable[174].

Balancing interests and ensuring that the sub-purposes are reasonably practicable to achieve that objective are decisions that should be supported by evidence. Ascertaining whether a purpose is reasonably practicable will depend on whether the objective can be achieved. If it is capable of being achieved, but not reasonable to do so as the impact on the creditors in terms of time and costs required to achieve that end then it is incapable of being classed as a justifiable course of action[175]. Whilst in most cases it will be obvious as to what objectives can be reasonably achieved, the administrator, to ensure that they increase the number of options left available, must perform his or her functions as quickly and efficiently as is reasonably practicable[176]. Primary concerns that need to be considered are: to prevent any further reduction of the funds payable to creditors on liquidation; to ensure that the business remained intact so it can continue to operate; or to identify and sell off parts of the business at a reasonable rate to ensure that the creditors receive a better payment than if it was liquidated immediately. The extent that IPs should contemplate the general consequences of the insolvency proceedings in the wider community is a matter that is contested. Nevertheless, there is a growing consensus that despite the wording of para 3(2) that provides the requirement of the administrator to perform his or her functions in the interests of the company's creditors as a whole, socio-economic implications are essential and should be

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Realities and the Need for a Delicate Balancing Act', *International Company and Commercial Law Review*, (2012), at 61, 62.

[174] See L. Doyle and A. Keay, *Insolvency Legislation: Annotations and Commentary*, (Jordans: Bristol, 2007), at 625.

[175] See generally, L. Doyle and A. Keay, *Insolvency Legislation: Annotations and Commentary*, (Jordans: Bristol, 2007), at 626.

[176] See the time constricting provisions contained in paras 76 and 77, Insolvency Act 1986.

considered even if it appears that this is often regarded as optional and can be disregarded in the face of reimbursing creditors[177].

Whether this approach sits well with the other statutory obligations is not entirely convincing, since the ripple effects of an insolvent company can be felt beyond its premises, and affect, especially, the local economy that is reliant on the business it generates. But it must be accepted that by securing capital at the expense of these social implications, whilst it may be detrimental in one instance, may contribute in general to the revenues, and jobs in other companies. It will be seen that the distribution of this available capital by the IP has had a profound effect in shaping the way in which insolvency legislation has developed.

Essentially creditors will have competing interests. Just considering the creditors for one moment, on the one hand there is the creditor wishing to protect and secure his interest, whilst on the other hand there is the creditor wishing to realise her interest. In most cases the two cannot function together, and this has had the effect of transforming the law itself[178]. As previously stated in Chapter Two the language and tests that have been adopted to determine insolvency are the critical factors that need to be assessed. From determining when a company is distressed, the point when a company is insolvent, to the questions surrounding whether a company can continue to trade are not easy to define. This responsibility is placed into the hands of an IP who should assess each case on its individual merits. However, it is more than likely that the assessment will follow a trend, which will confirm a picture of self-contained practices developed by a common approach[179]. This supports moves to further regulate the profession as new challenges have emerged raising questions regarding the assumed objectivity, competence and independence of the IP[180].

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[177] C. Offe, *Disorganised Capitalism*, (Cambridge: Polity Press, 1985), at 191, where it is said that "Even before it begins to put explicit political pressure and demands upon government, capital enjoys a position of indirect control over public affairs".
[178] B. G. Carruthers and T. C. Halliday, *Rescuing Business: The Making of Corporate Bankruptcy Law in England and the United States*, (Oxford, Clarendon Press, 1998).
[179] P. Arnold, C. Cooper and P. Sikka, '*Insolvency, Market Professionalism and the Commodification of Professional Expertise*', (2003) at 6, see http://aux.zicklin.baruch.cuny.edu/critical/html2/8018arnold.html (accessed 11th June 2011).
[180] V. Finch, 'Insolvency Practitioners: The Avenues of Accountability', 8 *Journal of Business Law*, (2012), 645.

### 2.4. Monitoring

Before the extent of the discretion afforded to IPs is explored it is worth reviewing the measures that are in place to monitor the actions that they may take whilst in office. There is a considerable lack of research surrounding the work that is carried out by IPs. This is not through the want of trying. Rather the restrictions are due to the current requirements placed on IPs to record the decisions made. This has not been further helped by the fact that sometimes practitioners may provide a different answer in practice than is dictated by theory[181]. There are obstacles to pursuing a closer examination of IP's conduct, undoubtedly secrecy[182] that surrounds much of his/her work. This has invariably led to questions being raised concerning the fairness, transparency and general compliance with the legislation and relevant regulations[183].

The willingness to self-regulate is supported by the profession, demonstrated by the action to reject the need for an independent ombudsman to investigate and sanction disciplinary action or fines in relation to complaints that are substantiated[184]. The RPBs want to privately deal with the complaint and decide themselves what action should be taken, if any. How exactly these complaints are to be investigated is not covered by any set procedural guidelines; they are not required to respond to complaints within a specified timeframe, nor publicly provide a list of the complaints that they have received and how they were dealt with[185]. It should also be noted that whilst IPs have the right to appeal against a decision of a disciplinary action, the complainant has no such right. This enhances the perception that the regulating bodies are seen to protect their own interests against any possible threat which may bring the profession into disrepute, or lead to a campaign to change the law, which ultimately may risk an overhaul of the practice[186].

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[181] B. G. Carruthers and T. C. Halliday, *Rescuing Business: The Making of Corporate Bankruptcy Law in England and the United States*, (Oxford: Clarendon Press, 1998).
[182] B. Singleton-Green, 'Rare Glimpses of Secretive Creatures', *Accountancy*, (March 2001), at 18.
[183] There remains limited research regarding post 2002 regime in terms of performance levels regarding transparency, accountability or access, something which is required in the near future to fully determine the success of the procedure as well as assessing the outcomes it produces. See V. Finch, 'Corporate rescue Processes: the Search for Quality and the Capacity to Resolve', *JBL*, (2010), 502, at 516.
[184] Insolvency Regulation Working Party, 1997, 1999.
[185] J. Cousins, A. Mitchell, P. Sikka, C. Cooper and P. Arnold, 'Insolvent Abuse: Regulating the Insolvency Industry', *Basildon: Association for Accountancy and Business Affairs*, (2000).
[186] P. Arnold, C. Cooper and P. Sikka, *'Insolvency, Market Professionalism and the Commodification of Professional Expertise'*, (2003), at 7, see http://aux.zicklin.baruch.cuny.edu/critical/html2/8018arnold.html (accessed 11th June 2011).; See also *Lathia v Dronsfield* (1987) BCLC 321 shows that at best insolvency practitioners owe a "duty of care" to the party appointing them i.e. a bank or secured creditor.

Some change however was inevitable given the socio-economic fallout of failed companies spiralling out of control in the early 1970s which led to mass unemployment. This demonstrated that something had to be done with the UK's outdated insolvency system[187]. The government's answer was to apply a private sector solution to "problems" like insolvency[188]. This had important consequences on the regulation of IPs, no longer undertaken by the Official Receivers and the Insolvency Service housed in the Department for Trade and Industry (DTI), but by the respective RPB of IPs, independent of the government[189]. This move was aimed at reforming the procedural inadequacies by making the process more accountable and transparent but additional regulations such as the Code of Ethics were deemed equally necessary to ensure that all IPs met certain professional requirements[190].

It is evident that the regulatory texts are intended to act as guidelines as a breach of these rules by the IP does not automatically give rise to disciplinary action, nor does it have the force of law to lead to any penalty[191]. In essence as long as the IPs' actions can be broadly justified, they may perform his/her functions as they see fit[192].

**3. Opportunity and Professional Fees**

Corporate failure is viewed as a business opportunity for accountancy firms; this forms part of its business plan and will contribute to the expansion, reputation and profit success of any firm. It would seem that results are not particularly as important as securing the business, and so they are content with accepting the likelihood that not all attempted rescues can be expected to succeed[193]. The way in which success is measured within accountancy firms had

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[187] K. Cork & H. Barty-King, *Cork on Cork*, (London: Macmillan, 1988).

[188] T. C. Halliday & B. G. Carruthers, 'The Moral Regulation of Markets: Professions, Privatization and the English Insolvency Act 1986', 21(4) *Accounting, Organisations and Society*, (1996), pp. 371-413.

[189] The DTI now has a regulatory role.

[190] Insolvency legislation has increasingly become all about checks and balances, ensuring that main issues are properly addressed. See J. McQueen, 'Insolvency Law Reform – a Second Chance', *Journal of International Banking Law*, (2002), 85, at 87.

[191] S. Frisby, 'Balancing Interests in Administration: Contributions from the Courts and the Coalface', 24(4) *B.J.I.B. & F.L.* (2009) 198, at 198. However see Statement of Insolvency Practice 16--Pre-Packaged Sales in Administrations (2008), *http://www.icaew.com/en/technical/insolvency/insolvency-regulations-and-standards/statements-of-insolvency-practice-sips-england* (Accessed 4th July 2012).

[192] Justification for their actions is merely a front as in reality there is no opportunity for creditors to claim an independent assessment of the insolvency practitioner's actions, see P. Walton, 'Pre-packin' in the UK', 18 *Int. Insolv. Rev.* (2009), 85, at 92.

[193] This outcome can be further enhanced in situations where the administrators do not have the support of an appointing debenture-holder, see H. Anderson, 'Insolvent Insolvencies', 17(3) *Insolvency Law and Practice*, (2001), 87, at 87.

contributed to the way in which corporate rescues are approached. Like most firms they are audited, assessed and rated according to their performance. The success of firms is measured by a number of factors, including: fees generated, profits, market share and the emphasis is "very firmly on being commercial and on performing services for the customer rather than on being public spirited"[194]. This creates a conflict of interest. The social well-being of the community and state and the benefit of creditors will be secondary to the maximisation of personal gain, as commercially driven targets set by the actors charged with administering the insolvency services takes charge[195]. Whilst there is no doubt that administration will generally be a more expensive option for the company than liquidation, the IP must consider all possibilities[196]. Nevertheless, it is submitted that some businesses may be subject to rescue proceedings, not because this is the most viable option for the company, but rather it is more profitable for accountancy firms than liquidation.

Choosing options based on how profitable they may be is a delicate issue that has not received much attention. The reason for this is partially due to the IPs exercising discretion, but mainly because of the reluctance of the judiciary to interfere with an IP's decision[197]. The courts, with a number of exceptions including concerns regarding professional fees, prefer to leave insolvency related issues for the IPs to decide[198]. The courts consider these professionals to be properly placed to use their commercial awareness to deal with distressed businesses[199]. This reliance does raise questions as to whether this presumption is misplaced and office holders do sometimes act in bad faith. However, establishing this is another matter as almost all actions can be justified, and it is only with hindsight and extensive evidence, that often does not exist, that a decision can be recognised as erroneous.

Examples that have highlighted serious concerns are few and far between but perhaps the most notable case was the collapse of the Maxwell empire where the subsequent report by the

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[194] G. Hanlon, *The Commercialisation of Accountancy*, (London: Macmillian, 1994), at 150.
[195] G. Hanlon, *The Commercialisation of Accountancy*, (London: Macmillian, 1994), at 150.
[196] J. Flood and E. Skordaki, *'Insolvency Practitioners and Big Corporate Insolvencies'*, ACCA: Research Project 43, (1995), at 3.
[197] R. Parry, *Corporate Rescue*, (London: Sweet & Maxwell, 2008), at 102.
[198] In the 1998 Ferris Report on the Remuneration of Office Holders and Certain Related Matters, Judge Ferris decided not to force liquidators and their lawyers to fix their fees in advance as a percentage of assets recovered. Instead he recommended that "value achieved" by the liquidators should be rewarded, rather than just the time recorded. He also recognised that the courts should have regard to several factors including time spent, the complexity of the case, the effectiveness of performance and the value and nature of the property dealt with.
[199] The exception tends to be where is it evident that the administrator has erred in law or are notably unfair to one or more creditors, see *Re CE King Ltd* [2000] 2 B.C.L.C. 297.

Social Security Select Committee, chaired by Frank Field M.P. raised serious concerns about the way in which a number of accountancy and legal firms had performed in sorting out the affairs of the Maxwell Group's shareholders, creditors and pensioners, making particular reference to the cost of the process and the slow rate of progress[200]. However, despite the criticism, especially in overstating the size of the recoveries to increase the professional fees, the RPB, which in this case was the Insolvency Practitioners Association (IPA), found that no wrongdoing had been done to warrant disciplinary action[201]. It has previously been mentioned that a breach does not necessarily mean that any disciplinary action will be taken. Notwithstanding this the issue of fees remains a sensitive issue and the courts have no option but to investigate such matters as to whether any action should be taken[202]. That said, this has not done anything to restore the confidence or reputation of an already distained insolvency system where the conduct of IPs is often frowned upon[203].

But the courts should refrain from making their own observations and judgement about what the law should be; if the legislation is deficient then it is for Parliament to change it and not for the courts to feel inclined to adopt the IP's preconceptions[204]. As the law stands, priority is given to IPs to secure their expenses before the creditors are paid, unless explicitly stated otherwise in the terms of their contract. This process is a development taken from the rules that govern liquidation. Despite this, the press is perhaps responsible for conjuring up the image of "fat cat professionals", labelling IPs' fees as "obscene"[205], but the profession will suggest that this does not reflect the majority of cases[206]. In fact what the IPs imply happens

[200] See Social Security Committee (UK, Social Security Committee, 1993), at 7. See generally G. Lightman, 'Office holder's Charges – Cost Control and Transparency', *Insolvency Intelligence*, (1998), 1, at 3.
[201] *Mirror Group Newspapers plc v Maxwell and Others* [1998] BCC 343, see Mr Justice Ferris.
[202] Following *Mawell* the Statement of Insolvency Practice 9 was revised in 2002. This was then followed by the 2004 Practice Statement of Chief Registrar Baister on *The Fixing and Approval of the Remuneration of Appointees* [2004] B.C.C. 912, the provisions of which are now reproduced in Pt Five of the 2012 *Practice Direction: Insolvency Proceedings* (reported in [2012] B.C.C. 265). The importance of adherence to this standard was confirmed by the Court of Appeal in *Brook v Reed* [2011] EWCA Civ 331; [2012] 1 W.L.R. 419; [2011] B.C.C. 423. Further pro transparency measures were enacted through the Insolvency (Amendment) Rules 2005 (SI 2005/512). When applying these rules the courts do recognise that particularly difficult cases may be more expensive to resolve - see for example *Re Super Aguri F1 Ltd* [2011] B.C.C. 452.
[203] "The success of any insolvency system … is very largely dependent upon those who administer it. If they do not have the confidence and respect, not only of the courts and of creditors and debtors, but also of the general public, then complaints will multiply and, if remedial action is not taken, the system will fall into disrepute and disuse", Cork Report, para 732.
[204] D. Milman, 'Judicial Reflections on the Administration Process: a 2010 Perspective', *Company Law Newsletter*, (2010), at 4.
[205] A. H. Christer, *'The King's New Clothes: An Operational Researcher's look at Corporate Insolvency'*, Inaugural Lecture, University of Salford, (1992), at 29.
[206] Cork Cully, *'Insolvency Practitioners' Fees in Perspective'*, Phoenix, (1992), 15:6.

is that they justify what has been done, and why so many hours are charged,[207] giving a true picture of the task and the extent of the work carried out, and charging accordingly.

In some instances a rescue attempt may be nothing more than the reaction of over-cautious specialists choosing to demonstrate that they have considered the alternative to liquidation and in turn avoid any potential legal action against them if it turns out in hindsight that it was the wrong decision to have been made. The initiation of rescue may be a needless expense, but the fear of making the wrong decision should not be a reason for acting in a particular way as even a company ripe for rescue may afterwards find that it has to be liquidated[208]. Quite simply, making the right decision is difficult, but there will always be an expectation by creditors that the most informed decision will be made.

**4. Discretion and Secrecy**

As already stated there appears to have been a decisive move away from liquidation, to considering rehabilitation. Partially responsible for this was the Enterprise Act 2002, which removed the option for floating charge holders to appoint an administrative receiver[209]. The shift in direction has meant more emphasis placed on averting the dangers of financial distress and with it a new opportunity for IPs to interpret the law[210]. Fundamentally, the Act made it a duty for the IP to consider the interests of the creditors as a whole, but exactly how they are to achieve this and to what extent is within the IP's discretion[211]. This discretion as noted above operates under a veil of secrecy and as such it has attracted calls to make the decision making process more transparent and open[212]. As they are under no direct obligation to provide a full report on what they find, questions are raised regarding the fairness of how these administrations are implemented[213].

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[207] J. Flood and E. Skordaki, *'Insolvency Practitioners and Big Corporate Insolvencies'*, ACCA: Research Project 43, (1995), at 23.

[208] S. Mallinson, 'Banking on a Better Service', *Accountancy Age*, (10 April 2000), at 18.

[209] Applicable only to holders of a floating charge created after 15th September 2003.

[210] It has also been described as a shift from "pathology" to "preventive medicine", see L. Hornan, 'The Changing Face of Insolvency Practice', *International Accountant*, (March, 2005), 24, at 24.

[211] The Enterprise Act 2002, with departing from administrative receivership has changed the focus from serving one interest – the bank, to multiple interests – the creditors. This balancing exercise is a difficult task, which has developed the role of the IP from technician to mediator, see V. Finch, 'The Recasting of Insolvency Law', 68(5) *Modern Law Review*, (2005), 713, at 735.

[212] Particularly if a pre-pack strategy is being proposed. For a discussion regarding the concerns that creditors have in not being informed see *http://www.insolvency-practitioners.org.uk/uploads/PressPublications/16SIP* (Accessed 11th June 2011).

[213] If however the administrator requires guidance as to whether their proposed course is permissible as a matter of law, he may apply for an application for directions where a declaration of the legal position is required. See *Re Lewis's of Leicester Ltd* [1995] B.C.C. 514; *Re T & D Industries Plc* [2000] 1 W.L.R. 646.

It is however possible to imply that this is already in the process of being achieved through this “new voice” that creditors – secured and unsecured alike - have been given in which they can dictate to the IP what they want, and the IP must not only listen, but give heed to the interests when deciding strategy[214]. It has created a commercially driven relationship whereby the client seeks a service providers’ expertise to find the best solution in the circumstances. The transition of the IPs role has gone from being a funeral director, eagerly giving out liquidations to being a fire fighter, doing what he or she can to save the company[215].

Despite the wide discretion, the parameter of this power needs to be put into perspective. It must be made clear that an IP inherits the problems of the company and whilst he/she may not be initially responsible, they can become liable if the issues remain outstanding after the administration ends. However, this predicament is not clear-cut and depends entirely upon what protection the IP has afforded themselves, whether that is under legislation, and, or supported by the terms of his/her employment contact[216]. If there are financial liabilities outstanding at the point of discharge then this will take priority over any floating charge[217]. The issue surrounding super-priority[218] ranking has continued to cause much debate, with some suggesting that the IP has room for discretion and if needs be can include all the prior payments and future ones that would eventually fall within the scope of the statutory discharge[219]. This useful option provides a safeguard for IPs who wish to protect themselves against any future liabilities. Whether they should be afforded such a sweeping right at the expense of other interested parties remains contested; and also it remains a concern that they have been invested with the judgment to settle any liability as they see fit, with possible self-serving factors influencing decisions.

### 4.1. Availability of Information

Determining how decisions are made will usually mean assessing a vast array of information. A single corporate rescue procedure can involve a complex web of multiple transactions occurring at the same time. This may involve interacting with a number of other legal systems; locating a centre of main interests to establish who has the right to commence

[214] Ibid.
[215] The increased awareness of the rescue culture has placed a new emphasis on IPs to avert disaster, see L. Hornan, ‘The Changing Face of Insolvency Practice’, *International Accountant*, (March 2005), 24, at 24.
[216] PAYE is a contractual liability for these purposes: *IRC v Lawrence and Anor* [2001] 1 BCLC 204 (CA).
[217] Insolvency Act 1986, s. 44 (1).
[218] See *Powdrill v Watson* [1995] 2 AC 394 (HL).
[219] *Powdrill v Watson* [1994] ICR 395 (CA)

primary proceedings; determining the price of assets, intellectual property, stock; working out the terms of a lease; whether the company owned any land, buildings; and dealing with issues surrounding the work force – potential redundancies, settling wages and perhaps most critically prevent any theft which would prove detrimental to the overall realisation of funds.

Having accurate, updated information is therefore critical given the intensity of corporate rescue. Occasionally, whether it is oversight or selling, the assets may be sold at a loss, which brings the process into question, especially the legality, policy and ethics of the IP[220]. For now the IP is often able to rebut accusations of misconduct by controlling the flow of information and justifying his/her decision based on the interpretation of the available data. Whilst he/she may have a number of options to chose from: liquidation, administration, and voluntary arrangements, the selection process is entirely reliant on the value that is placed on the data at the time of the IP making that decision. This value is inevitably provided according to what the IP decides and it is a mechanism that allows some flexibility at least by offering three possible outcomes – liquidation, dissolution or rescue. The IP should not feel restricted with the available options, but equipped with the tools to do the job.

### 4.2. Management Displacement

Whatever the option taken, the IP has the full power to trade, dismantle businesses and make decisions on company affairs in the pursuit of his/her ends[221]. It is from the preceding context of possible abuse of administration that a "manager-displacing insolvency regime" seems justifiable and it should be noted that this concept is not peculiar to the UK[222]. The old law governing Germany[223] and the current Australian law project stricter views on the matter, portraying the idea of leaving existing management in charge of an ailing business is like

[220] It is interesting to note that the expectations on IP's are consistent with the values of professionalism, see D. Milman, 'Governance, Stewardship and the Insolvency Practitioner', *Company law Newsletter*, (2012), 1, at 2. The premise for this finds support in *Medforth v Blake* [2000] Ch. 86; [1999] B.C.C. 771 when the Court of Appeal held that Receivers owe a duty not merely to act in good faith but also to take reasonable care. This has been confirmed in *McAteer v Lismore* [2012] NI Ch 7 where it was held by Deeny J. that trustees in bankruptcy owe a duty to take reasonable care to obtain the best possible price in realising assets included in the estate.

[221] Insolvency Act 1986, s. 14 and Sch. B1.

[222] P. Okoli, 'Rescue Culture in the United Kingdom: Realities and the Need for a Delicate Balancing Act', *International Company and Commercial Law Review*, (2012), at 61, 63.

[223] Prior to the recent changes German law dictated that all proceedings begin as a liquidation but can be converted with organisation proceedings. See G. McCormack, 'Control and Corporate Rescue - an Anglo-American Evaluation', 56(3) *I.C.L.Q.* (2007), 523. For an overview on how the German law has changed see F. B. Herding, 'Germany is on the Move: the New Insolvency Law Survives its First Test', 6(3) *Corporate Rescue and Insolvency*, (2013), at 95-98.; F. Tschentscher, 'The Modern German Insolvency Regime: Process, Reform, Financing and Creditor Ranking', 10(3) *International Corporate Rescue*, (2013), at 167-171.

"leaving the fox in charge of a henhouse"[224] As the IP effectively replaces the management of the company as the prime decision maker there are concerns regarding the suitability and the level of quality control in place to ensure that the IP can fairly and efficiently deal with the affairs of a distressed company[225]. However, in most situations an IP rarely has the chance to exercise any management skills, in the real sense of the word, as the "ship has sailed" by the time they are appointed[226]. It is likely that the available options will be restricted by the actions of the managers[227]; in particular the task will be made much harder from the loss of the valuable experience and knowledge that the existing management had to offer. It is for this reason that the action of displacing management has contributed to the stunted growth of a rescue culture as external personnel have to instigate its own conclusions, some of which might not be so obvious from cold print[228]. It is therefore often recommended that the directors should be left in place so the administrator can rely on their advice. If this does not occur, given the amount of time that is often required to determine the true financial position of the company it is frequently the case that the course of direction that the IPs must take the company has already been determined long before they were appointed.

With this in mind, it could be said that a more accurate description of what occurs is not management replacement but an insertion of professional insolvency crisis management[229]; the difference being the former involves an almost passive take over where the IP aims to salvage a position other than liquidation, with the latter referring to a more proactive involvement that is geared towards assessing the extent of the failure and determining what would be the most effective solution. Nevertheless, it is apparent that most of the provisions that govern IPs focus on the exercise of his/her powers as opposed to the performance of their duties[230]. Although results have important repercussions for the local economy, welfare and of course the creditors, the validity of the eventual outcome would be nothing without being implemented in accordance with a set of principles that brings respect to the process.

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[224] G. McCormack, 'Control and Corporate Rescue', 56(3) *I.C.L.Q.* (2007), 523, at 524.
[225] The duties are not too dissimilar to that of a director as he is able to 'step into the shoes of the board and bring actions on behalf of the company', see A. Keay, 'Office-holders and the Duty of Directors to Promote the Success of the Company', *Insolvency Intelligence*, (2010), 129, at 130.
[226] S. Frith and S. Davies, 'Clearing up the Mess: Applying the Basic Principle of Insolvency Law – A Review of Cases Decided in 2008 on the Theme of Administrators – Part 1', *Insolvency Intelligence,* (2009), 117, at 117.
[227] This is taken to mean the board of directors' who previously controlled the company.
[228] P. Okoli, 'Rescue Culture in the United Kingdom: Realities and the Need for a Delicate Balancing Act', *International Company and Commercial Law Review*, (2012), at 61, 63.
[229] See V. Finch, 'The Recasting of Insolvency Law', 68 *Modern Law Review*, (2005), 713.
[230] Insolvency Act 1986, s. 14 (5). See generally H. Anderson, 'Insolvent Insolvencies', 17(3) *Insolvency Law and Practice*, (2001).

## 4.3. Protection

It is suggested that the IP, in order to fully exercise his/her powers, must be afforded some protection and one way to achieve this was to make sure that he/she would not be personally liable on any contract entered into or adopted[231], unless of course this was an explicit term of the contract. There has however been literature to suggest that the role of the IP is not that different from a director of a company, but traditionally it has only been the latter that has been held personally liable in tort, not the former[232]. It would seem that the difference in treatment is a conscious policy decision by the government and the judiciary to maintain confidence in the market and to allow the IP to do the job to the best of his/her ability without the fear of making difficult decisions, which could make them prone to civil action.

## 4.4. Professional Conduct

It was intended that the legislation enacted in the UK would promote a level of professionalism[233] at a time when mass privatisation[234] was occurring. Within this environment however there were real concerns regarding the level of corruption and abuse within insolvency proceedings[235]. To address this matter a way was devised to monitor the conduct of IPs, and as mentioned above the RPBs collectively agreed that the best way forward was to produce a standard set of rules and obligations across the profession that governed the way in which insolvency proceedings are implemented. One such way to achieve this goal was to introduce a number of codes and regulations that the members of the regulatory body had to follow. One such code was the Ethical Code. This has been revised over the years with each refreshed version slightly clarifying rather than modifying the existing guidance[236]. Within the Code there are a number of principles and safeguards that must be upheld and maintained; this responsibility does not just rest on the IP, but they must

[231] *Gregory v Wallace* [1998] IRLR 387 (CA).
[232] *Williams and Anor v Natural Life Health Foods Ltd. and Anor* [1998] 1 WLR 830 (HL); *C Evans and Sons ltd v Spritebrand Ltd. and Anor* [1985] BCLC 105 (CA).
[233] P. Arnold, C. Cooper and P. Sikka, *'Insolvency, Market Professionalism and the Commodification of Professional Expertise'*, (2003), at 19.
[234] Particularly under the Thatcher government in the 1980's.
[235] T. C. Halliday & B. G. Carruthers, 'The Moral Regulation of Markets: Professions, Privatization and the English Insolvency Act 1986', 21(4) *Accounting, Organisations and Society*, (1996), at 371; B. G. Carruthers and T. C. Halliday, *Rescuing Business: The Making of Corporate Bankruptcy Law in England and the United States*, (Oxford: Clarendon Press, 1998).
[236] The Insolvency Ethical Guide was adopted in 2004, and was altered in 2006 to align the ethical principles in line with a model adopted by the International Federation of Accounting Bodies (The IFAC Code). It was subsequently agreed that the Insolvency Ethical Guide should be reviewed and redrafted to align it more closely to the IFAC Code. A draft Code was produced in 2007 by the Joint Insolvency Committee (The JIC) and after various meetings a substantially revised draft of the Code was produced, which brings us to the current 2008 Code of Ethics.

ensure that others in the team are also working within the set parameters. The Code is not intended to be exhaustive; invariably there will be circumstances not covered by the Code and so the emphasis must be on the spirit of the Code rather than the actual wording[237]. Understanding the importance attached to the Code of Ethics[238] will contribute to a greater understanding of how this regulation has given IPs the flexibility to conduct their duties in a fashion best suited to their own personal needs, which does not necessarily mean following a corporate rescue model recognised in the UK.

**5. The Code of Ethics**

The Code specifies five fundamental principles that govern the conduct of an IP: integrity, objectivity, professional competence and care, confidentiality and professional conduct. These principles are not extensive, but are intended to offer general guidance and reassurance that the work undertaken is done so with the highest standards and professionalism[239]. For a more specific area like rescue proceedings it is necessary to consider additional principles and values that should be fostered. The previous chapter covered these aspects in detail and it is something that will be discussed in the next chapter in relation to efficiency, but for ease of exposition it is best to reiterate here. Collectively, it is understood that the substantive aims of rescue are: rescuing viable companies (what this thesis construes as pure rescue); preserving businesses that are viable even if the company is not (what this thesis construes as rehabilitation and therefore not strictly rescue); protecting the rights of creditors and employment and balancing interests fairly (socio-economic interest). It is also accepted that the procedure should be carried out by IPs with reference to a number of key virtues, such as: openness, transparency and accountability, procedural fairness and the basing of decisions on sound evidence and not mere assertions[240]. In addition to these virtues, further assistance can be drawn from government papers, which shed light onto the key aims of corporate rescue. It is when these papers are viewed together with existing legislation that an overall list of objectives can be determined. For the purposes of this section the Insolvency Service's 2009

[237] Insolvency Practitioners Association, *'Insolvency Code of Ethics: Background and Overview'*, (November 2008), para 8.

[238] Insolvency Practitioners' Association, Ethics Code for Members (London: IPA, November 2008). IPs authorised by the Secretary of State are, however, subject to the separate Guidance to Professional Conduct and Ethics (London: Insolvency Service, undated).

[239] It is often assumed that the Code of Ethics lacks teeth, but this is a misconception. The insolvency Service publishes an *Annual Review of Insolvency Practitioner Regulation* detailing the sanctions visited against errant office-holders. See D. Milman, 'Governance, Stewardship and the Insolvency Practitioner', *Company law Newsletter*, (2012), 1, at 2.

[240] See The Insolvency Code of Ethics, November 2008; see also V. Finch, 'Corporate Rescue Processes: The Search for Quality and the Capacity to Resolve', *Journal of Business Law*, (2010), 502, at 511.

consultation, *Encouraging Company Rescue*[241], the Enterprise Act 2002 and the House of Commons Business and Enterprise Committee[242] in 2009 will be used. The list is not intended to be exhaustive, but aims to provide an overview. The objectives that can be derived are[243]:

- Making the United Kingdom the best place in the world to start a business;
- Making the United Kingdom the best place in the world to grow a business;
- Supporting viable companies when they struggle;
- Promoting the rescue of viable businesses;
- Preserving jobs and livelihoods;
- Producing an international competitive insolvency regime;
- Balancing debtor and creditor interests fairly (in procedures and outcomes);
- Balancing different creditors' interests fairly (in procedures and outcomes);
- Producing rescue processes that are transparent and free from abuse[244];
- Making insolvency proceedings collective and inclusive[245];
- Maximising the economic value that is rescued from troubled companies, and providing better returns for creditors;
- Balancing help for distressed companies with the wider effect of the rescue regime on lending for all companies, troubled or not;
- Protecting against the systemic risk that corporate failures will produce 'knock-on' failures that, inter alia, reduce economic performance and tax revenues[246];
- Ensuring that public confidence in the UK insolvency regime and the reputations of its practitioners;
- Minimising the transaction costs that are incurred in rescue processes;
- Making rescue processes as speedy as feasible;

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[241] Insolvency Service, *'Encouraging Company Rescue'*, (London: 2009).
[242] House of Commons Business and Enterprise Committee, The Insolvency Service – Sixth Report of Session 2008-2009, (2009), HC 198, at 11.
[243] See V. Finch, 'Corporate Rescue processes: The Search for Quality and the Capacity to Resolve', *Journal of Business Law*, (2010), 502, at 511, 512.
[244] See also the Insolvency Service, Report on the First Six Months Operation of Statement of Insolvency Practice 16 (IS, 2009); In March 2010 the Government announced it would consult on a range of new measures to boost the confidence in pre-packs: see further R. Install, 'Pre-Packaged Administration: Misguided or Misunderstood?', 99 *Corporate Rescue & Insolvency*, (2010).
[245] Proceedings in which all creditors participate, under 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', see White Paper, Productivity and Enterprise (2001), discussed in S. Frisby, 'In Search of a Rescue Regime', 67 *M.L.R*, (2004), 247, at 250.
[246] See Insolvency Service, *Impact Assessment of Encouraging Company Rescue*, (London: 2009)

- Preserving market confidence by promoting enforcement of the rules governing insolvency and rescue.

