

The Law and Practice of Contractual Receivership

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by

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CHAPTER 4

THE SPECIAL CASE OF EMPLOYEES

Introduction

The previous Chapter examined the extent to which the interests of third parties affect the decisions of a privately appointed receiver. A recurring theme of this work is the extent to which the law departs from the basic position that such a receiver's primary function is to deploy the company's charged assets in a manner best designed to promote the interests of his appointor. This principle appears, for the most part, to derive from the debenture-holder's proprietary priority over the company's assets and the law's deference to proprietary rights in general. Such rights are not, however, unassailable and policy initiatives may demand their modification.

A system of law based purely on the sanctity of property rights may fail to address the policy issues raised by insolvency in general and receivership in particular, and so may require adjustment to meet the needs of certain interest groups deemed worthy of special consideration. This Chapter explores the law's response to one such group, namely the employees of a company in receivership. It should be noted from the outset that, ordinarily, a company's employees will have no proprietary interest in its assets¹, and so no contractual means of elevating their claims. The foundation of 'receivership law' being property rights, one might therefore expect

¹ With the exception of those participating as equity stakeholders, usually through the medium of an employee share ownership scheme.

to find that employees are little more than a marginal consideration, both in terms of their right to participate in the distribution of assets and their petition to be protected against the repercussions of the receiver's allegiance to his debentureholder. In fact, this is far from the case.

This Chapter investigates how the law confronts the particular problem of employee rights in receivership situations. This subject merits separate treatment because it illustrates how one body of law, seemingly unconnected to the question of priorities in insolvency, may encroach upon the course of a receivership in a dramatic manner. The position is made complex because although the Insolvency Act protects the interests of employees to certain extent, a number of 'employment law' provisions have relevance in receivership situations, and not always by design.

Davies and Freedland, in 1980, identified receivership as an "island" located somewhere between the separate "lands" of company and labour law², this graphic description serving to emphasise the fusion which occasionally unites apparently disjointed legal regimes. This process of cross-pollination continues to the present day, but, it will be argued, is directionless, and uninformed by any consideration of policy. The question which both courts and legislature have studiously avoided addressing is whether the proprietary rights of a secured creditor should prevail over the social and financial interests of employees of a company in receivership. This Chapter will return to this central enquiry at various stages, in an attempt to determine where the merits lie. It is first necessary, however, to describe the general

² *The Effects of Receiverships Upon Employees of Companies* (1980) 9 ILJ 95.

position of employees in receivership situations and to chart the legal response.

1. The interests of employees

“It is possible to divide the interests of employees as they are affected by receiverships into three classes. First, the interests of those employees employed in any viable part of the business which is sold to a third party. Secondly, the interests of those employees employed in parts of the business that are closed down. Thirdly, the interests of employees as a whole in the decisions which a receiver takes and which will have an impact upon their prospect of continued employment.”³

A different view of the manner in which receivership affects a company's employees may be offered. They may be interested as preferential creditors, or as post-appointment creditors to the extent that they continue to supply services to the receivership company. In this regard there are specific ‘receivership law’ provisions designed to protect them from the consequences of their employer's insolvency and the debenture-holder's floating charge. It is, however, difficult to argue with the assertion that employees have an interest of a more general nature in the conduct of a receivership. The aftermath of corporate failure is frequently the loss of employment, and, even in today's economic climate, job security is one of the most valuable of all employee rights. As Samwell puts it:

“Some employees may be happy for trading to cease if there is alternative employment available, but in areas of high unemployment employees will usually be keen to assist in continued trading in the hope of keeping their jobs.”⁴

³ Davies and Freedland, *supra* n 2, 101.

⁴ *Corporate Receiverships* (1981 : ICAEW : London), 77.

Employees, therefore, might be said to suffer from a “triple-whammy” effect in receivership, in that they may be owed money by the company for pre-receivership services, they may continue to supply their labour post-appointment, and, most importantly, will face an uncertain future once an appointment has been made⁵.

Prima facie there is a strong case for disapplying the usual proprietary priority regime that tends to govern third party rights in receivership where employees are concerned. Their claim for special treatment is further bolstered by their peculiar vulnerability. The weak position of employees as against their employer is commonly cited as justification for employment protection legislation, and this factor is equally relevant in receivership, although the emphasis switches to the position of employees as against the debenture-holder. Strictly speaking, employees are not involuntary creditors, but to suggest that they are in a position to withdraw their labour as soon as their wages fall into arrears is specious to say the least.

On the other hand, their importance in the scheme of receivership should not be underestimated. If even minimal post-appointment trading is contemplated a receiver must be able to rely on the continuing services of the workforce. Whilst he may be able to secure ‘new’ suppliers and customers, it is not feasible to suggest that a receiver could conjure up new employees to keep the company running in the short-term. Of all the stakeholders involved in a receivership, the workforce are likely to be of prime significance, just as the receiver’s stewardship of the company

⁵ See, e.g., Doyle, *Administrative Receivership : Law and Practice* (1995 : FT Law and Tax : London), 54.

will be decisive of their own future prospects. This element of symbiosis gives rise to extra-legal considerations for receivers, and, indeed, all insolvency practitioners whose remit is to perform a rescue operation on an ailing company. Belcher perceptively makes this point when she remarks:

“...it must be remembered that, in dealing with employees, what is politically expedient and practically feasible may be as important as what is legally allowable ... in dealing with employees, the legal position should not be considered in isolation; if the long-term survival of the business depends on the commitment and motivation of continuing employees, the political and motivational aspects of employment changes must be part of the decision-making process.”⁶

An acknowledgement of the interests of employees will therefore be vital if the receiver is to maximise his appointor's welfare. Indeed, it may be that the interests of both employees and debenture-holder coincide in many receiverships, although, as will be illustrated later, one particular situation gives rise to a seemingly irreconcilable conflict. In practice, receivers tend to treat the claims of employees seriously. Whilst the debenture-holder's well-being will inevitably be uppermost in a receiver's deliberations, in order to effectively promote it he will be obliged to devote substantial consideration to the position of the company's employees. They are indispensable if the optimal outcome is to be achieved.

This being the case, one might anticipate that a relationship of such enormity would be the subject of detailed legislative attention, and that the employee/receiver nexus would be governed by a comprehensive statutory structure. Contrary to expectation,

⁶ *Corporate Rescue* (1997 : Sweet & Maxwell : London), 181.

the Insolvency Act makes minimal provision in relation to the position of employees, and even this was included as a postscript, designed to address a problem unforeseen at the Review stage⁷. The reality is that the situation of employees in receivership is determined by a mixture of case law, both specific and non-specific to receivership, and statute, the latter comprising provisions from various enactments, some of which were conceived without any reference to their potential to influence receivership cases. The following sections focus upon particular instances where, in the context of the position of employees of a receivership company, the law has had to intervene, and attempts to evaluate its success in this regard.

⁷ See *infra* 344.

Employees and Receivership - the Legal Context

1. Effect of an appointment

On the making of a winding-up order, the employees of a company are automatically dismissed⁸, and the same appears to be true in relation to court-appointed receivers⁹. In *Re Foster Clark Ltd's Indenture Trusts*¹⁰ Plowman J held that the appointment of a receiver by debenture-holders, rather than by the court, did not *per se* terminate employment contracts, although a sale of the business of the company by such receiver would have this effect¹¹. This basic principle was refined in *Griffiths v Secretary of State for Social Services*¹², where Lawson J noted three qualifications to the 'non-termination' rule. The first was where an appointment was accompanied by the sale of the business, the second where a receiver entered into a new agreement with an employee which was inconsistent with his contract of employment. The third was where the continuation of a particular employment contract would be "...inconsistent with the position, role and functions of a receiver and manager"¹³.

The latter was envisaged as relevant to the position of senior management or directors of the company. The learned judge appeared to contemplate that where the

⁸ *Re General Rolling Stock Co., Chapman's Case* (1866) LR 1 Eq 346; *Fox Bros. v Bryant* [1979] ICR 64.

⁹ *Reid v Explosives Co.* (1887) 19 QBD 264, but see *International Harvester Export Co. v International Harvester (Australia) Ltd* (1983) 7 ACLR 391.

¹⁰ [1966] 1 All ER 43.

¹¹ *Ibid.* 49. The latter proposition has been undermined by the enactment of the Transfer of Undertakings (Protection of Employment) Regulations 1981; see *infra* 369.

¹² [1973] 3 All ER 1184.

¹³ *Ibid.* 1199

functions of such employees would be identical to those of the appointee than an automatic termination would supervene.

The concept of automatic dismissal is, it is submitted, problematic. Lawson J himself noted that the mere fact that an employee occupied the position of 'managing director' would not be sufficient to trigger the automatic termination of his contract upon the appointment of a receiver. The nature of the manager's functions should be examined, and only where they coincided precisely with those of the receiver, and, perhaps, were not subject to outside control, would such termination take place. In this regard, the capacity of the receiver is to be viewed pragmatically, for, as Lawson J observed:

"...I think one has got to be a little realistic about what the role and functions of a receiver and manager are. The normal course one may I think say is that one finds debenture-holders appointing a receiver and manager ... not with the intention that he should be employed full-time to conduct all the company's business but as someone who is going to exercise supervision and control of the way in which the company's business is run, particularly the financial implications of the way in which the company's business is run as from the time when the receiver is appointed."¹⁴

If the gist of this judgment is correct, a number of questions arise. If automatic dismissal takes place, does it qualify as an unfair dismissal for the purposes of the Employment Rights Act 1996? Further, are those subject to the automatic termination of their contracts redundant within the meaning of that Act?

¹⁴ [1973] 3 All ER 1184, 1199.

The notion of automatic termination of employment contracts on the appointment of a receiver is, it is submitted, an awkward and inconvenient one, and may give rise to damaging uncertainty. Whether automatic dismissal has taken place or not appears to be a question of fact, and the scope for disagreement between courts, receivers and employees on this matter is incontestable. The Insolvency Act makes no reference to such a principle, but arguably proceeds on the assumption that whether a contract of employment continues or not is dependant upon the receiver's actions: he may choose to treat it as remaining in existence or otherwise. It is submitted that the better view is that *Griffiths*, in this regard, is obsolete, and even those director/employees whose functions can be said to perfectly mirror those of the receiver remain in the company's employment unless and until he chooses to dismiss them.

A few points remain to be addressed. First, it is still good law that a contract of employment will terminate upon a receiver entering into a new agreement with the employee in question the terms and conditions of which are inconsistent with the former contract¹⁵. The receiver might then find himself personally liable on the new contract under s 44(1)(b) IA¹⁶. Further, the courts have held that a *de facto* break in continuity of employment caused by a receiver entering into a new agreement, or effecting a transfer of the business after liquidation had intervened, does not automatically disturb the employee's continuity of employment. The correct

¹⁵ *Supra* n 12, 1199.

¹⁶ *Re Mack Trucks (Britain) Ltd* [1967] 1 All ER 977, 983, *per* Pennycuick J, with reference to s 369(2) Companies Act 1948.

approach is to consider “the realities” of the circumstances in which the break occurred, and, if it was a purely technical one, to ignore it for the purposes of employee protection legislation¹⁷.

Finally, a vexed question that has never been addressed by the courts is the effect of a post-receivership winding-up order being made. Without the benefit of authority it is unclear how contracts of employment are affected. One analysis proceeds as follows. Firstly, following *Re General Rolling Stock Co*¹⁸, all contracts of employment subsisting at the time of the order automatically terminate. If the receiver continues to utilise the services of the ex-employees, he does so as principal, his agency similarly terminating on the making of the winding up order¹⁹. As principal he is personally liable to those whose services he utilises. On what terms is something of a mystery, although the courts might infer an agreement to the effect that services are rendered on the same terms and conditions of the terminated employment contracts²⁰.

If this represents the law, it is an extraordinary state of affairs. A receiver who continues to ‘employ’ after liquidation, even for a short time, might find himself personally liable for all pre-dismissal contractual entitlements, including wages, holiday pay, pay in lieu of notice and redundancy payments²¹. These might

¹⁷ *Deaway Trading Ltd v Calverley* [1973] 3 All ER 776, 781, *per* Sir John Donaldson.

¹⁸ *Supra* n 8.

¹⁹ IA s 44(1)(a) (hereinafter ‘IA’).

²⁰ Doyle assumes that the terms and conditions of the pre-liquidation contracts will subsist in relation to a receiver acting as principal; *supra* n 5, 318.

²¹ These may be limited to “qualifying liabilities” as defined in s 44(2A) IA. Doyle suggests that this is the better view, although there is no precedent to confirm his opinion; *supra* n 5, 318.

conceivably be covered by the receiver's s 44(1)(c) indemnity²², although it is at least arguable that this does not survive liquidation, or claimed as expenses of the receivership. In either case, a receiver is only protected to the extent that the assets of the company are sufficient to meet what might be substantial sums.

Perhaps the critical question is the extent to which a receiver becomes the 'employer' of those whose services he retains post-liquidation, and the consequences of such a denomination. If *Deaway Trading Ltd v Calverley*²³ is correctly decided, employees will still be able to claim against the National Insurance Fund in respect of the items listed above²⁴. There is, however, nothing in either the Insolvency Act or the case law to suggest that they would be precluded from pursuing the receiver instead.

The lack of authority on this matter suggests that it has not proved a problem in practice. Nonetheless, clarification would be welcome, not least because it might forestall a receiver making widespread dismissals in anticipation of a winding-up order, or, indeed, being forced into closing down the business altogether for fear of incurring hefty personal liability in respect of employees.

²² Lightman and Moss suggest that this will be the case: *The Law of Receivers of Companies*, 2nd ed (1994 : Sweet & Maxwell : London), para. 19-10, but *c.f.* Doyle, *supra* fn. 5, 318.

²³ *Supra* n 17.

²⁴ See ss 166-170, 182-190 Employment Rights Act 1996, and see *infra* 338.

2. Preferential status for pre-receivership debts

The nature and history of preferential debts was considered in Chapter 3, and the manner in which the protection offered by the scheme can be eroded by the taking of widespread fixed charges there illustrated. Clearly, such a strategy by debenture-holders may deprive employees of the financial advantages offered by preferential status, although the provisions of the Employment Rights Act 1996 offer alternative, and, indeed, enhanced protection²⁵. It is perhaps surprising that the Secretary of State for Employment has never seen fit to challenge the practice of subjecting ostensibly 'floating charge' assets to fixed charges purely in order to remove them from the scope of the preferential regime, or indeed, to scrutinise the apportionment of realisations between fixed and floating charge assets. The result of both these tactics is, in the context of employee claims, to shift the burden from debenture-holder to State, as will hereinafter be illustrated.

The items which employees may claim as preferential debts are to be found in Category 5 of Schedule 6 Insolvency Act. They include any remuneration payable in respect of a period of four months preceding the appointment of a receiver²⁶. Remuneration includes, *inter alia*, wages or salary in respect of services rendered during that period, guarantee payments, and the amount of a protective award made under s 189 Trade Union and Labour Relations (Consolidation) Act 1992²⁷. The amount claimed may not exceed "so much as may be prescribed by order made by

²⁵ *Infra* 338.

²⁶ Schedule 6 IA, Category 5, para. 9(b).

²⁷ *Ibid.* para. 13(1)(2).

the Secretary of State”, the current limit being £800²⁸. This risibly low figure further devalues the status of preferential creditor as far as employees are concerned.

Notwithstanding the relative ease with which a secured creditor can contractually ensure that the assets available to meet preferential debts are minimal, it remains the case that the preferential regime has the effect of elevating certain pre-receivership employee claims above his own. Lange and Hartwig support this position thus:

“The rule is justified because first, if preferential claims to employees were met before the appoint of an administrative receiver, the amount of secured assets would in any case be diminished, and the creditor would suffer a similar loss; secondly, employees have contributed to keeping alive the company, and thus to preserving secured assets for creditors; and thirdly, debenture-holders could, while claims were mounting, have made it unambiguously clear that they do not wish the company to continue. Thus it seems reasonable to impose on the creditor the accrued claims of workers.”²⁹

Whilst the first and second reasons are valid, one might question why trade creditors of the company are not afforded preferential status, as precisely the same reasoning could be applied to their case. As to the third, this comes dangerously close to ‘penalising’ secured creditors for failing to intervene, presumably by the appointment of a receiver, at an early stage.

The rationale behind the preferential regime is difficult to penetrate with any exactitude³⁰, but employees’ claims for unpaid remuneration have featured since its

²⁸ As fixed by the Insolvency Proceedings (Monetary Limits) Order 1986, S.I. 1986/1996.

²⁹ *The Law and Practice of Administrative Receivership and Associated Remedies* (1989 : Sweet & Maxwell : London), para. 3.71

³⁰ See Chapter 3.

inception. Employees, unlike Crown creditors, cannot be said to be genuinely involuntary creditors. Nobody forces them to work for a particular company, or to continue working when their wages are not paid. They are, however, in a weak position in terms of bargaining power and commercial vulnerability, and these characteristics distinguish them from the general body of creditors and add credibility to their favoured status.

Unlike the majority of trade creditors, employees concentrate their earning potential in a single location, *viz.*, their employing company. In the event of non-payment of wages, theirs is a stark choice between refusing to continue working for the company and 'soldiering on' in the hope that matters will improve. Management may well have been assuring their unpaid employees that the crisis is temporary, that the company is merely experiencing "cash-flow problems", and that arrears of pay will be forthcoming in the near future. Furthermore, and especially in the case of small companies, such appeals may be well received. It is not unusual for the workforce to feel some allegiance with management, and, indeed, the company itself, unlike suppliers and, of course, banks, who are unlikely to suffer pangs of conscience at the notion of defection. In short, employees labour under a disadvantage in terms of their lack of mobility and their intrinsic loyalty to one employer.

Similarly, the workers of a company are singularly incapable of protecting themselves against insolvency. Debt financiers are able to take security, trade

suppliers have the retention of title clause in their armoury³¹, and Crown creditors are notoriously well-equipped in terms of statutory remedies. Employees, in contrast, lack the business sophistication of their counterparts, and, indeed, the wherewithal to safeguard their interests. Whilst employees are not *necessarily* commercial innocents, their general position displays an extreme vulnerability, and one which warrants their elevation to preferential status as against the debenture-holder. If nothing else, such a claim can be seen as a 'reward' for their loyalty³².

3. The State's 'Guarantee' Function³³

"Certain debts payable to employees are guaranteed payment by the Secretary of State from the National Insurance Fund which, understandably, in recent times of high unemployment, has had a huge drain on its resources..."³⁴

Employee protection in the form of State restitution of certain of the insolvent employer's debts has existed for some years, and the relevant provisions are currently contained in the Employment Rights Act 1996³⁵ ss 166-170 and 182-190. The former deal with an employee's rights as regards statutory redundancy payments, the latter relate to certain other debts that might be incurred by the

³¹ Although this is admittedly a precarious shield.

³² It is not unknown for a workforce to support their employer in the full knowledge that their wages may not materialise for some time, or, indeed, not at all. A recent example was reported on local television news. A Staffordshire pottery firm enjoyed the unpaid services of its staff of 60 for almost three months, including a period over Christmas. When administrators were appointed they were promptly laid off.

³³ A detailed description of this subject is beyond the scope of this work. For comprehensive coverage the reader is referred to Upex, *The Law of Termination of Employment*, 5th ed (1997 : Sweet & Maxwell : London), Chapter 13.

³⁴ *Butterworths Employment Law Handbook*, 7th ed. (1996 : Butterworths : London), para. 15.07.

³⁵ Hereinafter the ERA.

company both pre-and post-receivership. The provisions apply in the case of the employer's "insolvency", which encompasses the situation where a receiver has been appointed³⁶, so whilst not specific to receivership they address a problem that that institution may engender, viz., unpaid contractual rights of the employees of an insolvent company. As noted above, at least some of these claims may have preferential status under Schedule 6 Insolvency Act, but the ERA regime has been described as "...[m]ore useful in practice..." as far as employees are concerned³⁷.

Under s 184 ERA an employee is entitled to claim from the National Insurance Fund arrears of pay subject to a limit of eight weeks arrears³⁸ and a ceiling, as from 1st April 1999, of £230 per week³⁹. Arrears are calculated from "the appropriate date", which is defined as being the date on which the employer became insolvent⁴⁰, and include a guarantee payment, payment for time off to carry out trade union duties, sickness and maternity pay, and remuneration under a protective award⁴¹. Also covered are payments in lieu of notice⁴², arrears of holiday pay⁴³ and the basic award of compensation for unfair dismissal⁴⁴. By s 189 ERA, the Secretary of State is subrogated to any rights and remedies an employee might have, and this includes the right to claim as preferential creditor under the Insolvency Act⁴⁵.

³⁶ ERA ss 166(7)(b), 183(3)(b).

³⁷ Deakin and Morris, *Labour Law*, 2nd ed (1998 : Butterworths : London), para. 5.6.4.

³⁸ ERA s 184(1)(a).

³⁹ *Ibid.* s 186(1)(a).

⁴⁰ *Ibid.* s 185(a). The Act does not expressly state that the date of 'insolvency' for this purpose is the date of the appointment of a receiver, but this seems implicit in s 183(3)(c).

⁴¹ *Ibid.* s 184(2).

⁴² *Ibid.* s 184(1)(b).

⁴³ *Ibid.* s 184(1)(c).

⁴⁴ *Ibid.* s 184(1)(d); the amount of any compensatory award is not covered.

⁴⁵ *Ibid.* s 189(2)(a).

There is a considerable degree of overlap between the provisions of the ERA and the Insolvency Act in relation to the categories of claims that can be advanced by unpaid employees. Arrears of wages or salary are both preferential and guaranteed, but the latter is more generous in terms of the monetary amount that can be recovered. Under Schedule 6 Insolvency Act the maximum amount of “remuneration” payable out of the proceeds of floating charge assets is £800, and “remuneration” includes the amount payable under a protective award. Under the ERA the maximum claim for arrears of wages is £1,840⁴⁶. It would appear that the amount of any protective award made under s 189 Trade Union and Labour Relations (Consolidation) Act 1992 is not included in this figure, and so can be claimed on top of it. The basic award of compensation for unfair dismissal is guaranteed by the National Insurance Fund, but does not carry preferential status. Upex concludes that:

“The only circumstances in which an employee will be forced to claim in insolvency, relying on his or her preferential status, will be in respect of sums due for periods outside Fund limits or where the employee is still employed by the insolvent employer.”⁴⁷

As well as guaranteeing enhanced recoveries, the National Insurance Fund may also be a superior source of payment for employees in terms of speed. Under the preferential regime, it is arguable that a receiver’s duty extends only to making payment out of floating charge realisations, and does not compel him to discharge

⁴⁶ 8 weeks x £230 per week.

⁴⁷ *The Law of Termination of Employment*, *supra* n 33, para 13.34.

preferential debts as soon as funds are available to do so⁴⁸. However, as Lange and Hartwig observe, expedience may require him to make prompt payments in order to secure the co-operation of the workforce⁴⁹, and, of course, no claim can be made under the ERA unless and until the employee's employment has been terminated⁵⁰. A further notable point concerning the State's guarantee function is that it has been perceived as rescue facilitative:

"Acceptance by the State of the claims of employees when an administrative receiver is appointed, gives the receiver an incentive to rescue the company. It enables him to have greater regard to his "social" obligations, and reduces the risk that rescuing the company will be endangered by the cost of accumulated rights of employees. The debenture-holder too will be more favourably inclined to rescue."⁵¹

This is an interesting perspective, but it is difficult to see how the accumulated rights of employees accruing during a rescue attempt would be in any way mitigated by the State's guarantee function, which only operates, as does the preferential regime, to discharge *pre-appointment* arrears of wages. Post-appointment liability attaches to the receiver where employment contracts are 'adopted' in order to continue the business of the company⁵², and not to the Secretary of State under the National Insurance Fund. Moreover, some debts

⁴⁸ See the discussion in Chapter 3.

⁴⁹ *The Law and Practice of Administrative Receivership and Associated Remedies*, *supra* n 29, para. 3.71. The learned authors express some doubt on the question of whether employees have a direct claim against a receiver for immediate payment. It is submitted that the better view is that they do not, s 40 IA imposing no more than a duty to discharge preferential debts out of floating charge realisations *before* such are handed over to the debenture-holder. The timing of such discharge appears to be entirely at the discretion of the receiver.

⁵⁰ ERA s 182(b).

⁵¹ Lange and Hartwig, *supra* n 29, para. 3.75.

⁵² IA s 44; see *infra* 344.

payable out of the Fund which accrue due post-appointment⁵³ would in any event be unsecured, and rank behind the debenture-holder for payment. Finally, as will be seen later, if an attempt to rescue the company results in a going concern sale of the business it is frequently the case that accrued liabilities will fall to be met by the *transferee* of that business⁵⁴.

With respect, it is submitted that to attribute a 'rescue promoting' effect to the guarantee function is somewhat roseate. A more pertinent enquiry is whether it indirectly shifts the burden of employees' claims from the debenture-holder to the State and whether such a displacement is justified. Without the National Insurance Fund to fall back on, employees would be reduced to claiming as preferential creditors. Given the parsimonious sums available to them as such, they would unquestionably have a strong 'moral' demand to be promoted over a secured creditor in respect of all, and not merely floating charge realisations. It is not inconceivable that the existence of the Fund has averted a high degree of employee dissatisfaction at their treatment in receivership, and thus forestalled a debate into the congruity of the elevation of contractually-bestowed proprietary rights over a category of extremely vulnerable unsecured creditors. In this regard, the secured creditor is conveniently shielded by the State.

The central issue here is the extent to which the debenture-holder should be expected to meet those claims of employees that are currently discharged by the

⁵³ For example, protective awards and compensation for unfair dismissal; ERA s 185(b).

⁵⁴ *Infra* 369.

State. It should be noted that the provisions of the ERA, and its predecessors, were at least partially necessitated by Council Directive 80/987/EEC⁵⁵, which required Member States of the European Union to take measures to ensure that the employees of an insolvent enterprise have their outstanding claims under contracts of employment or employment relationships guaranteed⁵⁶. There would therefore seem to be little option for the State but to donate to the unpaid claims of employees dismissed in receivership situations, and, on balance, this is probably a fair distribution of responsibility as between State and debenture-holder. The ERA protects employees on their dismissal, whereas, as will be seen later, those employees who continue to contribute to the receivership by supplying their services will, in the normal course, be subsidised by the debenture-holder through 'his' charged assets. The subrogation of the Secretary of State to the rights of employees also ensures that the debenture-holder, at least in part, discharges certain claims accrued during the run up to insolvency⁵⁷. It is not immediately obvious that the categories of claim covered by the ERA would be justifiably reassigned to the secured creditor, and the current location of responsibility seems reasonable. Where, on the other hand, employees' services are utilised post-appointment, and in order to promote the debenture-holder's interests, different considerations apply.

⁵⁵ The 'Insolvency Directive'.

⁵⁶ Directive 80/987, Article 3.

⁵⁷ Which attract preferential status.

4. Receivers and the provision of post-appointment services

4.1 The concept of adoption: a history from 1986 to Paramount

“In practice if insolvency practitioners wish to arrange for the company to continue to trade, they will need to arrange for (at least) on-going wages to be paid to the employees kept on. To do otherwise would be likely to result in the employees walking out and claiming damages for constructive dismissal.”⁵⁸

The practice of paying wages to employees in order to secure their continued services was noted by Dillon LJ in *Nicoll v Cutts*⁵⁹, and by Lord Browne-Wilkinson in *Powdrill v Watson*⁶⁰. The former, pre-Insolvency Act case concerned the allegedly unusual instance of a receiver utilising the services of an employee, or more accurately a director of the receivership company, without making any payment for them⁶¹. In the Court of Appeal, Dillon LJ was sympathetic, but could find no legal means of ensuring that a receiver conducting the business and using the services of employees would pay for them. The contract was not a new one entered into by the receiver and on which he would be personally liable under s 369(2) Companies Act 1948, nor could he be compelled to discharge the company's indebtedness in this respect as an expense of the receivership.

It is perhaps surprising that the Cork Committee made no recommendations in this regard in their Report⁶², although they were clearly under the impression that such

⁵⁸ Pollard, *Adopted Employees in Insolvency - Orphans no More* (1995) 24 ILJ 141, 142.

⁵⁹ (1985) BCC 99,427, 99,430.

⁶⁰ [1995] 2 All ER 65, 75.

⁶¹ Mr Nicoll's plight was made all the more poignant by the fact that he offered information and advice to the receiver from his hospital bed.

⁶² *Insolvency Law and Practice : Report of the Review Committee*, Cmnd 8558 (1982 : HMSO : London), (hereinafter the Cork Report).

debts would be met as a matter of course⁶³. It was therefore left to Parliament to take the initiative and remedy the perceived injustice of the *Nicoll v Cutts* decision. Its attempt to do so resulted in some of the most protracted litigation receivership law has ever experienced.

The debacle arose out of an addition to the Insolvency Bill designed to constrain receivers to adhere to practice of paying wages as they fell due. By s 44(1)(b) Insolvency Act an administrative receiver was to be personally liable “on any contract of employment *adopted by him* in the carrying out of [his] functions”⁶⁴. By s. 44(2), an administrative receiver “is not to be taken to have adopted a contract of employment by reason of anything done or omitted to be done within 14 days after his appointment”. Lightman and Moss observe that:

“Parliament clearly wished to be seen to have acted, but was apparently less anxious to make plain what it had done. The Statute thus contains no definition of the term “adopt”.”⁶⁵

Two critical questions arise. First, what is the meaning of “adopt” in this context? Secondly, what are the consequences of the adoption of a contract of employment? As regards the latter, it seems that Parliament overlooked the fact that contracts of employment habitually confer benefits going far beyond the payment of a weekly wage, examples including a right to holiday payment, payment in lieu of notice, bonus payments, commissions, golden handshakes and the like. From its inception,

⁶³ *Cork Report*, *supra* n 62, para. 457.

⁶⁴ Italics added. Non-administrative receivers were made similarly liable under s 37(1)(a). Administrators were to discharge post-appointment claims on adopted contracts in priority to their own expenses and remuneration; s 19(5) IA.

⁶⁵ *The Law of Receivers of Companies*, *supra* n 22, para 19-08.

s 44(1)(b) had the potential, on its literal wording, to render administrative receivers personally liable on all such items, and, not surprisingly, they responded by attempting to avoid such a consequence.

The method of doing so was highlighted in the case of *Re Specialised Mouldings*⁶⁶.

In that case, Harman J was called upon to appraise the efficacy of standard form letters circulated to employees by administrators stating that they were not, and would not at any time, adopt contracts of employment, and did not accept personal liability on such. It should be acknowledged that such tactics were not designed to escape the payment of wages to those employees whose services were used. Indeed, it appears that for the most part receivers and administrators continued to meet wage debts as they were incurred, even offering and paying loyalty bonuses on some occasions⁶⁷. Rather, the insolvency practitioners in question were attempting to avoid acceptance of liability for *all* the unpaid contractual rights of the employee in question. Harman J held that the letters⁶⁸ were sufficient to achieve the desired result, that the employment contracts in question had not been adopted and so, as a corollary, the administrators were not compelled to meet employees' claims ahead of their own remuneration⁶⁹.

⁶⁶ Unreported, Feb 13 1987.

⁶⁷ See the facts of *Re Paramount Airways (No. 3)* [1994] 2 All ER 513.

⁶⁸ Now famously described as 'Specialised Mouldings' letters

⁶⁹ Ironically, the letters were wholly inappropriate to *administration* 'adoption', referring to 'personal liability', which does not arise in relation to an administrator. One might infer that insolvency practitioners devised an all-purpose document based on receivership provisions of the IA.

With the reassurance of a Chancery judgment, insolvency practitioners blithely relied on *Specialised Mouldings* letters for the next seven years⁷⁰. Their confidence was misplaced. In relation to receivership, Lightman J subsequently held that a unilateral declaration of ‘non-adoption’ was ineffective, and that the continuance of an employment contract after the initial 14 day period of grace meant that that contract had been adopted⁷¹. As far as administrators were concerned, the Court of Appeal reached a similar conclusion in *Re Paramount Airways (No 3)*⁷², Dillon LJ observing of *Re Specialised Mouldings*:

“...a decision ... where there is no report, transcript or note of the reasons by which [Harman J] reached his conclusion and no indication of what the facts were, cannot rank as helpful authority.”⁷³

The learned Lord Justice cited with approval the conclusion of Professor Goode that whether or not a contract had been adopted was a question of fact, and that allowing a contract to remain in force and continuing to make use of the employee’s services after 14 days would amount to its adoption⁷⁴.

The first crucial question was thus authoritatively answered by the definition of adoption as, more or less, the continuance of employment after 14 days. The second question, concerning the consequences of adoption, was addressed by both Lightman J in *Leyland DAF* and the Court of Appeal in *Paramount*. With regard to

⁷⁰ A practice described as “unwise” by Lord Browne-Wilkinson in *Powdrill v Watson* [1995] 2 All ER 65, 76-77.

⁷¹ *Re Leyland DAF (No 2)*; *Re Ferranti International plc* [1994] 2 BCLC 760.

⁷² [1994] 2 All ER 513.

⁷³ *Ibid.* 521.

⁷⁴ See Goode, *Principles of Corporate Insolvency Law*, 2nd ed. (1997 : Sweet & Maxwell : London), 250.

receivers, their personal liability was coextensive with that of the company, so that any contractual right payable by the company was payable by the receiver. Administrators found their remuneration and expenses ranking behind all contractual claims of employees.

It is important to appreciate the implications of this position in order to understand the furore that followed. Receivers who had conducted their receiverships on the mistaken basis that contracts of employment had not been adopted were now faced with substantial personal liability. Whilst wages might have been paid during the receivership, other contractual benefits, including redundancy payments, accrued holiday pay, pay in lieu of notice and (potentially) compensation for unfair dismissal most likely would not, but, upon adoption, would have become the personal responsibility of the receiver.

By s 44(1)(c) Insolvency Act the receiver would be entitled to an indemnity out of the assets of the company in respect of his personal liability. However, this would amount to cold comfort for those who had left office and paid over realisations to their appointor. Further, many receiverships had been organised on the basis that only certain employee claims (usually wages) would be payable, and the adequacy of the assets to meet the indemnity calculated accordingly. In other words, receivers might find themselves liable to meet unexpected contractual claims for which they had not accounted in developing their trading strategy and which might well easily

outstrip the value of the company's assets available as an indemnity. This problem was particularly acute as far as 'big' receiverships were concerned⁷⁵.

Before examining subsequent developments, two points may be made. First, the *Leyland DAF* and *Paramount* decisions are, it is submitted, unobjectionable in their approach to the question of what is meant by "adoption" of a contract. Section 44(1)(b) was introduced late into the Insolvency Bill in order to counter the injustice exposed by the *Nicoll v Cutts* decision, so there can be little doubt that Parliament intended that employees of a receivership company should be paid for post-appointment services⁷⁶. If, as *Re Specialised Mouldings* suggests, a unilateral declaration of non-adoption could shift an unsecured liability back to the insolvent employer the purpose of the section could be effortlessly thwarted. By espousing a teleological construction of s 44(1)(b), both Lightman J and the Court of Appeal secured the requisite protection of employees envisaged by the Insolvency Act.

Their conclusion as to the *consequences* of adoption are less supportable, most notably because of the failure to recognise the adverse ramifications of holding receivers coextensively liable with the company. Employees were elevated from the worst possible position to the best possible, from having an unsecured claim on assets to being entitled to first call on the entirety of those assets. No justification for this upgrade was advanced in either *Leyland DAF* or *Paramount*, aside from

⁷⁵ The combined disputed amounts in the *Leyland DAF* and *Ferranti* cases totalled almost £5,000,000; see *Powdrill v Watson* [1995] 2 All ER 65, 72-74.

⁷⁶ See Lightman and Moss, *supra* n 22, para. 19-08

Lightman J's assertion in the former case that it was not absurd to attribute to Parliament a desire that employees be afforded "special protection"⁷⁷.

Moreover, no attempt was made to distinguish between the types of claim for which insolvency practitioners were to be made responsible, or to evaluate the relative merits of each as against the claims of other creditors. It is one thing to guarantee the payment of post-appointment wages and salary to those employees who continue to provide services, and few would argue that such debts ought to carry 'super-priority' status. This was the very least required to remedy the *Nicoll v Cutts* inequity. Both *Leyland DAF* and *Paramount* went far beyond this, and without any discussion as to the propriety of advancing such entitlements as golden handshakes, generous notice provisions, holiday payments and bonuses above the contractual priority of the secured creditor. As far as employees were concerned, their circumstances in receivership or administration went from the ridiculous to the sublime at the expense of secured and unsecured creditors and, potentially, the insolvency practitioner. It was inevitable that such a position would be challenged.

4.2 The aftermath of Paramount

Both *Paramount* and *Leyland DAF* were challenged, but before the appeals reached the House of Lords Parliament intervened in what Doyle describes as "an unprecedented legislative flurry"⁷⁸. Any suggestion that the construction afforded

⁷⁷ [1994] 2 BCLC 760, 778-779.

⁷⁸ *The Law and Practice of Administrative Receivership*, *supra* n 5, 314.

s 44(1)(b) in these two cases corresponded with the intention of Parliament in enacting the Insolvency Act was quickly proved to be without foundation. In the House of Commons debates, the Under Secretary of State for Corporate Affairs focused on the danger of both receivers and administrators dismissing employees out of fear of incurring liability:

“It cannot be in anyone’s interests for administrators and receivers to feel constrained to close businesses and dismiss employees because they cannot risk an otherwise viable rescue plan being subverted by the burden of rights that arise when they find it necessary to terminate a contract of employment that they have adopted, or because they would be personally liable for those costs.”⁷⁹

Parliament’s response was to restrict potential liabilities under s 44(1)(b) to “qualifying liabilities”, which are defined as:

“(a)...[liabilities] ... to pay a sum by way of wages or salary or contribution to an occupational pension scheme,
(b)...[which are] ... incurred while the administrative receiver is in office, and
(c)...[which are]... in respect of services rendered wholly or partly after the adoption of the contract.”⁸⁰

Whilst taking care of the worst excesses of *Leyland DAF* and *Paramount* for the future, insolvency practitioners’ immediate problems were left unsolved, as the Insolvency Act 1994 did not have retrospective effect and applied only to contracts of employment adopted on or after 15 March 1994. Pollard notes:

⁷⁹ *Hansard*, House of Commons, Vol. 240, Col. 24 (Mr Neil Hamilton).