The list provides a daunting insight into the responsibility that has been placed on IPs. Instead of analysing each objective individually the five fundamental principles contained within the Code of Ethics will be used as benchmarks to categorise the list. It is hoped that this approach will not only keep this section concise, but also draw attention to how the principles and objectives when combined together dictate not only how an IP should act, but also highlight the extent of their power. In essence, the question will be asked: do the Code of Ethics and the related legislation prevent the IP from abusing his power to pursue his own interests?

## 6. Fundamental Principles

In reference to the five key principles that exist within the guidelines produced by the RPBs, an Insolvency Practitioner is required to comply with the following fundamental principles[247]:

### (a) Integrity

*An Insolvency Practitioner should be straightforward and honest in all professional and business relationships.*

The correct usage of the integrity concept creates some conflicts as to its exact meaning. At best it is ambiguous; left open to the opinion of the IP to infer what is "straightforward and honest" which does not always correspond with the expectations of interested parties. There is tremendous difficulty in being able to fully assess the manner in which IPs undertake their duties. Without simply assuming, and irrationally suggesting ways in which IPs could have abused their power, specific empirical research to understand how the integrity principle is interpreted within the profession is necessary and in this case goes beyond the scope of this thesis.

### (b) Objectivity

*An Insolvency Practitioner should not allow bias, conflict of interest or undue influence of others to override professional or business judgements.*

[247] An example of the principles can be obtained from the Insolvency Practitioners Association http://www.insolvency-practitioners.org.uk/page.aspx?pageID=221 (accessed 22nd February 2011).

It is questionable whether any professional can be free from influence. It would seem that an element of bias will always be evident, whether this is in reference to a professional judgement or not. Determining the method in which the IPs process key decisions is a difficult task given the lack of co-operation and the optional requirement to complete full detailed reports. Further ambiguity is raised attempting to decipher what amounts to a professional or business judgement? What actually constitutes a judgement? How could these judgements stand up to scrutiny? Compliance with the relevant legislation and regulations would mean that the technical element could be satisfied with relative ease, but rarely can companies be investigated with conclusions drawn from cold facts without having at least some consideration for the implications that it will have on the workforce and people who rely on that company for their livelihood. It will also be evident in some cases that invested interests from powerful creditors (large investment from financial institutions such as banks) and IPs safeguarding their personal interests (with perhaps the interests of its accountancy firm also in mind) will dictate the course of action to be taken with the distressed company.

**(c) Professional Competence and Due Care**

*An Insolvency Practitioner has a continuing duty to maintain professional knowledge and skill at the level required to ensure that a client or employer receives competent professional service based on current developments in practice, legislation and techniques. An Insolvency Practitioner should act diligently and in accordance with applicable technical and professional standards when providing professional services.*

A distinction should be drawn between professional knowledge and how a particular business operates. Not all businesses can be treated in the same manner and specialist knowledge will be required to determine whether it is possible that the company can be rescued. An IP will be required to consider all options, which would include the sale of unique assets. However, an IP and his or her team do not have unlimited resources and knowledge, and do not have the luxury to investigate in leisure, given the fact that most of the work will be conducted within a limited time frame[248]. Acting in a professional manner with the emphasis on courtesy will satisfy customer care and relations, but will do nothing in the pursuit of rescuing companies. Logically, professional services need to be correctly applied to ensure

[248] J. Flood and E. Skordaki, *'Insolvency Practitioners and Big Corporate Insolvencies'*, ACCA: Research Project 43, (1995), at 25.

the correct measures are taken. But there is rarely a check up by any regulating body, partially because of the way the complaints have to be made, substantiated and self funded, and in some way because the whole process is carried out behind a veil of secrecy[249]. As part of exerting his/her professional competence, it will be necessary prior to accepting an insolvency appointment that the IP should ensure that he/she is satisfied that a number of matters have been thoroughly investigated. It is expected that this must involve:

- Obtaining knowledge and understanding of the entity, its owners, managers and those responsible for its governance and business activities.
- Acquiring an appropriate understanding of the nature of the entity's business, the complexity of its operations, the specific requirements of the engagement and the purpose, nature and scope of the work performed.
- Acquiring knowledge of relevant industries or subject matter.
- Possessing or obtaining experience with relevant regulatory or reporting requirements.
- Assigning sufficient staff with the necessary competencies to jobs.
- Using experts where necessary.
- Complying with quality control policies and procedures designed to provide reasonable assurance that specific engagements are accepted only when they can be preformed competently[250].

The general list ensures that an IP is fully prepared for the task ahead and is in a position to clearly state whether he/she is competent enough to conduct the role. This section is probably intended to act as a safeguard to protect the IP against possible liabilities that may arise from falling short of fulfilling what was necessary, and what should have been done for the distressed company. Possible incompetence arising out of such a case also affords interested parties some protection as well, but it is unclear given the way IPs are regulated how a bad example of professional conduct would ever publicly materialise.

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[249] B. Singleton-Green, 'Rare Glimpses of Secretive Creatures', *Accountancy*, (March 2001), at 18.
[250] See ICAEW website, Code of Ethics for Insolvency Practitioners, http://www.icaew.com/en/technical/insolvency/becoming-an-icaew-insolvency-licensed-practitioner, at 400.37, (accessed 17th March 2011).

**(d) Confidentiality**

*An Insolvency Practitioner should respect the confidentiality of information acquired as a result of professional and business relationships and should not disclose any such information to third parties without proper and specific authority unless there is a legal or professional right or duty to disclose. Confidential information acquired as a result of professional and business relationships should not be used for the personal advantage of the Insolvency Practitioner or third parties.*

In relation to confidentiality, the IPA has provided a document designed to be read in conjunction with the Code[251]. It provides an invaluable insight into the way the confidentiality principle should be interpreted. It must be stressed that in the light of any conflict between the contents of the Code and the supplementary document, the Code will prevail. The document goes into great detail explaining the importance of the role that confidentiality and transparency plays within the actions of the IP. Para 36 of the Code provides that an IP in his/her role as an office holder:

…has a professional duty to report openly to those with an interest in the outcome of the insolvency. An Insolvency Practitioner should always report on his acts and dealings as fully as possible given the circumstances of the case, in a way that is transparent and understandable. An Insolvency Practitioner should bear in mind the expectations of others and what a reasonable and informed third party would consider appropriate.[252]

The provision is central to the duties that are carried out by the IP, insofar that it promotes the other fundamental principles without conflicting with any legal or professional obligation. It should be the case that their actions are able to be readily determined and if necessary transparent to the extent that they may be subject to scrutiny[253]. Having the decisions of IPs readily available ensures that the actions have been fair and that third parties are being dealt with in an appropriate manner. This may seem elementary, but it is far from perfect. The

[251] Insolvency Practitioners Association, '*Insolvency Code of Ethics, Transparency and Confidentiality: A Guidance Note'*, 4th November 2008, (accessed 10th January 2011) http://www.insolvency-practitioners.org.uk/uploads/Transparency%20Final.pdf

[252] Insolvency Practitioners Association, '*Insolvency Code of Ethics, Transparency and Confidentiality: A Guidance Note'*, 4th November 2008, (accessed 10th January 2011) http://www.insolvency-practitioners.org.uk/uploads/Transparency%20Final.pdf

[253] Insolvency Practitioners Association, '*Insolvency Code of Ethics, Transparency and Confidentiality: A Guidance Note'*, 4th November 2008, (accessed 10th January 2011) http://www.insolvency-practitioners.org.uk/uploads/Transparency%20Final.pdf, para 5.

main problem, as will be identified in the next section, is the issue of information having been communicated effectively[254], or alternatively, critical information being kept from certain interested parties. It creates real problems because it affects the flow of information that allows actors to act effectively in the outcome of insolvency i.e. make informed decisions based on accurate, updated information. The only way that the interested parties can do this is to rely on the reports prepared by the IPs who in turn should make sure that the findings are not only clear and understandable[255], but also that where appropriate a full explanation is given for any of the key decisions made and the reason for them.

It will be appreciated that what qualifies as appropriate circumstances is to the discretion of the IP.[256] This discretion exercised is very rarely challenged and even if it was, despite the number of safeguards in place[257], it could be readily justifiable on the grounds that it was in the commercial interests of the company or more than likely the business. This certainly is the case when an approval is sought, for instance in relation to the IP's fees, but in these cases the IP must be particularly mindful of providing sufficient evidence to allow those responsible for the approval to form a judgement as to whether the approval is appropriate having regard to all the circumstances of the case[258]. Whilst this creates some duty on the IP to provide certain information, IPs are, nevertheless, in control as to what information is disclosed and to what extent that information is used. Whether this position is tenable is a moot point but it should be noted that the principle of transparency, as emphasised by the guidance note,[259] stresses the importance of wider disclosure, in particular where the assets and business of an insolvent company are sold shortly after appointment on pre-agreed terms.

Naturally creditors in conforming to the above will wish to be kept informed of what is occurring by way of detailed reports along with justifications as to why certain decisions were made and whether the actions of the IP were the best options for the creditors as a

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[254] Insolvency Practitioners Association, '*Insolvency Code of Ethics, Transparency and Confidentiality: A Guidance Note*', 4th November 2008, (accessed 10th January 2011) http://www.insolvency-practitioners.org.uk/uploads/Transparency%20Final.pdf, para 6.

[255] Insolvency Practitioners Association, '*Insolvency Code of Ethics, Transparency and Confidentiality: A Guidance Note*', 4th November 2008, (accessed 10th January 2011) http://www.insolvency-practitioners.org.uk/uploads/Transparency%20Final.pdf, para 7.

[256] Remarkable discretion is given, or not accounted for by the IA 1986 to IPs in their roles as charges d'affaires of businesses, see J. Flood and E. Skordaki, '*Insolvency Practitioners and Big Corporate Insolvencies*', ACCA: Research Project 43, (1995), at 6.

[257] The safeguards in place will be examined later on in this section.

[258] *Re Williams and Anor v Natural Life Health Foods Ltd. and Anor* [1998] 1 WLR 830 (HL); *C Evans and Sons ltd v Spritebrand Ltd. and Anor* [1985] BCLC 105 (CA), para 8.

[259] *C Evans and Sons ltd v Spritebrand Ltd. and Anor* [1985] BCLC 105 (CA), para 9.

whole[260]. Whether the explanations and justifications will satisfy all concerned parties is another matter. It is something that has caused problems in the past as it is not easy to extract relevant information and this is of course dependent on whether that information exists in the first place. The lack of available information covering corporate rescue strategies remains controversial especially when decisions have been made that concern selling parts of the business or company at what is considered by some creditors to be at either an unreasonable discounted price, or simply the wrong strategy decision to have been made. Exactly what amounts to a good justification or a full report is difficult to say. One would suggest that it must simply be compiled in such a way as to satisfy the aforementioned principles, but even with this in mind there is still wide discretion. This is helpful in situations where it may not be possible to provide certain information relating to a particular matter because of a conflicting legal or professional obligation. It must be remembered that whilst the IP is privy to confidential material, some aspects may not be intended to become public knowledge especially if it is commercially sensitive and the distribution of that information could be detrimental to the well-being of that company. There are legal obligations still to be followed despite the financial predicament the company may be facing; it is a question of balancing interests and ensuring that no one party is unfairly treated in the course of a corporate rescue attempt.

Returning to the guidance, paragraph 4 states that the fundamental principle of confidentiality requires that:

An Insolvency Practitioner should respect the confidentiality of information acquired as a result of professional and business relationships and should not disclose any such information to third parties without proper and specific authority unless there is a legal or professional right or duty to disclose. Confidential information acquired as a result of professional and business relationships should not be used for the personal advantage of the Insolvency Practitioner or third parties.

Substantiating any misconduct, in particular holding an IP liable for a breach of confidence it must be shown that: (1) the material communicated to him had the necessary quality of confidence; (2) it was communicated or became known to him in circumstances entailing an

[260] The position is likely to be based on a subjective review of the facts. If a creditor has been compensated to an agreeable degree then it is unrealistic to assume that he will care about the fortune of others.

obligation of confidence; and (3) there was an unauthorised use of that material. The guidance provided is stern, but has every reason to be. What amounts to confidential material has briefly been discussed, but it is not always conclusive, nor is the controlling of the flow of that sensitive information. For material to be protected as confidential its availability to the public must be restricted. It also follows that occasionally it is a possibility that sensitive information could inadvertently be disclosed and this is something that the IP must be aware of. As previously stated, whilst an IP has to perform his duties in compliance with the principles, the Code is not impregnable and occasionally some pieces of information may go astray. It is also true that any sensitive information that an IP may come across, cannot be used for his or her benefit other than in the course of performing professional duties. There has been some concerns raised about the confidential principle existing as a duty for IPs – is it not the case that IPs should disclose all information and that they should not act as gate keepers? Whilst this was the view of previous Insolvency Codes, most notable by the fact that they omitted the confidentiality principle[261], opinion has gradually changed and now provides that the above it is no longer viewed as inconsistent with an IP's duty, which one has to suspect, is the correct way to proceed.

**(e) Professional Behaviour**

*An Insolvency Practitioner should comply with relevant laws and regulations and should avoid any action that discredits the profession. Insolvency Practitioners should conduct themselves with courtesy and consideration towards all with whom they come into contact when performing their work.*

A professional's reputation secures contracts as well as earning recognition within a field; it will be therefore be of no surprise that a principle ensuring that this is maintained is contained within most professions charters. In regard to IPs, whilst the IFAC Code[262] did not cover this principle, it was covered by the Insolvency Ethical Guide, and was considered important enough to remain unchanged in the transition between the Guide and the Code. The difficulty with this principle is that it is not the actions and breaches being committed outside of the

[261] The fundamental principle of confidentiality did not appear in the Insolvency Ethical Guide as there were some concerns that the inclusion of this fundamental principle may be inconsistent with an IPs duty or obligation, in certain circumstances to disclose confidential material. However this was dismissed by the JIC as the principle makes it clear that where an IP has a legal or professional right to disclose he may do so. See Insolvency Practitioners Association, *'Insolvency Code of Ethics: Background and Overview'*, (November 2008), para 12.

[262] Code of Ethics for Professional Accountants.

Code that is causing unwanted attention and bringing discredit to the profession, but it is the fact that the Code is been followed and it allows IPs to act in this way. The actions of an IP during the course of a corporate rescue attempt will be under much scrutiny; his/her decision will decide the fate of many. For an IP to conclude the procedure with a substantial fee for his/her services, consequently rendering the payment that the creditors will receive as nominal is a “bitter pill to swallow”. Whilst there is little dispute that the IPs are complying with the relevant legislation and regulations, the Code can be manipulated to the advantage of IPs and the chance of appeal against the actions is at best minimal. The question that remains is not can a complaint be made about the conduct of an IP, but how likely is it that a breach will be found and disciplinary action taken against the IP?

**7. The Complaint Procedure**

As already stated every IP is a member of one of the RPBs. The bodies are authorised by the Secretary of State to issue insolvency licences and regulate IPs. It has been agreed that the RPB which issued the insolvency license will deal with that particular complaint that arises about his/her conduct. The licence is issued to individuals and not companies, and so if a complaint arises about the conduct of a team member under the supervision of the IP then he/she will be responsible. Whilst not all RPBs have the same procedure to deal with complaints, it is safe to say that they all follow a similar procedure. It is interesting to note that one of the RPBs, the Insolvency Practitioners Association (IPA), states that a large proportion of complaints that they receive are due to a breakdown in communication between the IP and the interested party[263]. It is suggested that before bringing a complaint to one of the RPB, that the interested party tries to resolve the issue with the IP, whether that be directly or within an internal complaints capacity with the firm that he/she works for. In essence it is emphasised that complaints should be mediated and early proactive steps should be taken to resolve any outstanding issues. If this is not possible then the relevant RPB will become involved. The extent of the RPBs involvement and the authority that they have is something that deserves more attention.

The RPB has one primary role: to investigate whether a complaint has grounds and if so decide whether any disciplinary action is required against a member. The nature of the work

[263] See Insolvency Practitioners Association, *‘Making a complaint against an Insolvency Practitioner: Licensed by the Insolvency Practitioners Association’*, (June 2010), (accessed 22nd February 2011) http://www.insolvency-practitioners.org.uk/uploads/Technical/June%202010%20complaints%20leaflet.pdf

undertaken by the IP deals with a number of conflicting interests and it is important to stress that the RPB will not intervene with disputes that are of a commercial or legal nature. This important exception allows IPs in corporate rescue proceedings to rely on this as a way to justify their actions and prevent any possible disciplinary action arising from their respective RPB. In regards to complaints arising from commercial disputes, these are the responsibility of the courts. However, the courts are reluctant to intervene in such matters and prefer to leave such decisions in the hands of the IP who they consider to be better placed, given that they are equipped with the knowledge and expertise to make those decisions[264]. Processing a complaint through the RPB should not be seen as a substitute for taking action through the courts; the two bodies remain distinct and it is clear that the RPB powers are limited in comparison. For instance a RPB cannot compel an IP to alter, amend or reverse an action he considers is correct. The proper means for controlling, replacing or challenging the actions of the IP rests in accordance with the provisions set out in the Insolvency Act 1986. In regards to the level of the IPs fees, the RPBs have no power to intervene unless it is in regard to a dispute arising over the incorrect approval procedure that has been followed. This therefore leaves interested parties relying on the Insolvency Act and asking the courts to reduce the fees, which they consider to be excessive.

In respect of a case of negligence being made against an IP it is made clear that not all errors committed by an IP result in disciplinary action. If an interested party wishes to pursue this course of action it is a case for the IP's indemnity insurers, not for the RPBs to assess an appropriate level of award[265]. Where the RPBs can take action is if the dispute arises from non-complying with a statute, Statements of Insolvency Practice and the individual RPBs Ethics code. Such breaches are factual and need no real assessment making it an easy task for

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[264] Very often when the exercise of powers is challenged in court the office-holder can seek solace in the *Wednesbury* test (*Associated Provincial Picture Houses Ltd v Wednesbury Corp* [1948] 1 K.B. 223). The courts traditionally have been disinclined to intervene with a matter of professional judgement unless *Wednesbury* unreasonableness is established. But in *Bramston v Haut* [2012] EWHC 1279 (Ch) Arnold J. made it clear that the *Wednesbury* test is now viewed as a flexible standard and that each case does turn on its own individual facts. See also See D. Milman, 'Governance, Stewardship and the Insolvency Practitioner', *Company law Newsletter*, (2012), 1, at 3.

[265] The RPBs are keen to stress that interested parties should consider seeking independent professional advice before exercising any recourse to the Court of before bringing a negligence claim. Proving such a case can be extremely difficult, expensive and sometimes an imprudent rash reaction to the circumstances.

the RPBs to determine whether disciplinary action is required[266]; the more challenging aspects are reserved for the courts[267].

## 8. Threats to the Fundamental Principles

Before looking at the judiciary it is worth exploring an aspect of the Code that should avert any threat to the fundamental principles. This section has taken a framework approach, which is a method adopted by the IPs to identity actual or potential threats, evaluate such threats and to appropriately respond to such threats. The Code provides a number of scenarios when a threat may occur, but it does not intend to provide a comprehensive list. It is interesting to note that an IP must not only take reasonable steps to identify the existence of any threats to the fundamental principles, but should also look to see whether any threats existed prior to the IP's appointment. The threats may fall into one or more of five categories:

(1) Self-interest threats: which may occur as a result of the financial or other interests of a practice or an IP or a close or immediate family member of an individual within the practice;
   - (a) An individual within a practice having an interest in a creditor or potential creditor with a claim, which requires subjective adjudication.
   - (b) Concern about the possibility of damaging a business relationship.
   - (c) Concerns about potential future employment.

(2) Self-review threats: which may occur when a previous judgment made by an individual within the practice needs to be re-evaluated by the IP;
   - (a) The acceptance of an insolvency appointment in respect of an entity where an individual within the practice has recently been employed by or seconded to that entity.

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[266] If the Committee decides that there is no prima facie case made out against the IP that brings the matter to an end and the complaint will be closed.

[267] Is it time to revisit the Cork Committee's idea of establishing an Insolvency Ombudsman (Cmnd 8558, para 1772). The profession appears to be in two minds on such a move and, in fairness, there is little to suggest that the current system is failing, but public perceptions do matter. The Office of Fair Trading report (*The Market for Corporate Insolvency Practitioners*) (OFT 1245, June 2010) favoured moves in this direction with the setting up of an independent complaints body (see paras 1.26-1.29), but it is clear as a result of the Insolvency Service's *Consultation on reforms to the Regulation of Insolvency Practitioners*, published on December 20, 2011 (at pp. 7-9), that there is a lack of consensus on the form and financing of the independent complaints mechanism. See D. Milman, 'Governance, Stewardship and the Insolvency Practitioner', *Company Law Newsletter*, (2012), 1 at 4.

(b) An insolvency practitioner or the practice has carried out professional work of any description, including sequential insolvency appointments, for that entity. These threats may diminish over time.

(3) Advocacy threats: which may occur when an individual within the practice promotes a position or opinion to the point that subsequently objectivity may be compromised;

(a) Acting in an advisory capacity for a creditor of an entity

(b) Acting as an advocate for a client in litigation or dispute with an entity.

(4) Familiarity threats: which may occur when, because of a close relationship, an individual within the practice becomes too sympathetic or antagonistic to the interests of others; and

(a) An individual within the practice having a close relationship with any individual having a financial interest in the insolvent entity.

(b) An individual within the practice having a close relationship with a potential purchaser of an insolvent's assets and/or business[268].

(5) Intimidation threats: which may occur when an IP may be deterred from acting objectively by threats, actual or perceived.

(a) The threat of dismissal or replacement being used to:

(i) Apply pressure not to follow regulations, this Code, or other applicable code, technical or professional standards

(ii) Exert influence over an insolvency appointment where the Insolvency Practitioner is an employee rather than a principal in practice.

(b) Being threatened with litigation.

(c) The threat of a complaint being made to the IP's authorising body.

Having identified and evaluated threats to the fundamental principles an IP should consider whether there are any safeguards available that could reduce the threat to an acceptable level. The relevant safeguards will vary depending on the circumstances. Generally safeguards fall into two categories; the first covers safeguards created by the profession, legislation or regulation, and the second covers safeguards in the work environment. The safeguards in place were hoped to encouraged a proactive attitude - complying with the fundamental principles, legislation and policies, and ensuring that responsibility and transparency is achieved in the implementation of the IP's work. It would perhaps be more accurate to

[268] In this regard a close relationship includes both professional and personal; see Code of Ethics for Insolvency Practitioners, http://www.icaew.com/en/technical/insolvency/becoming-an-icaew-insolvency-licensed-practitioner, at 400.42, (accessed 22nd March 2011).

describe the safeguards as offering professional protection for IPs, but they can, if they require, use their discretion to discard this. This has had the effect of deviating from the formal corporate rescue model in the UK to applying an improvised informal model like pre-packs that fits more comfortably with the IP's agenda. Although the Code tries to ensure that the fundamental principles are complied with, there is only an obligation to follow the guidelines and act in the spirit of the Code. On this basis an IP can control the company and justify almost any decision on the basis that it made more commercial sense than the alternatives. Subject to substantiating a claim against an IP it will also be seen that enforcing action through the RPB or the court is a troublesome affair.

### 8.1. Safeguards

To counteract these concerns there are some possible safeguards that could be adopted, which include:

a) Leadership that stresses the importance of compliance with the fundamental principles.

b) Policies and procedures to implement and monitor quality control of engagements.

c) Documented policies regarding the identification of threats to compliance with the fundamental principles, the evaluation of the significance of these threats and the identification and the application of safeguards to eliminate or reduce the threats, other than those that are trivial, to an acceptable level.

d) Documented internal policies and procedures requiring compliance with the fundamental principles.

e) Policies and procedures to consider the fundamental principles of this Code before the acceptance of an insolvency appointment.

f) Policies and procedures regarding the identification of interests or relationships between individuals within the practice and third parties.

g) Policies and procedures to prohibit individuals who are not members of the insolvency team from inappropriately influencing the outcome of an insolvency appointment.

h) Timely communication of practice's policies and procedures, including any changes to them, to all individuals within the practice, and appropriate training and education on such policies and procedures.

i) Designating a member of senior management to be responsible for overseeing the adequate functioning of the safeguarding system.

j) A disciplinary mechanism to promote compliance with policies and procedures.

k) Published policies and procedures to encourage and empower individuals within the practice to communicate to senior levels within the practice and/ or the Insolvency Practitioner and issue relating to compliance with the fundamental principles that concerns them[269].

In all cases the IP will need to exercise his/her judgment to determine how best to deal with an identified threat[270]. In determining this threat an IP should consider what a reasonable and informed third party, having knowledge of all relevant information, including the significance of the threat and the safeguards applied, would conclude to be acceptable[271]. Determining what is acceptable involves IPs using their discretion and an awareness that threats may appear as the work developments. Whilst there should be quality control policies and procedures in place to deal with new issues as they arise, in some circumstances the only available option will be to follow the wishes of the creditors who after full disclosure has been given, have the right to decide whether to retain or replace him or her[272]. In essence the task is twofold. Firstly, whether the threat can be eradicated; and secondly, can a threat be at least reduced to an acceptable level? If the answer to the latter is no, then an IP will have to conclude that it is not appropriate to accept an insolvency appointment. This in theory should ensure that no conflicts arise and a rescue procedure can be carried out, free from influence and not in showing preference to any individual, unless that happens to be the creditors as a whole.

**9. Judicial Intervention**

It is now worth returning to the role of the courts. Failure to abide by the provisions set out above can lead to the judiciary intervening to rectify any misdemeanours that the IP has been alleged to have committed. Whilst this right is very rarely used, it is nevertheless a tool that

[269] See ICAEW website, Code of Ethics for Insolvency Practitioners, http://www.icaew.com/en/technical/insolvency/becoming-an-icaew-insolvency-licensed-practitioner, at 400.25, (accessed 22nd March 2011).
[270] Ibid See ICAEW website, Code of Ethics for Insolvency Practitioners, http://www.icaew.com/en/technical/insolvency/becoming-an-icaew-insolvency-licensed-practitioner, at 400.30, (accessed 22nd March 2011).
[271] See ICAEW website, Code of Ethics for Insolvency Practitioners, http://www.icaew.com/en/technical/insolvency/becoming-an-icaew-insolvency-licensed-practitioner, at 400.25, (accessed 22nd March 2011).
[272] See ICAEW website, Code of Ethics for Insolvency Practitioners, http://www.icaew.com/en/technical/insolvency/becoming-an-icaew-insolvency-licensed-practitioner, at 400.29, (accessed 22nd March 2011).

can be used by a company's creditors or members alleging unfair harm[273]. The problem with intervention is that proving misconduct, or that a certain action implemented by the IP was unfair is exceptionally difficult as most decisions will appear to be based on commercial judgement, something which the judiciary has openly admitted that IPs are better placed to make than judges[274]. It will also be noted that that the judiciary is reluctant to tell IPs how to do their job, choosing to rely on the wide measure of latitude given by the legislature to conduct the day-to-day management of the administration[275]. Having said that, the court will not shun exercising, where necessary its wide discretion to order the removal of an administrator[276] even if this is not a matter of misconduct on the part of the administrator[277]. It is paramount to maintain the confidence in an administration process especially when rescue proceedings are being initiated; as such the court has a duty to aid the smooth running of the procedure and where possible enhance the success of corporate rescue where possible[278]. This has however created some disparities, particularly in cases where the procedure adopted endorses principles that are not recognised within the UK's corporate rescue model. The development of the pre-packs culture will be something that will be explored in greater detail in Chapter Five, but suffice to mention that the controversial topic of IP's expenses has had a bearing on the type and the way in which corporate rescue proceedings are conducted.

### 10. Summary

Insolvency practitioners are no longer simply the practitioners, but the architects of corporate rescue. Whilst it is commendable that IPs have used their experience and knowledge to create a pragmatic solution to help distressed, yet viable companies, there is a trend occurring which

[273] Insolvency Act 1986, Sch. B1, para 74.
[274] *Re Zegna III Holdings Inc*. [2009] EWHC 2994 (Ch).
[275] See *Re Lehman Bros International (Europe)*; *Four Private Investment Funds v Lomas* [2008] EWHC 2869 (Ch), [2009] B.C.C. 632.
[276] See Insolvency Act 1986, Sch. B1, para 88, but it must be stressed that cause has to be shown. In addition the IP may wish to resign, which is governed by s. 87, Insolvency Act 1986. This can only be achieved if it is done in compliance with the giving of notice in writing in the circumstances prescribed in para 87(2). If the reasons for resignation fall outside of the scope mention in s.87 then the administrator may apply for permission from the court, see r.2.119(2). It should however be noted that the IP cannot simply resign from his position because he does not wish to continue in office; reasons must relate to a valid reason, see S. A. Frieze, 'Resignation and removal of an Office Holder', *Insolvency Intelligence*, (2010), 157, at 157.
[277] *Clydesdale Financial Services v Smailes* [2009] EWHC 1745 (Ch) [2009] B.C.C. 810; see also D. Milman, 'Judicial Reflections on the Administration Process: a 2010 Perspective', *Company Law Newsletter*, (2010), at 4.
[278] The Court will foremost ensure to avoid assisting to such an extent that it prejudices the interests of creditors who are not procedurally involved, see V. Finch, 'The Recasting of Insolvency Law', 68(5) *Modern Law Review*, (2005), 713, at 735.

shows that there is an increased tendency to operate outside the principles dictated within the UK's insolvency law. However, it will be seen that the profession has been given a privileged footing, endorsed by the lack of available alternatives. It was stated in Chapter two that corporate rescue is an option available to a company that can prove it can be rescued as a going concern. But there are growing concerns as to whether practitioners are equipped with the knowledge to make decisions that may not necessarily fall within their field of expertise. In essence it has raised questions whether a corporate rescue model in the UK exists, as these professionals seem to have the discretion to apply their own rules and interpretations as to what they think the law should be. This position has been further strengthened by the lack of intervention from the courts demonstrating that they prefer to leave the commercial decisions to those better placed within the business world. There are a number of fundamental principles and safeguards in place designed to prevent or at least restrict potential abuses. This however is dependent on the action taken by RPBs and whether the response is reflective of the act committed. The lack of transparency and accountability remains a problem which ultimately contributes to suspicion around the conduct of those who work within the rescue process. This has had the effect of shrouding corporate rescue in an air of secrecy leaving little information to analyse exactly how rescue procedures are implemented.

# Chapter 4

# Determining the Existence of a Corporate Rescue Model - an Efficiency Approach

## 1. Introduction

The last chapter identified how some insolvency practitioners (IPs) were able, to a certain degree, manipulate the circumstances that were presented to them in a distressed company. It was seen that by using their wide discretion they could turn the situation to their own advantage, and by doing so extract a greater fee for their work. It was suggested that this practice has been allowed to flourish because the current law in dealing with corporate insolvency is inadequate. These faults have presented an opportunity to IPs to develop a new mechanism that could do the job more in line with what they consider to be more appropriate. It is on this premise that pre-packaged administrations were developed and are steadily increasing in popularity. In terms of how pre-packs are being advanced as an alternative to a formal process like full administration requires further examination.

This chapter takes into account the research discussed in Chapters Two and Three and assesses whether the corporate rescue model adopted in the UK (administration) is an efficient process. Specifically, it must be asked whether the formal rescue model as contained within administration is consonant with the fundamental principles as discussed in Chapter Two, and does it implement policy as set out in Chapter Three in a way that is considered efficient and fair, taking into account the appropriate fundamental principles? Of particular relevance, previous research will be drawn upon to assess whether the process of rescuing a company as stated in schedule B1, para 3(1)(a) of the Insolvency Act 1986[1] is efficient in its purpose, and whether any other interpretation such as that implied by IPs implementing pre-packs has led to the law that is applied being different from what was intended[2]. Whilst it will

[1] The purpose of administration as set out by paragraph 3(1)(a) states that the Administrator of a company must perform his functions with the objective of rescuing the company as a going concern. This is the primary purpose of administration and if this objective cannot be achieved then an alternative purpose may be selected. It will be noted that in Chapter Three it was suggested that para 3(1)(a) is the only true objective that can be referred to as corporate rescue; the alternatives within para 3 can be more associated with rehabilitation with the focus on the distribution of wealth to creditors.

[2] Reference will be made to The Insolvency Practitioners Regulations 2005, which aims to assist practitioners on issues of policy. Attention will also be drawn on the Statement of Insolvency Practice (SIPs), which proactively aims to bridge the gap between knowledge and practice, harmonising the approach taken by members when questioning insolvency practice.

be reiterated from Chapter Three, that some IPs have resorted to adopting a more pragmatic response to the needs of a distressed company and have done so by taking a more commercial realism view of how troubled companies should be dealt with, it remains to be seen whether the efficiency rule has played a role in ensuring that corporate rescue in the conventional sense has increasingly been overlooked.