⁸⁰ IA s 44(2A), as inserted by the IA 1994.

“In effect Parliament headed off the continuing problem in relation to future insolvencies, leaving the position of past insolvencies until the meaning of the 1986 Act had been confirmed by the House of Lords.”⁸¹

In *Powdrill v Watson*⁸² the House of Lords followed Parliament’s lead in holding receivers personally liable only for those claims arising after adoption, but were somewhat more generous in their determination of precisely which claims were to be met. Lord Browne-Wilkinson, delivering the only substantial speech, reached his conclusion largely by reference to the differential in the positions of employees whose contracts were adopted and those who were dismissed in the 14 day period allowed for in s 44(2):

“Even if it would be right ... to attribute to Parliament a special tenderness towards employees, it is most improbable that Parliament intended to produce such an unfair disparity between some employees and others, such disparity depending entirely upon whether or not they are dismissed within 14 days of the receiver’s appointment.”⁸³

As to the meaning of the term “adoption”, Lord Browne-Wilkinson at first observes:

“...the mere continuation of the employment by the company does not inexorably lead to the conclusion that that contract has been adopted by the administrator or receiver.”⁸⁴

Just over a page later he remarks:

⁸¹ *Adopted Employees in Insolvency*, *supra* n 58, 144.

⁸² [1995] 2 All ER 65.

⁸³ *Ibid.* 80.

⁸⁴ *Ibid.* 83.

“If employment is continued for more than 14 days after the appointment of an administration or receiver, there seems to be no escape from the conclusion that the whole contract is adopted.”⁸⁵

Goode, rather dryly, comments that:

“It is evident that on this crucial point Lord Browne-Wilkinson had a change of mind during the course of his speech.”⁸⁶

One might add that this appears to be a change of mind of which his Lordship was unaware. Given that the concept of “adoption” is the source of this whole conundrum, it is perhaps regrettable that Parliament failed the second time around to make clear what was meant by the term, and that the judgment of Lord Browne-Wilkinson leaves room for some residual doubt. The better view, it is submitted, is reflected in his Lordship’s second statement. If his first is correct, it would appear that there might be circumstances where even a *Specialised Mouldings* letter would not be necessary to avoid adoption, although when such would arise is indeterminate. Goode summarises the effect of *Powdrill v Watson*, correctly it is suggested, in the following terms:

“(1) By “adoption” of a contract of employment is meant causing or allowing it to continue in force.

(2) A receiver adopts a contract of employment if he does not within 14 days of his appointment either terminate the contract or repudiate it by failing to pay wages becoming payable within that period.”⁸⁷

⁸⁵ [1995] 2 All ER 65, 84.

⁸⁶ *Principles of Corporate Insolvency Law*, *supra* n 74, 254.

⁸⁷ *Supra* n 74, 254-255. See also Lightman and Moss, *supra* n 22, para. 19-08.

Having decided that the contracts in question had been adopted Lord Browne-Wilkinson went on to consider the consequences of adoption. Having concluded, surely correctly, that receivers and administrators were to be treated in like manner, he asserted that:

“...in the case of both administration and receivership the consequence of adoption of contracts of employment is to give priorities only to liabilities incurred by the administrator or receiver during his tenure of office.”⁸⁸

Those liabilities included both payment in lieu of notice and pension contributions in respect of that period⁸⁹, items notably absent from the Insolvency Act 1994 and ones that may represent a considerable sum where large numbers of employees are involved. As Pollard remarks:

“Accordingly, the beneficiaries of the decision of the House of Lords are likely to be, in the main, those employees who earned over the statutory maximum applicable to claims under the National Insurance Fund or had longer notice periods than the statutory maximum.”⁹⁰

The same author offers a damning and eloquent indictment of the entire saga:

“...this perhaps shows the British system of law making at its worst. A hasty reaction to a rather strange case in the Court of Appeal (*Nicoll v Cutts*) followed by a decision that all the Insolvency Practitioners relied on but for which no reasons were given (*Specialised Mouldings*), leads to eight years of no one challenging the position. This is followed by a ruling by the courts that the position was entirely different all the

⁸⁸ [1995] 2 All ER 65, 86.

⁸⁹ *Ibid.* 85.

⁹⁰ *Adopted Employees in Insolvency*, *supra* n 58, 147.

time. Parliament then intervenes in a half-hearted fashion, leaving the perils of litigation to try and sort out the mess. Surely a better system can be devised?"⁹¹

It is difficult to argue with this assessment. *Powdrill v Watson* has limited the damage for insolvency practitioners as far as contracts adopted prior to 15 March 1994 are concerned, but not to the extent that retrospective application of the Insolvency Act 1994 would have done⁹². The scope for arguing that contracts have not been adopted if they are allowed to continue after 14 days has been greatly curtailed, but Lord Browne-Wilkinson's ambivalence may yet prompt some optimistic litigation⁹³.

4.3 Contracting out of personal liability

The introduction of the concept of 'adoption' of contracts of employment has had a significant effect on the manner in which receiverships are planned and conducted. The combination of employee 'super-priority' and receivers' personal liability has meant that practitioners have had to adapt their strategies to take into account the fact that the company's assets will, post-1986, have to be sufficient to meet a number of 'new' liabilities ranking ahead of the debenture-holder's claims. The pre-1986 practice was, it appears, to pay wages to those employees who continued to provide their labour post-appointment. The position following the House of Lords

⁹¹ *Ibid.* 151.

⁹² For a comprehensive summary of the position in table form see Pollard, *supra* n 58, 150-151.

⁹³ It should be noted that, as far as administrators are concerned, employee claims incurred in the pre-1994 Insolvency Act period will not be time-barred until six years after the discharge of the administration order; *Re Maxwell Fleet and Facilities Management Ltd* [1999] 1 All ER 64.

decision in *Powdrill v Watson* will depend upon whether or not the employment contract was adopted before or after 15 March 1994. The Insolvency Act 1994 limits priority claims to wages or salary, pension contributions accruing due during the period of adoption, and holiday or sickness pay. The major disadvantage for insolvency practitioners arising from the *Powdrill* decision is that payment in lieu of notice constitutes what would now be described as a 'qualifying liability'. Mudd perceptively notes that:

"It is here that the most substantial claims against practitioners will arise ... This will be particularly true for the very large claims by senior executives which arose on the termination of long and generous service contracts."⁹⁴

It should be noted that the services of the company's directors or senior management may be retained in order to ensure a degree of continuity and a valuable source of information during the receivership, and, in monetary terms, the adoption of a director's service contract may prove expensive. In this regard, receivers have a number of options. One is to dismiss senior employees and directors within the 14 day period before adoption can legally take place, and then to utilise the services of those required on a 'consultancy' basis. Another possibility is that the receiver might consider 'contracting out' of *the consequences* of adoption, but whether or not this is legally possible remains somewhat unclear.

In *Re Leyland DAF (No 2)*; *Re Ferranti International plc*⁹⁵ Lightman J observed

⁹⁴ *Paramount - the House of Lords decision - Is there still hope of avoiding some of those claims?* (1995) 11 Insol L & P 78.

⁹⁵ [1994] 2 BCLC 760.

that there was nothing to prevent the avoidance of personal liability by an administrative receiver by means of entry into a bilateral arrangement with those employees whose employment contracts had been or were to be adopted. Since the same result could be achieved by dismissing them and then re-engaging them under new contracts, the learned judge considered that there could be no policy objection to adoption without the acceptance of personal liability. However, this could not be achieved unilaterally:

“For the exclusion of the statutory incident of personal liability, it is plain that what is required is a contract to this effect between the receiver and the affected employees, and nothing less will do.”⁹⁶

It is questionable whether the decision of the House of Lords in *Powdrill v Watson*⁹⁷ undermines Lightman J’s conclusions. Lord Browne-Wilkinson’s speech contains certain passages which might be taken to rule out the possibility of receivers (or administrators) contracting to accept only certain liabilities under employment contracts, and, indeed, his Lordship confessed to changing his mind on the issue during the course of argument⁹⁸. Whilst he accepted that allowing a receiver or administrator to ‘cherry-pick’ would ease the pressure on them, and thus promote rescue attempts, he was nonetheless forced to the conclusion that:

“...the concept of adoption of the contract covers at least accepting liability for payment for services rendered to the administrator under contracts which he has continued. If it were to be open to the administrator or receiver to exclude such

⁹⁶ [1994] 2 BCLC 760, 775.

⁹⁷ [1995] 2 All ER 65.

⁹⁸ *Ibid.* 83.

liability, the Act fails to remedy the mischief [of *Nicoll v Cutts*]. Therefore the concept of adoption of the contract is inconsistent with an ability to pick and choose between different liabilities under the contract.”⁹⁹

The critical question is therefore whether Lord Browne-Wilkinson, in this statement, was ruling out the possibility of a bilateral agreement between receiver and employee to the effect that personal liability would not be accepted. Most commentators think not, considering that his words were directed rather at a unilateral declaration of non-acceptance similar to the *Re Specialised Mouldings* assertions of non-adoption¹⁰⁰. Doyle comments that:

“The crucial point here is that the House of Lords had an ideal opportunity to discount the possibility of contracting out which was not taken. Neither did the Lords take the opportunity to cast aspersions on comments made at first instance and in the Court of Appeal in *Paramount* which at least hinted at the viability of contracting out.”¹⁰¹

One might add that Lightman J’s comprehensive consideration of this question, and his unconditional conclusion that contracting out was a viable option in the *Leyland DAF* case was in no way abjured by the House of Lords in *Powdrill*.

It therefore appears probable that receivers may avoid personal liability on adopted employment contracts by entering into an agreement to this effect with the employees in question, and it is submitted that there is nothing intrinsically objectionable to such an assumption. As Lightman and Moss point out, the mischief intended to be countered by s 44(1)(b) Insolvency Act is the *Nicoll v Cutts*

⁹⁹ *Ibid.* 83-84.

¹⁰⁰ See Mudd, *supra* n 94, 81; Fletcher, *The Law of Insolvency*, 2nd ed (1996 : Sweet & Maxwell : London), 377; but see Goode, *supra* n 74, 255 for a different analysis.

¹⁰¹ *The Law and Practice of Administrative Receivership*, *supra* n 5, 398.

scenario¹⁰². If employees agree with a receiver that they will provide their services and look only to the company for redress there seems to be no good reason to overturn such an arrangement.

4.4 The Redistributive Consequences of Contracting Out

It might appear unlikely that employees of a company in receivership would abandon their statutory right to look to the receiver for payment of qualifying liabilities. It might also seem ‘immoral’ for a receiver to attempt to disclaim personal liability by capitalising on the loyalty of a company’s employees or their (perhaps unfounded) perceptions that by providing their services without redress against a solvent individual will enhance the possibility of their jobs surviving the receivership intact. Doyle notes that:

“In practice, it may be envisaged that employees will be prepared to do this on a wholly voluntary basis if there is no other option open to an administrative receiver, say where the company’s charged assets are limited and no appropriate indemnities available in his favour, other than to dismiss employees summarily.”¹⁰³

This emphasises the fact that employees may be desperate enough to work on without the guarantee of payment, and that a receiver contracting out of personal liability in such circumstances is capitalising on their plight. A public policy argument might therefore be advanced against excluding personal liability, on the

¹⁰² *The Law of Receivers of Companies*, *supra* n 22, para. 19-08.

¹⁰³ *Supra* n 5, 399.

grounds that it is taking unfair advantage of an already susceptible group, and for the benefit of a powerful debenture-holder.

This analysis, though, fails to appreciate the fact that whilst those employees who waive their rights against a receiver will become unsecured creditors of the company, a significant proportion of their post-receivership claims will be met out of the National Insurance Fund if they are subsequently dismissed by the receiver¹⁰⁴. Although the Secretary of State is, by s 189 of the Employment Rights Act 1996, subrogated to the rights and remedies of employees, he will have no claim against the receiver in this regard, since the employees themselves will have contracted out of their statutory rights against that receiver.

The consequence of permitting contracting out, therefore, is not to effect a transfer of wealth from employees to debenture-holder, but rather to compel the State to finance post-receivership trading at least insofar as that involves the company's accrued liabilities to employees. In other words, the debenture-holder's gain is the State's loss. The former has first call on assets that would otherwise constitute his receiver's s 45(3) indemnity, whilst the latter is relegated to the position of unsecured creditor of the company. The arguments for and against this position are finely balanced. If a receiver's personal liability represents a genuine disincentive to rescue attempts, it might be thought justifiable that the State, having espoused a 'rescue-orientated' policy, should be prepared to sponsor continued trading towards that end. On the other hand, there may be circumstances where trading is

¹⁰⁴ The position of employees who are not dismissed is discussed further on.

conducted, and employee expenses incurred, simply in order to enhance realisations, without any prospect of even a partial rescue. In such a case, it is more realistic to see the State's contribution as insuring solely to the benefit of the secured creditor, and here it is more difficult to vindicate the expenditure of what is essentially taxpayers' money. Moreover, it should be noted that employee claims from the National Insurance Fund are subject to a ceiling, which may, in a fairly lengthy spell of trading, be exceeded, leaving the employees in question unsecured in relation to any deficit.

If there is a public policy argument against the legitimacy of receivers contracting out of their personal liability to employees, it can only be grounded in the notion that the State is expected to 'pick up the tab' for a trading strategy which may improve only the position of the debenture-holder. Without the benefit of empirical evidence, it is impossible to estimate the proportion of cases in which the National Insurance Fund subsidises trading activities in this manner. A further complicating factor is that if a going concern sale is achieved, it is frequently the case that the *transferee* may be liable for any unpaid post-appointment debts¹⁰⁵. Moreover, the fact that the receiver has contracted out of personal liability does not mean that he will not continue to pay wages as and when they fall due. On the contrary, this practice is prevalent, and it is therefore only in relation to qualifying liabilities other than straightforward wage payments that the National Insurance Fund will be called upon.

¹⁰⁵ See *infra* 369.

On balance, therefore, the public policy polemic against contracting out is not particularly strong as regards the majority of receiverships, and, it is submitted, it will only be in a few exceptional cases that the sole beneficiary of the exclusion of personal liability is the secured creditor. The protection of employees is, for the most part, achieved by requiring the State to meet those claims that the company/employer cannot. The State's own interest in the preservation of both businesses and jobs, which may in some cases only be pursued where a receiver can, for safety's sake, exclude his personal liability under adopted contracts, justifies its assumption of those liabilities the receiver is unwilling to take responsibility for.

5. A duty to have regard to the interests of employees?

“In recent years there have been strongly voiced suggestions that the duties of a receiver should be extended to embrace a duty to ensure continuing employment for the workforce, wherever possible, but until that laudable objective receives statutory endorsement which would provide presumably for any additional cost of so doing, a receiver must not allow this humanitarian aspect to colour his decision on whether to continue trading, which must be made on a purely financial basis.”¹⁰⁶

This proposition is *a fortiori* where the promotion of the interests of the company's employees would result in a corresponding relegation of those of the debenture-holder¹⁰⁷.

¹⁰⁶ Samwell, *Corporate Receiverships*, *supra* n 4, 71.

¹⁰⁷ See Lightman and Moss, *supra* n 22, para. 8-08.

It will not always be the case that the interests of employees and debenture-holder conflict. Where the latter dictate the pursuit of a going concern sale of the company's business, employees stand to gain, albeit incidentally, in at least two respects. First, if their services are retained by the receiver they will be entitled to be paid for their labour. Secondly, as will be seen later, if a going concern sale is achieved they may even keep their jobs. Given the very visible nature of the predicament of employees in receivership situations, the debenture-holder may even encourage his appointee to seek the most satisfactory outcome as far as the preservation of employment is concerned. Stewart encapsulates these extra-legal considerations thus:

“The duty of a receiver when realising assets is to get the best price reasonably obtainable. Where no conflict with that duty is involved, the receiver will prefer to realise assets on a basis which preserves employment - preserves a business - than a sale which does not, for obvious reasons. Debenture-holders who may fear adverse public criticism of the decision (however justified) to appoint a receiver may feel less vulnerable if it transpires that the business is to be continued by a new company employing some, if not all, of the old workforce.”¹⁰⁸

This ‘preference’ has to some extent been affirmed as a positive duty in one case. It is worth reproducing in full the comments of Lord Sutherland in *Larsen v Henderson*:

“I accept as a general proposition that a receiver stands in such a relationship with the employees of the company that he does owe to them a duty of care. Obviously

¹⁰⁸ *Administrative Receivers and Administrators* (1997 : CCH Editions : London), ¶ 515.

many of the steps which may have to be taken by the receiver will have an adverse effect on employees but, provided that the receiver acts reasonably, the employees can have no remedy. The fact that a receiver may have to take decisions which have an adverse effect on employees does not, however, mean that he can ride rough shod over all employees' rights. Accordingly, if there are two ways in which the receiver can achieve his desired end *he would have a duty to adopt that method which would have the least adverse effects on employees.*"¹⁰⁹

On the facts, this 'duty' translated into an obligation to inform employees that the receiver intended to terminate their pension scheme, thus giving them the opportunity to make alternative arrangements. There appear to be no subsequent judicial endorsements of Lord Sutherland's more general proposition that a receiver has a duty to adopt a strategy designed to preserve the interests of employees where such would not interfere with his duty to his appointor. Whilst such a declaration might appear eminently fair, there remains the difficulty that such a duty might have an effect on the position of other creditors of the company.

There may, for example, be circumstances where an over-secured debenture-holder may see his debt discharged either by an asset sale or a going concern sale of the business. The latter course will result in less being obtained in monetary terms, because the transferee of the business is prepared to take on its employees, but only at a discounted price¹¹⁰. The debenture-holder will be neutral as to the appropriate course, but the company's unsecured creditors would elect an asset sale, since the surplus realisations would go towards discharging their debts. The employees, on

¹⁰⁹ [1990] IRLR 512,514-515 (italics added).

¹¹⁰ The paradigm 'TUPE dilemma'; *infra* 374.

the other hand, will lose their jobs if an asset sale goes ahead, and will be left to claim from the National Insurance Fund. The above scenario might be something of a rarity, and Lord Sutherland's stance in *Larsen v Henderson* might appear warranted, but there is nothing in the Insolvency Act to reassure a receiver that such would be a permissible course to adopt. On the other hand, it is unlikely that the company's unsecured creditors would have any cause of action against a receiver were he to do so.

As will be illustrated later, there will often be a coincidence of interest as between debenture-holder and employees, in that the former's welfare will compel the receiver to seek a going concern sale of the business, which in turn will enhance the chances of employment preservation. Indeed many insolvency practitioners have defended receivership on the grounds that it has considerable potential as far as saving jobs is concerned. Their claims, however, have not been received without some suspicion:

“...we need to remember that those who support the rescue culture may do so more because they have the interests of creditors, especially banks, in mind than on broad public policy grounds.”¹¹¹

Whatever the true motives of receivers in pursuing employment friendly strategies, it should be acknowledged that employees will generally fare better in a receivership situation than they would if the company were to be simply wound up. It might also be contended that receivership is the better option for employees when

¹¹¹ Davies, *Employee Claims in Insolvency : Corporate Rescues and Preferential Claims* (1994) 23 ILJ 141.

compared with administration. Were an administrator to promote employees' interests in a manner likely to prove detrimental to other creditors, those creditors could possibly apply to the court under s 27(1) Insolvency Act on the grounds that the company's business was being managed in a manner unfairly prejudicial to them.

An administrator's freedom of action is thus subject to the ability of creditors to object to his strategies. His primary duty is to the company's creditors as a whole, leaving little room for a consideration of the position of its employees. This is to be contrasted with the relative independence of receivers, who may, it is submitted, take decisions in favour of employees without anticipation of challenge except from their appointors.

It remains the case, however, that the current law does not allow for the promotion of employees' welfare over that of the debenture-holder. The Cork Committee were petitioned by those especially concerned with employees' rights, most notably the TUC, but their comments in this regard are equivocal to say the least:

"We endorse fully the view of the TUC that every effort should be made to preserve viable commercial enterprises and to maintain employment ... But if the position of the business enterprise has deteriorated to such an extent that there is no possibility of restoring it to profitability, or of disposing of it as a going concern, then there is no alternative to closure.¹¹²

¹¹² The Cork Report, *supra* n 62, para. 942.

Far from imposing any duty on receivers, this appears to leave it to their discretion as to whether, in the first place, a rescue will be attempted and, in the second, whether such a scheme will specifically take account of the position of employees. Nonetheless, the Review Committee envisaged greater attention being paid to the rights of the workforce than the Insolvency Act eventually provided for. In particular, something akin to a right of audience was proposed:

“In receivership or administration ... we recommend that the receiver, or administrator, should be under a duty:

- (a) to keep the workforce informed of the position, and
- (b) to have one representative of the workforce appointed to his committee.

We further recommend:

- (a) that representative must be an employee (but not a director or former director),
- (b) that he should be entitled to attend all meetings of the committee but should not have a vote as a member of the committee, and
- (c) that he should have a right to apply to the Court as an aggrieved person.”¹¹³

This final recommendation appears to be directed at the administration regime, rather than receivership, since such a right was not provided for by the Committee in relation to the latter. In the event, this whole parcel of recommendations failed to make the Statute book, being removed without comment at the White Paper stage.

The *status quo* was thus, in this context, maintained. Whilst employees may be the incidental beneficiaries of a going concern sale policy, they cannot claim to have their interests elevated over those of the debenture-holder in the receiver’s

¹¹³ The Cork Report, *supra* n 62, paras. 946-947.

consciousness. There are those who consider this unsatisfactory. Lightman J has proposed that:

“With advantage two duties could statutorily be imposed on administrative receivers. The first is a duty to take into the equation when deciding whether to break up or retain or sell as a going concern the undertaking of the company the social and economic benefits of its preservation and with it thus the jobs of the employees of the company and the employees of its suppliers and customers. The second is a duty in all decision-making to have regard to the interest of employees ... Surely a receiver should be bound - or at least free - to have regard to the interests of employees and continue the business (and their employment) or to sell the business to a person who will continue their employment, if the interests of employees so require - *albeit at some cost to the appointor* ... The imposition on a receiver of duties designed to safeguard the vital interests of others besides his appointor is no more than what a caring society should expect.”¹¹⁴

This sentiment encapsulates the central theme of this Chapter. The critical question, which has yet to be comprehensively debated by policy makers, is whether the advantages of receivership for financial institutions should be compromised for the sake of employment protection. In other words, should banks be expected to forego recovery, or accept less than might otherwise be attained by a receiver, if this will mean that jobs are saved? In addressing this question, it is necessary to consider a somewhat ill-starred legislative initiative that has inspired a profusion of confusing and contradictory case law and which continues to confound the courts and commentators alike.

¹¹⁴ *The Challenges Ahead : Address to the Insolvency Lawyers' Association* [1996] JBL 113, 120-121

The Irreconcilable Conflict?

1. Introduction

The previous sections have focused on the pecuniary rights of employees in receivership situations. The position is that the debenture-holder is expected to contribute towards debts outstanding at the onset on receivership via the preferential regime. Further, where post-appointment debts are incurred, the fact of the receiver's personal liability again compels a donation from the appointor, *unless* his receiver contracts out of that liability, in which case the burden shifts to the National Insurance Fund, and so the State. The overall effect of these 'receivership law' provisions is neatly summarised by Collins:

"The normal pattern of provision in the event of the employer's insolvency consists in making outstanding claims of employees for remuneration count as preferential debts of the company, ranking equally with taxation, but ahead of the claims of secured and unsecured creditors. In addition, an employee can claim from the State out of the Redundancy Fund almost all outstanding rights, with the important exception of the compensatory award for unfair dismissal ... In the last decade the Government has placed increasing emphasis upon the guarantee function of the state in the event of insolvency. Despite the apparent inconsistency of this paternalism with the Government's usual preference for deregulation and free markets, it makes sense within the framework of a policy of the facilitation of a sale of the assets of the insolvent business in order for them to be put back to productive use as quickly as possible. For most of their rights the employees can turn immediately to the State for payment, leaving the liquidator, administrator or receiver with relative freedom to make an advantageous disposition of the assets of the insolvent business."¹¹⁴

¹¹⁴ *The Transfer of Undertakings and Insolvency* [1989] ILJ 144, 157.

The above analysis, in illustrating the 'trade-off' effect of the State's contribution to employees' claims from an insolvent company, similarly centres upon their financial interests, so much so that one senses that the valuable right of job security is almost an irrelevancy when receivership intervenes. This perception is not entirely accurate. The 'rescue culture' so espoused by the Cork Committee imparts at least some allusion to the preservation of employment, whether via the deliverance of the company intact from receivership or through a going concern sale of its business to a purchaser prepared to keep the workforce on.

As will be seen later, the going concern sale will invariably be the preferred option of a receiver appointed over the assets of a financially troubled company. If he is to fulfil his task of recovering as much of the appointor's debt as possible, he will be compelled to pursue such a course¹¹⁵. Such a strategy tends also to preserve employment. However, as will be illustrated, the 'job-saving' potential of receivership is an accidental by-product that, if it could be avoided, probably would be. This is because, for the most part, employment preservation will be at the expense of the appointing debenture-holder.

The next sections are concerned with the manner in which a single piece of legislation has effected an indirect redistribution of 'value'¹¹⁶ away from debenture-holders and other creditors for the benefit of employees. The enactment of the Transfer of Undertakings (Protection of Employment) Regulations 1980¹¹⁷ has introduced an additional complexity into the interaction of insolvency and employment law, and some would argue that it has yielded less than the optimal outcome in macrocosmic terms. In order to understand fully the implications of

¹¹⁵ See Chapter 5.

¹¹⁶ The term is used instead of 'assets' because employees' rights to secured property are not in issue.

¹¹⁷ SI. 1981/1794 (hereinafter TUPE).

TUPE, it is necessary to explore the subject at some length. This is especially so if the impact of recent developments, which may lead to the amendment of the Regulations, are to be accurately evaluated.

1.1 The Enactment of TUPE: under duress?

“When will governments learn that whenever they introduce legislation designed to protect jobs, the result is that jobs are lost?”¹¹⁸

The TUPE Regulations are of European origin. They were enacted to conform with the UK's obligations under the Treaty of Rome and implemented the Acquired Rights Directive¹¹⁹. The Directive was inspired by the European Commission's anticipation that, as progress was made towards a Common Market, increased merger and take-over activity would have the potential to threaten workers' rights, and is essentially a 'social' enactment, designed to protect employees. Its effect on transfers of insolvent businesses was probably unforeseen, or at least discounted, but as these have become visible the European Court of Justice has nonetheless proved intransigent, and refused to concede that the Directive does not apply in insolvency situations¹²⁰.

When it came to implementation of the Directive, the Government of the day dragged its feet until, under the threat of infraction proceedings from the European Commission, complied with its obligations in a cursory manner:

¹¹⁸ Sir Kenneth Cork, addressing the sixth annual congress of the Association Européenne des Practiciens des Procédures Collectif; see Floyd, *Saving Businesses and Companies – Formal and Informal Procedures* (1987) 2 IL & P, 2, 2-3.

¹¹⁹ Directive 77/187/EEC [OJ 1977, No. L61/27] (hereinafter 'the Directive').

¹²⁰ The Court has indicated that if the purpose of the insolvency procedure is anything other than liquidation *simpliciter* then the Regulations will apply; see, e.g., *Foreningen af Arbejdsledere i Danmark v A/S Danmols Inventar* [1985] ECR 2639; *Spano v Geotech SpA* [1995] ECR I-4321; *Europièces SA, in liquidation v Sanders & Automotive Industries Holding Co SA* (unreported, C-399/96, 12/11/98); *Jules Dethier Équipement SA v Dassyl* [1998] IRLR 266.

“...the Transfer Regulations were introduced somewhat hastily by the fairly unusual method of statutory instrument, which led to relatively little Parliamentary debate upon these provisions (the Transfer Regulations were debated in the House of Commons at 10. 15 p.m. for 1½ hours, and in the House of Lords at 6.32 p.m., i.e., respectively at bedtime and suppertime).”¹²¹

The Regulations were introduced in the Commons with “a remarkable lack of enthusiasm”¹²², and Hepple succinctly refers to the implementation procedure as “half-baked”¹²³. Before proceeding to examine how the courts have responded to the TUPE Regulations, a brief description of their provisions reveals the particular problems they were expected to pose for receivers and liquidators.

1.2. The Basic Operation of the TUPE Regulations

The TUPE Regulations comprise two core principles. The first is to be found in Regulation 5(1):

“(1) A relevant transfer shall not operate so as to terminate the contract of employment of any person employed by the transferor in the undertaking or part transferred but any such contract which would otherwise have been terminated by the transfer shall have effect after the transfer as if originally made between the person so employed and the transferee.”

This reverses the common law rule that the transfer of a business automatically terminates contracts of employment¹²⁴. By Regulation 5(2):

¹²¹ John McMullen, *Business Transfers and Employee Rights*, 2nd ed. (1992 : Butterworths : London), 38.

¹²² *Hansard* (House of Commons) vol. 991, col. 677, Mr David Waddington, Under-Secretary of State for Employment.

¹²³ *The Transfer of Undertakings (Protection of Employment) Regulations* (1982) 11 ILJ, 29, 40.

¹²⁴ *Nokes v Doncaster Amalgamated Collieries* [1940] AC 1014. .

“...on the completion of a relevant transfer –

(a) all the transferor’s rights, powers, duties and liabilities under or in connection with any such contract [of employment] shall be transferred by virtue of this Regulation to the transferee and;

(b) anything done before the transfer is completed by or in relation to the transferor in respect of that contract or a person employed in that undertaking or part shall be deemed to have been done by or in relation to the transferee.”

Thus a transfer of an undertaking contemporaneously transfers contracts of employment to the transferee, and employees previously employed by the transferor become employees of the transferee under the same terms and conditions as stated in their previous contracts. Further, any unsatisfied liabilities of the transferor also pass to the transferee. Employees, for these purposes, are those:

“...employed *immediately before the transfer*, including, where the transfer is effected by a series of two or more transactions, a person so employed immediately before any of those transactions.”¹²⁵

The second main principle of the TUPE Regulations is that employees dismissed *because of the transfer*, or a reason connected with it, are deemed to have been unfairly dismissed, and will thus be in a position to claim compensation for unfair dismissal¹²⁶. However, by Regulation 8(2):

“Where an economic, technical or organisational reason entailing changes in the workforce of either the transferor or the transferee before or after a relevant transfer is the reason or principle reason for dismissing an employee –

(a) paragraph (1) above shall not apply to his dismissal....”

The operation of Regulations 5 and 8 cannot be excluded by contract.¹²⁷

¹²⁵ TUPE Regulation 5(3) (italics added).

¹²⁶ TUPE Regulation 8(1).

¹²⁷ TUPE Regulation 12.

1.3 The TUPE Dilemma: an obstacle to going concern sales or an inevitable reduction in returns to the debenture-holder

In the context of a receivership transfer of the whole or part of the company's business, the TUPE Regulations would *prima facie* appear to involve the continuation of employment for the company's employees, whose contracts would be transferred to the new owner by virtue of Regulation 5. This might be problematic for a number of reasons. First, it might be the case that the business in question was overstaffed, and a purchaser would be loath to buy a business over-burdened by employees. Secondly, even where the business could support its current workforce, the fact of its insolvency might entail its employees being owed money, and those liabilities would, by operation of Regulation 5, pass to a purchaser. Whilst he might require a workforce of the same size as that which he would, by law, inherit, the fact that he would become liable to discharge what might be substantial claims would again deter purchase.

Thirdly, even where the claims of employees against the receivership company were minimal, a prospective purchaser might be discouraged by the possibility that he would have to make redundancies post-transfer if the business proved to be overstaffed. Since all liabilities pass to the transferee, he would find himself responsible for discharging claims for redundancy payments. The transfer itself does not terminate employment contracts, so the employees' previous period of employment with the transferor company would be taken into account in calculating the sum due to them. Again, such amounts could be considerable. Thus one, or a combination of the above factors might represent a significant hurdle to what would usually be the most productive course in receivership, *viz.*, a going concern sale of the business.

An alternative scenario is, however, discernible. A well-informed purchaser enthusiastic about buying the business, but less enthusiastic about the potential employees liabilities such would entail, could adjust his valuation of the enterprise to account for those liabilities. In other words, the business would remain saleable, but at a discounted price. This would involve one of two consequences.

First, the amount realised would still exceed that which could be attained from an asset sale, but might be insufficient to discharge completely the amount owed to the debenture-holder. Here, the debenture-holder subsidises the preservation of employment. On the other hand, the latent liabilities towards employees could be so great that more could be obtained by an asset sale, in which case both debenture-holder and employees would be prejudiced, the former because of the shortfall in realisations, the latter because they would lose their jobs.

This very basic analysis illustrates the exigency arising from TUPE as far as receivership is concerned. Prior to TUPE the position had been more favourable. The transfer would terminate employment contracts, liabilities under those contracts would, for the most part, be the responsibility of the National Insurance Fund, and the transferee could re-engage some or all employees, perhaps on different terms and conditions. It is perhaps not surprising that insolvency practitioners and purchasers of businesses from them sought to effect a *de facto* resurrection of such an arrangement, and that the government, in implementing the Acquired Rights Directive, sought to facilitate their doing so.

One option, which was in fact taken up successfully for many years, was to rely on the literal meaning of Regulation 5(3) which, it will be recalled, provides that only those employees employed in the transferred business *immediately before the*

transfer are subject to the operation of Regulation 5. This is well described by McMullen:

“A dubious, but not uncommon, practice of some transferors and transferees is for dismissals of employees to be effected by the transferor prior to the transfer of the undertaking with the aim that the undertaking can be transferred to the transferee clean of employees; these employees will, in that case, have their continuity of employment broken in order to be re-engaged, probably selectively, by the transferee in due course, but without the acquisition of previously acquired rights.”¹²⁸

Judicial intervention has rendered this virtually ineffectual, but it is interesting to note that such a strategy was clearly envisaged as being effective both by insolvency practitioners and, indeed, the Government. This is evidenced by the inclusion in the TUPE Regulations of Regulation 4 which, when viewed in conjunction with the stated distaste of the Government for the Acquired Rights Directive as a whole, offers a clear insight into the manner in which Regulation 5 was expected to work in insolvency situations.

1.4 ‘Hive-Downs’ and Regulation 4 TUPE

Hiving-down is a strategy adopted by receivers as early as the 1950s¹²⁹. Very concisely, it involves the receiver incorporating a new company, often a wholly owned subsidiary of the receivership company, to which the viable parts of the latter are transferred. These include the assets and ‘undertaking’ of the company in receivership, but none of its liabilities. The consideration for these assets is deferred, until the ‘hive-down company’ is subsequently transferred to a third party purchaser. The amount he pays will represent the consideration for the original transfer of assets

¹²⁸ *Business Transfers and Employee Rights, supra* n 121, 136.

¹²⁹ Davies and Freedland, *supra* n 2, 106.

between the receivership and hive-down companies, and so will be passed from the latter to the former where it will be caught by the debenture-holder's charge¹³⁰. As far as employees are concerned, their contracts of employment remain with the receivership company¹³¹.

At one time, hiving-down offered the advantage of transferring tax losses of the receivership company to the hive-down company. This taxation benefit was substantially removed by s 343(4) Income and Corporation Taxes Act 1988¹³². Nonetheless, hiving-down was still perceived as a valuable practice because it allowed the receiver to present for sale a "neat commercial package", free of liabilities to creditors and employees alike¹³³. Thus:

"The purpose of [hive-down] arrangements was to segregate the saleable asset ... into a clean package, free of obligations whether to staff or creditors, which would be more readily saleable, and, if the transaction were correctly effected, bring to the purchaser certain fiscal advantages."¹³⁴

Hiving-down therefore increased the chances of selling a business, whether because of the fiscal benefits or the 'clean package' attraction, which, in turn, resulted in increased realisations for the debenture-holder. Employees would not necessarily fare badly, since in some circumstances the purchaser of the hive-down company would be willing to re-engage them, but their continuity of employment would be lost. Their claims against the insolvent transferor would be left to be discharged out of the National Insurance Fund. Whilst hiving-down was perceived as a commendable idea in some quarters, and certainly by receivers and their appointors,

¹³⁰ This description is rudimentary in the extreme. More comprehensive accounts of the 'nuts and bolts' of hiving-down can be found in the following: Lightman and Moss, *supra* n 22, para. 9-08; Doyle, *supra* n 5, 386-387; Davies and Freedland, *supra* n 2, 104.

¹³¹ Parsons and Ratford, *Tolley's Employees' Rights in Receiverships and Liquidations*, 2nd Ed (1984 : Tolley Publishing Co : London), para. 5.9; Lightman and Moss, *supra* n 22, para. 9-09.

¹³² See Lightman and Moss, *supra* n 22, para. 13-14; Doyle, *supra* n 5, 386-387.

¹³³ See Davies and Freedland, *supra* n 2, 106.

¹³⁴ *Pambakian v Brentford Nylons Ltd* [1978] ICR 665, 669, *per* Phillips J.

others took a more jaundiced view. In Parliamentary debates in the House of Commons, Mr Harold Walker, for the Opposition, described it as:

“...a complex device used by receivers, usually with the effect of lining the pockets of asset-strippers and other fly-boys in the City.”¹³⁵

The courts also displayed some suspicion of hiving-down. When asked to comment on its propriety in *Pambakian v Brentford Nylons Ltd*¹³⁶ Phillips J was cautiously critical:

“All that we would say is that when amending legislation is under consideration, attention ought to be directed by those responsible to the problems which arise in such cases. For example ... since [the receivership company] is without assets the whole responsibility for the payment of redundancy payments will fall upon the redundancy fund, and hence upon the taxpayer: and the employees will not be able to recover the compensation for unfair dismissal to which they are entitled. The gainers will be the secured creditors; and, if the hiving-down agreement has resulted in a sale of the business as a going concern on terms which otherwise might not have been possible, those employees who have been re-employed ... But there are many conflicting interests involved, and it would not be right for us to express any general conclusions.”¹³⁷

It is possible to identify, therefore, two versions of the hive-down procedure: the first, offered by receivers and, indeed, the Tory Government of 1981, is that it is a utilitarian device which assists in the protection of employment and the most efficient use of the assets of insolvent enterprises; the second, more cynical view is that it inures only to the benefit of secured creditors and transferees of companies in crisis, the former reaping the financial benefit of an enhanced price for the business,

¹³⁵ *Hansard*, House of Commons, Vol. 14, Issue 1225, 4th-10th December, 1981, col. 678.