A number of values are to be used as benchmarks that will help determine not only the legitimacy of the corporate rescue model in the UK, but also highlight how effective the corporate rescue model has been. To achieve this end this chapter will commence with establishing the core values – namely efficiency and fairness - and how they have become integral to any discussion wishing to test a models' capabilities. It will be seen that it is often the case that there will have to be a trade off between the differing values as each naturally competes to become the most dominate in any discussion. In addition to efficiency and fairness, accountability and expertise will also be considered as they are all concepts that may be aims (in their own right) that are pursued as individual strands or as combinations. It is therefore important to note that not all need to be satisfied for something to be efficient. As already noted above, it will be seen that efficiency can be an aim in itself – a factor that is realised in the manner it pursues the intended outcome, which in this case is the pure rescue of a distressed company. A number of concepts will be discussed, namely Pareto efficiency; Kaldor-Hicks efficiency; technical efficiency; and dynamic efficiency. With a debate surrounding the notions of efficiency the value of fairness will be reintroduced and explored in greater detail. The question will be asked: what makes an efficient framework? This presents the opportunity to observe the substantive aims and procedural goals of corporate rescue and what is expected of such a model. Finally the tensions between the values will be explored to illustrate the difficulties involved in attempting to determine how best to measure an efficient model.

## 2. Overview

Corporate rescue has taken on a format that could be best described as subscribing to an "evolving philosophy" that is conscious of its theoretical underpinnings, whilst at the same time showing a willingness to be flexible with its principles to reflect contemporary issues that may be considered of significance[3]. The principles which form the foundations for corporate rescue supply it with its history and destiny, beginning and end, explanation and purpose[4]. The legal rules are not intended to be arbitrary interventions, but forming part of stories, and tending towards the achievement of the desired outcomes[5]. Ultimately, transformation is permitted and should be expected. This can be supported by case law; whilst there is perhaps no clear indication to demonstrate any division amongst policy decisions, they are nevertheless characterised by the development within the field and with it provide the necessary persuasion and confidence to insert these new found principles into the decision-making process[6]. By identifying these dominant principles within a body of law permits these assumptions to be assessed and, if appropriate, reformed. Fundamental principles like attitudes evolve over time, as notions in one legal measure are repeated and developed in another, until they command widespread, immediate and largely unchallenged assent[7]. With this in mind, the first main challenge that faces legal concepts is determining their purpose, which in this case translates to determining: what does corporate rescue aim to do? Once the objectives have been established, it must then be assessed whether the purpose of the law has been achieved. If it has not then the law must provide a solution to enable the purpose to be fulfilled.

### 3. Establishing the Values

Formulating the aspirations of corporate rescue allows for the evaluation of its procedure to take place. Critically, it will be remembered in the previous chapters that rescue operates in an environment that is full of tension between those who have the various interests in a distressed company. Assessing the effectiveness of corporate rescue within the current economic climate involves selecting a number of values that will be used to determine whether the law delivers on the promises it makes[8]. The adopted values in this instance will be efficiency and fairness, but whilst these have been chosen it is also important to note and provide a rationale as to why these values are used at the expense of others. In order to

[3] See further, V. Finch, *Corporate Insolvency Law – Principles and Perspectives*, 2nd edn, (Cambridge: CUP, 2009), who describes insolvency law developing in accordance to a ‘guiding philosophy’.
[4] R. Cover, ‘Nomos and Narrative’, 97 *Harvard Law Rev*iew, (1983), 4, at 5.
[5] J. Benjamin, ‘The Narratives of Financial Law’, 30(4) *OJLS*, (2010), 787, at 788.
[6] For example see the discussions that have occurred for calling on greater transparency of office holders’ remuneration and expenses, see V. Finch, ‘Insolvency Practitioners: the Avenues of Accountability’, *Journal of Business Law*, (2012), 645, at 656.
[7] J. Benjamin, ‘The Narratives of Financial Law’, 30(4) *OJLS*, (2010), 787, at 788.
[8] Effectiveness in this context will be used to determine whether the correct method has been adopted to allow the purpose of the law to be fulfilled.

thoroughly consider the reasons why these two values are more prominent it is necessary to revisit the critical aspects that make up the unique character of insolvency law.

### 3.1. Integral Concepts

Insolvency proceedings rest upon two profound, integral concepts: namely its role to enforce private rights (of creditors), and secondly to consider the "public issues" that such proceedings may have[9]. Combined, the concepts are so strong that they have helped to justify and secure respect for individual rights[10]. This in turn acts as a legitimacy tool[11] to suggest that insolvency law has embraced a vision that is both communitarian in nature as well as expressive of the notion that the creditors' interests are to be protected[12]. The tensions and how the differences can be resolved have been previously discussed in Chapter Three under the examination of policy, but it remains to be examined how the analysis of these different approaches can contribute to measuring the success of rescue. It is important to note that with the aforementioned issue, insolvency law is undoubtedly concerned with monitoring and restraining the actions of certain key actors within the rescue procedure (directors, insolvency practitioners and certain creditors)[13], whilst permitting the necessary space for these actors to fulfil their normative duties with the skill and expertise that the law demands. The discretion afforded to IPs, even if conducted in a rational and reasonable way, plays a key role in shaping the direction of corporate rescue[14]. This is something which in turn will help form part of the analysis in explaining how efficient and fair corporate rescue is in the UK.

### 3.2. Trade-offs Between Differing Values

The focus invariably turns to the method, or more specifically the effectiveness in which the identified principles (substantive goals of corporate rescue) are achieved (with focus on the procedural model adopted). The competing values used to measure just how responsive the

[9] See generally, V. Finch, 'Re-invigorating Corporate Rescue', *Journal of Business Law*, (2003), 527, at 540.
[10] See S. Wheeler, 'Directors' Disqualification: Insolvency Practitioners and the Decision-making Process', 15 *Legal Studies*, (1995), 283.
[11] This term will be discussed later on.
[12] This approach recognises the existing interests in society and looks to regulate companies in such a way to satisfy public interest. This has allowed a framework in which allows social changes can occur. See L. Sealy, 'A Company Law for Tomorrow's World', 2 *Company Lawyer* (1981), 195, at 195; D. Millon, 'Communitarians, Contractarians and the Crisis in Corporate Law, 50 *Washington & Lee Law Review*, (1993) 1373, at 1386.
[13] Caution should be applied with treating these interests as entirely separate concerns. Whilst tensions will exist between the competing interests, they should be valued on an individual basis but only for the purpose of determining factors that can be used in the trade-off process.
[14] For further reading see G. Lightman and G. Moss, *The Law of Administrators and Receivers of Companies,* 4th edn, (London: Thomson/Sweet & Maxwell, 2007), at 246; R. Mokal and J. Armour, 'The New UK Rescue Procedure - the Administrator's Duty to Act Rationally', 1 *Int. Corp. Rescue 136*, (2004), 137-138.

law is to the issues of concern involves a process whereby "trade-offs" between differing values are deemed a necessity[15]. There have been a number of insightful academic articles that have captured the inconsistencies and tension that befalls deciding which value should be chosen to assess the legitimacy of a process or mechanism. The research conducted within this thesis will tend to focus on the relationship between law and economics, adopting a theoretical approach to the debate, whereby the aim is to explore not just what the law is, but what also underpins and inspires it[16].

Assessing the viability of corporate rescue invites a rethink in the way it is interpreted and how its success is measured. It is to be noted that success is a subjective notion that can be measured in many forms[17]. However, for the purposes of this thesis determining success will involve carefully examining the principles at the heart of rescue and forming a framework that employs an identified, but limited, collection of values[18] that could be used to "reassure ourselves" about the exercise of powers[19].

It has been highlighted in the previous chapters how insolvency law is highly dependent not only on the efficient pursuit of the "rescue principles", but also, as Chapter Three highlighted, the degree of expertise exercised by relevant actors, the level of supervision, monitoring and accountability within the process and the extent of procedural fairness that is shown in dealing with affected parties' interests. With this in mind, measuring the legitimacy of each goal/objective faces a challenge as to whether a group of values or an individual element should be employed. Finch has argued, contrary to the classical approach adopted by Frug, that the individual justificatory arguments may prove contentious and possess limitations, but

[15] Where certain objectives cannot be achieved simultaneously this presents a "hard card" scenario, where trade-offs will have to be made. See R. Dworkin, *Taking Rights Seriously*, (London: G. Duckworth, 1977), at 85.
[16] For some of the interdisciplinary work on the subject see, J. Armour and S. Deakin, 'Norms in Private Insolvency Procedures: The "London Approach" to the Resolution of Financial Distress', *JCLS*, (2001), 21; J. Armour and S. Frisby, 'Rethinking Receivership, *OJLS*, (2001), 21; A. Keay, 'Directors' Duties to Creditors: Contractarian Concerns Relating to Efficiency and Over-Protection to Creditors', 66 *Modern Law Review*, (2003), 665.
[17] Determining what would be a successful rescue is mostly dependant on when the question is asked; see A. Belcher, 'The Economic Implications of Attempting to Rescue Companies', in H. Rajak (ed.), *Insolvency Law Theory and Practice* (London: Sweet & Maxwell, 1993), at 237. Because a company may seem successful soon after restructuring but may end up operating rather skeletally; P.Okoli, 'Rescue Culture in the United Kingdom: Realities and the need for a Delicate Balancing Act', *ICCLR*, (2012), 61, at 62.
[18] See M. Stokes, *'Company Law and Legal Theory'* in W. Twining (ed.), Legal Theory and Common Law, (Oxford: Blackwell, 1986); G. Frug, 'The Ideology of Bureaucracy in American Law', 97 *Harvard LR*, (1984), 1277; B. Sutton, *The Legitimate Corporation*, (Oxford: Blackwell, 1993).
[19] See G. Frug, 'The Ideology of Bureaucracy in American Law', 97 *Harvard LR*, (1984), 1277, at 1281

they may nevertheless possess force and may be combined with other arguments[20]. The values that are often referred to as benchmarks can, and have been, used to test the legitimacy of a particular process or principle within disciplines of the law. Reference will be made to Finch's four values, but it must be noted that this is not intended to be in anyway representative of an exhaustive list as to what values should be evident. The values referred to are: Efficiency which looks to the securing of desired intended outcomes at lowest costs; expertise which refers to the proper exercise of judgement by specialists; accountability looks to control of insolvency participants by democratic bodies or courts or through openness of processes and their amenability to representations; and fairness considers the issues of substantive justice and distribution[21] (which does not and should not imply equality). Whilst Finch's approach can be best described as endorsing a framework that involves "paraphrasing and reorganising"[22], and "building on, but repackaging"[23] the views of Frug[24], it is best to advance this model as an entirely separate way of considering the issue of legitimacy. Frug's rationale draws on the four elements mentioned (efficiency, expertise, accountability, and fairness), but argues that they fail to address the issue of legitimacy in a meaningful way and that combining them "only shifts the problem of making a subjective/objective distinction away from any particular model and locates it, instead, on the boundaries between the different models"[25]. Endorsing a collective approach ignores the immediate tensions and inconsistencies evident in the individual strands and creates a false impression that these internal difficulties are unimportant[26]. It should be noted that establishing the method which should be adopted to determine the legitimacy of a model faces a number of difficulties. The critical limitation that has been identified is the task of providing an objective justification for rendering one value more dominant than another, otherwise it would lack force[27]. However, it has been suggested that this limitation can be overcome and that the exercise of power can be supported by a thread of different arguments based on a limited number of identifiable rationales that are invoked on a collective basis[28].

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[20] V. Finch, *Corporate Insolvency Law – Principles and Perspectives*, 2nd edn, (Cambridge, CUP, 2009), at 55.
[21] V. Finch, *Corporate Insolvency Law – Principles and Perspectives*, 2nd edn, (Cambridge, CUP, 2009), at 56.
[22] V. Finch, *Corporate Insolvency Law – Principles and Perspectives*, 2nd edn, (Cambridge, CUP, 2009), at 49.
[23] V. Finch, *Corporate Insolvency Law – Principles and Perspectives*, 2nd edn, (Cambridge, CUP, 2009), at 50.
[24] G. Frug, 'The Ideology of Bureaucracy in American Law', 97 *Harvard LR*, (1984), 1277.
[25] G. Frug, 'The Ideology of Bureaucracy in American Law', 97 *Harvard LR*, (1984), at 1378.
[26] G. Frug, 'The Ideology of Bureaucracy in American Law', 97 *Harvard LR*, (1984), at 1379.
[27] G. Frug, 'The Ideology of Bureaucracy in American Law', 97 *Harvard LR*, (1984), at 1380.
[28] V. Finch, *Corporate Insolvency Law – Principles and Perspectives*, 2nd edn, (Cambridge, CUP, 2009), at 55. Also note D. R. Korobkin, 'The Role of Normative Theory in Bankruptcy Debates', *Iowa L Rev*., (1996-7), 82, at 108-9, who states that there are no 'clear winners' in arguments based on competing values, but: "much of the

## 4. Legitimacy: Reasonable Expectations

The rationale of legitimacy has a critical relationship with efficiency. It will be remembered in Chapter Two that it is important to emphasise and grasp the importance of the relationship between contractual obligations and the expectations it can produce. The concept of reasonable and legitimate expectations[29] is the substance that fuses the principles together. It is within this premise that enables us to consider what we would reasonably wish to see in a contract if we drafted it[30]. The concept has a bearing on the efficiency of the agreement and the terms it produces, having the effect of creating a consensual obligation that brings an element of fairness to all reasonable parties concerned. In terms of enforcing reasonable and legitimate expectations, given that all contracts are in their very nature incomplete[31], it can have an efficiency benefit as well as providing for fairness in that it enables parties to engage in agreeing complicated contracts without incurring high transaction costs[32].

In terms of the relationship between creditors and IPs and what the former can expect from office holders, it would be reasonable and legitimate of creditors to expect a certain level of professionalism and that IPs comply with all relevant legislation and codes of conduct when dealing with their interests, where the company is, or is potentially, in financial distress, as the creditors have the residual claim over the company. If these expectations are not met, then the creditors can reasonably expect that they would be held accountable and potentially directly responsible for any loss.

Whilst a fully comprehensive discussion surrounding the legitimacy of the values chosen is beyond the scope of this research, the rationale of legitimacy is critical to evaluating the UK's corporate rescue model in light of its effectiveness and in turn its efficiency. As such, the focus will turn to examining the values that enjoy a broad acceptance within the field. It will be on this premise that it will determined whether a collective approach is required whereby a number of different values support each other, or whether it is possible to assert that there are some values so prominent that they can stand individually? Part of the answer to this question

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purpose of a full debate is to compare the relative strengths and weaknesses of plausible arguments, not to find a clear winner".

[29] See A. Keay, 'Directors' Duties to Creditors: Contractarian Concerns Relating to Efficiency and Over-Protection of Creditors', 66 *Modern Law Review*, (2003), 665, at 679.

[30] L. Mitchell, 'The Fairness Rights of Bondholders', 65 *New York University Law Review*, (1990), at 1225.

[31] This notion will be discussed later.

[32] See A. Keay, 'Directors' Duties to Creditors: Contractarian Concerns Relating to Efficiency and Over-Protection of Creditors', 66 *Modern Law Review*, (2003), 665, at 679.

rests with, and depends on which procedural goals are affirmed and in turn what substantive goals have been chosen in order to achieve the aims. Providing justifications as to why different substantive goals should be pursued at the expense of another is not easily determinable. Assessing whether creditors' interests should carry more weight against that of employees depends upon the inherent theoretical, cultural and social dispositions evident within the jurisdiction in question. Various arguments can be employed to adopt different values dependent on the purpose and aims identified by the policy makers. It seems inevitable that in order to measure an instrument to establish the level of success it generates, it invariably means that the substantive and procedural goals will have to embrace a certain level of influence that would manipulate the direction the decision making process takes. Such is the influence of these values that they may be accorded currency in debates on insolvency law. Furthermore, the rationales formulated from such discussions may offer an insight as to how different values interact and what factors are considered more important[33]. It therefore follows that these selected values are not chosen just on how well they integrate, but on the ability to show distinctions and how certain characteristics within them can be traded off. The selection, which presupposes an elimination process, should be seen as natural, with due attention being drawn to the Darwinian approach mentioned in Chapter Two. In order to decide what trade-offs would be necessary it is presupposed that there would be a set of questions framed which would highlight the values at work. Whether or not this can operate in reality is a different matter as the visions we have regarding the distribution of rights within the corporate rescue model vary considerably[34]. The trade-offs between competing values provide for an environment where the different characteristics of each are discussed and debated, which in turn allows each value to be properly assessed on its own merits. The practice by which the values are chosen involves an elimination process that discards values based on a number of factors; including the suitability of a particular value to successfully measure a mechanism that is to be tested. By adopting this method, this process permits the value which has the most persuasion in the circumstances to prevail[35].

[33] V. Finch, *Corporate Insolvency Law – Principles and Perspectives*, 2nd edn, (Cambridge: CUP, 2009), at 57.
[34] See L. M. LoPucki, 'Reorganisation Realities, Methodological Realities, and the Paradigm Dominance Game', 72 *Wash. ULQ*, (1994), 72, 1307, 1310, which involves the aim of not looking to solve a problem but to get everyone thinking about the problem on one's own frame of reference and taking about it in one's own language.
[35] Whilst a theory in general can offer guidance for resolving problems of competing values inherent in corporate insolvency, see D. R. Korobkin, 'Contractarianism and the Normative Foundations of Bankruptcy Law', 71 *Texas Law Review*, (1993), 98, at 111. It may never fully provide solutions to specific insolvency questions; see E. Warren, 'Bankruptcy Policy', 54 *U. Chi. L. Rev*., (1987), 775, at 797.

## 5. Determining what Value to Measure?

This brings us to the next point – do the values identified intend to measure corporate rescue as a procedure or the law that governs it?[36] The two components offer separate lines of enquiry, but the latter cannot be scrutinised without a benchmark to measure it against. The former however can be assessed to reveal the extent to which its substantive objectives have been implemented. The analysis will consider how corporate rescue has developed and whether the mandate contained within its foundational principles correspond with that endorsed and enacted by the IPs when they have carried out their duties[37]. It follows that the discretion afforded to IPs has raised concerns surrounding the appropriateness of the expertise required of them, the accountability of their actions, and the overall fairness of the procedure[38]. Attention should be drawn to the Insolvency Practitioners Regulations 2005, which provides assistance to IPs when considering the legitimacy of their actions[39]. Of particular interest is regulation 6 which covers the matters for determining whether an applicant for an authorisation is a fit and proper person. Whilst the majority of this has already been discussed in Chapter Three, it suffices to mention regulation 6(d) given its association with providing an adequate system. It states that "...there were established adequate systems of control of the practice and adequate records relating to the practice, including accounting records, and whether such systems of control and records have been or were maintained on an adequate basis"[40]. This should be read in conjunction with subsection (e), which states that in the process of an IP conducting his or her work "...such a practice, will be, carried on with the independence, integrity and the professional skills appropriate to the range and scale of the practice and the proper performance of the duties of an insolvency practitioner and in accordance with generally accepted professional standards, practices and principles"[41]. Together the sections formulate a level of acceptable practice and that anything falling short of this standard would be deemed to be rendering the practice as inadequate,

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[36] A normative theory of insolvency law dictates that it is critical to establish values that underlie current law; see D.R. Korobkin, 'Contractarianism and the Normative Foundations of Bankruptcy Law', 71 *Texas Law Rev*. (1993), 98.

[37] See D. J. Galligan, *Discretionary Powers: A Legal Study of Official Discretion*, (Oxford: Clarendon Press, 1986), pp. 34-7.

[38] It is worth noting that in regards to the level of competence required, acting as an IP in any designated proceeding when not qualified to do so constitutes a criminal offence: Insolvency Act 1986, s.389. See also generally, V. Finch, 'Insolvency Practitioners: The Avenues of Accountability', *JBL*, (2012), 645, at 658.

[39] See generally Statutory Instrument 2005 No. 524, The Insolvency Practitioners Regulations 2005 http://www.legislation.gov.uk/uksi/2005/524/contents/made (accessed 12th November 2012).

[40] See Statutory Instrument 2005 No. 524, The Insolvency Practitioners Regulations 2005 http://www.legislation.gov.uk/uksi/2005/524/regulation/6/made (accessed 12th November 2012).

[41] Statutory Instrument 2005 No. 524, The Insolvency Practitioners Regulations 2005 http://www.legislation.gov.uk/uksi/2005/524/regulation/6/made (accessed 12th November 2012).

inferring that the system is falling short of what an efficient insolvency procedure should achieve. It is accepted that having a level of professionalism in itself could be classed as endorsing an efficient framework as it eradicates poor performance at an early stage and reduces the extent along with the risk of damage[42]. This submission however relies on a system that it transparent and accountable for its actions. Whilst subsection (e) clarifies what the untenable position would be, paragraph (f) provides where an IP "...has failed to disclose fully to such persons as might reasonably be expected to be affected thereby circumstances where there is or appears to be a conflict of interest between his so acting and any interest of his own, whether personal, financial or otherwise, without having received such consent as might be appropriate to his acting or continuing to act despite the existence of such circumstances"[43]. This provides for an element within the sphere of insolvency law that can be assessed, but it is not as clear cut as the section makes it out to be[44]. To address these issues whereby the system can be judged collectively as opposed to being treated as individual strands, principles are adopted that can be applicable to the system as a whole. For instance, adopting a basic principle that can be applied as a general tool, such as transparency, can allow the system to be viewed as a whole.

**6. Transparency**

Transparency is a universal value that can be applied to any area of law. The principle has a number of meanings but in this context it implies openness, communication, and accountability. Transparency is a principle that aims to remove all barriers to – and the facilitating of – accessible (available) corporate information to determine the reliability of a process. This process often includes verifying the level of protection that the procedure affords individuals and associated bodies involved, and whether the regulations and rules in

[42] Collectively by observing the relevant insolvency legislation such as Sch. B1 para 4, Insolvency Act 1986 and regulations such as the Code of Ethics, a general trend is clear and promotes a view entirely consistent with the expectations of professionalism. See D. Milman, 'Governance, stewardship and the Insolvency Practitioner', *Company Law Newsletter*, (2012), 1, at 3.

[43] See Statutory Instrument 2005 No. 524, The Insolvency Practitioners Regulations 2005 http://www.legislation.gov.uk/uksi/2005/524/regulation/6/made (accessed 12th November 2012).

[44] As expressed in Chapter Three, a closer look at the way in which IPs operate reveals great difficulty in assessing with any accuracy the extent IPs protect rights that is in line with the rules and regulations. Structured bias within the profession in favour of the company or certain creditors may never be fully eradicated. This has found support in the fact that the Insolvency Act 1986 does not expressly prevent an IP from acting where there is a conflict, but at the same time 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); see Insolvency Practitioner Regulations 2005 reg.4(f); V. Finch, 'Insolvency Practitioners: the Avenues of Accountability', *Journal of Business Law*, (2012), 645, at 658.

place are adequate. The transparency principle attempts to operate in such a way that it makes it easy for others to see what actions are performed. For example, how a rescue strategy has been developed by an IP. The purpose of increasing transparency is to determine whether, after all the available information is known, the decision that was made by the IP was based on reasonable justifications and not one based on prejudicial information that would be erroneously beneficial to one interested party over another. Transparency, which is understood to aid the rationales of accountability and fairness would go a long way to reassuring the general public and the interested parties of a distressed company, that despite the discretion IPs possess a consideration of their interests would be represented through the principle of transparency as it would allow the affected parties some input into how the decisions were to be applied[45]. In other words by ensuring that transparency is evident within transactions and the decision making process, it can be shown what issues were considered, what was omitted and in turn allow accountability for actions taken and input where necessary. This of course is not free from criticism, particularly when the focus turns to interpreting the notion of procedural fairness – exactly how can we be expected to measure this when there are so many differing notions involved? Whilst some would suggest assessing the concept broadly, it is more appropriate to apply a method that suits the content of the subject matter[46]. Referring back to the values, with the above in mind it reaches a point where establishing the benchmarks and how they should be utilised has been described as "elastic yardsticks"[47], something that should not be too rigid whilst at the same time provide the necessary degree of flexibility to avoid insurmountable tension.

In this case, the issue of discretion forms the foundation for challenging and evaluating the purpose of corporate rescue with reference made to the rationales of legitimacy. Essentially, measuring rescue involves assessing whether it can be achieved in an effective manner whilst adhering to conduct which may be described as fair[48]. Exactly what these terms mean remains to be explored.

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[45] See further V. Finch, *Corporate Insolvency Law – Principles and Perspectives*, 2nd edn, (Cambridge: CUP, 2009), at 59.
[46] D. R. Korobkin, 'The Role of Normative Theory in Bankruptcy Debates', *Iowa L Rev*., (1996-7), 82, at 96, who argues that different types of insolvency theory can be thought of as doing different jobs.
[47] V. Finch, *Corporate Insolvency Law – Principles and Perspectives*, 2nd edn, (Cambridge: CUP, 2009), at 60.
[48] Issues surrounding transparency and pre-packs is something that will be discussed in Chapter Five, but it suffices to mention that the problems associated with independent review has led to a loss of public confidence – a factor that is ultimately affecting the perception of corporate rescue in general. See generally P. Okoli, 'Rescue Culture in the United Kingdom: Realities and the need for a Delicate Balancing Act', *ICCLR*, (2012), 61, at 64.

## 7. Concepts of Efficiency

Whilst the rationales would provide a guided direction to assessing the corporate rescue framework, there remains one more, albeit troublesome concept - efficiency[49]. There are variations as to what efficiency should achieve and in a world where differences are more common than homogeneous concepts it is of no surprise that a notion like efficiency has attracted much attention[50]. Not all notions of efficiency will be discussed. Reference will only be made to the ones that are applicable to this type of law[51]. Efficiency in general terms has been described as the relationship between the aggregate benefit of a legal rule and the aggregate costs of a legal rule[52]. The concept most commonly relied upon is the Kaldor-Hicks principle[53], which is to be distinguished from Pareto efficiency[54]. These two principles, which are known as allocative efficiency notions have been used by both legal and economics scholars for many decades[55].

### 7.1 Pareto Efficiency

Something is Pareto optimal (or Pareto efficient) if in the process of distribution (resources, opportunities or entitlements) any further change would not make even one person better off and would make at least one person worse off, and judged in both instances by the persons own standards. Amongst the concerns however with this process is that it does not make any enquiry into the desirability of the initial allotment of resources[56]; it therefore merely acts as a tool to measure the act of transformation from one point to another and not whether it was the correct choice to commit to the process of distribution in the first place.

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[49] However, other values may be used, see R. A. Posner, 'The Ethical and Political Basis of the Efficiency Norm in Common Law Adjudication', 8 *Hofstra Law Review*, (1980), 487, 494.

[50] The concept has been described as "[t]he bedrock of gold that has carried economic analysis of law", see G. Hadfield, *The Second Wave of Law and Economics: Learning to Surf*, in M. Richardson and G. Hadfield, (Sydney: Federation Press, 1999), at 56.

[51] S. Deakin and A. Hughes, 'Economic Efficiency and the Proceduralisation of Company Law', 3 *CifiLR*, (1999), 169, 173-175.

[52] A. M. Polinsky, *An Introduction to Law and Economics*, (Boston: Little Brown & Co, 1989), 7.

[53] N. Kaldor, 'Welfare Propositions of Economics and Inter-Personal Comparisons of Utility', *The Economic Journal*, (1939), 549; J. R. Hicks, 'The Valuation of the Social Income', *Economica*, (1940), 105.

[54] V. Pareto, *Manual of Political Economy*, edn, A. Schwier and A. Page, Eng tr A. Schwier, (New York; A. M. Kelly, 1971), 261; R. A. Posner, *Economic Analysis of Law*, 7th edn, (New York: Aspen, 2007), 14, and G. Lawson, 'Efficiency and Individualism', *Duke LJ*, (1992), 53, at 85.

[55] See generally on different measures of economic efficiency, B. Cheffins, *Company Law: Theory, Structure and Operation*, (Oxford: Oxford University Press, 1997), pp.14-15; and R. Mokal, *Corporate Insolvency Law: Theory and Application*, (Oxford: Oxford University Press, 2005), pp.20-26.

[56] R. A. Posner, *Economic Analysis of Law*, 7th edn, (New York: Aspen, 2007)

Conversely, something is Pareto superior where at least the lot of one person is improved while not making anyone else worse off. Whilst the notion is appealing, the principle has received a lack of support due to its failure to properly address situations that arise in reality[57], not to mention that such situations hardly ever occur. In respect to corporate rescue it is inevitable that the actions undertaken will affect countless parties, at least some of whom will be made worse off because of a transaction. It therefore follows that just about every transaction that does occur can be categorised as satisfying the Pareto optimal criterion to some degree. Applying this notion to corporate rescue, if (a) represented the company and (b) represented the creditors, the contractual relationship may demonstrate Pareto efficiency in that group (b) may look to enforce their entitlements, but refrain from doing so on the premise that they are compensated by potentially greater returns in the future (given real incentives to enhance their prospects), and (a) may gain from this as they are given the space to plan a potential rescue and give more to creditors (potentially through more credit) as well as benefiting other interests such as the employees. Fulfilling this exchange may be mutually beneficial if it has been fully exhausted, and the distribution may in this case be correctly referred to as Pareto superior as one position has been improved whilst the other remains static, but not made worse. It is recognised that if the official avenue of administration under Schedule B1were pursued this may defeat Pareto efficiency as the bargaining power of one party would be substantially increased, namely the company, at the expense of the other party, namely the creditors. In other words the lack of entitlement for creditors to enforce their rights against a company that has entered administration (thus bringing a moratorium into effect) interferes with the distribution of resources and restricts the extent of transactions taking place between the groups[58]. The implications associated with the restriction of transactions within this twofold relationship changes the pattern of demand, which in turn affects the market price of that resource. Whether it is the price of security for lending further credit (terms of contract dictating higher interest because of a deemed higher risk), or the lack of agreement amongst creditors to allow debt subordination to secure new finance, the increase of this resource (opportunity) adversely affects the ability to carry out corporate rescue procedures[59]. It follows that if those who have been compensated are unhappy or if the compensation distributed is greater than what the distributors of the compensation have gained then the theory is soundly defeated. As noted above, the notion lacks coherence when

[57] R. Mokal, 'Review Article on Fairness and Efficiency', 66 *Modern Law Review*, (2003), 452, at 454.
[58] See G. McCormack, 'Rescuing small Businesses: Designing an 'Efficient' Legal Regime', *JBL*, (2009), 299, pp. 300-306.
[59] See R. Dworkin, 'Is Wealth a Value', 9 *Journal of Legal Studies*, (1980), 191, at 193.

applied to a scenario in practice, but as suggested if the notion was applied in a more restrictive way i.e. the proposed relationship in question was eliminated and only elements were analysed, it may be possible to satisfy aspects of Pareto efficiency. This of course begs the question whether the notion can only be applied in its entirety without any compromises to its form, and that any attempt to use the mechanism in a restrictive sense leads to incorrect usage.

**7.2. Kaldor-Hicks Efficiency**

An alternative notion that is often referred to as potential Pareto efficiency, albeit with concerns as to whether the former can be classed as a notion at all given its lack of credibility as a working theory, is Kaldor-Hicks efficiency (also referred to as cost-benefit analysis, wealth maximisation, or allocative efficiency). The difference between this version of efficiency and Pareto is that there is no actual requirement for the winners to compensate the losers[60], and in fact they very rarely do[61]. The critical aspect of the notion requires that the gains to the winner are larger than the losses incurred by the losers[62]. Exactly how this is to be determined concerns observing whether there is consent for the losses that have occurred. In other words, if the compensation does not satisfy the grievance and as such the amount of compensation must be increased then there is an escalating chance that the model's delicate balancing point will be disrupted to such an extent that the Kaldor-Hicks efficiency notion may be defeated[63]. Applying the notion to corporate rescue, the difficulty rests with the knowledge that if one party cannot be bought (consents to the compensation for the losses) then the notion is entirely defeated[64]. In respect to corporate rescue proceedings, it is highly unlikely that the company would be able to compensate the creditors to such a degree that the grievances were satisfied. To compensate on a level that would put the creditor back into a position that existed prior to the distress to the company, and as if it never occurred, would be to disregard the risky nature of business. This includes the acts to suppress/reduce risk by implementing audit risk assessments and observing market forces, but at the same time it acknowledges that obligations must be fulfilled in accordance with the clauses in contacts.

[60] The only requirement is that gains to the winners are larger than are the losses to the losers; see R. Posner, *Economic Analysis of Law*, 5th edn, (New York: Aspen 1998), at 14.
[61] M. J. Whincop, 'Painting the Corporate Cathedral: The Protection of Entitlements in Corporate Law', *OJLS*, (1999), 19, at 33.
[62] R. Posner, *Economic Analysis of Law*, 5th edn, (New York: Aspen, 1998), at 14.
[63] It requires one person who sincerely cannot be bought, a person who values autonomy highly enough that no amount of compensation could leave them as well off as he would have been had the loss never been inflicted in the first place; see G. Lawson, 'Efficiency and Individualism', 42 *Duke LJ* , (1992), at 84.
[64] G. Lawson, 'Efficiency and Individualism', *42 Duke LJ*, (1992), at 91-92.

Enforcing the specific performance of contracts, or perhaps more aptly put, the effective collection of debt owed, in some ways prevents efficiency being achieved as it does not consider all parties to be equal. However, despite one of the primary aims of administration us that an IP should consider the interests of the creditors as a whole, and equally, is not the same as stating that all claims for debt owed are to be treated as equal. Nevertheless, to restrict conflicts amongst creditors, this could be overcome if the objectives are not identified and only the end product is considered of relevance, not its means[65]. Logically, if this is taken into consideration, then the majority of a single group gain at the expense of a smaller group could be said to be enough to satisfy the Kaldor-Hicks test. The critical issue here is that the value of the gain is susceptible to an individual's own wealth and so it depends upon whether in the scheme of things he or she places a value upon a resource at such a level that it could be classed as satisfying the requisite level of compensation for the distributor to be said to have offered an amount that assures Kaldor-Hicks efficiency. However, if there has been prior distribution of wealth amongst the parties in the contractual relationship and this turned out to be unjust, it makes the objective of efficiently allocating resources meaningless since that action would be no more desirable from an ethical viewpoint than if it were inefficient[66].