¹³⁶ [1978] ICR 665.

¹³⁷ *Ibid.* 673. See, to similar effect, Davies and Freedland, *supra* n 2, 107.

the latter being able to engage a workforce 'on the cheap', as it were, at the taxpayers expense.

The hazard facing the practice of hiving-down if Regulation 5 of the TUPE Regulations were to operate should be understood in order that the thinking behind the Government's response is better appreciated. On a transfer of the business of the receivership company to the hive-down vehicle, Regulation 5 would 'transfer' the former's employees to the latter, together with all outstanding rights and obligations relating to their contracts of employment. If the hive-down company, acting by the receiver, then dismissed those employees prior to its own acquisition, the consideration paid by the purchaser would be available to meet their claims¹³⁸. The solvent subsidiary would be responsible for discharging employees' entitlements, these ranking *pari passu* with the 'debt' owed to the insolvent parent. The end result would be reduction in the sum filtering back to the receivership company, and, concomitantly, to the debenture-holder. Alternatively, should the purchaser 'acquire' the employees directly from the hive-down company, again by virtue of Regulation 5, his likely discounting of the price he would be willing to pay would similarly result in a net loss to the debenture-holder¹³⁹.

Thus the Government was prompted to enact Regulation 4 of TUPE, which reads as follows:

"(1) Where the receiver of the property ... transfers the company's undertaking, or part of the company's undertaking (the "relevant undertaking") to a wholly owned subsidiary of the company, the transfer shall for the purposes of these regulations be deemed not to have been effected until immediately before:

¹³⁸ It should be noted that the debenture-holder's charge would not extend to the assets of the hive-down vehicle.

¹³⁹ See *Hansard, supra* n 122, col. 678, Mr David Waddington

- (a) the transferee company ceases (otherwise than by reason of it being wound up) to be a wholly owned subsidiary of the transferor company; or
 - (b) the relevant undertaking is transferred by the transferee company to another person;
- whichever first occurs and, for the purposes of these regulations the transfer of the relevant undertaking shall be taken to have been effected immediately before that date by one transaction only.”

Lightman and Moss describe the operation of Regulation 4 thus:

“By Regulation 4 ... the transfer is not deemed to take place until either the subsidiary ceases to be wholly owned by the holding company ... or the business of the subsidiary is transferred. The transfer then comes out of a form of suspended animation. In general it should therefore be possible for the vendor to terminate contracts long before the ultimate sale to a third party so that the latter has no liabilities to employees.”¹⁴⁰

What is particularly interesting about Regulation 4 is its clear signal that the Government intended that receivership transfers should remain unencumbered by the effect of Regulation 5. Further, it was plainly envisaged that dismissals completed *prior to the transfer of the undertaking* would similarly avoid the operation of the TUPE Regulations. In the event, this policy was to be undermined.

¹⁴⁰ *The Law of Receivers of Companies*, *supra* n 22, para. 19-19; see also McMullen, *supra* n 121, 226.

2. TUPE in the courts: an unexpected turn

Given the inclusion of Regulation 4, with its bias towards maintaining the *status quo* as regards the transfer of insolvent businesses in receivership or liquidation, it is apparent that the perceived wisdom was that Regulation 5(3) would be taken literally by the courts. It will be recalled that that provision states that the ‘automatic transfer’ of contracts of employment applies only to those employees “employed immediately before the transfer” of the undertaking in question. If this phrase were to be narrowly construed insolvency practitioners could avoid the deleterious effects of Regulation 5(1) by running the business with a full compliment of staff and dismissing them at some point before the actual transfer took place. This allowed their appointors, and, indeed, purchasers of the business, to enjoy the best of both worlds: the company could continue to operate so as to maintain it in a saleable condition but could be sold free of onerous employment contracts, thus rendering it more valuable in monetary terms¹⁴¹.

Employees would find themselves in a more equivocal position: when dismissed, if their dismissal was for a reason connected with the transfer¹⁴², they would be deemed to have been unfairly dismissed by virtue of Regulation 8(1). Their remedy would lie against the transferor company, which would be insolvent, and so the *basic award* for unfair dismissal would be paid out of the National Insurance Fund¹⁴³. Whether or not they found themselves unemployed depended upon the requirements of the purchaser of the business, who could in any event re-engage them on less favourable terms and conditions than those previously enjoyed.

¹⁴¹ See Upex, *supra* n 33, para. 2.60; McMullen, *supra* n 121, 136.

¹⁴² This matter has become pivotal and will be discussed in detail shortly.

¹⁴³ The National Insurance Fund would also meet redundancy payments, and any arrears of wages. It would not, however, discharge any *compensatory* award for unfair dismissal.

Much therefore rested on the attitude of the courts to that critical phrase “immediately before the transfer”. At first the question was treated as one of fact¹⁴⁴ inevitably leading to differences of opinion between tribunals. The tendency appears to have been to favour employees in deciding whether a temporal gap between dismissal and transfer nullified the argument that they were employed immediately before the transfer¹⁴⁵.

This vexed question finally came before the Court of Appeal through the intervention of the Department of Employment. In *Secretary of State for Employment v Spence*¹⁴⁶ it was argued that liability for redundancy payments of workers dismissed a mere three hours prior to a transfer had passed to the transferee, and so was not the responsibility of the National Insurance Fund. The Court of Appeal rejected this contention. According to Balcombe LJ, commenting on Regulation 5(1) of TUPE:

“That provision can clearly only relate to a contract of employment which is subsisting *at the moment of transfer*, otherwise, there is nothing on which the Regulation can operate.”¹⁴⁷

In other words, *any* temporal break between dismissal and transfer would be sufficient to disapply the operation of Regulation 5(1), since the requirement in Regulation 5(3), that the employee be employed by the transferor immediately before the transfer, would not be satisfied. On this ‘*scintilla temporis*’ approach, it should be an easy matter for parties to business transfers to structure their transactions so as to ensure that liability for employee-related matters remained the responsibility of the transferor.

¹⁴⁴ *Apex Leisure Hire v Barratt* [1984] 3 All ER 795.

¹⁴⁵ See, e.g., *Apex Leisure Hire v Barratt*, *supra* n 147; *Ellison v R & JK Pullman (Retail) Ltd*, COIT 10988/83; *Dickinson v Bryant*, EAT 73/84, Lexis Transcript; *Kestongate Ltd v Miller* [1986] ICR 672; *c.f. Browne v Catlow & Pilling*, COIT 13862/41; *Bannister v Brasway plc*, IDS Brief, 254/June 1983, 7.

¹⁴⁶ [1986] ICR 651.

¹⁴⁷ *Ibid* 661 (*italics added*).

With the benefit of hindsight, commentators remarked on the predictability of a challenge to the *Spence* judgment¹⁴⁸. In particular, the case conferred *carte blanche* on insolvency practitioners to avoid the effect of a mandatory European Community initiative. The aim of the Acquired Rights Directive was proclaimed by the European Court of Justice in *Foreningen af Arbejdsledere i Danmark v Daddy's Dance Hall A/S* to be:

“...to ensure as far as possible the safeguarding of employees’ rights in the event of a change of proprietor of the undertaking and to allow them to remain in the service of the new proprietor on the same conditions as those agreed with the vendor.”¹⁴⁹

That this objective could be so effortlessly thwarted by strategic timing ought perhaps to have alerted the Court of Appeal in *Spence* to the possibility that its ruling might render the UK in breach of its Treaty obligations. *Spence* was, for receivers and their appointors at least, a reassuring decision: in much the same way *Re Specialised Mouldings Ltd*, gave credence to a formulaic avoidance device¹⁵⁰ *Spence* endorsed a blatantly manipulative procedure. Both cases authorised the evasion of a deliberately protective regime. Both eventually met the same fate when the House of Lords were afforded the opportunity to reconsider the law.

¹⁴⁸ Ryley, writing after the event, considered “an attack on *Spence* on policy grounds inevitable” - *Business Transfers after Litster : Dangerous Liaisons?* (1989) LSG 86(23) 18.

¹⁴⁹ [1988] IRLR 315, 317.

¹⁵⁰ See *supra* 346.

2.1 “Immediately Before the Transfer”: the purposive approach of the House of Lords

Receivers and liquidators lulled into a sense of false security by *Spence* were to be sorely disappointed when, three years later, the House of Lords considered the effect of the TUPE Regulations for the first time. The facts of *Litster v Forth Dry Dock & Engineering Co Ltd*¹⁵¹ bear a remarkable resemblance to those of *Spence*. Receivers were appointed over the assets of an ailing shipyard. They continued to use the services of the workforce whilst negotiating a transfer of the business. One hour prior to its completion they dismissed the transferor’s employees, who were informed that their claims for redundancy payments lay against the insolvent transferor and would be met out of the National Insurance Fund.

In the House of Lords, Lords Oliver of Aylmerton and Templeman reviewed the effect of the TUPE Regulations and concluded that liability for employee-related obligations had in fact passed to the transferee. This result was, on the critical point of what was meant by the words “immediately before the transfer”, diametrically opposed to that in *Spence*.

Lord Oliver based his decision on the clear purpose of the Acquired Rights Directive and the duty of the courts to give effect, wherever possible, to such a purpose by construing implementation provisions in accordance with it. That purpose was:

“...to ensure that on any transfer of an undertaking, the employment of existing workers in the undertaking is preserved or, if their employment terminates solely by reason of the transfer, that their rights arising out of that determination are effectively safeguarded.”¹⁵²

¹⁵¹ [1990] 1 AC 546.

¹⁵² *Ibid.* 562.

Moreover, that purpose could not be frustrated in the manner contended by the receivers:

“It can hardly have been contemplated that, where the only reason for the determination of employment is the transfer of an undertaking or relevant part of it, parties to the transfer would be at liberty to avoid the manifest purpose of the Directive by the simple expedient of wrongfully dismissing the workforce a few minutes before the completion of the transfer. The European Court of Justice has expressed, in the clearest terms, the opinion that so transparent a device would not avoid the operation of the Directive, and, if the effect of the Regulations is that under the law of the UK it has that effect, then your Lordships are compelled to conclude that the regulations are gravely defective and the Government of the UK has failed to comply with its mandatory obligations under the Directive.”¹⁵³

To avoid that conclusion, the Regulations had to be construed in a teleological manner, and Lord Oliver was prepared to do so:

“In effect this involves reading regulation 5(3) as if there were inserted after the words “immediately before the transfer” the words “or would have been so employed if he had not been unfairly dismissed in circumstances described in regulation 8(1)”. For my part I would make such an implication which is entirely consistent with the general scheme of the Regulations and which is necessary if they are effectively to fulfil the purpose for which they were made of giving effect to the provisions of the Directive.”¹⁵⁴

The House of Lords were thus constrained to treat Regulations 8(1) and 5(3) as effectively cumulative. The latter provides that employees are to be treated as unfairly dismissed if the transfer or a reason connected with it is the reason or principal reason for the dismissals. Thus, if an employee can bring himself within this provision, *prima facie*, on the *Litster* approach, he will be deemed to have been employed immediately before the transfer for the purposes of the former. The

¹⁵³ [1990] 1 AC 546, 563.

¹⁵⁴ *Ibid.* p. 577. See also the remarks of Lord Templeman at 558 to this effect.

question is not *when* the dismissals took place, but rather *why* they occurred¹⁵⁵, and although the construction of the House of Lords may appear strained, given the wording of Regulation 5(3), it is clearly in accordance with the protective emphasis of the Directive.

For receivers, their appointors and prospective purchasers of the business of a receivership company, the result of *Litster* was less than positive. Under the *Spence* approach purchasers could demand the pre-transfer dismissal of the workforce, cherry pick those they wished to re-employ, engage them on whatever terms and conditions they thought fit, and rely on the State to foot the bill for redundancy and unfair dismissal claims. As far as receivers were concerned, *Spence* improved their chances of achieving a going concern sale, and their appointors benefited from the inevitably higher price that would be obtained.

Litster effectively stymied this practice, and the effect of ‘transferring’ employee claims to a transferee gave rise to the ‘TUPE dilemma’ described earlier, *viz.* the transfer of ‘value’ away from secured creditors and towards employees, and, indeed, the State in its capacity as guarantor. As McMullen puts it:

“In many cases it will simply not be possible to ignore employee rights and in many cases a purchaser has no alternative but to respect those rights. In a situation where a deal is not naturally structured so as to fall outside the ambit of the Transfer Regulations this area is a classic case of *caveat emptor* or ‘buyer beware’.”¹⁵⁶

¹⁵⁵ See Collins, *supra* n 114, 146.

¹⁵⁶ *Business Transfers and Employee Rights*, *supra* n 121, 172.

3. Transfer-related dismissals: Regulation 8(1)

The significance of *Litster* is that it shifts the emphasis from Regulation 5(3) to Regulation 8(1), so that central to the application of the ‘automatic transfer’ principle is the question of whether “the transfer or a reason connected with it is the reason or principal reason for ... dismissal.”¹⁵⁷ Regulation 8(1) derives from Article 4 of the Acquired Rights Directive, which states that:

“The transfer of an undertaking, business or part of a business shall not in itself constitute grounds for dismissal by the transferor or transferee. This provision shall not stand in the way of dismissals that may take place for economic, technical or organisational reasons entailing changes in the workforce.”

It appears that it is for the dismissed employee to establish that his dismissal was effected for a reason connected with the transfer¹⁵⁸.

This question has been approached pragmatically by courts and tribunals, being treated as one of fact to be decided upon the available evidence. Complex enquiries as to whether the dismissal would have taken place regardless of the transfer have been eschewed¹⁵⁹. This much was expressly recognised in the Northern Irish case of *Willis v McLaughlin and Harvey plc*, where Kerr J stated:

“I do not accept that the question whether regulation 5 applies in these circumstances must necessarily depend upon one’s estimate of what is likely to have occurred had a transfer not taken place. It may well be, of course, that if one can be confident that an employee would continue to be employed but for a transfer one may readily conclude that his employment was ended because of the transfer. It appears to me, however, to be possible to decide that an employee ceased to be employed by reason of the transfer

¹⁵⁷ Regulation 8(1) TUPE. See also McMullen, *Business Transfers and Employee Rights*, *supra* n 124, 194; Upex, *supra* n 34, para. 2.61.

¹⁵⁸ *Willis v McLaughlin and Harvey plc* [1996] NI 427.

¹⁵⁹ Although there is at least a hint of such an approach in the decision of the Court of Appeal in *Whitehouse v Chas A Blatchford & Sons Ltd* [1999] IRLR 492.

without being confident that he would have continued to be employed if the transfer had not taken place.”¹⁶⁰

It is, however, possible to establish that dismissals were not transfer-connected in certain extreme circumstances, and, not surprisingly, these are such as are encountered in receivership. The House of Lords in *Litster*, whilst reformulating the approach to Regulation 5(3) taken in *Spence*, did not oppose the *result* of that decision¹⁶¹. On the contrary, they agreed that the *Spence* dismissals were *not* connected with the transfer, because it was not concrete at the time of the dismissals¹⁶² and because the receivers had been under pressure from the appointing bank to trim the company’s wage bill¹⁶³. Given the House of Lords approval of the *Spence* outcome, it seems that where a receiver can provide credible evidence that the business could not, because of extreme financial constraints, maintain its workforce any longer, this *may* support an argument that dismissals were effected for a reason other than the transfer. If the business itself ceases to operate prior to the transfer this will bolster such an argument¹⁶⁴. In the *Willis* case, Kerr J goes even further:

“As I have already said, *if the survival of the company depends on the dismissal of certain members of the workforce*, termination of their employment should not be regarded as due or mainly due to the transfer which happens to coincide with a necessary reduction in the workforce.”¹⁶⁵

¹⁶⁰ [1996] NI 427, 440.

¹⁶¹ See McMullen, *supra* n 121, 164.

¹⁶² With respect, this is hardly convincing. Three hours elapsed between dismissals and transfer, suggesting that the latter was a foregone conclusion.

¹⁶³ The coincidence of dismissals and transfer supports the inference that any pressure had been successfully resisted *because of* the prospect of a transfer.

¹⁶⁴ It would seem that the cessation of business was the only genuine distinction between the facts of *Litster* and those of *Spence*.

¹⁶⁵ [1996] NI 427, 444 (*italics added*).

On the facts, however, the Northern Ireland Court of Appeal were not prepared to accept that the circumstances described by the learned judge were present¹⁶⁶.

The notion that 'business survival' might constitute a non-transfer-connected reason for dismissal is problematic, not least because most receivership transfers fall into this category. Further, such an approach tends to blur the distinction between dismissals by reason of a transfer under regulation 8(1), which are automatically unfair, and those adjudged to be for an "economic, technical or organisational reason entailing changes in the workforce" under regulation 8(2), which, although transfer-connected, may nonetheless avoid the automatic unfairness principle¹⁶⁷. This seeming difficulty was resolved in *Willis* itself by juggling the burden of proof. Kerr J stated:

"[Counsel for the transferee] accepted (correctly in my view) that where the dismissal of an employee is coincident with the transfer of the undertaking, the burden of showing that the dismissal was for reasons other than the transfer shifted to the transferor and transferee. It appears to me that that burden can only be discharged if it is shown that the dismissal was objectively necessary and not merely for the purpose of meeting requirements imposed by the purchaser for his own purposes."¹⁶⁸

Where there is evidence of collusion between transferor (in practice the insolvency practitioner) and transferee, this burden will be difficult to surmount, as was the case in *Willis* itself. Frequently such collusion will take the form of the transferee drawing up a 'wish-list' of those employees to be retained in the business and communicating its contents to the receivers, who then dismiss those not required. In *Litster*, the entire workforce was dismissed so as to be replaced by unemployed individuals who were,

¹⁶⁶ The dismissals had taken place five days before the transfer, at the behest of the transferee. It appears that no evidence was introduced to support a finding that the business would not have survived if not transferred, although this seems an inevitable inference.

¹⁶⁷ Regulation 8(2) will be discussed in detail shortly.

¹⁶⁸ [1996] NI 427, 442.

no doubt, willing to accept less than generous terms¹⁶⁹. The response of the courts to such stratagem has been less than accommodating. In cases such as *Litster*, this is entirely understandable, given that the dismissals in question were dictated by the less auspicious consequences of the TUPE regulations rather than the staffing requirements of the 'new' business¹⁷⁰. It is, however, less easy to see that collusive dismissals intended to *reduce* the number of staff transferred are not "objectively necessary", yet this appears to represent the reasoning in *Willis*. McMullen prefers to confine challengeable dismissals to the former, *Litster*-type:

"Where employees are re-engaged after the transfer, or where new labour is engaged by the transferee at lower rates of pay then, patently, there seems to have been no need in terms of the requirements of the business to effect dismissals, and the dismissals should be automatically unfair."¹⁷¹

Evidence of complicity between transferor and transferee may not, however, be conclusive of a 'transfer-related' dismissal, as witnessed by the decision in *Longden v Ferrari Ltd*¹⁷². In this case the eventual purchaser of the business made an advance to its receivers of £4000 in order that wage bills be met and the business kept 'ticking over'. This was accompanied by a list of employees he wished to retain. The next day the receivers dismissed all those employees whose names did not appear on the list, and the transfer of the business was completed thirteen days later. The Employment Appeal Tribunal refused to interfere with the Industrial Tribunal's finding of fact that the dismissals were eventuated by "financial constraints, and ... pressure from the bank which appointed [the receivers], and not because they had

¹⁶⁹ A variant of this practice is the re-engagement of dismissed employees post-transfer, on less advantageous terms.