Applying this notion to maximising social wealth (as this is the objective of all commercial activity and as such is one of the key factors that dictate the actions of a company), it is possible that this could be achieved by pursuing a policy of Kaldor-Hicks efficiency[67]. There is a tendency to rely on the efficiency model as a means to provide a given framework some practical application; allowing theoretical principles to be applied in practice[68]. The difficulty with the model is if the goal is to increase social wealth, then there is a presumption that it must be shown why a society with more wealth is better, or better off than a society with less wealth. If social wealth is a component of social value, an incremental improvement in social wealth must also be an improvement in value. If not, then the claim that social wealth is a component of value fails[69].

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[65] See C. Korsgaard, 'Kant's Formula of humanity', in her book, *Creating the Kingdom of Ends*, (Cambridge: CUP, 1996), 106-132.
[66] R, Mokal, 'Review Article on Fairness and Efficiency', 66 *Modern Law Review*, (2003), 452, at 456.
[67] T. Bose, 'Resolving Financial Distress: Justice as Fairness and Reciprocity', *UCL Jurisprudence Review*, (2004), 230, at 235.
[68] G. Lawson, 'Efficiency and Individualism' 42 *Duke Law Journal*, (1992), 53, at 92.
[69] R. Dworkin, 'Is Wealth a Value?', 9 *Journal of Legal Studies*, (1980), 191, at 194.

### 7.3. Technical Efficiency (Transaction Cost Efficiency)

Moving away from the allocative efficiency notions, another notion that is worth exploring is that of technical efficiency (or transaction cost efficiency), which is aimed at "achieving desired results with the minimal use of resources and costs and the minimal wastage of effort"[70]. Attention should be drawn to the work of Coase and Hart, with the former considering the definition of the firm (company[71]) and in turn what its purpose is, and what it should be[72], whilst the latter focused on the sources of transaction costs[73]. Coase suggested that any mechanism that actively interacts with the economy, such as a company, is subjected to and co-ordinated by the price mechanism and because of this society should be viewed as not an organisation but an organism[74]. In this capacity the "price mechanism" is to be defined and set by the human need (demand for a product) and the supply is "adjusted to demand and production to consumption by a process that is automatic, elastic and responsive"[75]. In other words the market in which products are bought and sold should be flexible and responsive enough to adapt to changes at short notice to fulfil the demand that exists, or to encourage an increase in the demand by reducing the price of the product. However, this theory implies that the economic system somehow works itself and that any attempt at individual input to plan a course of action is disregarded, despite this group exercising foresight and choice between alternatives[76]. There are some concerns regarding this suggestion as it implies that the direction of resources is dependent directly on the price mechanism; thereby suggesting that economic planning merely tries to do what is already done by the price mechanism[77]. However this general description cannot be applied to all. Whilst it may be applied comfortably in theory, in practice different variables exist which are not always foreseen. Of particular interest is the "organisation" factor which has been referred to as "islands of conscious power in this ocean of unconscious co-operation like lumps of butter coagulating

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[70] V. Finch, *Corporate Insolvency Law – Principles and Perspectives*, 2nd edn, (Cambridge, CUP, 2009), at 56. It should be also noted that transaction costs can be reduced by the organisational design of the company, specifically the way a company governs itself and this in turn may make the operations of the company more efficient, see O. E. Williamson, 'Transaction-Cost Economics: The Governance of Contractual Relations', 22 *Journal of Law and Economics*, (1979), 233.
[71] For an overview of the economic theory of the company, as opposed to its definition see E. Fama, 'Agency Problems and the Theory of the Firm', 88 *Journal of Political Economy*, (1990), 288, at 290.
[72] R. H. Coase, 'The Nature of the Firm', *Economica*, (November, 1937), at 386-405.
[73] O. Hart, *Firms, Contracts, and Financial Structure*, (Oxford: Clarendon Press, 1995).
[74] See F. A. Hayek, 'The Trend of Economic Thinking', *Economica*, (May, 1933).
[75] J. A. Slater, *Allied Shipping Control: An Experiment in International Administration*, (Oxford: Clarendon Press, Oxford, 1921), at 16-17.
[76] See C R. H. Coase, 'The Nature of the Firm', *Economica*, (November, 1937), at 387.
[77] See F. A. Hayek, 'The Trend of Economic Thinking', *Economica*, (May, 1933).

in a pail of buttermilk"[78]. This description has been used to demonstrate how price movements direct production, particularly outside the firm with the purpose of co-ordinating a series of transactions on the market[79]. In essence, the purpose of the firm is to become a vehicle whereby multiple transactions may be carried out within its organisation (entrepreneur-co-ordinated)[80] to eliminate any complicated market structure and reduce transactional costs that would otherwise be applicable if they operated on the open market[81]. The costs of negotiating and concluding separate contracts for each exchange transaction would conflict with the purpose of fulfilling transaction cost efficiency as the desired results would not be achieved within the limits of what was considered as the minimal use of resources and costs and the minimal wastage of effort to achieve this goal would be viewed as undesirable.

Hart takes a look at the sources of transaction costs and chooses to focus on what happens in reality rather than limiting his scope to theory. He states that contracts are not comprehensive and are revised and renegotiated all the time[82], reinforcing the view that contracts are always incomplete[83]. Four reasons as to why this occurs are provided. Firstly, the unpredictability of world affairs can have an effect on the original plan as it is difficult to account for all the contingencies that may arise[84]. The ability to foresee future events is limited[85], which may in turn lead to inadequate contractual provisions being exerted. This limitation is the problem of

[78] D. H, Robertson, *Control of Industry*, (Nisbet & Co Ltd: 1923), at 85.

[79] Contacts are developed as part of a mass co-ordinated process whereby association with a company will produce many relations, of different kinds (express or implied), at different times, see F. H. Easterbrook and D. R. Fischel, 'The Corporate Contract', 89 *Columbia Law Review*, (1989), 1416, at 1426.

[80] Further to this, some commentators have suggested that the company is nothing more than a number of complex, private, consensual contact-based relations, see M. Klausner, 'Corporations, Corporate Law, and Networks of Contract', 81 *Virginia Law Review*, (1995), 757, at 759. However, note that referring to the relations as contacts is probably incorrect as not all relations constitute contracts and should as a matter of caution be referred to as bargains, see M. A. Eisenberg, 'The Structure of Corporation Law', 89 *Columbia Law Review*, (1989), 1461, 1487-8; see also A. Keay, and H. Zhang, 'Incomplete Contracts, contingent Fiduciaries and Director's Duty to Creditors', 32 *Melbourne University Law Review*, (2008), 141, at 151.

[81] See C R. H. Coase, 'The Nature of the Firm', *Economica*, (November, 1937), 388, at 392.

[82] According to the law and economics theory, corporate law should be seen as a body of default rules which the parties are entitled to choose to vary or omit, see I. Ayers and R. Gertner, 'Filling Gaps in Incomplete Contracts: An economic Theory of default Rules', 99 *Yale Law Journal*, (1989), 87.

[83] This is now a generally recognised notion. Attempting to formulate a complete contact can only exist as a theoretical exercise, such as Arrow-Debreu contingent claims contacts. This notion supposes that perfect foresight and complete information can be obtained. The two opposites should be considered as extremes to highlight the differences, see I. MacNeil, 'Company Law Rules: As Assessment from the Perspective of Incomplete Contract Theory', 1 *Journal of Corporate Law Studies*, (2001), 107.

[84] The economic perspective of incomplete contracting is based on the idea that the human mind is a scarce resource, see O. E. Williamson, *Markets and Hierarchies: Analysis and Antitrust Implications*, (Free Press, new York, 1975).

[85] F. H. Easterbrook and D. F. Fischel, *The Economic Structure of Corporate Law*, (Harvard: Harvard University Press, 1991), at 90.

bounded rationality, or in other words – people are rational as opposed to hyper-rational[86]. Secondly, negotiations may take place with individuals and plans being devised (such as opportunistic behaviour of self-interest seeking parties), but they may face difficulties in covering these aspects and previous experience may not be available to guide them through where conflicts arise[87]. Thirdly, the plans even if have been agreed must be written down in such a format that it could be deciphered by outside parties (courts and other arbitration bodies) as to what exactly was agreed[88]. Fourthly, the high transaction costs involved in developing contracts and rectifying terms to cover all possible circumstances renders them unworkable[89]. As such, it would be considered more prudent to factor into the contract the basic terms that can be agreed without too much difficulty and leave the other non-essential, or non-specific issues to be resolved by some other means[90]. Because of these problems, contracting parties (who are inherently self-interest seeking) cannot account for every eventuality and therefore a complete contact cannot be created.

However it is possible to eradicate significant costs, thereby minimising resources required to fulfil an objective if the parties could easily switch to new trading partners at the renegotiation stage[91]. More specifically in relation to corporate rescue, there are various different interests amongst the parties involved and because of this reaching an efficient agreement is made all the more difficult[92]. But any breakdown in a working relationship does not have to be a costly event, as the process may be started again with new factors

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86 See A. Keay, and H. Zhang, ‘Incomplete Contracts, contingent Fiduciaries and Director’s Duty to Creditors’, 32 *Melbourne University Law Review*, (2008), 141, at 154. See also D. B. Tauke, ‘Should Bonds have more Fun? A Reexamination of the Debate over Corporate Bondholder Rights’, 1 *Columbia Business Law Review*, (1989) at 16, where it is said: ‘the ability of contracting parties to enter into complete contingent claims contracts in the face of complex and uncertain contingencies is limited by the ‘bounded rationality’ of the parties – the limits of the human mind in comprehending and solving complex problems’.

87 See O. Hart, *Firms, Contracts, and Financial Structure*, (Oxford: Clarendon Press, 1995), at 23.

88 For further discussion see C R. H. Coase, ‘The Nature of the Firm’, *Economica*, (November, 1937), 388; O. E. Williamson, *The Economic Institutions of Capitalism*, (New York: Free Press: 1985); B. Klein, R. Crawford, and A. Alchian, ‘Vertical Integration, Appropriable Rents, and the Competitive Contracting Process’, 4(1) *Journal of Law and Economic and Organization*, (1988), 199-213.

89 G. S. Crespi, ‘Rethinking Corporate Fiduciary duties: The Inefficiency of the Shareholder Primacy Norm’, 55 *Southern Methodist University Law Review*, (2002), 141, at 141.

90 See I. MacNeil, ‘Company Law Rules: An Assessment from the Perspective of Incomplete Contract Theory’, 1 *Journal of Corporate Law Studies*, (2001), 107, at 113.

91 I. MacNeil, ‘Company Law Rules: An Assessment from the Perspective of Incomplete Contract Theory’, 1 *Journal of Corporate Law Studies*, (2001), 107, at 113.

92 This scheme is often referred to as “a nexus of contacts”. For an overview on the subject see S. M. Bainbridge, ‘In Defence of the Shareholder Wealth Maximisation Norm: A Reply to Professor Green’, 50 *Washington and Lee law Review*, (1993), 1423; S. Deakin and A. Hughes, ‘Economic Efficiency and the Proceduralisation of Company Law’, 3 *Company Financial and Insolvency Law Review*, (1999), 169; I. MacNeil, ‘Company Law Rules: An Assessment from the Perspective of Incomplete Contract Theory’, 1 *Journal of Corporate Law Studies*, (2001), 107.

considered, including additional unforeseen variables[93]. The fundamental thing to grasp is that successful businesses cannot solely be the result of well thought out clauses in contracts, but rather its ability to forward plan and act when action is required. In the same way, corporate rescue is not a predicable mechanism that can be controlled; it is a concept that tries to accommodate all four of the above scenarios associated with incomplete contracts and offer a solution that addresses each one. How well it achieves this entirely depends on individual cases.

The ultimate aim is about reaching optimum results with little input and its characteristics are very similar to that with administrative efficiency[94]. The underlying principle of the latter is to let the stronger competitor, principle or result dictate the flow[95]. To adopt this notion alone does not explain why something should act in a certain way, but it may nevertheless influence the entitlements or opportunities that are available if there are two options in conflict, or even if they are not so indifferent, and one option may be preferred over another because it is the more cost effective[96]. This justification can also be applicable to situations where the goal is to reduce the duration of proceedings (in this case the time it takes for a distressed company to find a solution, if any, to its financial problems) or to increase the gain for interested parties (creditors, and not to forget IPs fees as noted in Chapter Three)[97]. Taking both points into consideration, there is some support for the suggestion that corporate rescue is in fact an inefficient process and it is in fact better to liquidate a distressed company. Some commentators have argued that the only concern that insolvency proceedings should have is to maximise returns to creditors and it is not the function of insolvency law to alter relative pre-insolvency entitlements[98] and to allow other measures, such as rescue to prevail. They

[93] This can include finding lower cost supplies; considering costs that have/will be incurred due to wider financial events external to that of the company (i.e. change in economic climate such as a recession), and even a change in partnerships where mutual objectives are more likely to be achieved.
[94] Here there is a particular emphasis on the company needing to change its company structure in order to streamline the business. For further reading on the need to reduce transaction costs so as to improve efficiency, see O. E. Williamson, 'Transaction-Cost Economics: The Governance of Contractual Relations', 22 *Journal of Law and Economics*, (1979), 233.
[95] See G. Calabresi and A. D. Melamed, 'Property Rules, Liability Rules, and Inalienability: One View of the Cathedral', *85 Harvard Law Review*, (1972), 1089, at 1093.
[96] G. Calabresi and A. D. Melamed, 'Property Rules, Liability Rules, and Inalienability: One View of the Cathedral', 85 *Harvard Law Review*, (1972), 1089, at 1093.
[97] The parties involved in these contracts are regarded as rational economic actors, and it is accepted that each of these actors will endeavour to maximise their own positions with the intention of gaining benefits for themselves, see H. N. Butler, 'The Contractual Theory of the Corporation', 11(4) *George Mason University law Review*, (1989), 99; C. A. Riley, 'Understanding and Regulating the Corporation', 58 *Modern Law Review*, (1995), 595, 598.
[98] E. Warren, 'Bankruptcy Policy', 54 *University of Chicago Law Review*, (1987), at 775.

believe that rescue is in fact a separate goal to that of insolvency law[99]; reinforcing the view that insolvency law has one overriding goal: to allocate the common pool of assets in such a way as to maximise benefits for creditors as a whole[100]. However, adopting this approach in the UK would be contrary to the "rescue culture" that has emerged over recent years. The solution was therefore to divert attention away from getting "bogged down" in debates regarding fundamental principles and develop an alternative rescue device that focused on speeding up the process and maximising returns. This alternative mechanism is referred to as pre-packaged administrations. Whilst the current model reflects objectives endorsed by the Enterprise Act 2002, namely for the IP to consider the interests of the creditors as a whole, it does not provide for a basis in which pre-packed administrations can be justified.

### 7.4. Dynamic Efficiency

Following on from this, attention should now be drawn to Dynamic efficiency, which whilst central to the analyses of capital accumulation and economic growth, will in this instance be used to describe the ability of a given system to evolve and ultimately adapt according to the changing needs and wants of a particular market. The critical factor that must be evident to satisfy this test is firmly on the ability of a given process, over time and through implementing innovative measures to successfully survive in a changing and uncertain environment[101]. The question of what characteristics should be central to determining whether a mechanism is economically efficient remains unresolved[102]. Nevertheless, it is suggested that by looking at the conventional methods that have been adopted to analyse the relationship between economic growth and the distribution of capital wealth, a process can be deducted which can be applied to other situations. It is through this process that a set of

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[99] T. H. Jackson, *The Logic and Limits of Bankruptcy Law*, (Cambridge, Mass: Harvard University Press, 1996), Ch 9; D. G. Baird, 'The Uneasy Case for Corporate Reorganisations', 15 *Journal of Legal Studies*, (1986), at 127.

[100] See T.H. Jackson, 'Bankruptcy, Nonbankruptcy and the Creditors' Bargain', 91 *Yale Law Journal*, (1982), at 857; T.H. Jackson, *The Logic and Limits of Bankruptcy Law*; D.G. Baird and T.H. Jackson, 'Corporate Reorganisations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors,', 51 *Chicago Law Review*, (1984), at 97; T.H. Jackson and R.E. Scott, 'On the Nature of Bankruptcy: An Essay on Bankruptcy Sharing and the Creditors' Bargain', 75 *Virginia Law Rev*iew, (1989), at 155.

[101] See A. B. Abel, N. G. Mankiw, L. H. Summers, and R. J. Zeckhauser, 'Assessing Dynamic Efficiency: Theory and Evidence', 56 *Review of Economic Studies*, (1989), 1-20, see http://www.economics.harvard.edu/files/faculty/40_Assessing_Dynamic_Efficiency.pdf (accessed 3rd August 2011).

[102] For instance see E. S. Phelps, *Golden Rules of Economic Growth*, (New York: Norton and Amsterdam: North Holland: 1966); P. Weil, 'Love Thy Children: Reflections on the Barro Debt-Neutrality Theorem', 19 *Journal of Monetary Economics*, (1987), 377-391; S. M. Feldstein, 'Perceived Wealth in Bonds and Social Security. A Comment', 84 *Journal of Political Economy*, (1976), 331-336.

criteria can be established, which if satisfied may substantiate whether a given mechanism can be classed as dynamically efficient. It is the intention to adopt this method and make it applicable to corporate rescue.

In rudimentary terms dynamic efficiency when applied in economic terms has been said to demonstrate an act whereby due to an intervening event, an imbalance occurs between competing interests and as a result one interest must look to support the other to its detriment[103]. To demonstrate this, a clear example would be to visualise a situation where a given economy was steady (stabilised) with plenty of capital at its disposal. If an influx occurred, such as a growth in the population which exceeds the steady marginal rate of capital, or if the state was investing more than it was earning, this would be deemed as dynamically inefficient[104]. Interestingly, however there is a possibility of making a Pareto improvement to the dynamic inefficient outcome, even if the actual implementation of such is not credible. To create the improvement, making sure that the ceiling of "best result" has been reached, the current generation would have to consume a portion of the capital stock and dictate that the level remains constant perpetually, binding future generations in the process. In essence, to apply the rule generally, dynamic efficiency seems to dictate that if a system, mechanism or principle gains more (opportunity or entitlement) than it outputs (greater than the distribution of resources) it satisfies the concept; if on the other hand the output is greater than the return it will be referred to as an inefficient process.

The concept adopted in this case will reflect a model sensitive to fluctuations in risk (distress within a company) and its ability to embrace change as a means to survive. If the factors within a particular exposure can be captured and the values within can be said to maximise social welfare for some set of positive weights, it can be said that the model in question is dynamically efficient, but only on the basis that a Pareto improvement is impossible[105]. On this basis if an original model could be changed and that this transition would be Pareto improving, depending upon the feasibility, it could be concluded that the initial model was inefficient. Applying this notion to corporate rescue and the options that are made available to a distressed company, namely administration and the increasingly popular pre-packed

[103] P. Diamond, 'National Debt in a Neoclassical Growth Model', 55 *American Economic Review*, (1965), 1126-1150.
[104] A. B. Abel, N. G. Mankiw, L. H. Summers, and R. J. Zeckhauser, 'Assessing Dynamic Efficiency: Theory and Evidence', 56 *Review of Economic Studies*, (1989), at 1.
[105] A. B. Abel, N. G. Mankiw, L. H. Summers, and R. J. Zeckhauser, 'Assessing Dynamic Efficiency: Theory and Evidence', 56 *Review of Economic Studies*, (1989), at 5.

administrations, it begs the question whether the growing preference of the latter by IPs has by default rendered the former as inefficient and the pre-pack option as its Pareto-improvement.

### 7.5. Summary: Types of Efficiency

Exploring the different notions of efficiency has raised some complex issues that would benefit from a brief summary.

In a Pareto efficient economic allocation no one can be made better off without making at least one individual worse off. An allocation is defined as "Pareto optimal" when no further Pareto improvements can be made.

Kaldor-Hicks efficiency represents an outcome that is considered more efficient if a Pareto optimal outcome can be reached by arranging sufficient compensation from those that are made better off to those that are made worse off so that all would end up no worse off than before.

Technical efficiency is concerned with achieving desired results with the minimal use of resources and costs, and the minimal wastage of effort.

Dynamic efficiency describes the ability of a given system/process to evolve and through implementing innovative measures to successfully survive in a changing and uncertain environment.

## 8. Notion of Efficiency

Despite the importance placed upon the notion of efficiency, it is a value, best described as "an abstract concept" concerned with the "the outcome of a theoretical model of how resources can be best allocated in society"[106]. The objective of the notion disregards the wider social/ cultural perspective and chooses to lead policy astray with its own integrated, albeit secluded concerns[107]; away from values that if adhered to may prove beneficial to society. The debate surrounding why/whether one notion should be chosen over another, or why

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[106] C. W. Maughen and S. F. Copp, 'The Law Commission and Economic Methodology: Values, Efficiency and Directors' Duties', 20 *Co Law*, (1999), 109, at 112.

[107] See M. J. Whincop, 'Painting the Corporate Cathedral: The Protection of Entitlements in Corporate Law', 19 *OJLS*, (1999), 19, at 19-20.

efficiency should be the sole determinant remains a matter of debate[108], with commentators justifying their arguments based on personal interpretations of what they consider to be the core values (whether that be social norms or within a contract theme), which is usually heavily influenced by their associated discipline (school of thought) and the desired aim of the concept in question. It remains that whilst efficiency serves a valuable role in determining what the law should be, it is as suggested above, one of a few that deserve consideration. Whether efficiency should be treated in the same manner as the other values is a moot point, but one thing that is clear is that it should not be seen as an end in itself[109]; it does not in itself provide a goal that any area of the law should aim to achieve as it creates no sufficient reason for the law to be one way or another[110]. Despite this caution, it does however appear that efficiency dominates analytic discussions on the law, certainly among law and economics scholars[111] and with this prognosis it led to what can only be described as satisfying the modern obsession with producing multiple visual aids (usually in the form of colour coordinated graphs) to harshly criticise what in real terms is oversimplified technical data[112].

With this in mind, the real difficulty with analysing an aspect of the law is that one must endeavour to accommodate the other values within a world that is dominated by efficiency[113]. What is critical regarding this predicament is that it has to be justified why another value and efficiency are not ejusdem generis. On this premise the value that deserves to be singled out and treated as a key value that helps determine the direction of a piece of law is that of fairness as most people will agree that this should form the basis for most legal concepts[114]. Addressing the question of fairness requires a distancing process whereby the detail is

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[108] See S. Deakin and A. Hughes, 'Economics and Company Law Reform: a Fruitful Partnership', 20 *Co Law*, (1999), 212, 218; J. Armour, 'Share Capital and Creditor Protection: Efficient Rules for a Modern Company Law', 63 *Modern Law Review*, (2000), 355, at 358.
[109] C. A. Riley, 'The Law Commission's Questionable Approach to the Duty of Care and Skill', 20 *Co Law*, (1999), 196, at 198.
[110] R, Mokal, 'Review Article on Fairness and Efficiency', 66 *Modern Law Review*, (2003), 452, at 457.
[111] See A. Keay, 'Directors' Duties to Creditors: Contractarian Concerns Relating to Efficiency and Over-Protection to Creditors', 66 *Modern Law Review*, (2003), 665, at 678.
[112] See R. B. Campbell, 'Corporate Fiduciary principles for the Post-Contractarian Era', 23 *Florida State University Law Review*, (1996), 561, at 623, and referred to by A. Keay, 'Directors' Duties to Creditors: Contractarian Concerns Relating to Efficiency and Over-Protection of Creditors', 66 *Modern Law Review*, (2003), 665, at 678, who describes the process as "a world dominated by the pursuit of economic efficiency is often lacking in grace and kindness, those wonderful human qualities that society in its finer moments find so attractive".
[113] A. A. Leff, 'Economic Analysis of Law: Some Realism about Nominalism', 60 *Va. L. Rev*., (1974), 451; B. Ackerman, 'Talking and Trading', 85 *Colum. L. Rev*., (1985), 899; R. Dworkin, 'Is Wealth a Value?', 9 *J. Legal Stud*., (1980), 191; M. Kelman, 'Legal Economists and Normative Social Theory', in *A Guide to Critical Legal Studies*, (Cambridge: Harvard University Press, 1987).
[114] See L. C. Ho, 'The Financial Collateral Directive's Practice in England', *Journal of International Banking Law and Regulation*, (2011), 151, at 152.

examined as a whole, rather than as a single element (refraining from extracting and analysing individual strands that form the characteristics of the mechanism as a whole)[115]. Given the apparent tension between efficiency and fairness it is critical that the differences are set aside if normative economic analysis is to be accepted as a legitimate tool of public policy[116]. But it cannot through its analysis provide justification for weighing efficiency against any social interests that may be evident[117]. Exactly what the notion of efficiency should apply to depends upon the strain of law under the microscope, but there does appear to be some support for suggesting that efficiency should only be defined and applied to transactions that are voluntary as opposed to involuntary[118]. Adopting this method permits some control to be asserted over when a particular aspect should be measured and whether the obtained results are to be relied upon for further analysis. Unlike efficiency (whose main concern rests with choosing which notion of efficiency should be endorsed), fairness suffers from some terminological issues[119]. Defining fairness, as it will be seen, is not easy as it is an intrinsic term embedded so deeply in almost all basic legal principles that it could be best described as endorsing evolving characteristics operating in multiple dimensions that is incapable of precise definition[120]. Exploring this notion with reference to corporate rescue in its entirety is beyond the scope of this thesis. However, one critical component that features regularly in any analysis with this notion is how wealth is distributed in society[121]. Whilst this element will be explored, the key aspect of the research is concerned with examining the role that IPs have in this transaction and whether their conduct with reference to the notions of efficiency and fairness have contravened and in turn altered the characteristics of corporate rescue.

## 9. Fairness

Defining fairness to a certain degree suffers from the same difficulties as defining efficiency. Ultimately, it comes down to subjectively selecting one theory over another. It is expected

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[115] *Odelola v Secretary of State for the Home Department* [2009] UKHL 25; [2009] 1 W.L.R. 1230 at 39.

[116] A. Devlin, 'Irish Jurist', *Law and Economics*, (2010), 165, at 189.

[117] R. A. Posner, 'The Problematics of Moral and Legal Theory', 111 *Harvard Law Review*, (1998), 1637, at 1670.

[118] R. A. Posner, *Economic Analysis of Law, 7th edn*, (New York: Aspen, 2007), at 12.

[119] See L. Mitchell, Fairness and Trusts in Corporate Law', 43 *Duke Law Journal*, (1993), 425, at 428; A. Keay, 'Directors' Duties to Creditors: Contractarian Concerns Relating to Efficiency and Over-Protection to Creditors', 66 *Modern Law Review*, (2003), 665, at 678; V. Finch, *Corporate Insolvency Law – Principles and Perspectives*, 2nd edn, (Cambridge: CUP, 2009), at 261-265.

[120] See L. Mitchell, Fairness and Trusts in Corporate Law', 43 *Duke Law Journal*, (1993), 425, at 451.

[121] See A. G. Anderson, 'Conflicts of Interest: Efficiency, Fairness and Corporate Structure', 25 *UCLA Law Review*, (1978), 738, at 745.

that a reasonable justification can be provided to demonstrate why an alternative theory is not as adequate as the one chosen. After all there must be a reason why it was favoured, even if this was because it complemented the authors' way of thinking, or it fundamentally provided a premise upon which the core argument may be properly addressed. With this in mind this thesis will adopt John Rawls *Justice as Fairness* theory as it is a well-respected and often used approach, and it will allow the wider aims of this thesis to be examined and explored[122].

According to Rawls, fairness is a term that is associated with neutrality, a task of deciding what is just independently of any vested interest, bias or partiality. Developed further it can be understood that the fairness principles of justice must be "publicly reasonable", i.e. arguable from a diversity of particular social stakes or values[123]. To demonstrate what this exactly means it is worth taking a moment to illustrate. Imagine the familiar experience of distributing pieces of birthday cake at a children's' party[124]. The diplomacy involved to ensure that no one received a larger slice than another is fraught with danger. To adopt a method that would reduce, but not eliminate the risk is to separate the slicing and choosing. If one child cuts the cake, and another distributes them, the slicer has every incentive to make each piece as close to equal as possible, as the slicer would not know which was his or hers[125]. Rawls fairness principle adopts a procedure which operates behind a "veil of ignorance" to ensure that decisions are fair and not as a result of vested interest. In other words their choice is constrained by the fact that they are deprived of certain types of knowledge about themselves[126]; encouraging an environment where you interact with others in a way that you would like to be treated yourself. Essentially, the veil of ignorance excludes the identity of parties being revealed by preventing any distinguishable feature being known to other persons. Because of this feature, no one can measure the position that they are in. They cannot determine what they do for a living, nor how intelligent they are, or what their abilities may be. Critically however the parties themselves cannot assess a concept, despite knowing themselves as individuals that they have their own definition of such a concept (and

[122] J. Rawls, *A Theory of Justice*, (Oxford: Clarendon Press, 1972).
[123] J. Rawls, *Political Liberalism*, (New York: Columbia University Press, 1993).
[124] Rawls' well known and often used example of two persons sharing a piece of cake demonstrates how the maximin decision rule works in actual practice; see J. Rawls, *A Theory of Justice*, (Oxford: Clarendon Press, 1972).
[125] J. Penner, D. Schiff, and R. Nobles, *Jurisprudence and Legal Theory: Commentary and Materials*, (Edinburgh: Butterworths/LexisNexis, 2002), at 726.
[126] N. E. Simmonds, *Central Issues in Jurisprudence: Justice, Law and Rights*, (London: Sweet & Maxwell, 2002), at 51.

that it may be different from the other concepts held by others), and they do not know what that concept is (what their personal ideals and values may be)[127].

The fundamental point to grasp is that this "ignorance" principle is to be applied to the choice of principles of justice to ensure that the process and outcome are defined from an impartial point of view rather than determined on personal interests. As stated, to achieve these aims individual interests must be eradicated from the equation and the theory of justice which aims to promote neutrality tries to ensure that the different interests are all considered equally. It therefore follows that if each party in the "original position" do not know what their concept of good is they are naturally more inclined to choose principles that does not reflect or infer preference for any one particular concept[128]. What does occur is a mixture of various ideals in a single framework which tries to satisfy a broad range of interests.

The discussion on *Justice as Fairness* offers an interesting insight into the way in which conflicts may be addressed and solutions found to satisfy a group in dispute as a whole. But it should be approached with caution as Rawls acknowledges that this idea of imposing conditions on the "original position" is only one point that is advanced to support his theory of fairness[129].

### 10. The Relationship between Corporate Rescue, Efficiency and Fairness

Understanding the relationship between corporate rescue and the values adopted to analyse the legitimacy of its underlying principles involves taking a look back at Chapter Two where people's reasonable and legitimate expectations were discussed. It will be remembered that these expectations form the substance that fuses other principles together. It is within this line of thinking that enables us to consider what would we reasonably wish to see in a contract if we drafted it[130]. The concept has a bearing on the efficiency of the agreement and the terms it produces, having the effect of creating a consensual obligation that brings an element of fairness to all reasonable parties concerned. Exactly what factors should be evident within this bargaining transaction all too often highlights a vulnerable party not represented within

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[127] N. E. Simmonds, *Central Issues in Jurisprudence: Justice, Law and Rights*, (London: Sweet & Maxwell, 2002), at 51.
[128] "Original Position" (OP) is defined as the way in which people can negotiate and agree to the principles that are to govern their society fairly, stripped of the influence of vested interests and partisanship.
[129] N. E. Simmonds, *Central Issues in Jurisprudence: Justice, Law and Rights*, (London: Sweet & Maxwell, 2002), at 52.
[130] L. Mitchell, 'The Fairness Rights of Bondholders', 65 *New York University Law Review*, (1990), at 1225.

the relationship. It appears the norm that one party will often not have the necessary information, knowledge or position within the relationship to protect their interests to a satisfactory level. Chapter Three brought into sharp contrast the relationship between the creditor and the IP and how the former party is left vulnerable to further risk after a company entered administration as there is a considerable lack of information that can be secured outside of the privileged position occupied by the IP. It was seen that IPs have been invested with wide discretion to enable them to act as they choose and free from any influence that the creditors may try to exert to recover debts. Fairness in this capacity can be diluted to imply that as long as the IP has considered the creditors' interest as a whole, it does not matter that the goal of satisfying the creditors is not fulfilled. Consideration of interests and taking action to secure interests are two very different aims; the decision of which selection to take is usually determined by the amount of wealth that remains in the distressed company and the justifications that are evident to support any transaction/ transfer of wealth. The only option that is left for creditors to ensure that fairness (being treated fairly in the proceedings) has been actively considered is that the RPBs that govern IPs monitor the actions of their members to ensure that the relevant regulations and Codes have been complied with. It is acknowledged that this review process seeks to address imbalances after the "wrong" has been committed, but assessing whether an act was fair tends to be an act that can only be properly determined when a matter has been concluded. It is perhaps not surprising that an increasing number of R3 members stated that the regime for regulation did not work efficiently[131]. The findings are understood to make the distinction between efficiency and effectiveness, with the former term being used to describe a process that works well, and the latter referring to situations where the right tools have been selected to complete the task in mind. It appears to be the case that simply labelling this as an administrative problem is only partially true as the reason for ineffective information gathering and a monitoring system that is incapable of effective regulation appears to result in insufficient time, money, organisation, coordination and clarity of objectives[132]. This can be read in conjunction with the shortcomings and concerns associated with the behaviour of accountants, particularly in large insolvency cases where the professional fees charged tended to be not proportional and in most cases appeared to fail to consider interested creditors[133].

[131] L. Verrill, 'The R3 Regulation Survey', *Recovery*, (Autumn, 2004), at 27.
[132] G. Rummney and R. Smith, 'Sorting Out the bad Apples', *Recovery*, (Winter 2005), at 36.
[133] See Chapter Three.

### 10.1. Efficient Framework

Taking this observation into consideration it is paramount to determine what is an "efficient framework"? Specifically, it should be asked by what benchmark should the outcome of a corporate insolvency procedure be measured? A framework of this nature requires a starting point (when an action qualifies to be audited by the criteria agreed) and a "critical point" whereby if a result hits an optimal point then it can be classed as not applying the efficiency value. Determining when an action qualifies as being inefficient depends entirely on the deed and the objective set. If a company enters liquidation then it could be said that the company was inefficient in what it did. There may be issues of poor management or external factors which have affected the operations of the said company. But it should be mentioned again that failure should not be seen as something that can always be avoided; it is a natural process and in some ways essential to the development of the business world and the economy[134]. If on the other hand a company has incorrectly entered administration, when the best course of action would have been to liquidate the company, then it may be said that the process in identifying the correct procedure has been inefficient. Pursuing the wrong procedure has important repercussions as it increases the professional chargeable fees as well as the costs associated with the procedures. Conversely, can it not be said that liquidation is an efficient process? This returns to the point of questioning the reasons why the company entered a rescue procedure in the first place. Issues that may be raised concern the behaviour of insolvency practitioners and how their actions may be influenced by potential personal financial gain in the insolvency proceedings[135]. Despite these reservations, in real terms the only way that corporate rescue can be measured is to determine how successful it has fulfilled a number of factors i.e. secures jobs, maintained the structure of the company, but it must be remembered that rescuing a company as a whole, unchanged, poses the risk of not addressing the issues that caused the distress in the first place. It follows that a method should not be adopted whereby only certain expectations that would prove fruitful to providing an efficient model should be chosen; expectations should be reasonable and aim to enhance and promote the strands that are used to measure legitimacy[136].

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[134] For further discussion see the Darwinian approach in Chapter Two.
[135] See Chapter Three.
[136] See Section 4, Legitimacy: Reasonable Expectations.

### 10.2. Substantive Aims and Procedural Goals

Much reference has been made in previous chapters concerning the substantive aims of corporate rescue and what the procedural goals were to achieve these aims. For instance, when a company is found to be distressed it is natural to assume that certain expectations should be fulfilled such as new finance being sought, whether that is from existing creditors extending credit or new investors. It is equally expected that during the course of a rescue attempt the operations and transactions are not done contrary to any insolvency legislation, the regulations or conduct code that governs the professional actors in the implementation of their duties. Following on from this, it was examined in Chapter Three that the majority of decisions made on behalf of a company when it was distressed are made by an IP. Therefore it is intended that this will form the main point for analysis in order to determine whether their role and duties contravene the values to such a degree that it precludes corporate rescue from being a legitimate mechanism.

Firstly, it should be remembered that expectations are reserved for parties privy to a contractual relationship, which in this case may refer to the company and its creditors. On this basis it could be said that the primary function for rescue in relation to the creditors, is to consider their interests as a whole. When defining 'interests' it is often done so in an isolated way, choosing to focus on actions that would produce the best financial return for the creditors (aggregate profit), when the task of minimising loses can also be seen to be just as beneficial. So in regards to this objective, what happens if expectations are not met? Based on a contractual relationship this would mean that someone would be accountable; if this was not the case then the lack of reasonable enforcement of expectations would create an unacceptable amount of uncertainty whereby agreements and actions would go unfulfilled. However, given the discretionary powers invested in IPs along with the way that they are governed and monitored, serious questions must be asked as to whether this apparent lack of duty based on an utilitarian approach, disregards a number of key values such as fairness and would make transactions almost impossible, rendering entire business networks (companies that are chain-linked and therefore dependent on each other, either for finance, employment or for parts to enable them to produce their product) at the mercy of becoming insolvent (the so called "ripple effect")[137]. IPs are entrusted with the discretionary power to implement the law within the boundaries set, but when these confinements are "elasticated" it brings into

[137] A. Keay, 'Directors' Duties to Creditors: Contractarian Concerns Relating to Efficiency and Over-Protection to Creditors', 66 *Modern Law Review*, (2003), 665, at 680.

question whether any reasonable expectation can be considered at all. In fact it begs the question whether it is unreasonable even in contractual relationships to have reasonable expectations.

### 10.3. Tensions between Values

Part of explaining this dilemma rests with acknowledging the tensions that exist between the values; it cannot be ignored that trade-offs, particularly between the concepts of fairness and efficiency that are in a constant state of conflict, where compromise often takes precedence as the only means to reach some agreement between the various parties in question. The nature of rescue as discussed in Chapter Two revealed a mechanism that accepts that it has to evolve and adapt to the unique circumstances that are present when dealing with a company. With short time frames, complex company structures and business models to understand, it is of no surprise that the actions of IPs will always receive some criticism given that they are in a constant state of having to consider the interests of multiple parties. Despite this, decisions are made and it will rarely be the case that all the values can receive the same careful attention as each other. With this in mind it is suggested that given the definition of economic efficiency, corporate rescue cannot satisfactorily fulfil the requirements; the substantive and procedural goals of rescue are not compatible, and in some respects appear to be in conflict with each other. However, it is possible that the rescue model in the UK could fulfil one notion of efficiency, namely the dynamic efficiency test which the next chapter will examine. The concept of corporate rescue has shown a great ability to innovate, modify and survive in a changing and uncertain environment to suit the needs of its audience. The dissection of pre-packs and whether it could fulfil the description of a legitimate process will be reserved for the next chapter, but what will now take place is a closer analysis of the relationship between fairness and efficiency.

Departing from Mokal's thinking that the efficiency rule cannot be a goal in itself because it does not determine why something should be one way or the other, one nevertheless cannot disregard core elements within a particular framework[138] that are fixed (have an end result), for example in insolvency law the termination of the company i.e. liquidation[139] or in relation to corporate rescue - completing a "pure rescue" strategy. It is suggested that if there is a thread that must run in one direction, whilst it may not be possible to determine the route, the

[138] A. Belcher, *Corporate Rescue*, (London: Sweet & Maxwell, 1997), at 89.
[139] A. Belcher, *Corporate Rescue*, (London: Sweet & Maxwell, 1997), at 89.

destination can be. In essence, as it can be determined that pure rescue has an ultimate end efficiency can be measured in three ways. Firstly, by how effective the procedure adopted is at rescuing the company (with reference to how intact the company remains); secondly, how effective is the procedure at dealing with a distressed company (the correlation between theory and practical application and whether this is in harmony); and thirdly, the way in which IPs implement rescue. This last measure takes a look at the process, the inherent characteristics and whether given the above, inefficiency has led to the use of professional discretion to modify the law so it is in tune with the needs of the market, but divergent when compared with the theme endorsed by current legislation.

### 10.4. Fairness

But what of fairness -can this be traded off against the concept of efficiency? This has caused some debate, with Finch stating that fairness may sometimes have to be traded off at the expense of efficiency[140] and Mokal suggesting to the contrary[141]. The basis for the latter's view is that substantive and procedural goals, which represent ends and means, do not compete. Reiterating, the objective of economic efficiency is to fulfil a contractual obligation "at minimal cost and without waste whatever social and distributional goals are set by society"[142]. So it is natural that the substantive goals must be set before the procedural goals can be approved. In essence, efficiency cannot be measured/ quantified until it has been decided what the end and means of rescue are.

It has been briefly noted what some of these substantive goals of corporate insolvency law should be. The economic theory provides the scope for corporate insolvency law to provide a framework which eliminates inefficiency and in turn take the necessary action against uneconomic enterprises that cannot operate in a competitive market. It is in the understanding that resources are limited and could be better used in some other activity[143]; but whilst the process of transferring valuable resources to credible projects is not only sensible, it is efficient to do so. But it must also be remembered that whilst limiting and reserving risk and funds alike is an important factor in the business world, a corporate rescue framework should also provide a workable option where a distressed, yet salvageable company can be saved. In

[140] V. Finch, *Corporate Insolvency Law – Principles and Perspectives*, 2nd edn, (Cambridge: CUP, 2009), at 25, 29, 34-35, 43, 51, 55-56, 407, 559.
[141] R, Mokal, 'Review Article on Fairness and Efficiency', 66 *Modern Law Review*, (2003), 452, at 458.
[142] V. Finch, *Corporate Insolvency Law – Principles and Perspectives*, 2nd edn, (Cambridge: CUP, 2009), at 190.
[143] M. J. White, 'The Corporate Bankruptcy Decision', 3 *Journal of Economic Perspectives*, (1989), 129.

essence the design of a rescue regime should incorporate various considerations which would ultimately provide for its purpose. There have been many attempts to provide a definition which would encapsulate the very meaning of corporate rescue; that would enhance its understanding in the wider context within a social, moral and economic environment. What will be emphasised here is that given the substantive goal of corporate rescue as being to save companies as a going concern, as opposed to the option of liquidation, the procedural goal to achieve this is flawed as rescue depends upon cost efficiency. Whilst noted above that some academics have suggested that efficiency cannot be a goal in itself, this thesis argues to the contrary in line with the argument made by Easterbrook who states that not only that "legal rules endure because they are efficient..."[144], but also that it is "not good design which produces economic efficiency, but economic efficiency which explains the changes in the law"[145]. This harbours the suggestion that corporate rescue is flawed as a mechanism as the procedural goal which contains the efficiency rule has made it not cost efficient. However, is it not possible for something to be efficient just for the sake of being efficient? Can efficiency not be a goal in itself? The problem with this line of thought is that efficiency cannot be assessed on its own merits; it has to have some benchmark that enables it to determine exactly what is efficient. To be measured, efficiency must be used in conjunction with another value, which in this case is fairness. Fairness, whilst it offers a way of measuring efficiency, should be used with caution as it is after all still a subjective value that depends entirely on the interests being measured.

Whilst it has been argued that corporate rescue in the way that it is structured in the UK is an inefficient, inadequate mechanism that does not reconcile with the commercial realities evident in the business world and does not provide a satisfying model that can be utilised with ease and confidence, a theory that requires more attention is the link that corporate rescue has with the concept of dynamic efficiency. Although the issue of dynamic efficiency is central to analyses of capital accumulation and economic growth, it may be applicable to cross-reference the term to models that are aware of, and recognise, the need to transform in order to survive in a changing and uncertain environment. The requirement to adjust to new challenges is understood to be critical to ensure the objectives of a particular model can be achieved. But if it tried to continue without addressing the concerns of the market, it would not only be considered detrimental to its existence as it would fail to justify its ability to be

[144] F.H. Easterbrook, 'Is Corporate Bankruptcy Efficient?', 27 *Journal of Financial Economics*, (1990), at 411.
[145] F.H. Easterbrook, 'Is Corporate Bankruptcy Efficient?', 27 *Journal of Financial Economics*, (1990), at 417.

economic efficient (i.e. wasteful), but it would also encourage alternative routes to be sought with the inadequate procedure being disregarded.

Whilst fairness is predominately assessed within a contractual relationship with the focal point firmly being on measuring creditors' expectations against the result, another aspect that should not be overlooked is the public interest factor. It was stated in Chapter Two that there is a general acceptance amongst the insolvency profession that a system dedicated to rescuing companies must do so with consideration to other interested parties, besides that of the creditors. In many cases companies operate within "dependent networks", all providing some assistance to the other by way of finance, parts, labour or goods. When there is any disruption to the network it affects the entire group, meaning that some creditors will not be able to pay their own creditors – the so called "ripple effect" which leads to an overall downturn within the collective welfare of society. It is therefore of no surprise that questions are raised as to whether the present regime of implementing insolvency processes ensures fairness to affected parties[146]. Given the multi-dimensional capacity of insolvency related work, the actions of IPs will usually present conflicts of interests, therefore potential acts which could be deemed as unfair are persistent and are particularly rife when the duty and inherent behaviour of IPs are considered. Of special note, an aspect mentioned in Chapter Three, is the concern regarding the office holders and their respective firms, drawing attention to the relationship that some firms have with creditors and the influence that the latter have over the former; personal interests and other appointments may be relevant. IPs 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 the work or remuneration that an IP receives may be affected by actions or recommendations made. Exactly how the present legal system controls conflicts and endeavours to resolve discrepancies amongst interested parties in a distressed company is far from clear and is often conducted in a tense environment.

## 11. Conclusion

A critical way to measure how well something is doing is to ask how effective does a model achieve its intended goal? Given the vast array of goals that can be pursued, not all can be assessed in the same way. Different benchmarks are set according to the nature of the goal and not all models can endorse the same fundamental principles as each will be different.

[146] V. Finch, 'Controlling the Insolvency Professionals', *Insolvency Lawyer*, (1999), 228.

Beside cultural influences, the overall model is subjected to wider issues which may be general in nature, such as economic downturn, or specific to the market in which the company operates. In essence the contents of a model must be put in context and assessed accordingly.

Subjecting corporate rescue to this framework involves identifying dominant principles within the current insolvency legislation that are presumed to be of significance due to the historical importance that they possess. Once these principles have been sought they may form the basis for assessment; providing a foundation in which they may reveal how one model compares to another in terms of how efficient they are in producing a desired outcome.

To reduce conflict basic principles must be applied which may act as general tools. Values such as transparency and fairness are important as they allow a system to be viewed as a whole. Transparency is a universal value that can be discussed in conjunction with accountability; both aid to reassure the general public and interested parties that a model is doing what it is meant to do. Corporate rescue however does not satisfy the test satisfactorily as the process is not accessible and IPs are not accountable enough for the actions that they take.

Applying the four main notions of efficiency to corporate rescue has revealed some interesting findings. The main difficulty identified when applying Pareto efficiency to a corporate rescue model is whether the notion can truly be applied to a functioning principle that operates in the "real world"? Based on this concern, the preference is to use the alternative notion known as Kaldor-Hicks efficiency. This notion has benefits as unlike the former notion there is no actual requirement to compensate the losers. The only requirement is that the winners must gain more than the losses to the losers. Applying this notion to corporate rescue it is highly unlikely that the company would be able to compensate the creditors to such a degree that their grievances were satisfied. Furthermore, should this be done at all? Why should the risk element of investment be disregarded? Whilst contractual obligations play a key role in determining how debt is divided, it does so with the knowledge that not all parties or debts are equal. Satisfying Kaldor-Hicks efficiency means that the value of the compensation provided must be at such a level to be sufficient to the affected party. But since this depends entirely on the individual's wealth the notion is susceptible to many possibilities and cannot be applied with any certainty.

In reference to practical application, technical costs are often applied which realises that the stronger competitor, principle or result should dictate the flow. The notion believes that the market provides the answers to the problems that exist in a particular area. As explored in Chapter Three, IPs have heavily influenced how administration is to be interpreted and in turn have been responsible for the rise in alternative rescue strategies such as pre-packs being deployed. This can be read in conjunction with dynamic efficiency which describes the ability of a given system to evolve and ultimately adapt the changing needs of a given market. It will be suggested that corporate rescue methods have evolved to the needs of the business world.

In terms of the actors who participate in a company there are legitimate expectations exerted that controls how the company is run as well as how potential financial distress is dealt with. Can administration be said to offer the best deal for a distressed company? The research completed in this chapter inclines us to conclude that it does not fully capture commercial practice, and survives only by categorising inconsistent elements as exogenous[147]. Whilst the legal uncertainty cannot be eliminated; it can only be managed[148] and this has created a two-tier system whereby an informal approach has been taken. The next chapter will now explore pre-packed administration.

[147] P. S. Atiyah, *The Rise and Fall of Freedom of Contract*, (Oxford: Clarendon Press, 1979), at 714.
[148] J. Benjamin, 'The Narratives of Financial Law', 40(3) *OJLS*, (2010), 787, at 807.

## Chapter 5

## The Pragmatic Response (The Compromise): Pre-Packaged Administration

### 1. Introduction

The previous chapters have highlighted the difficulty in assessing the United Kingdom's rescue regime, primarily because the basis of assessment is unclear[1]. It has been seen that the boundaries of "the rescue process" vary according to the subjective opinion of each commentator and the situation that this presents. Whilst Chapter Two examined the fact that rescue can be seen as "a major intervention necessary to avert eventual failure of the company", the definition is fraught with terminological deficiencies. What is clear is that rescues may operate through informal mechanisms as well as formal legal processes. But it is with the former process that most rescues are achieved as informal actions do not require any resort to statutory insolvency procedures[2]. Moreover, in addition to choosing one procedure over another, it is also possible to have a hybrid model that has a formal and informal stage. This is where the pre-packaged administration ("pre-packs") is involved as it has elements that can be found within a formal insolvency procedure (the administration process) but the actual substance of pre-packs comprises an array of negotiations and undertakings that take place prior to the company entering administration and are, therefore, informal. As such, it will be necessary to re-examine the role of the Insolvency Practitioner (IP) in this chapter and build on the research conducted in Chapter Three. As noted earlier, the discretion afforded to IPs often places the entire rescue process behind a veil of secrecy and the fundamental difference here when considering a pre-pack is that most of the negotiations and potential contracts have been drawn up before administration has been entered into. In addition to this it will be seen that a UK pre-pack frequently, but not always, takes the form not of a reorganisation and rescue of the company, but of a management buyout of the company's business[3]. With this in mind, there will be questions surrounding the legitimacy of pre-packs and whether they can be regarded as a true corporate rescue procedure. There will be some expected difficulties in assessing pre-packs as they lack a true identity, given that there is no

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[1] This concern is also raised by Finch, see V. Finch, 'Corporate Rescue Processes: The Search for Quality and the Capacity to Resolve', *Journal of Business Law*, (2010), 502.
[2] See S. Frisby, '*Report to the Insolvency Service: Insolvency Outcomes*', (Insolvency Service, London, June 2006). For informal rescues, see S. Slatter, D. Lovett and L. Barlow, '*Leading Corporate Turnaround*', (John Wiley & Sons Ltd, 2006).
[3] J. Moulton, 'The Uncomfortable Edge of Property – Pre-Packs or Just Stitch ups?', *Recovery*, (Autumn 2005), 2; M. Ellis, 'The Thin Line in the Sand Pre-Packs and Phoenixes', *Recovery*, (Spring 2006), 3.

legal definition of the "pre-pack" as with other rescue processes[4]. Nevertheless, the key questions remain: do pre-packaged administrations offer a viable and legitimate solution to the inadequacies of the current law governing corporate rescue? Given the nature of pre-packs and the increasing preference for them[5], can the trend be said to be contributing to a change in the corporate rescue regime in the UK? And lastly, does this change constitute a shift so fundamentally different to the corporate rescue model that exists in the UK that it could be said to render the current law partly redundant and in turn mean that the UK is lacking an effective corporate rescue model?

## 2. Background: Pre-Packaged Administration

Before an examination of what a pre-pack actually is and what this procedure involves, it is imperative to reiterate aspects of Chapter Two and Three which analysed the development of the corporate rescue process when the Enterprise Act 2002 was enacted. The original administration procedure was substantially altered by section 248 of EA 2002, which substituted a new Part II of the 1986 Act, now compromising a single section, section 8, which provides that "Schedule B1 to this Act should have effect". Paragraphs 3 and 4, headed '*Purpose of administration*' set out the objectives of administration:

(3)(1) 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 being in administration), or
- (c) realising property in order to make a distribution to one or more secured or preferential creditors.

(2) Subject to sub-paragraph (4), the administrator of a company must perform his functions in the interests of the company's creditors as a whole.

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[4] However, despite the lack of legal input, attention will be drawn to the Statement of Insolvency Practice (SIP) 16, which offers guidance on pre-packaged sales in administration and in particular provides a non-legal definition of pre-packs. Whilst this will be discussed in greater detail, it suffices to note that the purpose of SIPs is to set out basic principles and essential procedures with which insolvency practitioners are required to comply. Departure from the standard(s) set out in the SIP(s) is a matter that may be considered by a practitioner's regulatory authority for the purposes of possible disciplinary or regulatory action. It is therefore important to understand that SIPs should not be relied upon as definitive statements of the law. For reference see the website for the Institute of Chartered Accountants (in England and Wales) http://www.icaew.com/~/media/files/technical/insolvency/regulations-and-standards/sips/england/sip-16-e-and-w-pre-packaged-sales-in-administrations (accessed 17th January 2012).

[5] It has been estimated that at least 50% of all UL administrations are pre-packaged. See S. Davies, 'Pre-packs: He Who Pays the Piper Calls the Tune', *Recovery*, (2006), 16.

(3) The administrator must perform his functions with the objective specified in sub-paragraph (1)(a) unless he thinks either –

(a) that it is not reasonably practicable to achieve that objective, or

(b) that the objective specified in sub-paragraph (1)(b) would achieve a better result for the company's creditors as a whole

(4) The administrator may perform his functions with the objective specified in sub-paragraph (1)(c) only if –

(a) he thinks that it is not reasonably practicable to achieve either of the objectives specified in sub-paragraph 1(a) and (b), and

(b) he does not unnecessarily harm any of the interests of the creditors of the company as a whole.

Whilst it is stated that there is now a single purpose to administration, it comprises three objectives that are ranked in order of priority. In addition to these objectives it is paramount that the administrator performs his or her functions "in the interests of the creditors as a whole". As previously suggested, the primary objective of an administration appointment is the rescuing of the company as a going concern. It is apparent that in accepting such an objective, a high proportion of appointments of administrators have been made and will be made in cases where a rescue of the company in this sense is not reasonably practical and the alternative objective under paragraph 3(1)(b) is the more achievable[6]. Under this objective the sale of the company's business or undertakings as a whole or in parts would proceed. It is important to note that even if the administrator considers that it is practically possible to rescue the company, objective 3(1)(b) would be pursued if it would achieve a better result for the company's creditors as a whole. Determining which objective is achieved is entirely dependent on the administrator and is something that is often unknown until the administration appointment has been made. Whilst it is clear that the court will only make an appointment if it is satisfied that the purpose of administration is likely to be achieved (this should be distinguished from out of court appointments), the evidence adduced must contain an opinion from the proposed administrator on whether the objective is achievable[7].

[6] See *Key2law (Surrey) LLP v Gaynor De'Antiquis (Secretary of State for Business, Innovation and Skills intervening)* [2011] EWCA Civ. 1567, para 32.
[7] See Insolvency Rules 1986, rule 2.3(5).

With the basic outline of administration covered, the question is: where do pre-packaged administrations fit in? Because in most cases the idea of rescuing a company is rejected as an unachievable objective, the focus is instead on the objective of achieving a better result for the company's creditors as a whole than would be likely evident if the company were wound up (without first being in administration). If the court is satisfied that this objective can reasonably be achieved, then the condition set out in para 3(1)(b) will be satisfied.

A pre-pack involves a pre-arranged sale of all or part of a distressed business or assets of the company, which will be executed immediately, or shortly, after the appointment of an administrator[8]. It will be remembered in Chapter Two that a detailed discussion took place regarding the sale of the business and the sale of the company and how the two differ. It remains that administration is closely associated with a business sale[9]. The difference between a classic administration and pre-packs however brings a new dimension, as a pre-pack sale is arranged prior to the appointment of the administrator and the creditors get no say in relation to the sale[10]. At the time of entering into administration there is effectively "a done deal". From an unsecured creditors' perspective the pre-pack is a mechanism that is not only potentially prejudicial to their interests, but also causes questions to be asked concerning the legitimacy of a model that can be completed without all the interested parties knowing about the existence of the transaction, and which often is designed to benefit those inside the company.

Turning to the efficiency of pre-packs and drawing on the research considered in Chapter Four, there is a growing consensus amongst IPs that it is best and most beneficial if the business of a distressed company can be sold as a going concern at the optimum time. It should be noted that pre-packs are often conceived weeks or even months before the appointment of an administrator. The justification for having such early intervention is often cited as being the result of adopting a prudent commercial judgement, as it is accepted that

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[8] Insolvency Service, *'Report on the First Six Months'*, Operation of Statement of Insolvency Practice 16', (2009), para 2.1.

[9] It appears that Frisby's research shows that between 2004-2006 on a database of 2,063 companies which entered into administration or administrative receivership between September 2001 and September 2004, 32% of the post Enterprise Act 2002 administration case samples are as a going concern sale of the company's business, while 56% are asset sale where a company's assets were sold on a break up basis. See S. Frisby, *'Report on Insolvency Outcomes'*, (Insolvency Service, 2006), at 61.

[10] The distinction between pre-packs and business sale within administration should not be understated as the latter is driven by considerations and assessments raised post appointment of an administrator, see S. Frisby, *'A Preliminary Analysis of Pre-Packaged Administrations'*, (R3: Association of Business Recovery Professionals, 2007), at 9.

the conduct of modern business is complex in nature. The complexity allows administrators to go about their business knowing full well that there are expectations placed upon them from stakeholders to do the necessary preparatory work before an administration takes place, without which the potential value from the proposed sale of all or part of a distressed business or assets of the company would be reduced, and hence make the purpose of the process less effective[11]. Despite the main justification provided for allowing pre-packs there are concerns, which have now been recognised by professional regulators, that pre-packs are capable of being abused by those intent on doing so[12]. Exactly how these abuses may materialise, and to what extent might they occur, is something that will be discussed shortly. What must now be examined are the theoretical and practical reasons behind pre-packs.

### 3. Pre-Packs and Legitimacy

As previously stated, any attempt made to find a comprehensive definition of a pre-pack, or what the process involves may prove to be a fruitless task. But that is not to say that no guidance exists. On the contrary, little by little assistance is being provided to those who wish to understand more about the pre-pack strategy. In recent years much attention has been drawn to the case of *Kayley Vending Limited*[13], which, as will be seen, has not been unwarranted. It should be made clear from the outset that this case was completed in two halves, with the first consideration merely occurring to allow the court to make the administration order, and the second stage materialising on the premise that the court accepted the invitation (from the applicant) to provide the profession with some guidance as to the approach of the Court to what had become known as pre-pack administration applications. The details of the case itself will not be recited as the circumstances were largely unremarkable and would not contribute anything to the overall discussion. Nor will it be necessary to recall every matter that was discussed in the judgment as various aspects will be analysed throughout this chapter at points where it is more appropriate to do so. That said, the first main point worth highlighting from the deliberations is that the court was keen to remind the profession that the purpose of the Insolvency Act 2000 and the Enterprise Act 2002 were in fact to reduce the involvement of the court in the initiation of insolvency processes. In cases where an application to the court was still required the process would be

[11] R. Robinson, 'President's Column', *Recovery*, (Winter 2005), at 34.
[12] Insolvency Service, '*Report on the First Six Months'*, Operation of Statement if Insolvency Practice 16', (2009), para 2.3.
[13] *Re Kayley Vending Ltd* [2009] EWHC 904 (Ch), [2009] B.C.C. 578.

streamlined with a greater clarity concerning the information required for that purpose[14]. However, determining exactly what information is required is far from clear and remains an issue that has still not properly been addressed despite the introduction of SIP 16. SIP 16 will be discussed in detail later in this chapter. But it suffices to mention that despite efforts made to make the process more transparent a concern that has not been fully addressed is how, or what, the courts will or should do when faced with a possible clear case of abuse within a pre-pack? Should they address the issue and try to rectify the wrong, or is the issue a matter for the legislature? This challenge clearly weighed heavily in the mind of the presiding judge, HHJ David Cooke (sitting as a High Court judge) in *Re Kayley Vending Ltd*, who made it clear that he did not want his judgment to be construed as being anything like a practice direction[15]. Nevertheless, his findings, in conjunction with assessing the legality issue, are worth exploring, in particular the concerns and positives regarding pre-packs.

Starting on a positive note, it is common knowledge that the main advantage of a pre-pack process is that it enables the business to be sold quickly, with the minimum possible adverse impact from either public knowledge of its insolvency or the restrictions imposed by the insolvency process itself[16]. In some cases this may mean that employees can be retained who may have left, or have to be dismissed once a formal insolvency process commences. This continuity of the business, even if it only exists on an external front can encourage the customer and supply contracts to be maintained. Of course, this depends on a lot of factors, namely the ability of the financially distressed company to continue to trade whilst negotiations are ongoing to secure a sale of business. Inevitably attempts to sustain value may result in the company suffering some damage to its value, despite best efforts to maintain the company's value. Reasons for this vary from the general stigma associated with failed businesses as discussed in Chapter Two, to the perception that bad management is to be blamed and investors wish to protect their interests.

Whilst there is a clear advantage to be gained from concealing the troubles of a company from the general public, a pre-packaged proposed sale has not been subjected to the competitive forces of the market, which ultimately may lead to the company or assets within the business being sold at a value below what would ordinarily have been the case if it had

[14] *Re Kayley Vending Ltd* [2009] EWHC 904 (Ch), [2009] B.C.C. 578, para 3.
[15] *Re Kayley Vending Ltd* [2009] EWHC 904 (Ch), [2009] B.C.C. 578, para 3.
[16] *Re Kayley Vending Ltd* [2009] EWHC 904 (Ch), [2009] B.C.C. 578, para 6.

been exposed to the market for an appropriate period[17]. In addition to the rights of stakeholders to participate in the decision making process, effectively by-passed in a pre-pack, something which is a central principle in the administration process, it becomes clear as mentioned above that the lack of transparency within the pre-pack process renders it difficult for most creditors to determine how the deal was struck and whether the administrator has properly conducted all the necessary enquiries as well as completed his or her duties in a manner that complies with the legislation and does not prejudice the creditors' interests[18]. It appears that the lack of transparency has eradicated any attempt to question accountability, especially in regards to any creditor wishing to challenge the practitioner's conduct, as retrieving the correct information in the first place will be very difficult[19].

It is in relation to the lack of transparency and finding a potential purchaser that leads us on to perhaps the most troublesome issue associated with pre-packs, that of selling the business to a party previously connected with the company. This process by its very nature raises some immediate questions, ranging from why is the process not advertised, given the profound assumption that these meetings to negotiate the sale, if they can be classed as meetings, are held in private and with haste, to questioning the soundness and legality in giving the ownership to what appears to be the same people who controlled the company at the time the company became distressed[20].

Explaining the justifications behind these decisions will for the majority of the time "falls on deaf ears" as far as the creditors are concerned. Why should previous managers of failed businesses be given a second chance by buying and controlling the same company at a discounted price? Granted it is not always this clear cut. The business may be restructured and as a result of this it may not technically be the same, the managers may not be fully to blame for the insolvency of the company, and in fact the ones that remain, if anything, are showing that they still believe that the business can be profitable. But the problem, or perhaps

[17] The debate around pre-packs essentially centres upon whether or not the pre-pack is an appropriate and effective method of selling a business, see S. Frisby, '*A Preliminary Analysis of Pre-packaged Administrations*', Report to the Association of Business Recovery Professionals, (August 2007), at 8.
[18] S. Frisby, '*A Preliminary Analysis of Pre-packaged Administrations*', Report to the Association of Business Recovery Professionals, (August 2007), at 8
[19] S. Frisby, '*A Preliminary Analysis of Pre-packaged Administrations*', Report to the Association of Business Recovery Professionals, (August 2007), at 8.
[20] Cf Chapter 11 bankruptcies whereby the bankruptcy estate vests in the "debtor in possession" and so the company's management may remain in place during the reorganisation period. See generally R. Parry, *Corporate Rescue*, (London: Sweet & Maxwell, 2008), at pp. 262-265.

more aptly put – the suspicion – is how quickly these deals are undertaken. How to remove this suspicion will not be easy as there is no guidance note as to "what represents a good pre-pack" and in turn "what represents a bad pre-pack"[21]. Whether such a list could be compiled is another matter as it can be appreciated that all variables when placed together produce unique circumstances. From the type of business to the speed in which a deal must be done, all this has a bearing on how such a procedure should be carried out; and even when the circumstances of companies share similar characteristics there will be no shortage of differing opinions as to the best method to employ and indeed whether the procedure is infringing the legislation. Whether the parameters have been overstepped depends often on whose perspective is offered. Questions surrounding potential areas susceptible to being abused will only be quashed or at least quietened if there is a genuine effort by the regulating authorities or the Department of BIS to provide a framework which can be used as a "best practice" model.

What needs to be assessed before suggesting any factors which could produce a model of bad practice is to fully assess the charges that are laid against pre-packs. However it must be stressed that prejudices and assumptions are prevalent as the nature of pre-packs affects a sensitive issue – the distribution of wealth and control. Therefore it is imperative that the arguments are supported by data and research. There is already one report conducted by Dr Sandra Frisby entitled '*Preliminary Analysis of Pre-Packed Administrations*', but this chooses to focus on the debatable factors surrounding what makes a good pre-pack and the report also provides a comprehensive data analysis illustrating the various success rates of pre-packs at different stages of being initiated rather than questioning the fundamentals of the legality of pre-packs.