¹⁷⁰ See the remarks of Lord Oliver, [1990] 1 AC 546, 565.

¹⁷¹ *Business Transfers and Employee Rights*, *supra* n 121, 138. See also Collins, *supra* n 114, 146.

¹⁷² [1994] BCC 250.

received any request or instruction from [the purchaser]”¹⁷³. This finding was made on very little evidence¹⁷⁴, but was not considered so outlandish as to be perverse, or unsupportable on what meagre evidence was available.

In *Longden*, no express instructions as to dismissals were given to the receivers, but the fact that only those employees whose names were not included on the family tree were dismissed suggests that the receivers were perfectly capable of taking the hint. Interestingly, the dissent of the minority focuses clearly on the issue of financial limitations as providing a ‘non-transfer connected’ reason for dismissal:

“There is a public policy point. The purpose of the regulations is to give protection to employees where there is a transfer. If receivers could successfully plead financial constraints, this could open up a potentially large loophole. The majority try to block this potential loophole by calling for ‘the best evidence’ from receivers. But this of itself does not sit easily with the public policy behind the formation of industrial tribunals.”¹⁷⁵

It might further be observed that the ‘financial constraints’ pleaded must have been mitigated by the advance payment of £4000 made by the transferee prior to the dismissals and eventual transfer.

The relevance of both collusion and the pecuniary problems experienced by companies in receivership to the question of whether dismissals fall within regulation 8(1) is therefore not authoritatively established. At best one might estimate that the more ‘strategic’ the dismissals, the more likely a court will be inclined to deem them ‘transfer-connected’, as will be the case where employees are subsequently re-engaged on new terms and conditions. A simple reduction in the number of staff prior to transfer, with no re-engagement after the transfer *may* avoid the operation of

¹⁷³ [1994] BCC 250, 257, *per* Mummery J.

¹⁷⁴ The receivers gave no oral evidence, and no sworn evidence was given by any of their employees. Documentation describing the financial state of the business was presented, which included a statement to the effect that the receivers were anxious to minimise their own trading loss.

¹⁷⁵ [1994] BCC 250, 259-260.

regulation 8(1) if there is evidence that the receivers found themselves with insufficient funds to contemplate keeping the workforce on. Evidence of demands from the appointor to reduce outgoings may, if *Longden* is representative of the attitude of the courts, achieve the same result. This raises the possibility of avoiding the operation of regulation 5(1) by the calculated provision of evidence of compulsion on the part of the appointor. This, it is submitted, is hardly an engaging prospect.

3.1 'A' Transfer or 'The' Transfer?

The protective effect of the Acquired Rights Directive, has recently been strengthened so as to safeguard employees' rights even further. It now appears resolved that a 'transfer-connected' dismissal can occur, and so prompt the application of regulation 5(2), notwithstanding that the dismissal takes place before a *specific* transferee is identified.

In *UK Security Services (Midlands) v Gibbons*¹⁷⁶ the TUPE Regulations were held to apply where staff were dismissed at 11.30 am, half an hour before two tenders for the business were opened¹⁷⁷. This approach was followed in *Harrison Bowden Ltd v Bowden*, where Tuckey J said this:

"We are bound to say that [if a *particular* transfer is a pre-requisite to the application of the Regulations] ... it would open a loophole in this legislation which presumes continuity of employment and attempts to ensure protection of workers when undertakings are transferred. There is also a conceptual difficulty in distinguishing between a prospective transferee and an actual transferee. Why should it make any difference if there is one front runner at the point of dismissal who is then, perhaps, as the example was put to us, gazumped by another one but in the meantime the employees

¹⁷⁶ Unreported, 1990, EAT/104/90, Lexis Transcript.

¹⁷⁷ Contracts were exchanged at 3.00 p.m. and the transfer was completed three days later.

have been dismissed? If their dismissal was connected with a transfer one would expect this legislation to protect them...”¹⁷⁸

The loophole was closed by the simple expedient of construing the words “the transfer” in Regulation 8(1) as referring to the transfer which eventually takes place.

Morison J, in *Ibex Trading Co Ltd v Walton*¹⁷⁹, was more cautious. An offer to purchase the business was made seven days after the dismissals in question, completion taking place a further three months later. The learned judge remarked:

“...here, the employees were dismissed before any offer had been made for the business.

Whilst it could properly be said that they were dismissed for a reason connected with a possible transfer of the business, on the facts here we are not satisfied that they were dismissed by reason of *the* transfer or for a reason connected with *the* transfer. The transfer was, at the stage of the dismissal, a mere twinkle in the eye and might never have occurred. We do not say that in every case it is necessary for the prospective transferee to be identified; because sometimes one purchaser drops out at the last minute and another purchaser replaces him.”¹⁸⁰

It appears that the distinction between *Harrison Bowden* and *Ibex* is simply one of degree, and that the cases can be thus reconciled. The difficulty, however, is in deciding precisely where the line demarcating transfer and non-transfer related dismissals is to be drawn when dismissals occur before any prospective transferee has been identified.

In *Morris v John Grose Group Ltd*¹⁸¹ the transferor (in receivership) was a motor dealership franchise, and the eventual purchaser was introduced to the receivers by the franchisor on the same day, but just after, the applicant was dismissed. The transfer was completed just over a month later. The Employment Appeal Tribunal

¹⁷⁸ [1994] ICR 186, 191.

¹⁷⁹ [1994] IRLR 564.

¹⁸⁰ *Ibid.* 567.

¹⁸¹ [1998] IRLR 499.

concluded that the applicant had been dismissed for a reason connected with the transfer, preferring to regard the word “the” in relation to a transfer in regulation 8(1) as an indefinite article. This was driven by a desire to give effect to the underlying purpose of the Acquired Rights Directive and to avoid anomalies, according to Bell J:

“In our judgment this view of the meaning of regulation 8(1) is more consistent with the broad scope of the Directive ... to decide otherwise would lead to quite unfair anomalies ... why, for instance, should employees who are dismissed by reason of a particular anticipated transfer which does not go through but which is promptly replaced by another comparable transfer in circumstances where a transfer to someone was inevitable, not have the benefit of regulation 8(1), subject to regulation 8(2), when they would have had that protection if the original transfer had gone through? Yet this would be the result of a restrictive construction of ‘the transfer’ in regulation 8(1).”¹⁸²

The *John Grose* judgment, whilst purposive, does little to introduce clarity into this troubled area of law. It clearly contemplates a potential transfer of employee rights where one transfer is finalised at the time of dismissals but is subsequently substituted by a different one, but on the facts of the case this did not happen. The decision is based upon the construction of the language of regulation 8(1), determining that the word “the” in relation to a transfer is an indefinite article. Thus, employees who can show that their dismissal was prompted in order to facilitate a transfer ought to be able to rely on the case as supporting an argument that the eventual transferee is liable to discharge their claims. Bell J was not convinced that his judgment would necessarily prove problematic:

“To construe regulation 8(1) in the way which we do will not, in our view, open a floodgate of automatic unfair dismissal in any case where dismissal has in fact preceded a transfer ... the transfer or a reason connected with it must still be the reason or

¹⁸² [1998] IRLR 499, 503.

principal reason for the dismissal for regulation 8(1) to apply, and a tribunal is unlikely to find that requirement proved if there are dismissals so that the undertaking can continue when the transfer is no more than a remote possibility.”¹⁸³

This is reminiscent of the reasoning in *Ibex*, where the transfer in question was “a mere twinkle in the eye”. The loophole identified in *Harrison Bowden* remains partially open, if a little narrower, and Bell J’s remarks indicate that future tribunals will once again be presented with complex factual enquiries, and that much may depend upon the quality of evidence. If, for example, dismissed employees are able to provide documentation, perhaps in the form of a prospectus, circulated by insolvency practitioners in order to attract purchasers for the business from which they were dismissed, does this render any eventual transfer sufficiently advanced to attract the operation of regulation 8(1)?

In essence, there is nothing qualitatively distinct between dismissals effected at the behest of the transferee and those effected by an insolvency practitioner inclined to second-guess the likely requirements of an as yet unidentified purchaser. Both are made with a transfer in mind yet it remains unclear which will attract the operation of the TUPE Regulations. Since it is for dismissed employees to show that their dismissals were by reason of the ultimate transfer, those who are dismissed before negotiations are finalised, or even commenced, will labour under a heavy evidential burden. Whilst the *John Grose* case removes a technical barrier to unfair dismissal applications, it introduces a further element of ambiguity into the whole TUPE debate, and may prove counter-productive. It provides a veiled incentive for insolvency practitioners to make dismissals earlier than would perhaps have been the case, and it is not untenable that jobs might be lost as a result. It will often be impossible to predict whether an anonymous future transferee would in fact be

¹⁸³ [1998] IRLR 499, 503.

reluctant to take on any given number of employees, yet insolvency practitioners may be tempted to err on the side of caution and make more dismissals than are strictly necessary. Further, it is likely that temporal considerations, deemed to be irrelevant in *Litster*, will make an unwelcome comeback in matters concerning regulation 8, since the time elapsing between the dismissals and eventual transfer may be the only available evidence upon which a tribunal can draw inferences.

3.2 Regulation 8(1): some final thoughts

In the context of a going concern sale of the business of a company in receivership, regulation 8(1) has proved a minefield for insolvency practitioners. Negotiating its latent hazards has been extraordinarily awkward, especially when the courts have appeared to 'move the goalposts' on so many occasions. The seemingly simple question of whether a particular dismissal is or is not transfer-related is not easily answered in receivership situations, and may in the final analysis amount to little more than a matter of impression.

Three further points are worth making. It is now authoritatively decided that automatically unfair dismissals under regulation 8(1) are effective to terminate the employment relationship. In other words, notwithstanding that liability passes to the transferee by reason of a combination of regulations 5(1) and 8(1), the unfair dismissals themselves are not rendered a nullity by the latter. It is arguable that this was inherent in the *Litster* judgment, but it has now been confirmed by the House of Lords in *British Fuels Ltd v Baxendale; Wilson v St Helens Borough Council*¹⁸⁴. The effect of this ruling is that a transferee willing to meet unfair dismissal and

¹⁸⁴ [1998] 3 WLR 1071.

redundancy claims may nonetheless re-engage dismissed employees on less favourable terms and conditions than they previously enjoyed.

Secondly, Regulation 4, which, it will be recalled, was intended to preserve the employment advantages of the hive-down mechanism has been held to be subject to the *Litster* approach in *Re Maxwell Fleet Facilities and Management Ltd (No 2)*¹⁸⁵.

Finally, the position of employees has been further improved by the recent enactment of The Unfair Dismissal and Statement of Reasons for Dismissal (Variation of Qualifying Period) Order of 1999, which reduces the qualifying period for an unfair dismissal claim from two years to one as from 1/6/99.

¹⁸⁵ [2000] 2 All ER 860

4. “Economic, technical or organisational reasons”: the Regulation 8(2) ‘defence’

4.1 An introduction to economic, technical or organisational reasons

Regulation 8 is divided into two paragraphs. Regulation 8(1) contains the ‘automatic unfairness’ principle, where a dismissal is connected with the transfer. Regulation 8(2) reads as follows:

“Where an economic, technical or organisational reason¹⁸⁶ entailing changes in the workforce of either the transferor or transferee before or after a relevant transfer is the reason or principal reason for dismissing an employee –

(a) paragraph (1) above shall not apply to his dismissal....”¹⁸⁷

It has traditionally been assumed that Regulation 8(2) provides a defence to automatic unfairness under Regulation 8(1). Upex explains this in the following terms:

“It is clear from the wording of the regulations and from decisions of the Employment Appeal Tribunal that the correct approach is to consider first whether regulation 8(1) applies so as to make dismissals automatically unfair; if it does, then the tribunal should consider whether regulation 8(2) applies....”¹⁸⁸

Given the structure of Regulation 8, this would appear to be a realistic construction of its terms. One might, however, contend that ETO reasons are, by definition, those rendering dismissals unconnected with the transfer altogether, and so outside the terms of regulation 8(1). Regulations 8(1) and 8(2), on this reasoning, are mutually exclusive. Either the reason for dismissal is the transfer, or it is an ETO reason, and the two cannot exist contemporaneously.

¹⁸⁶ Hereinafter ‘ETO’ reasons.

¹⁸⁷ This provision reflects, almost word for word, the second sentence of Article 4(1) Acquired Rights Directive.

¹⁸⁸ *The Law of Termination of Employment*, *supra* n 33, para. 2.70. See also McMullen, *supra* n 121, 192; IDS Brief 623 Oct 1998, 12.

In *Warner v Adnet*¹⁸⁹ the Court of Appeal expressly rejected this analysis. The dismissed employee had argued that, on finding that the reason for his dismissal was connected to the transfer, it would be erroneous for a tribunal to then consider whether regulation 8(2) applied. Mummery LJ considered this submission to be “misconceived”:

“...regulation 8(2) ... expressly contemplates circumstances in which regulation 8(1) will be disapplied and where the view formed by the tribunal under regulation 8(1) is not final, conclusive or exclusive ... It is plainly not correct to construe regulations 8(1) and (2) in the mutually exclusive way proposed by [the applicant] ... If the transfer is not the reason, there is no need to enquire further. If it is the reason, regulation 8(2) *may* apply. If it does, regulation 8(1) is then disapplied and the dismissal is not *automatically* unfair.”¹⁹⁰

Some doubt has been cast upon the accuracy of this proposition, inadvertently it would appear, by the Court of Appeal in *Whitehouse v Chas A Blatchford & Sons Ltd*¹⁹¹. Beldam LJ puts the matter thus:

“I would approach the decision in the present case by accepting that, if the employee’s dismissal is *solely* by reason of the transfer, he must be taken to be unfairly dismissed. But if, *in addition* there is an economic, technical or organisational reason, the tribunal of fact has to determine whether *that is the principal reason within the meaning of regulation 8(2)*.”¹⁹²

This does not depart radically from the position in *Warner v Adnet*. It emphasises, correctly it is submitted, that a determination should be made as to whether the ETO reason was the *principal* reason for the dismissal or not. More difficult is the reasoning of Buxton LJ:

¹⁸⁹ [1998] IRLR 394.

¹⁹⁰ *Ibid.* 397.

¹⁹¹ [1999] IRLR 492.

¹⁹² *Ibid.* 495 (italics added).

“Looked at, Article 4 says no more than two things. First of all, the transfer cannot in itself justify a dismissal; second, in a situation involving a transfer, it is still open for dismissals to take place that would otherwise be justified according to the law of the country to which it applies. The words “dismissals ... for economic, technical or organisational reasons entailing changes in the workforce” are, in my judgment, merely a very broad description of a whole range of circumstances that might, in the law of any one of the Member States, give rise to justification for dismissal. And it goes no further than that.”¹⁹³

With respect, this begs the question of whether transfer-connected dismissals are justified by ETO reasons or not under English law. Nevertheless, at least one commentary has interpreted the learned judge’s remarks as supportive of the notion that regulations 8(1) and (2) are in fact exclusive:

“The Court’s reasoning implies that the dismissal is either for a reason connected with the transfer or for an ETO reason within Regulation 8(2), and that it cannot be both.”¹⁹⁴

The *Whitehouse* decision is unfortunately ambiguous. The Court of Appeal gave no indication that it believed itself to be changing the law as to the proper approach towards Regulation 8. *Warner v Adnet* was not considered, although the comments of Beldam LJ, cited above, appear to reflect the orthodoxy as stated in that case. The Employment Appeal Tribunal in *Kerry Foods Ltd v Creber*¹⁹⁵ displayed an initial inclination to depart from the reasoning in *Warner v Adnet*, but was constrained to follow the ruling of the Court of Appeal in *Whitehouse*, which was stated to decide the following:

“...if the main reason for the dismissal was the transfer, the decision to dismiss was automatically unfair ... But if the transfer was *a* reason but that an ETO reason was the main reason then the dismissal would not be automatically unfair.”¹⁹⁶

¹⁹³ [1999] IRLR 492, 496.

¹⁹⁴ ‘Economic, technical or organisational reason’ for dismissal’, IDS Brief, 641, July 1999, 9.

¹⁹⁵ [2000] IRLR 10.

¹⁹⁶ *Ibid.* 12, per Morison J.

This appears to be a fair reflection of the remarks of Beldam LJ in *Whitehouse*. A tribunal should therefore carry out an ‘assessment exercise’ as to whether the transfer or the ETO reason was the dominant reason for the dismissal. The question is one of fact and degree, and to the extent that the judgment of Buxton LJ suggests otherwise, it must be viewed as misconceived.

4.2. What amounts to an ETO reason?

4.2.1 ‘Enforced’ dismissals

The broader the view taken of what constitutes an ETO reason the less critical becomes the ‘TUPE dilemma’. If dismissals can legally be made for ETO reasons, a receiver can effect them and avoid transferring extensive liabilities which will affect the price the purchaser is willing to pay. The ETO defence, if extensively construed, restores the pre-TUPE advantages of transferring a business free of its employees.

The words “economic, technical or organisational reason entailing changes in the workforce” are given no more precise definition in the TUPE Regulations or the Acquired Rights Directive. Their meaning has been left to the courts and, as far as insolvency practitioners and their appointors were concerned, the case law began on an auspicious note. In *Anderson and McAlonie v Dalkeith Engineering Ltd (in receivership)*¹⁹⁷, dismissals made in order to comply with the requirements of a purchaser of the business were accepted as ‘economic’ within regulation 8(2):

“The reasons were, in our view, economic. The best deal which the receiver could get was to sell the undertaking to purchasers who insisted that, before the deal was finalised, the whole workforce must be dismissed.”¹⁹⁸

¹⁹⁷ [1984] IRLR 429.

¹⁹⁸ *Ibid.* 431, per Lord McDonald.

This gives an extremely broad meaning to the term 'economic', and, if correct, would mean that employees of an insolvent transferor would be effectively divested of the protective intentions of the Acquired Rights Directive. Receivers and liquidators could continue with their pre-TUPE strategy of dismissing employees prior to transfer and then simply plead the regulation 8(2) defence to a claim for unfair dismissal¹⁹⁹.

This potentially cavernous lacuna in the Regulations did not commend itself to subsequent tribunals. In *Wheeler v Patel* it was addressed in the following terms:

"If Lord McDonald's view as to the scope of the phrase "economic, technical or organisational" is correct, it is difficult to think of any case falling within para. (1) where the reason for dismissal would not be 'economic' for the purposes of para. (2)."²⁰⁰

In order, therefore, to give regulation 8(2) some meaningful content:

"We think 'economic' must be given a more restricted than literal meaning ... 'Economic' reasons apt to bring the case within para. (2) must, in our view, be reasons which relate to the conduct of the business. If an economic reason were no more than a desire to obtain an enhanced price, or no more than to achieve a sale, it would not be a reason which related to the conduct of the business. It would not, in our judgment, be an economic reason for the purposes of para. (2)."²⁰¹

Two points are worthy of note here. First, *Wheeler v Patel* did not concern the transfer of an undertaking in receivership, although it appears from the facts that the business in question was suffering from severe financial constraints. That being so, it is clear that the particular exigencies faced by insolvency practitioners were present and, presumably, contemplated by the Tribunal. Nonetheless, they expressly rejected

¹⁹⁹ Although dealing specifically with a case of receivership, there seems to be no reason why this 'purchaser compulsion' analysis could not be applied as between solvent parties. If the transferor's desire to achieve the 'best deal' amounts to an economic reason, why is it necessarily restricted to insolvency situations?