What now needs to be looked at again is the objective of corporate rescue, as mentioned in Chapter three and whether pre-packs can be correctly associated with rescue or is it simply a process that allows management buy outs?

### 4. Insolvency Practitioner's Discretion and the Objective of Rescue

The administration procedure, as reformulated by the Enterprise Act 2002 has provided IPs with a three-tier hierarchy list of objectives which should be considered in order of

[21] S. Frisby, '*A Preliminary Analysis of Pre-packaged Administrations'*, Report to the Association of Business Recovery Professionals, (August 2007), at 7.

preference, commencing with the rescue of the company as a going concern. As submitted earlier, whilst administration will very rarely lead to a genuine company rescue[22], there are serious questions raised as to what is the purpose of the procedure? The IP is duty bound to consider the first objective contained within paragraph 3(a) and be seen to make efforts towards rehabilitating the company. However, the difficulty with pre-packs is that the IP is usually involved prior to his or her formal appointment and will often have already settled a price for sale with a prospective buyer; upon his or her formal appointment the transfer of the business is swiftly, undertaken. The process does perhaps offer a pragmatic solution to a distressed company whose board and shareholders desire it to be saved, but fears that any publicity of its financial troubles may further contribute to the company's demise[23]. Furthermore the option is favourable to secured creditors as it allows them to participate in the process and ensures that they negotiate a secured return. However, the position is entirely different with unsecured creditors. Despite financially supporting the company in providing services or other necessities, they share the risk that comes with distress, but it is questionable whether their interests are considered on the same level regardless of being susceptible to the same challenges that face secured creditors. Pursuing one option at the expense of another, which is a fundamental characteristic associated with a pre-pack strategy, there is a danger that the company is developing a single way forward without fully consulting all of the interested creditors[24]. It could be argued that this process neglects the important principle of ensuring that any potential action by the company is fair and transparent[25]. Essentially, given that most 'new' purchasers are in fact members of the existing management of the distressed company, there is a question as to whether there is a breach of duty committed by the IP i.e. a conflict caused by the threat of familiarity[26]. It follows that since a pre-packed sale does not achieve the first (primary) objective of administration, the IP has potentially failed to consider the statutory duty of rescuing the company as a going concern. Thus, it appears that pre-packs have been designed with objective two and three in mind, which causes one to

[22] Reference should be made to the empirical research obtained by Frisby '*Report on Insolvency Outcomes'*, (2006): whole or part company rescues among the post-EA administrations sample are 2.4% and in the pre-EA sample 4.7%.
[23] This is particularly relevant in companies that rely on public perception, such as a business that is focused on services or those that have many intangible assets like a strong brand or intellectual property. See M. Ellis, the Thin Line in the Sand Pre-Packs and Phoenixes', *Recovery*, (Spring 2006), at 3.
[24] V. Finch, 'Pre-Packaged Administrations: Bargains in the Shadow of Insolvency or Shadowy Bargains', *Journal of Business Law*, (2006), 568. See A. Katz and M. Mumford, *'Study of Administration Cases'*, Insolvency Service, (October 2006), at 50.
[25] However, for a different view to these concerns see S. Frisby, 'The Pre-pack Promise: Signs of Fulfilment?', *Recovery*, (Spring 2010), 30.
[26] A. Kastrinou, 'An Analysis of the Pre-Pack Technique and Recent Developments in the Area', *Company Lawyer*, (2008), 259, at 260. See also Chapter Three, Part II – Section 9: Breach to the Fundamental Principles.

question whether pre-packs can be associated with corporate rescue; but at the same time it should also be assessed whether, given the characteristics of pre-packs, they should be seriously considered as a true alternative to the administration process?[27]

### 4.1. Making the Right Decision – when to Sell?

A serious headache that is often given to IPs is the conflicting strategies: whether to turn a company around, or to sell the business as a going concern. The distinction is absolutely critical. Whilst it has been noted that administration is concerned with the attempt to rehabilitate the company, the intention behind pre-packs is not to be concerned with such a matter. The debate that has surrounded the use of this procedure by practitioners has been well documented, with proponents of the procedure providing commercial common sense as a justification for offering this option, as a means of extracting value for creditors from the distressed corporate estate[28]. This is true to a certain extent, and particularly true if the company has retained part of its business that is worth salvaging[29]. It therefore remains that instead of selling off the assets belonging to a distressed company in the hope that the value holds, it will often be the case that selling a business as a going concern will reap better rewards for the creditors. But this should not be read as merely selfishly maximising the surplus for creditors, for it may also assist in saving employment, and supplier and customer relationships, as well as affording the business a second chance[30]. This wider consideration often acts as a justification for initiating a pre-pack strategy, stating that the second objective contained within the administration procedure aims to achieve a better result for creditors as a whole[31] than would be achieved in liquidation. Support for this stems from the premise that the administrator must pursue his or her functions in the interests of the company's creditors

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[27] It seems to be the case that it is the ability under para 68 of Sch. B1 to appoint an administrator out of court (a clear difference in comparison to the original administration regime) with minimal formality which has led to the recent widespread adoption of the pre-pack version of administration. See S. Harris, 'The Decision to Pre-Pack', *Recovery*, (Winter 2004), 26, at 27. See also A. Zacaroli, 'The Powers of Administration Under Schedule B1 Prior To The Creditors' Meeting – Transbus International Limited', 1(4) *International Corporate Rescue*, (2004), 208, who suggests that the administrator may now enter into an immediate sale of the company's assets after being appointed by the company managers, without any court involvement or scrutiny from the courts.

[28] V. Finch, 'Pre-packaged Administrations: Bargains in the Shadow of Insolvency or Shadowy Bargains?', *Journal of Business Law*, (2006), 568; P. Walton, 'Pre-Packaged Administrations: Trick or Treat?', 19 *Insolvency Intelligence*, (2006), 113; J. Moulton, 'The Uncomfortable edge of property – Pre-Packs or Just Stitch ups?', *Recovery*, (Autumn, 2005), 2; S. Frisby, *'A Preliminary Analysis of Pre-packaged Administrations'*, Report to The Association of Business Recovery Professionals, (August, 2007).

[29] B. Xie, 'Protecting the interests of General Unsecured Creditors in Pre-Packs: the Implication and Implementation of SIP 16', *Company Lawyer*, (2010), 189, at 189.

[30] A. Bloom and S. Harris, 'Pre-packaged Administrations What should be Done Given the Current Disquiet', 19 *Insolvency Intelligence*, (2006), 122, at 122.

[31] Insolvency Act 1986 Sch. B1 para 3(2).

as a whole. Therefore it is clear that the administrator is not compelled to rescue the company at all costs; there has to be an unbiased assessment to determine the value to be gained from the various options available. Needless to say that the tension between protecting the company and protecting the business is something that was expected and hence catered for within the legislation[32]. The result of this foresight within the law means that rescuing the company gives way to arrangements that would provide a better result for the creditors as whole. Thus the priority of rescue is weighed in favour of saving the business where this leads to a better result for the creditors[33]. Nevertheless, whilst this may appear straight forward a word of caution should be applied as this should be read in conjunction with the explanatory notes contained within the Enterprise Act 2002, which state that rescuing the company as a going concern should mean "the company and as much of the business as possible"[34]. As such, rescuing parts of the company will not satisfy the objective, the focus should be on the company and its ability to operate as a going concern[35].

### 4.2. Is a Pre-pack really Corporate Rescue?

The recurring theme however draws us back to the question: is the pre-pack really a corporate rescue procedure? Or to put it another way: does the disregard of the primary objective negate the entire legacy of corporate rescue? To answer this question attention should be drawn to the accountability of IPs and the participation of creditors within the process. Whilst most of this was discussed in Chapter Three, there are some aspects which are particularly noteworthy and warrant further consideration. As regards administration it is necessary for IPs to provide a framework as to how they are to achieve the purpose of administration, and within eight weeks of taking office they must send notice of the proposal to the company's creditors[36]. In addition to this framework, it also a requirement that within 10 weeks of taking office the IP must call a creditors' meeting in order to vote on the plan[37]. So whilst it is clear that the IP must perform his or her functions in the interests of the creditors as a whole[38] and as quickly and efficiently is possible[39], this does not necessarily mean that what the creditors

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[32] Whilst the primary objective is to save the company as set out in para 3(1), the secondary objectives focus on the salvaging of the business, see para 3(3) and 3(3)(b).
[33] See V. Finch, Corporate Rescue Processes: The Search for Quality and the Capacity to Resolve', *Journal of Business Law*, (2010), 502, at 509.
[34] Enterprise Act 2002, para 647.
[35] See S. Frisby, 'In Search of a Rescue Regime', 67 *Modern Law Review*, (2004), 247, 262-263.
[36] Insolvency Act 1986 Sch. B1 para 49.
[37] Insolvency Act 1986 Sch. B1 para 51.
[38] Insolvency Act 1986 Sch. B1 para 3(2).
[39] Insolvency Act 1986 Sch. B1 para 4.

would see as the most desirable outcome will be achieved. Part of the issue rests with the significant powers of discretion that have been afforded to the IP. Ultimately the IP is the architect rather than a guardian of the administration process and it is this perception that has been fortified by the Enterprise Act 2002 which permits them to perform their functions as they see fit. In addition it is interesting to note that the courts are aware of their own limitation (expertise and commercial knowledge) and because of this place a great reliance on the expertise and experience of impartial IPs[40]. Because of the reluctance demonstrated by the courts to interfere with the decisions and commercial judgement of the administrators[41], IPs have been afforded wide discretion[42]. A clear example that exemplifies the extent of this discretion can be seen when an administrator reviews the primary objective (the only true objective that promotes corporate rescue) and may override this if he or she "thinks" that it is not reasonably practicable to rescue the company as a going concern[43]. What constitutes an acceptable level of "thinking" can hardly be tested apart from perhaps making sure that the administrator complies with the relevant guidelines and regulations such as SIP 16, which requires the administrator to demonstrate his or her reasons for the actions taken and that they have considered alternative financial options[44]. But even this is subjected to his or her discretion and despite the somewhat unequivocal directions on how complete the reports

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[40] See *DKLL Solicitors v HM Revenue & Customs* [2007] EWHC 2067 (Ch), [2007] B.C.C. 908. Earlier support can be drawn from Re T & D Industries Plc [2000] 1 All E.R. 333, where the court held that administrators have the power to sell the whole of the assets and business of the company in advance of convening a creditors' meeting and without the need to go to the court for directions. Reference should also be made to the Insolvency Act 1986 s.17 (2) states: "...[T]he administrator shall mange the affairs, business and property of the company (a) at any time before proposals have been approved (with or without modifications), in accordance with any directions given by the court, and (b) at any time after the proposals have been so approved, in accordance with those proposals as from time to time revised, whether by him or a predecessor of his".

[41] C. Swain, 'A Move towards A Stakeholder Society?', 19 *Insolvency law and Practice*, (2003), 7.

[42] Further support can be drawn from *Re Transbus International Ltd* [2004] 2 All E. R. 911, in which the court accepted that in many cases the administrator will be called to reach an urgent and important decision in his attempt to preserve the value in a viable business which would otherwise be lost. See A. Lockerbie and P. Godfrey. 'Pre-packaged Administration: The Legal Framework', *Recovery*, (Summer, 2006).

[43] Insolvency Act 1986 Sch. B1 para 3(3) a-b

[44] On the scope and meaning of the word 'think' in this context see J. Armour and R. J. Mokal, 'Reforming the Governance of Corporate Rescue: The Enterprise Act 2002', *LMCLQ*, (2005), 28. In particular it is worth referring to their reference to Hansard,10 April 2002 : Columns 569-70 ("The word 'thinks' in those paragraphs means that the administrator will have to reach a considered view [about which objective to pursue]. In such situations, the administrator's decision would be subject to a rationality test by which it would be challenged if it could be shown that no reasonable administrator would have acted in such a way in those circumstances"); 29 July 2002 : Column 768 ("The present wording would mean that if the administrator's view were then to be tested, it would be subject to a 'rationality' test — that is, his decisions would be subject to successful challenge if it could be shown that no reasonable administrator would have acted in such a way in the particular circumstances of a case"), and 21 October 2002 : Column 1105 ("If necessary, we would expect the courts to assess whether the office holder, in this case the administrator, has been rational in his decision. We are not seeking to apply any other test").

should be, this is not always done[45]. As such it leaves the administrator with considerable room for manoeuvre to dismiss the primary objective and to then consider the secondary options[46].

However, notwithstanding the three objectives open to the IP, complying with the provision that requires a creditors' meeting to be held is conditional upon a number of points. There are four exceptions to the requirement to hold a meeting, with one that is central to the development of pre-packs. The three non central exceptions cover (1) where the IP considers that the company has sufficient property to enable each creditor of the company to be paid in full[47]; (2) that the company has insufficient property to enable a distribution to be made to unsecured creditors[48]; or (3) it is not feasible to achieve a result better than winding up[49]. The fourth and critical exception relevant to this thesis is where the rescue of the company as a going concern cannot be achieved then this renders a creditors' meeting unnecessary[50]. In effect this sanctions the action for the IP to take measures that will bring about a pre-pack prior to a creditors' meeting. However, it should be stressed that the IP will prior to a creditors' meeting usually consult any secured creditors (particularly banks), but it is unlikely that all creditors will be afforded the same treatment, in particular if they happen to be less powerful and with little resources to make their interests known when compared to others[51].

It is often noted that the speed in which a business sale under a pre-pack may be completed is something that has an advantage over a purer form of administration. The differences between the two also continue when the focus is placed upon the extent that a distressed company is exposed to the market in which it operates. In a pre-pack the business is often subjected to investigations that are done in secret and hence hardly subjected to the market,

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[45] It appears to be a reoccurring theme that there is virtually no opportunity for any independent assessment of the insolvency practitioner's actions, see also P. Walton, 'Pre-packin' in the UK', 18 *International Insolvency Review*, (2009), 85, at 92.
[46] Insolvency Act 1986 Sch. B1 para 3(1)b-c.
[47] Insolvency Act 1986 Sch. B1 para 52(1)a.
[48] Insolvency Act 1986 Sch. B1 para 52(1)b. Other than by virtue of section 176A (2)a, which covers the action of the liquidator, administrator or receiver to make a prescribed part of the company's net property available for the satisfaction of unsecured debts.
[49] Insolvency Act 1986 Sch. B1 para 52(1)c.
[50] Insolvency Act 1986 Sch.B1 para 52(1). However, see para 52 (2)-(4), which states that the administrator shall summon an initial creditors' meeting if it is requested by creditors of the company whose debts amount to at least 10 per cent of the total debts of the company.
[51] A. Kastrinou, 'An Analysis of the Pre-Pack Technique and Recent Developments in the Area', *Company Lawyer*, (2008), 259, at 260; see also *Re Trident Fashions Limited (No2)* [2004] 2 BCLC 35 per Lewison J, at para 39 who states that it appears an insolvency practitioner can legitimately disenfranchise unsecured creditors, if the IP believes the best result for the creditors in general can be achieved via the pre-pack.

which might give the impression that minimal effort was made to attract potential purchasers other than those already identified as members of the existing management. This begs the question: how could the best price have been obtained under such circumstances?[52] The issue here returns to the valuation process and the suggestion that pre-packs may not involve a sufficiently robust valuation exercise[53]. Frisby who has provided much empirical research on the subject has concluded that it is perhaps safe to conclude that no marketing of the business had occurred prior to the eventual sale unless the IP's administration reports expressly indicates otherwise. Whilst Frisby remains open to any challenges that can rebut this presumption she goes on to provide some statistics to validate her opinions. The research, aimed at illustrating the way pre-packs operate in practice ambitiously provides, for perhaps the first time, a comprehensive overview of what really happens with a growing number of distressed companies. Amongst the findings the report suggests that only 18 of the 227 businesses (7.9%) of the whole pre-pack database were marketed in the appropriate way[54]. The report went on to state that effective and reasonable marketing by IPs were not often implemented which in turn failed to identify the interested purchasers[55]. In addition it is interesting to note the tactics adopted to ensure that the distressed company's situation did not become public knowledge[56], thereby having a potential impact on the value of the company. It may be inferred, given the lack of transparency evident within a pre-pack process, that practitioners operating under a cloak goes against the very integrity of the principles highlighted through the thesis, whether that is the principles identified with the law in general or the duties associated with the IPs when they administer their duties. For completeness and to highlight the disparity, the overall business sale cases compared to pre-packs indicated a more positive picture with a greater number of marketing strategies being undertaken. Out of

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[52] See S. Frisby, *'A Preliminary Analysis of Pre-Packaged Administrations'*, (R3: Association of Business Recovery Professionals, 2007), at 49.

[53] It should be made clear that "testing the market" and exposing the company to the "open market" is about identifying the market and making it aware of the opportunities – it is not about exposing the proposal to the word, see M. Ellis, 'The Thin Line in the Sand: Pre-packs and Phoenixes', 3 *Recovery*, (Summer 2008).

[54] S. Frisby, *'A Preliminary Analysis of Pre-Packaged Administrations'*, (R3: Association of Business Recovery Professionals, 2007), at 30, 49.

[55] The nature of the database attempted to address whether any form of marketing has taken place or not. The author however concedes that the best that could be done was to answer the question in the positive where reports indicated that this was the case. The second aim of the research was to determine whether a valuation had taken place prior to the sale. This was not conclusive in most cases, as some reports made no mention of whether the services or valuers had been engaged or not. See S. Frisby, *'A Preliminary Analysis of Pre-Packaged Administrations'*, (R3: Association of Business Recovery Professionals, 2007), at 30, 49.

[56] For instance practitioners may conduct preliminary investigations into a company's affairs without formally being appointed to that position, thereby not attracting unwanted attention to the fragile company. Or alternatively they might target specific purchasers with a set agenda (with an attempt to retain some bargaining power within any deal) with the intention of preventing the company being exposed to the market.

the 412 business sale cases on the database, 229 (55.6%) gave some account of a marketing campaign[57].

Returning to the issue concerning the efforts taken by the IP to find the best market value for the business, whilst reasonable efforts will be taken to ensure that potential purchasers are identified and brought in to negotiate possible prices[58], this action is extremely complex and can, if neglected, cause the business further distress. As noted above, Frisby's research implies that the fate of most companies is not subjected to the market for fear that it may diminish the business value. What is clear is that even if a company was this way inclined (to be exposed to the market), the period for which potential buyers are willing to make good offers for the business as a going concern will be very short[59]. It therefore follows that IPs will often see it as the logical conclusion that in order to extract the value of the business and prevent it from further diminishing in value, a pre-pack sale would be the best course of action[60].

Before examining a collection of recent cases to identify how pre-packs are dealt with in reality, it is paramount to take a closer look at the relationship between the creditors and the duty that is imposed on IPs and determine whether pre-packs are compatible with the relevant guidelines.

**5. Statement of Insolvency Practice 16 (SIP 16)**

Given the confusion surrounding pre-packs, including technical compliance and potential breaches of duties by the administrator, it was only a matter of time before some guidance was deemed essential for the survival of the procedure as well as the reputation of the IPs. The Statement of Insolvency Practice 16 goes some way to clarifying the procedure, attempting to ensure that any pre-pack is carried out in a more transparent way than was perhaps done in the past, whilst at the same time addressing the issue surrounding unsecured creditors having no voice in the proceedings by requiring a detailed explanation and

[57] See S. Frisby, *'A Preliminary Analysis of Pre-Packaged Administrations'*, (R3: Association of Business Recovery Professionals, 2007), at 49.

[58] M. Crystal QC and R. J. Mokal, *'The Valuation of Distressed Companies a Conceptual Framework'*, (Insolvency Service, 2006), at 2.

[59] B. Xie, 'Protecting the Interests of General Unsecured Creditors in Pre-Packs: The Implication and Implementation of SIP 16', *Company Lawyer*, (2010), 189, at 190.

[60] This is also supported by the fact that there will usually be a failure of any party to fund the administration period, and lengthy large-scale marketing would further reduce the value of the business, see P. Walton, 'Pre-Packaged Administrations - Trick or Treat?', 19 *Insolvency Intelligence*, (2006), 113, at 115.

justification as to why a pre-pack sale was undertaken[61]. It is important to refresh our memories and understanding concerning the relationship (if any) that pre-packs have with the formal administration process. As stated in the previous chapters, pre-packs have been endorsed as a mechanism that works around the administration process, something which can be viewed as addressing the real issues that face distressed companies, whilst at the same time being able to offer more relevant, pragmatic solutions that are flexible and not so restrictive as if carried out within the administration process. What we seem to be witnessing is the general acceptance of pre-packs as a necessary tool in the administrators' armoury, but also recognising that it is not regulated or currently legislated for within the Insolvency Act. In order to address this concern, the Joint Insolvency Committee (JIC)[62] approved SIP16 which was issued by the RPBs and The Insolvency Service and came into force on 1 January 2009. SIP16 requires administrators to explain in detail to creditors the background to their appointment and the reasons for any transaction undertaken through a pre-pack administration[63]. Because of its importance it is worth exploring the SIP 16 in full.

**5.1. Contents**

First the following attempts to define the term "pre-packaged sale" (or "pre-pack"), referring to it as an arrangement under which the sale of all or part of a company's business or assets is negotiated with a purchaser prior to the appointment of an administrator, and the administrator effects the sale immediately on, or shortly after, his or her appointment. It is an incomplete definition, but one that sheds light on the intentions of the procedure, namely that the focus is fixed on business rescue (dealing in assets) as opposed to "pure" company rescue. In the interests of bringing clarity to the process it is important to note that in any given situation the interested parties will have different perceptions about quality, even if they broadly agree on the relevant benchmarks[64]. What parties want and expect from a potential pre-pack will vary considerably. Therefore, any attempt to tie down a definitive description

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[61] S. Frisby, *'A Preliminary Analysis of Pre-packaged Administrations'*, Report to The Association of Business Recovery Professionals, (August 2007), at 31.

[62] The Joint Insolvency Committee (JIC) is a Committee on which all of the RPBs are represented together with The Insolvency Service, and was formed in 1999. It is concerned with professional and ethical standard setting across the profession, which it achieves through the approval of an Ethical Code, Statements of Insolvency Practice3 (SIPs) which are binding on insolvency practitioners, and Insolvency Guidance Papers. The JIC meets quarterly, with sub groups taking forward specific issues between meetings, and publishes a report each year.

[63] It is often said that SIP 16 codified what has been the best practice in handling pre-packs. For a judicial consideration of the main concerns surrounding the main issues in pre-packs see *Re Kayley Vending Ltd* [2009] EWHC 904 (Ch), [2009] B.C.C. 578.

[64] Values and divergences play an important role in the shaping of processes, see V. Finch, Corporate Rescue Processes: The Search for Quality and the Capacity to Resolve', *Journal of Business Law*, (2010), 502, at 517.

that does not take into account the tensions that exist amongst the creditors fails to consider the delicate balance that is required to make a pre-pack workable, which in this context means reaching an agreeable outcome without the need to over-indulge in compromises. The position regarding negotiations and permitting these to take place before the formal stage has commenced, is a decisive action that separates pre-packs from the other rescue processes. Best described as offering a pragmatic solution to companies that are in financial distress, pre-packs strategies have no tangible characteristics that link them with either a formal or informal process. Negotiations may commence in an informal way (outside administration), but the company needs to enter administration, albeit if only for a moment, for the "deal" to be implemented. Questions surrounding the "legality" of pre-packs have ensured that it is necessary for the proposed strategy to be given formal legal status. Entering administration provides these "informal negotiations" with the legal certainty and approval that is required to ensure that the strategy is binding on all interested parties. It appears that pre-packs suffer from something of an identity crisis that makes it difficult to confirm what principles, aims or values it embraces and in turn how it may be integrated into the existing legal framework.

### 5.2. The Conduct of the Insolvency Practitioner

Moving on to examining the conduct that is expected of practitioners, whether as adviser to the company before the appointment, or as the appointed administrator, or both, the SIP 16 makes it imperative that the administrator is aware of his responsibilities. In particular it is noted that they should bear in mind their duties for those who act on their advice, what he or she owes to parties who might be affected by the arrangement, and should take into consideration the risks associated with his or her decisions (that will affect all parties – the so called "ripple effect") [65]. Following on from this it is now expected that administrators should be able to provide justifiable reasoning behind the decision to undertake a pre-packaged sale, and why such a course of action was considered appropriate[66]. By introducing such measures it is hoped that this will contribute, in time, to making the decision process more transparent than previously existed, and in turn more accountable to interested parties. How this change will make a difference remains to be seen, but it already faces challenges in the form of administrators' "discretion" and "commercial judgement" which is often endorsed by the courts as acceptable best practice. It may be argued that administrators instead of viewing SIP

[65] SIP 16, para. 2, see http://www.icaew.com/~/media/files/technical/insolvency/regulations-and-standards/sips/england/sip-16-e-and-w-pre-packaged-sales-in-administrations (accessed 17th February 2012)
[66] See S. Frisby, *'A Preliminary Analysis of Pre-Packaged Administrations'*, (R3: Association of Business Recovery Professionals, 2007), at 31-32.

16 as a regulatory requirement actually see it as endorsing what has already been the practice for some years. Non-compliance with SIP 16 is a grey area, with clear breaches being dealt with by the relevant RPB. It should be stressed that whilst every effort will be made to ensure that disclosure is complied with as there is an obligation on administrators to follow a number of objectives[67] to ensure that the process takes into account as far as possible the different interests extant in a company[68], the list is not conclusive. Of particular interest, SIP 16 provides an exemption to disclosure, permitted under the Insolvency Act for various reasons which ultimately allow the administrator the flexibility to plan strategies as he or she sees fit[69]. The "exceptional circumstances" contained within paragraph 10 of the SIP 16 is conditional on the basis that the reason why particular information is not disclosed should be clearly stated. It goes on to say that if the sale is to a connected party then it is unlikely that considerations of commercial confidentiality would outweigh the need for creditors to be provided with this information. Note the term "unlikely", leaving open the window of opportunity for administrators to combine, if necessary, their discretion and commercial expertise to justify their actions not to disclose. It is usually the case, as noted above that pre-pack strategies rely heavily on discreetness to allow the deal to work to its full potential. Limiting the exposure of the distressed company to the market for the consideration of a selected few, aids the company's business prospects as suppliers etc. will not be aware of the

[67] SIP 16, para 9 of the SIP 16 provide for a number of examples where information should be disclosed to creditors. In relation to all cases where there is a pre-packaged sale, as far as the administrator is aware after making appropriate enquiries: the source of the administrator's initial introduction; the extent of the administrator's involvement prior to appointment; any marketing activities conducted by the company and/or the administrator; any valuations obtained of the business or the underlying assets; the alternative courses of action that were considered by the administrator, with an explanation of possible financial outcomes; why it was not appropriate to trade the business, and offer it for sale as a going concern, during the administration; details of requests made to potential funders to fund working capital requirements; whether efforts were made to consult with major creditors; the date of the transaction; details of the assets involved and the nature of the transaction; the consideration for the transaction, terms of payment, and any condition of the contract that could materially affect the consideration; if the sale is part of a wider transaction, a description of the other aspects of the transaction; the identity of the purchaser; any connection between the purchaser and the directors, shareholders or secured creditors of the company; the names of any directors, or former directors, of the company who are involved in the management or ownership of the purchaser, or of any other entity into which any of the assets are transferred; whether any directors had given guarantees for amounts due from the company to a prior financier, and whether that financier is financing the new business; any options, buy-back arrangements or similar conditions attached to the contract of sale.

[68] It is in the nature of a pre-packaged sale in an administration that unsecured creditors are not given the opportunity to consider the sale of the business or assets before it takes place. It is important, therefore, that they are provided with a detailed explanation and justification of why a pre-packaged sale was undertaken, so that they can be satisfied that the administrator has acted with due regard for their interests. See *T&D Industries Plc* [2001] 1 WLR 646; *Transbus International Ltd* [2004] EWHC 932 (Ch), [2004] All ER 911; *DKLL Solicitors* [2007] EWHC 2067 (Ch).

[69] SIP 16, para. 12 provide that The Insolvency Act 1986 permits an administrator not to disclose information in certain limited circumstances. This Statement of Insolvency Practice will not restrict the effect of those statutory provisions.

company's predicament and will not therefore "pull the plug". By discreetly operating behind the scenes to forge a deal, administrators are attempting to get the best out of a bad situation. That said, some of the methods employed, as submitted elsewhere in the Chapter are questionable and contrary to the principles, aims and values evident in the relevant legislation, case law, guidelines and regulations.

### 5.3. Guidance

Looking at the guidance offered on the initial stages when an administrator is instructed, it was discussed at the beginning of this chapter the duty that is imposed on administrators and their responsibility in informing creditors. Unless it is impracticable to do so, the information contained within paragraph 9[70] should be provided along with the first notification to creditors[71]. It has already been explored, that in some instances creditors' meetings may not be convened where a pre-packaged sale has been undertaken. If this is the case the administrator should as soon as it is practicable after his appointment provide the statement of proposal which states what he or she intends to do with the distressed company. This of course is conditional on a number of factors, and if the administrator thinks that disclosing certain information to creditors may jeopardise a deal then they may decide to refrain from taking such action[72]. A concern that arises is the effect that the administrators' discretion may have on the principle of transparency[73]. Transparency as explained in Chapter Three is one of the fundamental principles contained within the Code of Ethics that an administrator is expected to abide by and promote whilst carrying out his or her duties[74]. Whilst there are grounds to suggest that the law does not leave it entirely to the administrator's commercial judgement (which is correct for cases involving administration) [75], the lack of anything but

[70] See A. Kastrinou, 'An Analysis of the Pre-Pack Technique and Recent Developments in the Area', *Company Lawyer*, (2008), 259, at 260; see also *Re Trident Fashions Limited (No2)* [2004] 2 BCLC 35 per Lewison J, at para 39 who states that it appears an insolvency practitioner can legitimately disenfranchise unsecured creditors, if the IP believes the best result for the creditors in general can be achieved via the pre-pack.
[71] SIP 16, para 11.
[72] Insolvency Rules 1986, rule 2.33(2)(m). The rule permits that the administrator may apply to the court for limited disclosure with regards to statement of affairs. See also rule 2.33(2)(n), which allows for the non-disclosure in the statement of the administrator's proposals of information "which could seriously prejudice the commercial interests of the company".
[73] Creditors often feel that they are presented with a done deal, which can lead to a lack of confidence in the openness of the procedure. See The Association Of Business Recovery Professionals (R3). '*Briefing on Pre-Packs*', http://www.r3.org.uk/search/default.asp?search_query=pre-packs (accessed 19th June 2010).
[74] See para 36, Insolvency Practitioners Association, '*Insolvency Code of Ethics, Transparency and Confidentiality: A Guidance Note*', 4th November 2008, (accessed on 10th January 2011) http://www.insolvency-practitioners.org.uk/uploads/Transparency%20Final.pdf
[75] See Insolvency Rules 1986, rule 2.33(2), which specifies that that an IPs statement shall include a number of matters covering, details relating to his appointment as administrator (; how it is envisaged that the purpose of the administration will be achieved and how it is proposed that the administration should end; where the

total compliance with this principle (particularly in regards to pre-packs) poses serious questions regarding the legality of the process and whether it can address the imbalance between the creditors as a whole (maintaining the commercial interests of the company) and the perceived advantage that connected parties may have in a management buy-out strategy (this will be discussed shortly)[76]. In regards to recent developments on pre-packs and the proposal statement required under SIP16, empirical research conducted by Frisby has highlighted a number of concerns.

In an attempt to provide some guidance to the pre-pack process, the courts have held that, where the circumstances of the case warrant it, an administrator has the power to sell assets without the prior approval of the creditors or the permission of the court[77]. However, it should be borne in mind that reliance on such authority does not protect administrators from potential challenges to their conduct[78], or claims for misfeasance[79] . But as noted above, in real terms the likelihood that the RPB or the court will take action is minimal. It would seem that the commercial awareness (technical knowledge) that is expected of administrators has provided them, to a large degree, with a protective blanket to allow them to operate how they see fit. Whilst the Code of Ethics and similar guidelines aim to persuade them to make decisions so as to reflect an endorsed philosophy, there are questions as to what really is the rationale of pre-packs and corporate rescue in general.

### 5.4. Legality

The difficulties surrounding pre-packs, and the main issue concerning the legality of the process, are highlighted in the preparatory work carried out by the administrator[80]. SIP 16 does provide some rough guidance to practitioners, suggesting that they should be clear about the nature and extent of their role and their relationship with the directors in the pre-

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administrator has decided not to call a meeting of creditors, including his reasons; and the manner in which his affairs and business of the company have been managed and financed.

[76] In regards to recent developments on pre-packs and the proposal statement required under SIP16, empirical research conducted by Frisby has highlighted a number of concerns with the standard of information provided on the statement. For instance whilst the justification and background to the deal should be provided, it is often the case that the identity of the purchaser of the business and the date in which sale negotiations started is missing. See S. Frisby, *'A Preliminary Analysis of Pre-packaged Administrations'*, Report to The Association of Business Recovery Professionals, August 2007, at 31.

[77] SIP 16, para. 3.

[78] Insolvency Act 1986 Sch. B1, para 74.

[79] Insolvency Act 1986 Sch. B1, para 75.

[80] SIP, para 4 suggests that given the nature of pre-packs it has the effect of bringing other issues (variables) that are evident within the circumstances into sharper focus.

appointment period[81]. Understandably, it is critical at the earliest stage possible that when they are instructed to advise the company, they should make it clear that their role is to advise the company and not to advise the directors on their personal position. Particular attention should be drawn to Chapter Three, Part II which highlighted a number of scenarios that had the potential to threaten the fundamental principles[82]. These fundamental principles will now be examined again to demonstrate how they apply to a pre-pack procedure and at the same time highlight the flaws evident within the process.

## 6. Revisiting the Five Threats to the Fundamental Principles: a Review of IPs and Pre-Packs

To briefly reiterate aspects contained within Chapter Two, the Cork Report made a number of suggestions regarding the regulation and licensing of insolvency practitioners that were incorporated into the Insolvency Act 1986[83]. The suggestions provided that the IP be licensed, either directly by the Secretary of State for BIS, or by the Recognised Professional Bodies (RPB). There are seven RPBs who have agreed a joint ethical code to be applied to its insolvency practitioner members. The Code of Ethics sets out five fundamental principles of integrity, objectivity, professional competence and due care, confidentiality and professional behaviour. Whilst a breach of the Code may not lead to the removal of the administrator, it may lead to professional disciplinary action taking place. A key aspect of the Code is that it sets out a framework that allows IPs to identify actual or potential threats to any of the fundamental principles. If a threat is identified the IP must assess whether an appropriate safeguard can be used to neutralise the threat. If this is not possible then he must not act or continue to act in the same manner.

### 6.1. The Self-Interest Threat

In regards to pre-packs there are concerns that the process is open to serving potential self interests. Given the transactions that may arise in the course of the IP's functions, it is notable that the IP (or his or her accountancy practice) would deal with an interest (financial or otherwise), in which he or she has a significant interest. The most obvious example would focus on the practitioner's fees in relation to the preparatory work that he or she has completed before the company had entered administration. It becomes apparent that the

[81] SIP, para 5.
[82] Those being: integrity, objectivity, professional competence and due care, confidentiality, and professional behaviour.
[83] The Cork Report at para 735.

administrator who has a stake in the funds yet to be realised from the sale of the business, is in fact a creditor of the company and the extent of his or her pre-appointment work would require subjective adjudication[84].

**6.2. The Self-Review Threat**

This threat prevails when a previous judgment made by an individual within the practice and in relation to the insolvent company needs to be re-evaluated by the IP. It therefore means that when a practitioner has carried out his or her professional work, whether that be pre-pack related or not, if the administrator is called in by the directors of the company to advise either or both the company and its directors on a possible pre-pack, the carrying out of such a work would possibly cause a self-review threat[85]. There should be a clear separation of roles between those who carry out the insolvency related work pre-appointment and those who deal with the company at a later date. If a practitioner is a position where he or she has to review previous decisions there are questions as to whether this would be done with their full attention and whether they would be so willing to rectify their own work.

**6.3 The Advocacy Threat**

This threat may occur when an individual within the practice promotes a position or opinion to the point that subsequently the ability to be neutral on a point concerning the company may be compromised. In regards to pre-packs this may occur in situations where the practitioner advises a creditor of the company. The integrity of the practitioner's advice provided pre and post administration may vary and accordingly it would seem probable that any advice given to a main creditor prior to the company entering administration will have an impact on his or her objectivity with other creditors at a later stage. Providing advice on potential issues that may arise within a company is based on a prediction that may be amended each time further information is gathered and confirmed accurate. The timing and to whom this advice is given will have a bearing on how the company is perceived and whether that information has been distributed fairly amongst the creditors as a whole. In these circumstances it is reasonable to foresee that there will be cases where the main creditors prior to a company entering a pre-pack strategy will gain an unfair advantage by having possession of information that other creditors do not have.

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[84] See P. Walton, 'Pre-Packin' in the UK', 18 *International Insolvency Review*, (2009), 85, at 95.
[85] P. Walton, 'Pre-Packin' in the UK', 18 *International Insolvency Review*, (2009), 85, at 96

### 6.4. The Familiarity Threat

This threat covers situations where a close relationship, usually an individual within the practice becomes too sympathetic with, or antagonistic to, the interests of others. In a pre-pack this may occur where the practitioner has formed a close relationship with either the directors of the company or the main secured lender[86]. The result of which infers that this relationship appears to be, or is influencing and ultimately favouring the position of directors over the general body of creditors.

### 6.5. The Intimidation Threat

The last threat may occur when an IP may be deterred from acting objectively by threats, actual or perceived. This aspect was covered in Chapter Three where it was suggested that the insolvency administrator is influenced by the source from where there are financial gains to be had. If a secured lender can provide repetitive business for a practitioner he or she may well be inclined to act in a certain way, otherwise face the risk or actual threat of the lender making his or her wishes known, of losing potential future business.

Without venturing too far into speculation, rather than basing conclusions on actual instances of abuse it is not too far removed to suggest that whilst the profession has done a lot to ensure the professional integrity of the administrators by introducing measures such as the fundamental principles, it cannot control how the public (often influenced by the press) view them. Whilst in some respects one may say that this does not really matter, the profession has clearly taken steps to ensure that their collective image coincides with the principles that they abide by. They want to be seen in the way that they desire. That said, even with IPs conscious that their every move will be scrutinised by potentially dissatisfied creditors[87], it may be sometimes difficult not to breach one of the fundamental principles given the involuntarily relationship that the IP will have through the normal course of business with individuals (who have a financial interest) in the distressed company. Furthermore, pre-pack strategies usually mean that a relationship will also be formed with a potential purchaser of the insolvent's assets and/or business[88].

[86] P. Walton, 'Pre-Packin' in the UK', 18 *International Insolvency Review*, (2009), 85, at 96.
[87] This is particularly the case if there is a possibility of the directors acquiring an interest in the assets in the pre-packaged sale.
[88] In this regard a close relationship includes both professional and personal; see Code of Ethics for Insolvency Practitioners, http://www.icaew.com/en/technical/insolvency/becoming-an-icaew-insolvency-licensed-practitioner, at 400.42, (accessed 22nd March 2011).

**7. Safeguards to Potential Threats that may occur during a Pre-Pack**

Addressing these issues, there are a number of safeguards that may be put in place to identify threats to compliance with the fundamental principles, the evaluation of the significance of these threats and the identification and the application of safeguards to eliminate or reduce the threats, other than those that are trivial. But applying them to a given situation is a delicate act that highlights the tension between administrators pursuing their set objective (which may be rescue or not) and keeping interested parties informed. Chapter Three highlighted a number that may be of particular relevance to pre-packs. The full list will not be reiterated here, but options like offering leadership that stresses the importance of compliance with the fundamental principles; identifying the interests or relationships between individuals within the IP's practice and third parties; ensuring that appropriate training and education on such policies and procedures are provided to individuals within the practice; ensure that there is a continuous monitoring process controlling the quality of engagements undertaken, and that there is a disciplinary mechanism to promote compliance with policies and procedures, are a few worth mentioning[89].

Following on from the compliance obligation, practitioners should bear in mind the duties and responsibilities which are owed to creditors in the pre- appointment period. In Chapter Three it was examined how IPs in certain circumstances may be personally liable for actions which contribute to enhancing the financial distress of the company in addition to allowing the company to incur further credit knowing that there is no good reason to believe it will be repaid. Whilst such liability is not restricted to the directors, and comparisons have been made about the fiduciary duties owed by both groups, in reality the IPs are treated differently due to their position of trust (external, independent help) and responsibility when entering the company. Given this perception, it is envisioned that action would only be taken against a practitioner if it was clear that their actions were so critical to contributing to the financial problems of the company and that further unrecoverable losses that were accumulated could have been foreseen and prevented. This position remains the same whether the act was carried out within administration or under a pre-pack strategy, but the crucial difference perhaps lies in the process and the relevant standards that apply. As already noted pre-packs follow an informal process and so are not as regulated as pure administration. It will therefore

[89] See ICAEW website, Code of Ethics for Insolvency Practitioners, http://www.icaew.com/en/technical/insolvency/becoming-an-icaew-insolvency-licensed-practitioner, at 400.25, (accessed 22nd March 2011).

be more difficult to bring action against a practitioner for any wrongful conduct under the former process as the standards will be deemed to be not as high. But what practitioners engaged in a pre-packaged sale should be able to demonstrate is that they have considered the objectives covered by paragraphs 3(2) and 3(4) of Schedule B1 to the Insolvency Act 1986. Failing to consider this may lead to action being taken by creditors whose interests have been unjustly harmed.

**8. Reflections on SIP 16**

It remains to be said that the guidance provided by SIP 16 does provide some assistance[90], but it should be viewed as an exercise that has codified the current practice rather than adding anything new. Examining the figures that have been obtained by the Insolvency Service regarding the level of compliance, one must approach the data with some reservation as the monitoring which took place during the evaluation is almost certainly a subjective matter. Whilst available information suggests that the vast majority of IPs are complying with SIP 16, the focus should be on those who are not and what, if any are the consequences for breaches that occur. The Insolvency Services figures for the first half of 2009 shows that 65% of pre-packs were compliant and that this dropped to 62% in the last six months of the same year[91]. This differs somewhat from the findings of R3 (the Association of Business recovery Professionals), which shows that when SIP 16 went operational only 3% of cases were referred back to the relevant RPBs[92]. This in itself does not provide any conclusive evidence that the regulations in place are successful in controlling: those who work within the profession; that the manner in which the profession is monitored is capable of identifying all potential breaches; or that even if there were breaches would the RPB take action? Would they consider it justifiable given the reason provided by the IP? Or would the situation arise where the affected party did not have the means (financial or time) to take action, or failed to realise that he could have taken action? All these questions cannot be addressed in a report as it would prove nearly impossible to extract the relevant information and show that a possible omission could have led to a potential breach that would in turn have required action to

[90] It was recognised by the Insolvency Service that the SIP 16 requirements were open to some interpretative uncertainty, therefore it would be useful to read this in conjunction with the further guidance that was issued in October 2009 (*Dear IP letter 42*), at http://www.insolvencydirect.bis.gov.uk/insolvencyprofessionandlegislation/dearip/dearipmill/hardcopy.htm (accessed 22nd March 2012).

[91] Further assessment will be required to determine whether this trend has continued.

[92] See R3, *'Pre-Packs and SIP 16'*, (22nd March 2010), http://www.r3.org.uk/media/documents/policy/policy_papers/corporate_insolvency/Pre_packs_and_SIP_16_March_2010.pdf (accessed 4th April 2012).

rectify the wrong. But this does not mean that the concerns should be disregarded, on the contrary the statistics that will continue to flow from such reports will provide a useful resource in highlighting how SIP 16 is working in practice, and from this it will draw out any shortcomings in the process that may need to be addressed.

The R3 Report has stopped short of stating in any definitive terms whether the process should be recognised as a legitimate procedure that offers a viable alternative to formal rescue processes[93]. Discussing the legitimacy of a pre-pack strategy remains a technical argument, one that this thesis has aimed to utilise to demonstrate that the informal procedure operates in a fashion that is not in compliance or within the boundaries of the current corporate rescue legislation. The insolvency market led by IPs has created their own pragmatic solution to dealing with the needs of distressed companies in the current financial climate. They have moved faster (in some cases dictated by the flow of the business/financial market) than the law could have regulated and so we have found ourselves in a position where the courts cannot/will not override their decisions as they have minimal case law/guidelines to do a better job. In some ways this acts as a justification for suggesting that the courts would rather remove themselves from the arena and let the IPs, who use (regularly) and have a better understanding of the process receive the praise and more often than not the backlash for any action that is called into question.

**9. IPs and Professional Fees with Pre-Packs**

It was discussed in Chapter Three that when a company enters administration there are likely to be substantial fees and other expenses accumulated by the insolvency practitioner. This is also the case for a company entering a pre-pack strategy except the only difference is that with the latter the expenses will have been incurred in the period leading up to the administration. Given the substantial fees to be gained it was previously suggested that this may have a bearing on how the company's problems are approached and dealt with. Different methods endorsed by the IP may produce greater profits at the end of the process and it is clear from the examples mentioned in Chapter Three that tactics have been employed to this end. Whilst that line of enquiry has been explored, what needs to be addressed here is how pre-appointment administration fees work in practice.

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[93] See generally, R3, '*Pre-Packs and SIP 16*', (22nd March 2010), http://www.r3.org.uk/media/documents/policy/policy_papers/corporate_insolvency/Pre_packs_and_SIP_16_March_2010.pdf (accessed 4th April 2012).

From information gathered by IPs, it is clear that extensive pre-appointment work is being undertaken[94]. But there appears to be quite a divergence between different practitioners as to how exactly the fees are being processed. There appears to be no logical conclusion why some, for instance, rely completely on rule 2.67(1)(c) to recover their costs, whilst others do not use it at all[95]. It must however be stressed that certain rules tend to apply only to administration and adopting this for pre-appointment work in relation to a pre-pack may not be possible[96]. Whether this is merely a limitation based on the current legislation, there appears to be some potential scope for change on this matter[97]. However there are concerns that if the ability of the administrators to recover pre-appointment costs from the insolvent estate is increased, it would reduce the confidence in the mechanism as it would be seen as an additional financial incentive for practitioners to incur additional fees[98]. Again, the perception of abuse plays a key role in tarnishing such strategies, especially in situations where unsecured creditors have been left 'in the dark' about the deal[99].

Given the divergence within the profession it is probably due to the lack of transparency within the process that has allowed the differences to go unchallenged[100]. That said, it is possible to suspect that payments can be made in a number of forms and this may cover separate payments by the company (directors) to the IP before the formal process of administration is entered into. Any concerns that the administrator may not get paid for work completed should probably be dismissed, as it is likely to be the case that even if there was a

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[94] See P. Walton, 'Pre-appointment Administration Fees – papering over the cracks in pre-packs', *Insolvency Intelligence*, (2008), 72, at 73.

[95] See Insolvency Rules 1986. The rule sets out that the costs (including expenses) may be claimed if they have been incurred 'in connection with the making of the appointment'.

[96] Beyond the relatively limited costs of putting into effect the formal mechanism for the appointment. See *Re Cablelel Installations Ltd* [2005] BPIR 28; S. Frisby, '*A Preliminary Analysis of Pre-packaged Administrations'*, Report to The Association of Business Recovery Professionals, (August 2007); P. Walton, Pre-packaged administrations – trick or treat', *Insolvency Intelligence*, (2006), 113, at 119.

[97] Whilst draft proposals are still not finalised it was proposed that any amendment to the rules should allow pre-pack administrators to claim the cost of their pre-appointment work as administration expenses subject to the approval of the company's creditors, see The Insolvency Service Consultation, (June 2007).

[98] See The Insolvency Service report entitled '*Improving the Transparency of, and Confidence in, Pre-packaged Sales in Administration'*, Summary of Consultation Responses, (March 2011), at para 4.14, http://www.bis.gov.uk/assets/insolvency/docs/insolvency%20profession/consultations/prepack/responses/final%20pre-packs%20summary%20of%20responses.pdf (accessed 3rd April 2012).

[99] This issue has been a major concern for some time, See the Insolvency Service, '*Annual Review of Insolvency Practitioner Regulation'*, (June 2009), at 11, http://www.bis.gov.uk/assets/insolvency/docs/insolvency%20profession/ip%20regulation%20reports/annual%20review%20of%20ip%20regulation%20report%20march%202010.pdf (accessed 3rd April 2012).

[100] P. Walton, 'Pre-Packin' in the UK', 18 *International Insolvency Review*, (2009), 85, at 102.

lack of payment in the informal process, this would only mean that IPs would take this factor into consideration when setting their fees for post-appointment work[101].

It should be further noted that in recent monitoring visits, the RPBs have identified a number of cases where the responsible insolvency practitioner's pre-appointment administration fees and expenses have been paid directly by the purchaser of the insolvent business. While there is no specific regulation which prohibits this practice, they were of the opinion that such payments may represent a conflict of interest which threatens the objectivity of the IP, and so constitute a breach of the Ethical Code[102]. The concern arises when an agreement has taken place for the purchaser to pay pre-appointment fees as this might effectively reduces the total consideration payable in the transaction by a similar or equivalent amount. Additionally, if the purchaser was in fact a connected party (to the company) it may be the case that the directors of the distressed company may spend company funds on pre-appointment fees at a time when it is apparent that the company is insolvent. If it turns out that the insolvency practitioner whose fees have been met is later appointed the administrator, it is unlikely that this would ever be scrutinised. This is not withstanding the fact that this could represent a self-review threat to the IP's objectivity, one of the fundamental principles of the Ethical Code[103]. Naturally all of this poses questions whether the IP is a "gun for hire" and can be influenced to act in a certain way to secure the lucrative position later on.

It is worth reiterating that any arrangement for the purchaser to directly pay pre-appointment fees and expenses may lead to a reduction in the funds available for creditors. To address this concern the Insolvency (Amendment) Rules 2010 was introduced which intended to ensure that creditors would have the opportunity to review the pre-appointment expenses, to consider whether they are reasonable in the circumstances of the case, whether they were incurred in support of the objective of the administration and ultimately to approve their payment. Therefore any arrangement to pay fees would be contrary to this statutory mechanism and place creditors in a vulnerable position. Whilst this move demonstrates a step in the right direction, it is susceptible to reliance on the transparency of the IP's and/or

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[101] This has also been noted by See P. Walton, 'Pre-appointment Administration Fees – Papering over the Cracks in Pre-Packs', *Insolvency Intelligence*, (2008), 72, at 73.

[102] See Insolvency Service, *Dear IP letter 50*, (2010), at http://www.insolvencydirect.bis.gov.uk/insolvencyprofessionandlegislation/dearip/dearipmill/hardcopy.htm (accessed 22nd March 2012).

[103] See Chapter Three.

administrator's report. If the information is not there to fully review whether the fees can be justified, then the power invested in the creditors is as good as redundant.

The extent of the information provided, as already noted above, depends entirely on the IP. Where IPs are considering entering into such an arrangement with a proposed purchaser, it is expected that the practitioner would recognise the potential conflict of interest and retain written evidence that the matter had been considered and appropriate safeguards put in place to reduce any perceived or actual threat to his objectivity[104].Again there needs to be more transparency surrounding professional fees and appointments.

**10. Phoenix Pre-packs (Sales to Connected Parties – Management Buyouts)**

A concern regarding pre-packs was contained in the 2009 report of the House of Commons Business and Enterprise Committee in which it stated that there was too much emphasis on rescuing collapsed businesses and too little attention paid to the damage that "phoenix pre-packs" do to supplier companies and the wider economy[105]. As noted, whilst pre-packs have some legitimate reasons for operating as they do, permitting "phoenix trading" by offering company directors ways to start again could be seen as a way of encouraging entrepreneurial behaviour, but at the same time there is considerable discontent as it is viewed primarily as an opportunity for existing management to bypass the creditors and buy back the business at a low cost[106]. It is difficult to contemplate an area of law in recent years that has attracted so much attention; but part of the reason for this is the apparent unfairness that results from a pre-pack procedure[107]. One commentator has provided a sceptical view of the process whereby a company is heading into trouble. Its directors and shareholders "are introduced to an appealing fellow who drives a very nice BWM, who explains that if they work with him they will get rid of most of their creditors and will be able to buy the business back pretty

[104] See Insolvency Service, *Dear IP letter 50*, (2010), at http://www.insolvencydirect.bis.gov.uk/insolvencyprofessionandlegislation/dearip/dearipmill/hardcopy.htm (accessed 22nd March 2012).

[105] House of Commons Business and Enterprise Committee, The Insolvency Service: Sixth report of Session 2008-9, (May 6, 2009), HC 198, at 11.

[106] There has been some empirical research gathered to suggest that a larger proportion of pre-packs do involve selling a company to a connected person, see S. Frisby, 'The Second Chance Culture and Beyond: Some Observations on the Pre-Pack Contribution', *Law and Financial Markets Review*, (2009), 242.

[107] Creditors suspicions can result in believing the whole deal was a "stitch-up" job, see S. Davies, 'Pre-Pack: He Who Pays the Piper Calls the Tune', 16 *Recovery*, (2006), 16. See also S. Frisby, *'Report on Insolvency Outcomes*', 19 *Recovery*, (2006), at 70, available at http://www.insolvency.gov.uk/insolvencyprofessionalandlegislation/research/corpdocs/InsolvencyOutcomes.pdf (accessed 17th February 2012).

well immediately at a very modest cost"[108]. This underlines a concern shared by some creditors who consider pre-packs resembling phoenix trading, in that the distressed company continues to operate with the same or some of the same directors and the same name. The fact is that pre-packs can cause confusion amongst creditors, in the sense that who they are in fact dealing with is a new company and the debts owed to them by the failed company are no longer recoverable[109].

The major concern, however, for the Government, backed up by some creditors, is the sale to connected parties, typically the existing management or owners of the insolvent company (minus the debts of course). In 2010 it was revealed that 72% of pre-pack sales to date were to individuals and companies associated with the failed company[110]. As such the issue of accountability becomes a focal point with management buyouts[111]. There will be reservations from creditors as to whether the best value for the business has been obtained, when the pre-pack was sold to the existing management. In particular there will be questions asked as to whether the business was properly exposed to the market[112]. With this in mind there are questions as to whether pre-packs are an efficient mechanism. Although they should be subject to the notion of fairness and accountability[113], there is a considerable lack of transparency in the way pre-packs are implemented. Whilst there is an almost unquestioned presumption that a legal procedure should produce behaviour in a certain way, possessing certain characteristics that are typical of acknowledging the wider social considerations and are construed to comply with the relevant guidelines, regulations and legislation, it is not always possible to balance the interests whilst at the same time pursuing the aim. To put it another way, complying with the principles that were primarily designed to ensure that the actions of the administrator were fair, may now be counterproductive to that course. Some distressed companies require a quick sale to ensure that the value of the business remains

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[108] J. Moulton, 'The Uncomfortable edge of property – pre-packs or just stitch ups?', *Recovery*, (Autumn 2005), 2; see also S. Frisby, *'A Preliminary Analysis of Pre-packaged Administrations'*, Report to The Association of Business Recovery Professionals, (August 2007).
[109] Reference should be made to the Insolvency Act 1986 s.216 which was designed to deal with the issue of 'phoenix trading' by imposing restrictions on the re-use of a failed company name. See also I. Fletcher, 'Phoenix Companies: Exceptions from the restriction on the Re-use of Company names', *Journal of Business Law*, (1987), 395, 395.
[110] See data compiled by the Insolvency service (IS), part of the Department for Business, Innovation and Skills (BIS).
[111] See Statement of Insolvency Practice 13, *'Acquisitions of Assets of Insolvent Companies by Directors'*, (1997), para 1.2 at 1.
[112] S. Frisby, 'Report on Insolvency Outcomes', 19 *Recovery*, (2006), at 71, available at http://www.insolvency.gov.uk/insolvencyprofessionalandlegislation/research/corpdocs/InsolvencyOutcomes.pdf (accessed 17th February 2012).
[113] See Chapter Four.

intact. Any restriction on this may be considered harmful to the company's potential future. The entire purpose of a pre-pack is to allow the administrator to make full use of his discretionary powers and act swiftly if he so wishes as long as he can reasonably justify his actions (within reason). It is this combination of allowing a quick sale and to existing management that rests uncomfortably with the creditors. The criticism therefore seems to focus on not what pre-packs aim to achieve, but rather the way in which it proceeds.

Attention should be drawn to the directors of a company and how it is perceived that they may abuse the process to financially gain a 'discounted' interest in a distressed company[114]. When an administrator needs to obtain certain information within a restricted time frame it is acceptable to assume that they will often rely on the knowledge and expertise of the directors. The main concern with relying on this form of investigation to obtain information is that it is more than likely that the directors may have a vested interest in the company and a skewed view about the company's affairs, and may want to participate in a management buyout. It would therefore be in their interests if they became economical with the truth, or rather simply restricted what information they provided to ensure that the lack of interest within the market would allow the company to be bought at a considerable lower price[115]. Of course there is a chance that this "opportunity" may turn on its head as the lack of information may result in the company being grossly undervalued, which may attract rival bidders who sense a good deal[116]. Whether or not anyone would hear about such a deal is unlikely, but it has to be accepted that in business there are always some people who specialise in making other people's business their own and have a skill in making it their business to find out information that may not necessarily be public knowledge. It cannot be denied that the pre-pack process is open to abuse. A process of this kind that potentially allows for the sale to take place back to the old management, whether they were dishonest or incompetent, serves as a warning to creditors that they may with little or no consultation have new unfair terms forced upon them[117]. Objectivity therefore remains a cause of concern but given the way in which pre-packs are implemented changes to this would have to be carefully weighed against the benefits to be had. That aside, determining the level of abuse that occurs within the process is difficult to substantiate. Not only does the term "abuse" attract different

[114] See D. Milman, 'Strategies for Regulating Managerial Performance in the 'Twilight Zone' Familiar Dilemmas: New Considerations', *Journal of Business Law*, (2004), 493.
[115] Mason, 'Pre-packs for the Valuer's Perspective', 19 *Recovery*, (2006).
[116] A. Kastrinou, 'An Analysis of the Pre-Pack Technique and Recent Developments in the Area', *Company Lawyer*, (2008), 259, at 261.
[117] See A. Katz and M. Mumford, *'Study of Administration Cases'*, Insolvency Service, (October 2006), at 51.

definitions, there is the more pertinent question to ask: "we talking about the scope of abuse, or actual evidence of abuse?"[118] The distinction is critical as previously noted above, but it should also be noted that the abuse associated with pre-packs is not unique to pre-packs; it is a wide ranging problem that can be found within many legal disciplines. Putting speculation to one side, it would appear, given one leading study, that actual abuse is minimal and that directors often will pay a higher price for a company (special value) than that would be achieved in the open market[119]. But in reality there is no conclusive way to determine the extent of the abuse prevalent with pre-packs, and so whilst the offers from connected parties may on the face of it amount to the best deal at the time, it is not always possible to say with any certainty if this actually is the case or whether the deals have in some way been manipulated to the advantage of the former management of the company.

### 11. Case study

No two businesses are alike. Some are sought after in a general capacity whilst others are so unique that finding potential investors is a very difficult process. Whilst it will usually be the aim to sell the company as a going concern at the best market value, it is not necessarily the most viable option. To achieve the correct level of exposure within the relevant markets can be lengthy and expensive with no guarantee of success. Recently there have been a number of pre-packaged administrations that have grabbed the headlines. Retailers Habitat UK, Alexon Group and Jane Norman are a few worthy of mention. But it must be stressed that pre-packs are by no means restricted to a particular sector as assets of the top 50 law firm Halliwells were purchased by Hill Dickinson, HBJ Gateley Wareing and Barlow Lyde & Gilbert as part of a pre-pack in 2010[120]. More recently Cobbetts, a leading law firm in the North of England, was set to be acquired by rival practice DWF in a pre-pack deal after revealing on the 30th January 2013 that it had gone into administration[121]. Before proceeding with a more in depth examination into the Halliwells case, as a note of caution it should be observed that some of the earlier cases mentioned such as *Re T & D Industries Plc*[122] and *Transbus International*

[118] A. Katz and M. Mumford, '*Study of Administration Cases*', Insolvency Service, (October 2006), at 22.
[119] S. Frisby, 'Report on Insolvency Outcomes', 19 *Recovery*, (2006), at 71, available at http://www.insolvency.gov.uk/insolvencyprofessionalandlegislation/research/corpdocs/InsolvencyOutcomes.pdf (accessed 24th February 2012).
[120] See *Halliwells LLP v Bannon* [2010] EWHC 2036 (Ch).
[121] Details regarding the exact arrangements to be put in place are yet to be revealed, see http://www.thetimes.co.uk/tto/business/industries/supportservices/article3674763.ece (accessed 1st March 2013).
[122] [2000] B.C.C. 956.

*Ltd*[123] were not pre-pack cases as such, but in fact cases that concerned an accelerated sale of business. The distinction is critical as the latter sale is not something that is pre-arranged[124].

### 11.1. Halliwells LLP[125]

### I. Background

*Halliwells LLP* ("*Halliwells*") was a national law firm providing a range of legal services, with 116 partners and over 600 employees and with offices in Manchester, Sheffield, Liverpool and London. *Halliwells* had entered into a number of historical occupational leases which had left it with onerous payment obligations to landlords. The burden of these payments, a fall in revenue caused by the departure of several partners and a drop in turnover occasioned by the economic climate left *Halliwells* unable to pay its debts as they fell due. The financial difficulties led *Halliwells* to engage X and Y (later to become the Administrators) on 6th May 2010 in order to assist with the management of the sale of its business. X and Y were of the opinion that *Halliwells* could not be rescued as a going concern and that it would not be reasonably practicable to achieve the objective of a better result for *Halliwells*' creditors as a whole than would be likely if it were wound up without first being in administration. From this it was deemed that the best course of action would be to realise the assets of Halliwells by means of various sales in order to make a distribution to one or more secured or preferential creditors.

Given the size of *Halliwells* it quickly became apparent in the three months prior to the firm entering the administration process that there were not many potential purchasers to take on the business. Negotiations were conducted with eight different firms and these generated four proposed sales, which in the opinion of the administrators represented the best return for the creditors. It was decided that an administration order would be sought due to: the potential purchasers' desire for it, the protracted nature of the negotiations, and the need for the administrators to seek the approval of the court for the proposed sales.

In regards to the creditors, the largest single creditor was the Royal Bank of Scotland plc to which *Halliwells* owed £18 million and this debt was increasing each month. This debt was

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[123] [2004] EWHC 932 (Ch).

[124] See A. Kastrinou, 'An Analysis of the Pre-Pack Technique and Recent Developments in the Area', *Company Lawyer*, (2008), 259, at 261.

[125] It should be noted that whilst Halliwells was not a company but an LLP, the rules on administration for LLPs is the same as for companies. See Limited Liability Partnerships Act 2000, s. 14.

secured by way of a debenture. A calculation based on the projected return of funds from the sale of the relevant parts of *Halliwells*' business alone revealed that *Halliwells* was insolvent on a balance sheet basis. In addition to the bank, special attention should also be drawn to the partners of *Halliwells* ("the members"). This aspect is what makes an insolvent law firm more complex. In this particular case it was necessary for negotiations to take place to ensure that the Members who had nearly £13 million of capital invested in *Halliwells*, funded mostly through Partnership Practice Loans (PPLs), would not find themselves unable to practice again. The issue became apparent because *Halliwells* had undertaken, through Halliwells LLP Deed to repay each Member's PPL when such Member ceased to be a member. Because *Halliwells* had now become insolvent, Members were potentially left personally liable for the amount as *Halliwells* would be unable to honour its undertakings[126]. The implication that this would have had would have been critical, especially if the Members were transferred to the purchasing businesses only to find that they could no longer practice as solicitors due to being made personally insolvent.

## II. Proposed Sale Agreements

In this case four asset sale agreements were identified[127], allowing the purchase price to consist wholly or partly of the proceeds of *Halliwells*' own debtors and work in progress, which the purchaser would endeavour to collect and pay over to the Administrators. Various technical agreements were worked out with the four purchasing businesses to ensure that the transferring Members would have the benefit of a trust fund which would be for the benefit of the PPL providers or a covenant from the purchaser that the loans would be taken over[128]. These agreements were forged with the intention of the purchasers to make it clear that if the deals were to proceed they wished the transferring Members not to become personally insolvent by reason of their obligations under the PPL in circumstances where *Halliwells* were unable to honour its undertakings[129]. These agreements showed considerable flexibility by allowing the deals to be tailored to cater for the needs of the purchasing businesses. By allowing their concerns to be addressed to ensure that there was no risk that some or all of the

[126] In relation to the Bank, the relevant part of *Halliwells*' undertaking reads: " We [Halliwells] irrevocably undertake:(i) that if the Customer [the Member] ceases to be a member of the LLP for whatever reason, sufficient of the monies standing to the credit of the Capital Account shall be remitted immediately to the Bank's office… for repayment of the Loan…". See *Halliwells LLP v Bannon* [2010] EWHC 2036 (Ch), at para 11.
[127] The asset sale agreements will not be recited here, but the full details can be found within the *Halliwells* case, see para 13.
[128] *Halliwells LLP v Bannon* [2010] EWHC 2036 (Ch), at para 10.
[129] *Halliwells LLP v Bannon* [2010] EWHC 2036 (Ch), at para 13.

transferring Members were no longer able to practice as solicitors, a financially distressed legal business was able to present itself in a light that allowed at least some of its business to be sold.

### III. Position of the Creditors

The administrator stated prior to this application for administration, loss making and those losses were projected to increase if it went into administration, significantly eroding asset value and having a knock-on effect for the funds available for distribution to all categories of creditors. The administrators considered that the intended pre-packaged sales of the business represented the best deal available and would result in a higher level of recoveries for the secured, preferential and unsecured creditors than if *Halliwells* were allowed to proceed into a traded administration[130]. As stated the bank, as a secured creditor was owed approximately £18 million and so the suggested deals rested on whether the bank was content with the deal brokered, in that some of the monies should be used for the purpose of repaying the PPLs of the relevant transferring Members. Critically the administrators within their draft sale agreements, attached to their witness statements contained the acknowledgement from the bank (letter dated 19th July 2010) that this was satisfactory.