²⁰⁰ [1987] IRLR 211, 214, *per* Scott J.

²⁰¹ *Ibid.* 214.

a construction of regulation 8(2) which would ameliorate this position, adopting a 'unitary' approach to both solvent and insolvent transfers.

Secondly, the *transferor* of the business effected the dismissals in question, and it was *the transferor's* reason that was adjudged not to be an economic one. It is nonetheless clear that the ETO defence is equally available to a transferee²⁰², and it appears from the decision of the Court of Appeal in *Whitehouse v Chas A Blatchford*²⁰³ that the transferee may rely on an ETO reason of the transferor as justification for an otherwise transfer-related dismissal, and vice-versa²⁰⁴.

McMullen describes the decision in *Wheeler v Patel* as "significant"²⁰⁵. In effect it blocks off a potential 'escape route' for receivers, their appointors, and purchasers from them by requiring dismissals to be shown to be objectively necessary to the conduct of the transferred business. It has since been followed in *Gateway Hotels Ltd v Stewart*²⁰⁶ and approved in *Whitehouse v Chas A Blatchford*, where Beldam LJ noted that:

"It seems to me that the words 'economic, technical or organisational reason *entailing changes in the workforce*' clearly support the conclusion that the reason must be connected with the future conduct of the business as a going concern."²⁰⁷

Further, the earlier jurisprudence of the European Court of Justice authenticates the *Wheeler* interpretation of 'economic':

"It is said that [the exception to Art 4] will always be open on economic grounds in a liquidation, so that Art. 4(1)'s first sentence is otiose. That does not seem to me to follow, since if a viable part of the business in liquidation is sold off, there may be no

²⁰² *Jules Dethier Équipement SA v Dassy* [1998] ICR 541.

²⁰³ [1999] IRLR 492.

²⁰⁴ See, to this effect, (1999) 23 Employment Lawyer, 13.

²⁰⁵ *Business Transfers and Employee Rights*, *supra* n 124, 200.

²⁰⁶ [1988] IRLR 287.

²⁰⁷ [1999] IRLR 492, 495.

valid economic grounds for dismissing any of the staff employed in that part of the business.”²⁰⁸

There have, however, been certain developments in the European approach which may indicate that a change of attitude is imminent. In *Jules Dethier Équipement SA v Dassyl*²⁰⁹, Advocate General Lenz, addressing the question of whether dismissals effected during the liquidation of a business were for ETO reasons, affirmed:

“If a transferor is allowed to dismiss employees for economic, technical or organisational reasons, the liquidation itself will also be facilitated, jobs at the undertaking in liquidation will be made safe and worker protection will thereby be enhanced.”²¹⁰

It is perhaps no coincidence that European Commission initiatives to amend the Acquired Rights Directive to take account of the particular constraints of insolvency related transfers were already well advanced at the time of this judgment²¹¹. The European Court of Justice, however, expressed no opinion as to whether dismissals effected in order to facilitate a transfer would be for an ‘economic’ reason within regulation 8(2).

There remains the possibility, therefore, that where dismissals are prompted in order to ‘rescue’ a business by means of a transfer, these may be properly categorised as having taken place for an ‘economic’ reason. In *Willis v McLaughlin and Harvey plc*²¹² Kerr J considered that dismissals objectively necessary to ensure the survival of the business would not be ‘for a reason connected with the transfer’, and so not

²⁰⁸ *Abels v Bedrijfsvereniging voor de Metaal-Industrie en de Electrotechnische Industrie* [1987] 2 CMLR 406 (opinion of Advocate-General Slynn).

²⁰⁹ [1998] ICR 541.

²¹⁰ *Ibid.* 554.

²¹¹ The result, an amended Directive, will be discussed later.

²¹² [1996] NI 427.

within regulation 8(1)²¹³. The learned judge further approached the question from the perspective of the application of regulation 8(2):

“It appears to me to be entirely consistent with the theme of the judgment in *Wheeler* that a decision to dismiss in order to bring about a sale which could not otherwise take place may be an economic reason if it can be shown that the prospective purchaser could not proceed unless the employee was dismissed. In those circumstances it may be said that the employee is dismissed to enhance the prospects of a sale of the undertaking but since this is necessary for the sale to proceed and the business could not otherwise survive, it is an economic reason which entails (i.e., requires) a change in the workforce.”²¹⁴

Boyd treats this proposition with circumspection:

“This should not be taken to mean that where a business cannot survive unless sold, that all dismissals which take place which ensure a sale will be dismissals taken for an economic reason within regulation 8(2). Much will depend on why the prospective purchaser cannot proceed without dismissals first taking place ... Certainly liability will not be avoided under regulation 8(1) simply because the dismissal is at the behest of the purchaser and that he will not buy unless the dismissals take place.”²¹⁵

This must be correct if the basic assumption of *Wheeler v Patel* that strategic dismissals to facilitate a sale of the business do not fall within Regulation 8(2) is to be upheld. It is perhaps significant that, on the facts of *Willis*, the Court of Appeal were unable to find that the business could not have survived without the dismissals taking place, although it is unlikely that counsel for the transferee thought fit to introduce evidence to this effect. Whether this potentially ‘economic’ reason will be more widely championed therefore remains to be seen.

²¹³ See *supra* 390.

²¹⁴ [1996] NI 427, 446.

²¹⁵ *Corporate Rescue and Employees’ Rights* [1997] 48 NILQ 297.

4.2.2 'Redundancy' dismissals

"...[A]n employee who is dismissed shall be taken to be dismissed by reason of redundancy if the dismissal is wholly or mainly attributable to –

(a) the fact that his employee has ceased or intends to cease

(i) to carry on the business for the purposes of which the employee was employed by him, or

(ii) to carry on that business in the place where the employee was so employed or

(b) that fact that the requirements of that business

(i) for employees to carry out work of a particular kind, or

(ii) for employees to carry out work of a particular kind in the place where the employee was employed by the employer,

have ceased or diminished or are expected to cease or diminish."²¹⁶

In *Gorictree v Jenkinson*²¹⁷ the Employment Appeal Tribunal accepted that 'redundancy' could be categorised as an economic reason for the purpose of regulation 8(2):

"As a matter of fact we suppose that redundancy is one of the most common of economic, technical or organisational reasons entailing changes in the workforce to which Regulation 8(2) applies."²¹⁸

With regard to the statutory definition of redundancy above, one might question whether a dismissal by reason of redundancy within the business of the *transferor* is a transfer-related dismissal in any event²¹⁹. In such circumstances it is submitted that Regulation 8(2) is not in point since, by definition, regulation 8(1) will not apply.

Redundancy as an ETO reason is a more credible proposition where dismissed employees would be regarded as redundant *in the business of the transferee*. Where a receiver dismisses employees because the *transferee* has no job for them, and again

²¹⁶ Employee Rights Act 1996 s 139(1).

²¹⁷ [1984] IRLR 391.

²¹⁸ *Ibid.* 394, *per* Mr J A Powell.

²¹⁹ Always assuming that the reason for dismissal is a genuine 'redundancy' reason as described in ERA s 139(1).

presupposing that the redundancies are genuine, it seems plausible to maintain that the dismissals are transfer-related, but for economic, technical or organisational reasons entailing changes in the workforce.

This construction of regulation 8(2) offers at least a partial solution to the TUPE dilemma. It ought to be possible to rely on the ETO defence where the transferee proposes to continue the business, but on a smaller scale, or with fewer employees. Further, if the receiver considers that that business is overstaffed, and effects dismissals in order to reduce the workforce to a realistically sustainable level, even where this is done with a view to a specific or non-specific transfer, the defence ought to apply. As Campbell and Underdown put it:

“The words ‘economic, technical or organisational reasons’ give the purchasing company considerable leeway to negotiate with an administrator/receiver on the redundancy of staff for economic reasons and to ensure that if *genuine* redundancies are necessary and agreed, due notice can be given to terminate contracts of employment...”²²⁰

The effect of establishing an ETO defence in this manner is as follows. If the *transferor* effects dismissals, and if these are adjudged to be for an ETO reason, they will not be automatically unfair under Regulation 8(1). They will not, therefore, fall within the *Litster* principle, the ultimate outcome being that Regulation 5 will not apply. From a receiver’s perspective, or rather that of his appointor, this is a hugely attractive prospect in that it neutralises the TUPE dilemma altogether. If a purchaser of the business is not confronted with the incident of potentially large employee-related liabilities he will perforce offer more for it, leaving employees’ claims to be settled by the National Insurance Fund.

²²⁰ *Corporate Insolvency in Practice: An Analytical Approach* (1991 : PCP : London), 141.

It should be noted that this consequence will only be possible where dismissals are effected *prior to the transfer*²²¹. Post-transfer dismissals may also be for ETO reasons, and so will avoid being unfair, but since Regulation 5 will have already operated to transfer employees' accrued rights to the transferee, he, and not the National Insurance Fund, will be responsible for any redundancy payments.

The difficulty with this strategy is its uncertainty in terms of outcome. In particular, a purchaser will have to be tremendously confident that any plea of justification based upon the ETO defence will be accepted by the courts, and this is by no means a foregone conclusion. Nevertheless, there are illustrations in the case law that suggest that reliance upon ETO reasons for dismissal may be an feasible tactic in appropriate circumstances.

McMullen draws attention to the case of *Sewell v DMG (Realisations) Ltd*²²² where an Industrial Tribunal considered that dismissals were for ETO reasons when it was clear that the transferor's financial position was so hopeless that only a complete restructuring of the business within that of the transferee could save it²²³. The Employment Appeal Tribunal, in *Trafford v Sharpe & Fisher (Building Supplies) Ltd*²²⁴, agreed that dismissals made in order to streamline the operation of the transferred business, and to achieve a viable turnover per employee ratio, were for an ETO reason. Mummery J conceded that 'overstaffing' could amount to an economic, technical or organisational reason justifying dismissals, and was clear that the demands of the business could, in certain circumstances, override those of its employees:

²²¹ I.e., by the insolvency practitioner.

²²² COITs 15486/89-15506/89; 13227/89-13254/89, 13681/89 (Feb 1990).

²²³ See *Business Transfers and Employee Rights*, *supra* n 121, 201-202. This case might also support the concept of 'rescue orientated' dismissals falling within Regulation 8(2).

²²⁴ [1994] IRLR 325.

“This Tribunal agrees that a purposive approach should be adopted to the construction of Regulation 8 and that the purpose of the Directive is a social one, aiming at safeguarding the rights of workers in the event of a change of employer. Such an approach does not, however, always mean that words should be inserted to enable an employee to succeed in a claim. The rights of workers must be safeguarded ‘so far as possible’. It is not always possible to safeguard the rights of workers. As is recognised in the second sentence of Art 4(1) the right of workers not to be dismissed on the transfer of an undertaking must not stand in the way of dismissals which take place for economic reasons entailing changes in the workforce. In such cases the rights of workers may be outweighed by economic reasons.”²²⁵

This case appears to offer hope of avoiding TUPE liability to those transferees who can show that the business of a receivership company is objectively overstaffed²²⁶. Given that it is open for pre-transfer dismissals to be made in anticipation of the requirements of the post-transfer business, ‘downsizing’ might well fall within the Regulation 8(2) defence. It should be emphasised, however, that a tribunal is unlikely to reach such a conclusion without evidence of the demand for rationalisation, and where the transferee re-employs dismissed workers after the transfer, this will almost certainly be fatal to the claim that the initial dismissals were for an ETO reason. This is precisely what happened in *Litster v Forth Dry Dock and Engineering Co Ltd*²²⁷. The House of Lords did not expressly deal with the question of Regulation 8(2), but Lord Templeman makes the following, illuminating remark:

“It would, of course, still be open for the new owner to show that an employee had been dismissed for an “economic, technical or organisational reason entailing changes in the workforce”, but no such reason could be advanced in the present case where there

²²⁵ [1994] IRLR 325, 328.

²²⁶ See McMullen, *Business Transfers and Employee Rights*, *supra* n 121, 201.

²²⁷ [1990] 1 AC 546.

was no complaint against the workforce, they were not redundant and there were no relevant reasons entailing changes in the workforce.”²²⁸

This could be taken to mean no more than that the subsequent engagement of a new workforce by the transferee proved that the original workforce could not be realistically said to be redundant. Collins, however, reads more into Lord Templeman’s comments:

“What I think Lord Templeman must be understood to mean is that, if the transferee has the same need for a workforce as the transferor, then the *transferor* cannot have a valid economic, technical or organisational reason for dismissals in connection with the transfer, *no matter that the transferor lacks money to pay the wages, has no work to be performed, and is planning an immediate cessation of the business* ... If this robust interpretation is correct, then there seems little danger that regulation 8(2) will effectively thwart the aims of the House in *Litster*. This view confines regulation 8(2) even more strictly than *Wheeler v Patel*, for that case left open the possibility that the transferor’s shortage of funds or lack of work might count as an economic reason for dismissal.”²²⁹

With respect, in the circumstances described by Collins a tribunal could well be disposed to conclude that dismissals were unconnected with the transfer altogether, as occurred in *Longden v Ferrari*²³⁰. Nevertheless, it is inordinately difficult to predict what any given tribunal will decide in the face of evidence of some collusion between transferor and transferee. There is some force to Collins’ argument that, notwithstanding that a transferor dismisses for reasons relating to the business as carried on in his hands, if a transfer follows shortly thereafter, and dismissed workers are re-engaged, the basic TUPE principle should apply.

In conclusion, the use of ETO reasons for dismissals is a possible route to avoiding

²²⁸ [1990] 1 AC 546, 558-559.

²²⁹ *The Transfer of Undertakings and Insolvency* *supra* n 114, 153 (italics added).

²³⁰ [1994] BCC 250.

TUPE liability, but one which requires circumspection on the part of insolvency practitioners and transferees alike. In a fascinating survey into the effect of the TUPE Regulations in insolvency, Sargeant uses empirical evidence to demonstrate how little used is the device in practice, largely because of the uncertainty of its scope, and the possibility that an unwarranted reliance upon ETO reasons may backfire. He concludes that:

“The indication appears to be that the economic, technical or organisational exception has been of little help and relevance to Insolvency Practitioners.”²³¹

Unless and until receivers and transferees are prepared to test the matter in the higher courts this is likely to hold true.

²³¹ *Business Transfers and Corporate Insolvencies – The Effect of TUPE* [1998] Insol. L & P, 10.

5. TUPE and Receivership: an Evaluation

5.1 The Impact of TUPE

The above illustrates the radical effect of the TUPE Regulations on the practice of receivers and other insolvency practitioners. Notwithstanding the abundance of case law the Regulations have generated, their precise scope and application remains difficult to pin down. On the one hand, seemingly collusive dismissals may escape the operation of Regulation 5 on dubious grounds²³². On the other, apparently ‘innocent’ dismissals, effected largely because a part of the business in which the relevant employees were employed had ceased to operate, have been held to be subject to the TUPE Regulations²³³.

Much of the inconsistency in this area arises out of the difficulty in determining when the dismissals are ‘transfer-connected’ in the receivership context. In some instances tribunals are prepared to take into account the financial state of the business, in others it is simply ignored. In more still, the paucity of evidence will render the subsequent factual analysis meaningless. If nothing else, the intervention of insolvency adds a further dimension to this seemingly simple enquiry, but this has not been consistently acknowledged.

To compound the uncertainty, the scope of the ETO defence in Regulation 8(2) remains inadequately defined. On its terms, it would *prima facie* appear to furnish insolvency practitioners, and transferees from them, an opportunity to validate dismissals essential to allow a transfer to proceed, but the restrictive approach seen in *Wheeler v Patel*²³⁴ has effectively blocked this potential escape route. This is not to say that there is no justification for a narrow formulation, but rather that the concept

²³² See, e.g., *Longden v Ferrari* [1994] BCC 250.

²³³ See, e.g., *Kerry Foods Ltd v Creber* [2000] IRLR 10.

²³⁴ [1987] IRLR 211.

of an ETO reason for receivership dismissals is unsuited to a determination of the substantive merits of the case. As noted in *Wheeler* itself, if broadly interpreted it loses its force altogether. Yet the narrow construction espoused by the Employment Appeal Tribunal could be said to swing to the opposite extreme, so that, in effect, Regulation 8(2) offers an ‘all or nothing’ alternative.

The significance of the ‘TUPE dilemma’ will depend upon the circumstances of each particular case. It should be emphasised that it may adversely affect employees as much as the appointor of a receiver who receives a lesser return on a going concern sale. The super-imposition of a protective regime upon a pre-existing system of insolvency ‘priority’ is one thing, and many would argue that a redistributive outcome away from banks and towards employees is wholly desirable. Yet there is an argument that the Regulations have miscarried in spectacular fashion, their net result being to *prejudice* rather than to protect job security. This will be the case where either no purchaser can be found for the business *because* of its employment obligations *or* because insolvency practitioners are perforce effecting surplus dismissals at a very early stage of their administration in the hope of rendering a going concern sale more viable. As Deakin and Morris put it:

“Prospective imposition of [employee related] obligations may mean that the sale does not go ahead. Where that is so, employees of the transferor will lose their chance of continuing employment; this raises the possibility that the level of protection conferred by the TUPE Regulations might be counter-productive from the point of view of securing *de facto* security of employment.”²³⁵

The extent to which the Regulations have backfired is unclear. The Select Committee on the European Communities charged with investigating the viability of changes to

²³⁵ *Labour Law*, *supra* n 37, para. 5.6.5. See also Lightman & Moss, *supra* n 22, para. 19-15; Campbell and Underdown, *supra* n 220, 141.

the Acquired Rights Directive received evidence from the Society of Practitioners of Insolvency in the following terms:

“It has been well known since the *Litster* case in 1989 that the transfer of undertakings legislation is an impediment to the rescue of businesses in the context of formal insolvency and has the opposite of its intended effect of preserving employment and employees’ rights. Insolvency Practitioners can cite numerous examples of cases where the prospect of taking over accrued liabilities under employment contracts has either deterred prospective purchasers of insolvent businesses from dealing altogether, or has caused them to discount the price which they are prepared to pay.”²³⁶

It should be noted that, from the point of view of assessing the practical effect of the Regulations, there is a substantive difference between the two situations described by the SPI. In the first case, where no sale can be achieved, both employees and secured creditor ‘lose out’. The former lose their jobs, the latter receives a lesser return. The second case, on the other hand promotes employment security *at the expense of* the secured creditor. By definition, the purchaser offers less for the business *because he inherits employees*, and the appointor is the party whom, in the first instance, bears this loss. Of course, such a purchaser may effect dismissals after the transfer, and pay for them from the saving on the price of the business, so that the result is not a straightforward ‘victory’ for employees.