In regards to the preferential creditors, this class was made up of employees of *Halliwells* who were not required by the purchasers. The estimated value within this claim was between £68,000 and £100,000, which was paid in full. The unsecured creditors received the maximum statutory prescribed part payment of £600,000 under section 176A. It is interesting to note that the pre-pack deal enabled the distribution of this sum to all unsecured creditors, which resulted in a dividend of £2.63p in the pound. If the four sales had not gone ahead and the business entered administration as a whole, the number of preferential and unsecured creditors would have greatly increased, and the dividend for unsecured creditors was forecasted at around the £1.60p in the pound[131].

### IV. Approval of the Proposed Pre-Pack Sales

On 20 July 2010 the court heard an application by *Halliwells* and Mr Shay Bannon and Mr Dermot Power ("the Administrators"), both Licensed Insolvency Practitioners and members of BDO LLP, for an administration order in respect of *Halliwells* and to seek the court's

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[130] See *Halliwells LLP v Bannon* [2010] EWHC 2036 (Ch), see para 16.
[131] *Halliwells LLP v Bannon* [2010] EWHC 2036 (Ch), see para 19.

approval of four pre-packaged sales of parts of the business of *Halliwells*. Reference was made in the *Halliwells* case to the significant case of *Re Kayley Vending Limited*[132]. In that case HH Judge Cooke summarised the concerns about the use of pre-packs as being that they may too easily lead the directors and the insolvency practitioner to arrive at a solution which is convenient for both of them and their interests[133] (perhaps also satisfying a secured creditor who might be in a position to appoint his own receiver or administrator) but which harms the interests of the general creditors. it was also noted that in exercising its discretion in pre-pack cases, the court must be alert to see, so far as it can, the procedure is at least not being obviously abused to the disadvantage of creditors and that for that purpose the court was likely to be assisted by the provision of (at least) the information required by SIP 16, in so far as known or ascertainable at the date of the application[134]. Whilst the requirements of SIP 16 is not legally binding, and should be viewed as providing guidance only to IPs, especially in relation to the disclosure of information by the IP to creditors, and reminds IPs of the duties they owe to those affected by the arrangement they are effecting[135], there is now case law which suggests that the courts do not question the legitimacy of pre-packs[136]. Returning to the *Halliwells* case, the administrator for the purposes of complying with the guidance contained with SIP 16 did inform the creditors of his intended actions by letter. Importantly it contains a detailed exposition of why it is not appropriate to trade *Halliwells* and offer the business for sale as a going concern in the administration, full details of the marketing process and a complete explanation of the terms materially affecting the consideration paid. Based on this information the court was satisfied that the proposals were SIP 16 compliant and that there was no evidence of any abuse of the process[137]. The perception, as opposed to actual abuse will be discussed later on, but it is worth highlighting that the court in this case had no qualms about suggesting that the pre-packs (based on these facts) are the only way forward (for this particular case). On this evidence it seems that the courts are likely to endorse pre-packs if the administrator can sufficiently prove that he has carried out his duties whilst heeding the interests of the creditors. Of course there will always be issues regarding the completeness of the information provided and what was disclosed to the court, but this will have to be assessed on an individual basis. Attending to questions surrounding the controversial nature of the procedure does not feature in the judgment; the courts are likely to

[132] [2009] BCC 578.
[133] See Chapter Three, insolvency practitioners and their desire for personal gain.
[134] *Halliwells LLP v Bannon* [2010] EWHC 2036 (Ch), at para 21.
[135] See (2009) 243 Co. L.N. 7.
[136] See *DKLL Solicitors v HM Revenue & Customs* [2007] EWHC 2067 (Ch), [2007] B.C.C. 908.
[137] *Halliwells LLP v Bannon* [2010] EWHC 2036 (Ch), at para 22.

refrain from inquiring into the legality of pre-packs in favour of determining whether the relevant legislation and guidance has been followed. In this particular case, the court found that because the administrators' justification was so compelling, in that the alternative to the pre-pack would have meant a reduced figure being made payable to the preferential and unsecured creditors and that the PPL's would have not been satisfied leaving solicitors personally insolvent, they conceded that the pre-packs were the only way forward[138].

**12. Proposals for Change: An Overview**

Given the controversial nature of pre-packs and the increasing usage of such a procedure it was announced in March 2010 by the Insolvency Service (IS) that a call for evidence on "improving the transparency of, and confidence in, pre-packaged sales in administration" would take place. As aforementioned, some measures have being taken to address the issue of improving transparency of pre-packs, notably SIP 16, but the Government had felt that a joint effort involving the practitioners was required to attempt to improve the overall effectiveness of the pre-packs as a process. The Government published draft regulations in June 2011, after much consultation with trade association, legal and insolvency firms and professional bodies, creditors and others in 2010. The draft proposals fell considerably short in obtaining a general consensus amongst the representatives and so in September 2011 the Government announced that it would be revisiting the drawing board and propose new draft regulations in January 2012. After some deliberations the Government in March 2013 announced an independent review into pre-pack administration during a Parliamentary debate on pre-packs. A timescale will be announced at the time the review is launched in late spring 2013[139].

But before the draft rules are examined in greater detail it is worth remembering the reason why these problems have arisen. As noted above there is currently no legislation on pre-packs, although some assistance may be gained from case law. Whilst limited, it does provide that a sale can be agreed in advance with the administrator[140]. It is possible to conclude that the reason why these draft rules have come to light, as discussed in Chapter Three, is because pre-packs have been developed by insolvency practitioners in their role as administrators and so now the Government feels the need to regulate this informal procedure which currently

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[138] *Halliwells LLP v Bannon* [2010] EWHC 2036 (Ch), at para 22.
[139] See the Insolvency Service website, http://www.bis.gov.uk/insolvency/news/news-stories/2013/Mar/PrePackStatement (accessed 12th March 2013).
[140] See *Re T&D Industries Plc* [2000] B.C.C 956; and *Re Transbus International Ltd*. [2004] EWHC 932 (Ch).

operates outside of current insolvency legislation[141]. It therefore appears that the desire of the Government and creditors alike is to bring pre-packs from out of the shadows and openly discuss the qualities and nature of this procedure, which according to some commentators all too often adopts a defensive role brought on by the fact that it usually has to address matters (and concerns) that were only evident in perception, rather than focusing on the actual evidence of abuse. Changing perception and making people more aware of the true characteristics of pre-packs is probably a task too great given the negative attention that the procedure has received in the news. The only option that remains is to reform aspects of the procedure which are considered to have contributed to the overall damage to its reputation. It was therefore necessary to examine administration and determine how cases were routinely being implemented[142], why pre-packs were on the increase, and what were the issues that needed to be clarified and amended.

### 12.1. Four Concerns

Attempting to make pre-packs a more viable option and addressing some of the concerns surrounding its legitimacy as a rescue model, four major points needed to be examined. One, as mentioned above, the transparency aspect of the process needs to be improved to allow the creditors' greater access to information, in particular the reasons why a company undertakes a pre-pack. Secondly, there needs to be a stronger identification between pre-packs and accountability, namely the report of an independent review committee that can improve the image of pre-packs publicly and provide a more open environment in which practitioners are more willing to provide information that can shed light onto the reasoning behind their decisions. This concern has particularly relevance to situations where a company is sold to connected parties. Thirdly, the discretionary power invested in the practitioner needs to be made transparent and accessible to interested parties. Whilst discretion may be necessary to ensure that the optimal outcome can be reached, it should be regulated and reviewed before the decisions are taken. Whilst this may cause delays and potentially contribute to expensive review boards, this role could be taken up by the RPBs' internal model structure which would increase knowledge and understanding of what their members are doing in such circumstances. This potential reform has not pleased all with some IPs arguing that this could

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[141] Ruth Jordan an insolvency barrister at Serle Court has also raised these concerns, see M. Taddia, 'Pre-packs administrations rule changes face trouble', *Law Gazette*, (November 2011), http://www.lawgazette.co.uk/features/pre-pack-administrations-rule-changes-face-trouble (assessed 2nd January 2012)

[142] For example see A. Katz and M. Mumford, *'Study of Administration Cases'*, Report to the Insolvency Service, (October 2006).

be the death knell of rescue. They state that the Government's intention to lengthen the time by requiring creditors to be given notice could effectively defeat the purpose of pre-packs. Lastly, effort needs to be made to bring pre-packs from out of the shadows and attempts need to be made to categorise the process and if appropriate decide whether it should be associated with formal rescue procedures such as administration.

**12.2. Three Days Notice**

In relation to the consultation on pre-packs, one of the key aspects of the draft rules, and by far the most controversial, is the proposition to require administrators to give creditors three days' notice of the pre-pack where a sale to a connected party is proposed and where the business or assets have not been exposed to the market. This proposed amendment aimed to address a number of concerns, namely that creditors were not given enough notice to potentially apply to the court for injunctive relief to prevent a pre-pack occurring on the grounds of suspected abuse, and secondly no chance was given to allow other creditors to express concerns or assess whether a better offer for the assets could be achieved[143]. It has been reported that this proposal came as something of a surprise, as this notice period was not in the original consultation. How exactly this aspect materialised is unimportant compared to the tension that it has created between the various interested parties. There are concerns that the three day period may not be enough time for the creditors to object. Conversely it is ample time to derail a potential rescue, especially if this includes three working days.

It will be remembered that a major advantage that is often put forward by administrators as a justification for using pre-packs is due to the speed it can be implemented and hence its ability to maintain the best value of a particular asset. Having a three day 'deliberation period' permits suppliers the chance to disrupt a pre-pack (usually with malicious intentions) by acting in a way that ensures the potential agreement falters. Whether action is taken or not is irrelevant as it appears that a mere threat to do so would suffice in varying terms. But the range of actions that could be taken or threatened vary considerably such as increasing the costs of materials, supplies or services, and reducing returns to creditors, all in which would prove effective. In addition to this disruption a critical aspect that must be considered is the way in which this knowledge (a company in financial distress) may be used and manipulated

[143] The proposed amendments appear to be some attempt to address the lack of rights that unsecured creditors currently enjoy, but stops short of allowing them to vote on the pre-pack deal itself. See P. Walton, 'Pre-packin' in the UK', 18 *International Insolvency Review*, (2009), 85, at 104.

by rival firms. Staff may be poached and others may choose to leave on their own accord, all in which would contribute to a demise in the key skills within a workforce necessary to successfully run a business (this is of course taking into account that the company suffered hardship as a result of an exogenous shock, as opposed to internal management failure). It would seem that the introduction of a three day notice period would negate the very purpose of a pre-pack, and would pose interesting questions as to how different the outcome of cases like *Halliwells* would be if this became normal practice.

The proposed notice period also has another intended purpose, to deal with the issue of a company being sold to a connected party and how this is considered unfair, in particular the potential this has in preventing the best price for the assets being obtained as it has not been fully exposed to the market. Obtaining competitive prices would satisfy creditors as it would/could result in increased returns. However, the decision to expose the company to the market should ultimately rest with the administrator as it will be by his or her judgment and calculation whether such a move would prejudice the value and hence prove detrimental to the creditors as a whole. As previously discussed there are already guidelines in place, notably SIP 16 which requires IPs to justify their decisions – why it was not appropriate to trade, why selling a company as a going concern would be more beneficial; detail what efforts were made during the process of negotiations with major creditors; provide details of valuations obtained and provide an account of other alternative measures that were considered and why they were not viable options. It should be stressed however that the proposals for encouraging wider exposure does not necessarily mean that higher valuations will be obtained, or that the deliberation period will add anything positive to the procedure. Despite the worries surrounding the three day, there has been a call for this to be extended to seven days to give creditors a sufficient amount of time to raise their own finance and make their own bid. Whether three or seven days is finally adopted, or if no amendment occurs it is clear that there is considerable tension between the creditors on the one hand and genuine interested parties who wish to invest in a company without the danger of its value being lost on the other.

**13. Conclusion**

The purpose of this chapter was not to question the validity of the procedure itself, but rather consider the legitimacy of the pre-pack strategy being portrayed as a true rescue process like administration. It is evident within the research conducted in this field that pre-packs are and will remain controversial. The procedure suffers from something of an identity crisis, having being developed outside of any formal rescue process currently recognised by UK Insolvency law. Practitioners who wish to use a pre-pack strategy have been assigned a number of regulations and rules to observe, some of which may be wilfully overlooked using their discretion if they think compliance with certain aspects may prove detrimental to a commercial judgement that may in turn affect the value of a proposed deal. It is apparent that the courts place a heavy reliance on the commercial and technical knowledge of practitioners and have shown great reluctance to intervene in cases where the dispute arises from a business decision as opposed to a statutory or other regulatory breach by the administrator. Whilst there are RPBs in place to ensure that professional conduct remains high and the core principles are being followed, failure to ensure that safeguards are adhered does not automatically warrant action to be taken by the governing body against one of its members. Indeed it seems that disciplinary action by RPBs is a rare occurrence not to mention the difficult that the process has on creditors seeking relief. Following this, it is without question that the biggest problem facing pre-packs is the lack of transparency throughout the process. This, along with the lack of accountability placed on practitioners has helped to provide pre-packs with a reputation that it perhaps does not fully deserve. But it has not been helped by the fact that at the centre of its operations conducting informal work in secrecy before the formal administration process is the norm and has been justified on the grounds that this helps to sustain the value of assets. Whilst creditors have shown considerable distaste for the pre-pack strategy that has been struck with the former management of a particular company, in most cases the only interested parties that will be willing to offer a good deal are those who have connections with the company.

Ultimately the emergence of pre pack strategies as an increasingly popular way to manage distressed companies has allowed for a pragmatic solution to surface, which offers an alternative to the formal administration process. But as an alternative measure, its characteristics are not found in conventional rescue philosophy in the UK and as such cannot be correctly labelled as a corporate rescue procedure recognised under the UK insolvency laws.

# Chapter 6
# Conclusion

The research that is the subject of this thesis has raised and addressed a number of issues. Given the nature of corporate insolvency law this has meant that discussions have often involved bringing together a number of concepts. The interdisciplinary character of corporate rescue has allowed for a truly broad approach to be taken regarding the extent of the research undertaken. The aims as iterated in Chapter One formed a platform, setting out the boundaries of the research and how this was to develop throughout the thesis. One of the critical factors was to establish whether the UK's corporate rescue model complies with the theoretical principles of rescue in general. In other words do the characteristics evident in the practical application of corporate rescue correspond with the fundamental principles that the rescue concept is founded upon?

## 1. Characteristics Evident within the UK's Corporate Rescue Model

To address this first question a closer examination of the historical development of corporate rescue was required. The features evident within the UK's corporate rescue model have been significantly shaped by the Cork Report which above all aimed to define the characteristics of what made a good modern insolvency system. The report remains so influential that to gain a full understanding of the UK's insolvency regime its reading is fundamental. The extensive research carried out within the report revealed a perception held by those who did not work or deal with insolvent or troubled companies that failure was something associated with errors, mistakes or mismanagement, not something that could be due to other, sometimes uncontrollable, factors like a change in the financial climate that affects the whole economy. Taking this into consideration there are also problems which could be subsequently rectified. The mere mention of financial distress has become heavily linked with failure and the report wanted to introduce a new philosophy – an alternative, promoting the rescue of corporations rather than immediate liquidation. This change in attitude was encouraged by the lack of clear guidelines as to how distress should be dealt with, in addition to wanting to limit the extent of the troubles from spreading beyond the company into the wider community. Whilst not all of the provisions within the report made it into the Insolvency Act 1986, it did represent the first real movement that allowed the rescue culture to emerge.

Notwithstanding that the concept of rescue has evolved and such changes have been noted in the subsequent Enterprise Act 2002, it remains an issue that the customs and general practices that were evident before the Acts continued to exist, causing conflicts with any progressive legislation. The “path dependency” concept goes some way to explain this phenomenon, suggesting that despite the natural and expected progression of corporate practices, a jurisdiction will refrain from adopting change to certain key principles if it presents any risk of diluting the existence of its own model. In essence it is commonplace to find with some old legal systems that the historical differences that separate one model from another are now so embedded in certain legal regimes that they have become fundamental to its identity. Therefore any change to the character/main body of the existing law would not simply amend the way in which rescue is implemented but it may imply that the current system was inefficient in producing its desired outcome. Rendering one system better than another is not so problematic if it stands in isolation. But since this is rarely the case, the change may interfere with years of customs and practices and strike at the heart of its philosophy. As this would be unacceptable to most legal systems, a pragmatic solution to this situation that has gained favour has been to relax the endorsement of formal rescue procedures. There has been a notable adjustment within the profession from applying the more formal route and taking a less stringent path, such as endorsing the informal pre-packs.

The combination of adopting rules from old customs and taking piecemeal aspects from various regulations has meant that certain terms such as ‘financial distress’ and the point at which ‘insolvency’ occurs remains disputable. It has been acknowledged that the lack of clarification on such matters has allowed some much needed flexibility in an area that is surrounded by ambiguity and rife in tension between the various interested parties within a distressed company. This elasticity has provided insolvency practitioners with a huge amount of scope to decide the affairs of a company in the way that they see fit. The extent of this discretion has raised some serious concerns. They can use the ambiguity of the concepts along with their discretion to formulate an opinion that may, in some instances, reinterpret aspects of the law beyond what was intended by Parliament. There is a case to be made that IPs are the architects of corporate rescue proceedings and will on occasions, intended or not, administer beyond their powers as set out in the 1986 and 2002 Acts and act in breach of Codes set out by the RPBs such as the Code of Ethics.

Inevitably it appears that corporate rescue unfortunately suffers from something that is best described as an identity crisis. Whilst a hierarchy of objectives have been provided within Schedule B1 of the Insolvency Act 1986, it produces mixed intentions. The primary objective as set out in paragraph 3(1) of the Schedule is to rescue the company as a going concern. This thesis categorises this as an attempt to complete a 'pure' corporate rescue process whereby the distressed company remains intact as much as it was before the troubles occurred. The secondary objectives should only be considered if the primary objective has been eliminated because it would not prove to be viable in achieving its aim. These other objectives are not concerned with protecting the company as a corporate entity but rather appeasing the creditors as a whole by attempting to achieve a better result than what would be realised through either pursing the primary aim as noted above or through the immediate winding up of the company. The concern regarding this objective is whether the primary aim is rejected as a matter of course and whether this is in reality viewed as the true primary objective.

The research certainly indicates that there is a pattern emerging whereby corporate rescue procedures have simply been used as substitutes for liquidation. Whilst this may have not been intentional, given the listed objectives set out, which aim to provide real alternatives, adhering to the hierarchy as set out in paragraph 3 seems to have created a new mechanism which ultimately does lead to liquidation, certainly in effect. The pertinent question is not whether administration is the new liquidation (which this thesis concludes it is) but whether pre-packs has become the new rescue process, albeit not one recognised within the UK's current insolvency legislation.

The corporate rescue process as noted above is largely controlled by IPs who use their discretion to interpret the various insolvency legislation, rules and regulations to arrive at an outcome that they consider reflects the optimal result for the distressed company. How decisions are reached often highlights a preference between company and business rescue, with the former associated with corporate rescue and the latter with reorganisation. It is with the reorganisation strategy that results in the sale of parts of the business (this can range from physical assets such as machinery or to land or to intellectual property covering designs for new or existing products). Implementing this would naturally result in the downsizing of the company and streamlining what will be the eventual remaining business. This can be seen with respect to 'rescues' such as Blacks Leisure being bought by JD Sports early last year. For all intents and purposes when the task has been completed the company that remains will often not reflect what it once was. If it is the case that the mere shell of the company remains intact then this cannot be said to have been a successful rescue (the process being more akin to reorganisation) and certainly not a rescue that enabled the company to continue as a going concern.

The extent of the IP's involvement will depend on the company and the troubles that are evident. In general corporate rescue has been defined as an act which involves a major intervention to prevent eventual failure in a financially distressed company. However, the key to increasing the possibility of a rescue is not only down to ensuring that an IP is notified of the company's troubles at the earliest opportunity, but it is the ability of the IP to present the company as a viable business with a future. Administration has the advantage of being able to grant a moratorium to provide a 'breathing space' for the company to turn around its fortunes without having to worry about creditors demanding their money. But it is still a public process that will advertise the woes of the company. Competitors, investors and purchasers of the company's products are all reliant to news regarding the well-being of the company. The general stigma associated with failure can enhance the original distress that a company faces and in some cases render the primary objective of rescuing a company as a going concern obsolete from the start. It was noted above that perception is everything with a company and this is where a pre-pack has the advantage as a buyer for the company can be sought without having to make it public that the company is having troubles. This in turn might help prevent the 'ripple effect,' with the distress spreading further than the company. It also critically prevents the value of the company from plummeting, making the company more appealing (retains value within the market it operates) and as such a rescue of the company more likely.

**2. The Relationship between Theory and Policy**

Turning attention towards the relationship between corporate rescue theory and government policy, the research demonstrates how they have developed at a different pace. The current economic environment has provided an environment to test the existing law. This has brought into sharp contrast the theoretical principles that the UK's insolvency regime is based on and what a distressed company requires to have a realistic chance of survival. Historically the UK has adopted a policy that has followed a Credit Bargain Theory approach, developing policies to reflect a more socio-economic stance. This has allowed the UK to follow a traditionalist philosophy, which supports the view above that there should be a move away from liquidation in favour of supporting the preservation of distressed companies. This again bring us back to what is the exact nature of rescue and how should Schedule B(1), paragraph 3(1) of the IA 1986 be interpreted? Since the idea of pure rescue will only happen on rare occasions, can it be said to have any practical application? On a basic level of what a corporate rescue model should achieve this thesis introduced eight principles derived from the Cork Report designed to cover a broad range of considerations that should be evident within a corporate rescue strategy. The principles covered a number of factors such as fairness, adaptability, simplicity, cost, efficiency, timelessness, transparency, and accountability. By following these eight principles a rescue model could be examined and quality checked on its substance to reveal whether it would be compatible with the cultural and economic aspects of the jurisdiction in question. Despite the changes contained within the Enterprise Act 2002, such as reiterating the importance of taking pre-emptive measures to tackle and counter financial distress, risk management, even if monitored, does not prevent failure and it is only often with the help from IPs when all of the relevant information is gathered that the extent of the situation can be fully determined. With a new emphasis on IPs to assess the situation and to consider the interests of the creditors as a whole, it is now seen that collective proceedings is a deliberate move away from the pursuit of individual interests as existed with receivership.

The amendments enacted in the EA 2002 intended to make strides to enhance the reputation of insolvency law, but many aspects of the old law remain. The actions of directors remain to influence the outcome heavily as the extent of the financial distress depends upon them acting proactively to report the problems and their ability to provide the correct information when required by an IP. This, along with securing finance to aid a rescue attempt, particularly the ability to negotiate a debt-subordination scheme, proves critical and not always successful. Despite these concerns, the main factor that has contributed to the questioning of the existence and efficiency of rescue has been the involvement of the IPs and the wide discretion that they have been afforded under the Code and principles contained within the legislation.

IPs, as it has already been submitted, are no longer simply the practitioners, but the architects of corporate rescue. Whilst it is commendable that IPs have used their experience and knowledge to create a pragmatic solution to help distressed, yet viable companies, there is a trend occurring which shows that there is an increased tendency to operate outside the principles dictated by the UK’s insolvency law. However, it will be seen that the profession has been given a privileged footing, endorsed by the lack of available alternatives. Corporate rescue is only an option available to a company that can prove it can be rescued as a going concern. But there are growing concerns as to whether IPs are equipped with the knowledge to make decisions that may not necessarily fall within their field of expertise.

In essence it has raised questions whether a corporate rescue model in the UK exists, as these professionals seem to have the discretion to apply their own rules and interpretations as to what they think the law should be. This position has been further strengthened by the lack of intervention from the courts demonstrating that they prefer to leave the commercial decisions to those better placed within the business world. There are a number of fundamental principles and safeguards in place designed to prevent or at least restrict potential abuses. This, however, is dependent on the action taken by RPBs and whether the response is reflective of the act committed. The lack of transparency and accountability remains a problem which ultimately contributes to suspicion around the conduct of those who work within the rescue process. This has had the effect of shrouding corporate rescue in an air of secrecy leaving little information available in order to analyse exactly how rescue procedures are implemented. As a result this thesis considered the possibility that the choice to liquidate or rescue the company is influenced by how lucrative the process may be to office holders who have been charged to administer the company's affairs. The conduct of some has been so astounding that this has gone some way to support this submission, but the act of a few should not be used to hold the profession in contempt. Further analysis needs to be conducted within this area to substantiate this claim.

Given the importance of rescue procedures, there has to be a way to assess how effective they operate. A critical way to measure how well something is doing is to ask how effective does a model achieve its intended goal? Given the vast array of goals, not all can be assessed in the same way. Different benchmarks are set according to the nature of the aim and not all can endorse the same fundamental principles as part of its identity. Besides cultural influences, the overall model is subjected to wider issues which may be general in nature, such as economic downturn, or matters that are specific to the market in which the company operates.

In essence the contents of a model must be put in context and assessed accordingly. Subjecting corporate rescue to this framework involves identifying dominant principles within the current insolvency legislation that are presumed to be of significance due to the historical importance that they possess. Once these principles have been identified they may form the basis for assessment, providing a foundation in which they may reveal how one model compares to another in terms of how efficient they are in producing a desired outcome.

To reduce conflict, basic principles must be applied and these are able to act as general tools. Values such as transparency and fairness are important as they allow a system to be viewed as a whole. Transparency is a universal value that can be discussed in conjunction with accountability. Both aid to reassure the general public and interested parties that a model is doing what it is meant to do. Corporate rescue however does not satisfy the test satisfactorily as the process is not accessible and IPs are not accountable enough for the actions they take.

**3. Determining an Efficiency Model**

The law like most things is about producing desirable results. For who does the law of insolvency serve remains a contentious issue beyond the scope of this thesis. What this thesis concerned itself with was have the characteristics contained within the UK's corporate rescue model become redundant so far as its capability to provide a framework that can efficiently produce a viable rescue package that could save a company? Applying the four main notions of efficiency to corporate rescue has revealed some interesting findings. The main difficulty identified when applying Pareto efficiency to a corporate rescue model is whether the notion can truly be applied to a functioning principle that operates in the 'real world'. Based on this concern, the preference is to use the alternative notion known as Kaldor-Hicks efficiency. This approach is beneficial as unlike the former notion there is no actual requirement to compensate the losers. The only requirement is that the winners must gain more than the losses to the losers. Applying this notion to corporate rescue it is highly unlikely that the company would be able to compensate the creditors to such a degree that their grievances were satisfied. Furthermore, should this be done at all? Why should the risk element of investment be disregarded? Whilst contractual obligations play a key role in determining how debt is divided, it does so with the knowledge that not all parties or debts are equal. Satisfying Kaldor-Hicks efficiency means that the value of the compensation provided must be at such a level to be sufficient to the affected party. But since this depends entirely on the individual's wealth, the notion is susceptible to many possibilities and cannot be applied with any certainty.

In reference to practical application, technical costs are often applied which realises that the stronger competitor, principle or result should dictate the flow. The notion believes that the market provides the answers to the problems that exist in a particular area. As explored in Chapter Three, IPs have heavily influenced how administration is to be interpreted and in turn have been responsible for the rise in alternative rescue strategies such as pre-packs being deployed. This can be read in conjunction with dynamic efficiency which describes the ability of a given system to evolve and ultimately adapt the changing needs of a given market. It will be suggested that corporate rescue methods has evolved to the needs of the business world.

In terms of the actors who participate in a company their legitimate expectations should control how the company is run as well as how potential financial distress is dealt with. Concerns surrounding the legitimacy of corporate rescue have posed some interesting questions, not all of which could be covered within the scope of this thesis. However, even with the self imposed limitations that were necessary to keep the thesis focused, the research does highlight the lack of any claim that the concept of corporate rescue in the UK may make to fulfil the needs of companies in today’s financial climate. Can administration be said to offer the best deal for a distressed company? Or has corporate rescue been modified so that a strategy has developed, which better suits the needs of businesses? The research completed in this thesis inclines us to lean against the latter and conclude that the current formal administration process does not fully capture commercial practice, and survives only by categorising inconsistent elements as exogenous. Whilst the legal uncertainty cannot be eliminated, it can only be managed and this has created a two-tier system whereby an informal approach has been taken.

**4. The Pragmatic Response**

Pre-packaged administrations have proven to be a controversial tool employed by IPs to tackle troubled companies. There are many questions as to whether the pre-pack can offer a legitimate solution to the inadequacies of the current law governing corporate rescue. Given the direction of the existing research conducted in this thesis it was necessary that a limit was placed on the extent pre-packs were to be examined. The purpose of this thesis was not to question the validity of the procedure itself, but rather consider the legitimacy of the pre-pack strategy inventing itself as a true rescue process like administration. Administration is a process that is embedded in the Insolvency Act 1986 and the Enterprise Act 2002, with a tangible framework how it goes about dealing with distressed companies. Pre-packs on the other hand do not share this. The procedure suffers from something of an identity crisis, having being developed outside of any formal rescue process that is currently recognised by UK Insolvency law. Despite this shortcoming pre-packs appear to be loosely based on elements of the Cork Report, such as the communitarian approach as it tries to limit the extent that the distress spreads beyond the company, and to, in some regards, safeguard jobs. But this does not always happen. The lack of legislation regulating pre-packs has resulted in a number of issues, most notably the inability to enforce a uniform approach to how pre-packs should operate.

This vacuum, whilst urgently needs addressing by the government, has for the time being presented as a golden opportunity for IPs. Practitioners have realised that this informal process can be beneficial not only to providing profit for the accountancy firm they work for but also a means of not having to adhere to the strict timeframe and provisions with the 1986 and 2002 Acts. That said, this does not mean than pre-packs are entirely unregulated. IPs are collectively members of professional bodies that amongst other things monitor the actions of their group. Within these RPBs, the bodies have recognised that some sort of guidance was needed as well as some regulation in order to ensure monitoring, since it was apparent that this strategy was common practice amongst its members across the profession. The RPBs in some respects have plugged the gap, dealing with issues arising out of practice where the government have failed to take responsibility.

Notwithstanding this arrangement, this does not mean the pre-packs are tightly controlled. Whilst each of the professional bodies have formulated a number of regulations and rules to keep the practice in check, the permitted use of discretion afforded to IPs allows them to conduct the affairs of the company how they see fit without having to provide clear and concise justifications for their actions. The only real test that has to be satisfied is whether a certain act would prove detrimental to a commercial judgement which may in turn affect the value of a proposed deal (the company) to a purchaser. Commercial judgement has proved a key concept as it is apparent that the courts place a heavy reliance on the commercial and technical knowledge of practitioners and have shown great reluctance to intervene in cases where the dispute arises from a business decision as opposed to a statutory or regulation breach by the administrator. This is, of course, consistent with the courts' traditional approach in dealing with the judgments of liquidators and trustees in bankruptcy.

Whilst it is part of the RPBs role to ensure that professional conduct remains high and the core principles are being followed, failure to ensure that safeguards are adhered to does not automatically warrant action to be taken by the governing body against one of its members. Indeed it seems that disciplinary action by RPBs is a rare occurrence not to mention the difficult that the process has on creditors seeking relief. In some ways this has encouraged alternative rescue models to arise as the potential consequences arising from a breach is nominal compared to the benefits that are on offer if the pre-pack works out. In conjunction with this it is difficult for RPBs to be in a position where they are certain after reviewing all of the relevant documentation that some action should be taken against its members. The data compiled in the cases does not always truly reflect all of the circumstances, nor is it often the case that the information obtained is accurate.

It follows that the biggest problem facing pre-packs is the lack of transparency throughout the process. This, along with the lack of accountability required of practitioners has helped to provide pre-packs with a reputation that it perhaps does not fully deserve. But it has not been helped by the fact that informal negotiations are commenced in secrecy before the company enters any formal administration process. This is not only the norm but it is a practice that has been justified on the grounds that this helps to sustain the value of the company. Sustaining the value is a critical objective of a rescue procedure as it allows the company to be valuable as a whole rather than merely its assets. If it was just the assets that had any value then the rescue of the company would be fruitless. Whilst creditors have shown considerable distaste for a pre-pack strategy that has been struck with the former management of a particular company, in most cases the only interested parties that will be willing to offer a good deal are those who do actually have connections with the company. However to establish such deals means operating outside the administration process and this could prove the 'tipping point' for how corporate rescue operates in the future.

Ultimately the emergence of pre pack strategies as an increasingly popular way to manage distressed companies has allowed for a pragmatic solution to surface, which offers an alternative to the formal administration process. The difficulty with pre-packs is that whilst they may reflect current trends in practice it is not something that is endorsed in either the Insolvency Act 1986 or the Enterprise Act 2002. Since there appears to be a legal vacuum whereby the realities evident in practice are not accommodated for within the law can the model referred to as corporate rescue in the UK be accurately described as corporate rescue? There are various regulations and codes from the RPBs which provide guidance on how pre-packs should operate but this is only to offer some uniform approach to be taken throughout the profession. The required level of change is not yet reflected in legislation. It is with this thought that makes it plausible to conclude that if this trend continues and the pre-pack continues to operate in a vacuum between various statutes without officially displacing administration it may reasonably be suggested that the UK does not have a legislated corporate rescue procedure.

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