Non-partisan commentators are less convinced of the actual, rather than potential counter-productive effect of TUPE with regard to employees. As McMullen points out:

“...there is comparatively little empirical, as opposed to anecdotal, evidence that a more employee-orientated approach in this area would deter purchasers from purchasing, or deter employers from hiring; only when there is such evidence should there be adopted,

²³⁶ Select Committee on the European Communities, Session 1995-96, 5th Report (Minutes of Evidence).

perhaps, without reservation, the insolvency practitioners' view that it is necessary to subordinate the concept of a transfer of acquired employee rights to the exigencies of selling an ailing business."²³⁷

Interestingly, a recent empirical survey on the impact of the TUPE Regulations, conducted by way of a questionnaire to insolvency practitioners, reports a certain divergence of views amongst respondents²³⁸. In response to an enquiry as to the percentage of cases where the TUPE Regulations presented a serious obstacle to rescue, some 53% reported that this was the case in less than one quarter of situations²³⁹.

In the final analysis, it is difficult to confirm or refute claims that TUPE works to the disadvantage of employees. At the margins, there will be cases where a better price could be obtained from an asset sale, and that this will be *solely* because of the crippling liability that a transfer of employee claims would involve. Either the business will simply be unsaleable *per se*, or its value will be discounted to such an extent that more could be realised by a breakdown sale. How frequently such a scenario occurs is, on current information, impossible to say. It serves, however, to re-emphasise the point that it is only in these circumstances that both secured creditor *and* employees are prejudiced. Where 'rescue' remains possible notwithstanding TUPE, but inevitably affords a lesser return on the business, the major casualty will be the appointing debenture-holder. Employees of the transferred business are in no worse a position, and might be in a considerably better one if the transferee is prepared to continue their employment. It is to this conflict that the discussion now turns.

²³⁷ *Business Transfers and Employee Rights*, *supra* n 121, 228.

²³⁸ 'The Middlesex Survey'. See Sargeant, *Business Transfers and Corporate Insolvencies*, *supra* n 231.

²³⁹ *Ibid.* 8.

5.2 TUPE – the merits

The TUPE Regulations confront Government, commentators and practitioners alike with a stark conflict between the interests of employees and financial institutions. With respect to those who identify an ‘employee/rescue’ polemic, this is misleading. There *may* be cases where a business cannot be sold *exclusively because of the TUPE implications*, but it is suggested that such circumstances will be rare. In the majority of receiverships, where the Regulations are an issue, the contest will be a straight one between employees and the appointor for the ‘extra value’ a ‘clean’ business would otherwise represent.

At present it would appear that the former have emerged victorious. One might add that a further ‘beneficiary’ in these circumstances is the State, since, to the extent that the transferee of a business becomes responsible for employee claims, its guarantee function is relieved. This reversal of fortune is especially striking when one considers the diametrically opposite result of the pre-TUPE era, where employees of a transferred entity could seek redress *only* against the State.

Is this an acceptable resolution? It must be incontrovertible that the original focus of the Acquired Rights Directive, the preservation of rights on the transfer of a business, was justified. Clearly the transfer of a business ought not to be the occasion of a blanket ‘expropriation’ of employees in terms of their rights, and fairness demands that neither transferor nor transferee should be able to capture ‘value’ from them. On the other hand, where the transferor is insolvent and its undertaking organically incapable of supporting its workforce, one might question why its secured creditor should subsidise the employee-related costs associated with rescue. The State has accepted its guarantee function in appropriate cases, and the circumstances of many

receivership transfers appear to justify a contribution from the National Insurance Fund rather than, directly, the transferee and, indirectly, the secured creditor.

The sheer number of variables that could be taken into account renders an evaluation of the merits intricate. In the *Litster* type of case it could be cogently argued that an application of the TUPE principle is warranted. Why should the State fund tactical redundancies and, in effect, afford a shrewd transferee a windfall? At the opposite extreme, where a business is clearly in need of downsizing, and redundancies are objectively necessary *whoever* runs the business, it seems less obviously fair that the secured creditor should be forced into the shoes of the State as guarantor of redundancy and unfair dismissal payments.

In the latter circumstances it is submitted that the courts have taken a wrong turn in denying the relevance of insolvency to the TUPE equation. A better approach would be to accept that, where there is evidence showing the necessity for redundancies either pre- or post-transfer, then the Regulations do not apply. In the first case the dismissals are not effected by reason of the transfer and in the second they are effected for an ETO reason. Admittedly, this is the approach adopted by some tribunals. In *Warner v Adnet*²⁴⁰, for example, the Court of Appeal agreed that where there was evidence of the applicant's job being 'absorbed' into the transferee's existing workforce, then the ETO defence applied.

This appears unobjectionable, for to use the TUPE Regulations to entrench employees is a gratuitous extension of their innate scope. As recently stressed by the House of Lords, the Regulations do not confer a sacrosanct right to continuity of employment on a transfer²⁴¹, rather they ensure that, should transfer-related dismissals occur, liability for such is met by the transferee, subject to the

²⁴⁰ [1998] IRLR 394.

²⁴¹ *British Fuels Ltd v Baxendale; Wilson v St Helens Borough Council* [1998] 3 WLR 1071.

establishment of an ETO defence. Redundancy is a 'vicissitude of ordinary life', and it appears anomalous that, where redundancies occur in the context of transfers of undertakings, there should be a risk that liability can be shifted from an appropriate body, the State, to a secured creditor of the transferor. Such an abdication of responsibility lends credence to the claims of insolvency practitioners that the Regulations work substantial injustice in insolvency situations.

Of course, the majority of cases will fall somewhere between the two poles of 'opportunistic' and 'objectively necessary' dismissals, and this is where the real difficulty of TUPE lies. The major flaw of the Regulations, as they apply in insolvency, is that their central precept cannot operate sensibly or fairly with regard to every case. Only at the margins, and with the benefit of comprehensive factual evidence, can it be said that the rationale of the Acquired Rights Directive, to protect employees against a strategic divesting of their rights, requires or does not require the application of TUPE. The middle ground is left to the courts to address, largely because, in the past, the legislature has appeared remarkably disinclined to grasp the nettle and act as referee between employees and secured creditors²⁴². The next section addresses a recent development in this regard.

²⁴² A contest in which, as guarantor, the State has a vested interest.

6. The Amended Acquired Rights Directive

6.1 Introduction

The European Commission, in 1994, put forward a proposal to amend the Acquired Rights Directive, and issued a revised proposal in February of 1997²⁴³. The UK Government responded with a Consultation Paper issued by the Employment Rights Directorate of the DTI²⁴⁴. However, before a full Report on the amendments to the Directive could be produced, the UK's Presidency of the Council of Ministers over the first half of 1998 produced "a minor, and perhaps unexpected, consequence..."²⁴⁵, that of the adoption of the Commission's proposal. The result is a new Acquired Rights Directive²⁴⁶.

As yet no Consultation Document has been produced by the DTI. It would appear, though, that the 1998 Consultation Paper remains representative of the Government's stance on the various options relating to the transfer of insolvent businesses contained in the amended Directive. It is therefore possible to examine the provisions of Directive 98/50/EC, to predict the likely response on the part of the UK legislature, and to evaluate the likely outcome of any such action. The UK Government has until 17 July 2001 to implement the Directive.

The amended Directive acknowledges that special considerations arise where the transfer of an undertaking is to take place in circumstances of financial distress. Its preamble explicitly addresses this matter, and proposes two options, the first being to remove certain insolvency regimes from its 'umbrella' altogether:

"...with a view to ensuring the survival of insolvent undertakings, Member States should be expressly allowed not to apply Articles 3 and 4 of Directive 77/187/EEC to

²⁴³ COM (97) 60 Final, OJ C124/48, 21/4/97.

²⁴⁴ *European Acquired Rights Directive and Transfer of Undertakings (Protection of Employment) Regulations 1981 (The TUPE Regulations)*, URN 98/513, December 1997.

²⁴⁵ *Amendments to the Acquired Rights Directive* (1998) 27 ILJ 365.

²⁴⁶ 98/50/EC, 29/6/98, the text of which is produced in full at OJ L 201/88, 17/7/98.

transfers effected in the framework of liquidation proceedings, and certain derogations from that Directive's general provisions should be permitted in the case of transfers effected in the context of insolvency proceedings.”²⁴⁷

It is clear from the following paragraph that a blanket exemption for all insolvency related proceedings is not contemplated:

“...such derogations should also be allowed for one Member State which has special proceedings to promote the survival of companies declared to be in a state of economic crisis....”²⁴⁸

The provisions of the amended Directive make clear that *two* distinct sets of circumstances are envisaged, and that each will attract the operation of a separate form of derogation from the original Directive. Where an undertaking is the subject of a ‘pure’ liquidation regime, Member States have the option of disapplying the ‘automatic transfer’ principle of Articles 3 and 4 altogether. Where the business is to be continued with a view to partial or total ‘rescue’, that principle will continue to apply, but States are offered the opportunity to agree to step into the shoes of the transferee and to discharge transfer-related liabilities from State funds. These two alternatives will be considered in turn.

6.2 Article 4a(1): the ‘bankrupt’ undertaking

“1. Unless Member States provide otherwise, Articles 3 and 4 shall not apply to any transfer of an undertaking, business or part of an undertaking or business where the transferor is subject to bankruptcy proceedings or any analogous insolvency proceedings which have been instituted with a view to liquidation of the assets of the transferor and are under the supervision of a competent public authority (which may be an insolvency practitioner authorised by a competent public authority).”

²⁴⁷ Directive 98/50/EC, para. (7) to preamble.

²⁴⁸ *Ibid.* para. (8).

This Article allows that ‘pure’ liquidation proceedings do not fall within the automatic transfer principle of Article 3 of the 1977 Directive. In the UK, the question is which insolvency regimes in particular might fall within the factually narrow compass of Article 4a(1). Receivership can comfortably sit in the “analogous insolvency proceedings” category, and may be described as “instituted with a view to the liquidation of the assets of the transferor”. This surprising conclusion stems from the fact that the ‘undertaking’ of the company in receivership will almost certainly be subject to a floating charge, and that a disposition of that undertaking could be said to amount to a liquidation of an asset of the transferor. In other words, a literal construction of Article 4a(1) would allow virtually all receiverships to be exempted from the operation of Article 3, notwithstanding the jurisprudence of the European Court of Justice to opposite effect²⁴⁹.

In response to a similar provision in the original proposal for an amended Directive²⁵⁰ the Department of Trade and Industry drew attention to the complexity involved in applying this derogation:

“...It can ... see great difficulty in attempting to distinguish between different types of insolvency proceedings on the basis of their envisaged outcome. Such a distinction would be difficult to draw both in law and in practice.”²⁵¹

This is indubitably correct. The particular denomination of insolvency procedure commenced gives no clue to the likelihood of whether a simple ‘liquidation of assets’ will be the eventual outcome. Whereas a compulsory liquidation may result in a going concern sale of the company’s business in auspicious circumstances, a receivership commenced with a view to achieving the same consequence may prove unsuccessful, and the receiver will then resort to a straightforward asset sale.

²⁴⁹ See the cases at n 120 *supra*.

²⁵⁰ COM (97) 60 Final, Article 1(5).

²⁵¹ URN 98/513, para. 25.

The CBI and SPI suggested that *all* insolvency-based transfers of undertakings should be excluded from the scope of the Directive²⁵². This would solve the classification problem outlined above but would almost certainly be *ultra vires* the Directive. It did not find favour with the Government:

“The Government considers that this would give Member States undue discretion to reduce protection for employees...”²⁵³

It therefore seems unlikely that a ‘liquidation/non-liquidation’ division, with TUPE applying only to the latter, will be adopted in future, especially since it has been dismissed as unworkable by commentators and practitioners alike²⁵⁴.

6.3 Article 4a(2)(a): Transferring the transferee’s burden to the State

“Where Articles 3 and 4 apply to a transfer during insolvency proceedings which have been opened in relation to the transferor ... and provided that such proceedings are under the supervision of a competent public authority (which may be an insolvency practitioner determined by national law) a Member State may provide that:

(a) notwithstanding Article 3(1), the transferor’s debts arising from any contracts of employment or employment relationships and payable before the transfer or before the opening of insolvency proceedings shall not be transferred to the transferee, provided that such proceedings give rise, under the law of that Member State, to protection at least equivalent to that provided for in situations covered by Council Directive 80/987/EEC ... relating to protection of employees in the event of the insolvency of their employer”²⁵⁵

This option, if enacted by the UK Government, would provide an unqualified solution to the TUPE dilemma, in that it would relieve the transferee of a

²⁵² URN 98/513, para. 26.

²⁵³ *Ibid.*

²⁵⁴ See evidence presented to the House of Lords Select Committee by Professor Paul Davies and the SPI respectively, as detailed in *Business Transfers and Corporate Insolvencies*, *supra* n 241, 12; Davies, *Amendments to the Acquired Rights Directive* (1998) 27 ILJ 365, 368.

²⁵⁵ Council Directive 98/50/EC Article 4a(2).

receivership business from employment connected liabilities, thus rendering the monetary value of, and likely offer for the business much higher. It appears that Article 4a(2) contemplates the voluntary assumption by the State of *all* transfer-associated liabilities to employees. At their widest, these would include claims for unpaid wages, redundancy payments and unfair dismissal claims. A pre-condition of its adoption is that the Member State provides protection equivalent to that prescribed in Directive 80/987/EEC²⁵⁶. Davies remarks of this provision:

“The option, in effect, provides for contractual liability on the part of the transferee “for the future only”, and, in insolvency cases, it is likely to constitute a considerable incentive for transferees to take on businesses from insolvent transferors.”²⁵⁷

A similar provision appears in the Commission’s proposal for an amended Acquired Rights Directive²⁵⁸, and the Government’s view, as reported in the subsequent Consultation Paper, is ambivalent:

“The Government is, however, mindful that no relaxation of the Directive’s requirements should be made without full consideration first being given to all possible implication ... there may be implications ... for public expenditure in terms of increased numbers of insolvency payments from the National Insurance Fund.

The Government intends to consider responses to this consultation document and to carry out an assessment of the potential costs and benefits before deciding whether or not to seek amendment to the Directive ... to provide that the transferor’s outstanding debts in respect of employees do not pass to the transferee...”²⁵⁹

²⁵⁶ The ‘Insolvency’ Directive.

²⁵⁷ *Amendments to the Acquired Rights Directive*, *supra* n 254, 368 .

²⁵⁸ COM (97) 60 Final, Article 3(4).

²⁵⁹ URN 98/513, paras. 26, 27. Officials at the DTI have intimated to the author that the Government remains well disposed to this option, and that it is likely to be adopted in subsequent amendments to the TUPE Regulations.

Not surprisingly, the CBI wholeheartedly endorsed the option in their evidence to the House of Lords Select Committee²⁶⁰. Davies, on the other hand, is less than fulsome:

“However, this option is open to the criticism that it constitutes simply wealth transfer from employees to the creditors of the transferor. Relieved of debts due to employees, the business will be more valuable in the hands of the transferee and so the transferor will be able to sell it at a higher price, in all likelihood for the benefit of its secured creditors. Indeed, although the transferor may be insolvent overall, there is no requirement that the business transferred itself be insolvent to benefit from this exemption. It might be a flourishing part of the transferor’s otherwise catastrophic collection of enterprises and entirely saleable even with employees’ debts attached to it.”²⁶¹

The central question regarding Article 4a(2)(a) is whether it raises the spectre of a widescale return to the practice of effecting strategic dismissals *before* the transfer, giving rise to redundancy and unfair dismissal claims to be met by the State. Such a development would favour secured creditors, their receivers being enabled to negotiate towards a going concern sale from a much-enhanced bargaining position. The extent to which it would prejudice employees is difficult to quantify. There will be some financial disadvantage to those compelled to pursue the National Insurance Fund in that the State sets a ceiling on the amount recoverable, and does not meet compensatory awards for unfair dismissal. On the other hand, it is not inconceivable that at least *some* jobs may be saved. Purchasers of receivership businesses may be more inclined to re-employ a larger proportion of the dismissed workforce where they are assured that, should future dismissals prove necessary, such will be considerably less costly.

The real quandary raised by Article 4a(2) is that it may give rise to perverse

²⁶⁰ See Sargeant, *An Amended Acquired Rights Directive* [1998] JBL 577, 586.

²⁶¹ *Amendments to the Acquired Rights Directive*, *supra* n 254, 368.

incentives for receivers and transferees. *Litster*-type scenarios could well re-emerge as standard practice, and this is surely unacceptable. What is objectionable about the TUPE Regulations in their current form is their failure to sensibly address the distinctive problems associated with transfers of insolvent businesses. As suggested above, it is not immediately obvious that a secured creditor should be indirectly compelled to bear the cost of reimbursing employees who are, objectively, surplus to the requirements of any given business. The *raison d'être* of a State guarantee function is to address this event, and to the extent that the Regulations have relieved the National Insurance Fund at the expense of a secured creditor there is genuine cause for complaint. On the other hand, a solution that goes beyond confronting this particular issue and encourages tactical behaviour on the part of receivers and those they negotiate with is equally open to criticism.

The amended Acquired Rights Directive may itself impede the ability of those concerned with 'insolvency' related transfers to structure their transactions artificially and in a manner detrimental to employees. Article 4a(4) reads as follows:

“Member States shall take appropriate measures with a view to preventing the misuse of insolvency proceedings in such a way as to deprive employees of the rights provided for in this Directive.”²⁶²

How the draftsmen charged with implementing this provision will go about their task is an intriguing question. The Commission was clearly alert to the possibility of abuse of Article 4a(2), but the above article is ambiguous in the extreme. Would, for example, the pre-transfer dismissal and post-transfer re-engagement of employees amount to a “misuse of insolvency proceedings”? What of the situation, as in *Litster*, where the transferee engages a *new* workforce? Perhaps even more fundamentally,

²⁶² Directive 98/50/EC, Article 4a(4).

can such devices deprive employees of “rights provided for in this Directive”? As the House of Lords pointed out in *British Fuels Ltd v Baxendale*²⁶³, the rights protected by the TUPE Regulations do not include a right to employment with the transferee, although it is at least arguable that employees enjoy the ‘right’ not to be unfairly dismissed for a reason connected with the transfer.

It is suggested that what is called for is an approach that ensures that responsibility for *objectively necessary* dismissals is located with the National Insurance Fund. Such dismissals should not be restricted to those effected *before* the transfer²⁶⁴, but should encompass those made by the transferee *post-transfer*, within a given period of, perhaps, one year. Where such dismissals occur, in order that the State guarantees the dismissed employees’ claims, the party effecting them should be required to establish that the employees in question were redundant within the meaning of s 139(1) Employment Rights Act 1996.

If the ‘dismissing’ party is the transferor/receiver a refined approach to this question will be necessary, since employees of the *transferor* will inevitably be redundant within the meaning of the section²⁶⁵, but may well be employable post-transfer in the business of the *transferee*. One solution would be to enact a rebuttable presumption that, where dismissal and re-engagement occurs pre- and post-transfer respectively, those employees were not dismissed “by reason of redundancy”.

Such an approach would have the merits of addressing the core ‘mischief’ of the current regime. It is submitted that it is justifiable to expect a State contribution to ‘rescue’ where such is facilitated by the selective dismissal of surplus staff, and a compromise solution such as that suggested above would achieve precisely that

²⁶³ [1998] 3 WLR 1071.

²⁶⁴ As envisaged by Article 4a(2).

²⁶⁵ Because the employer will intend to cease carrying on the business for the purposes of which the employees were employed; s 139(1)(a)(i).

outcome without overburdening the public purse. What is perhaps ironic is that the present TUPE Regulations could have worked to this effect, had a consistent and sensible approach to Regulation 8(2) been adopted from the outset. Legislation is only rendered necessary because of the uncertainty associated with that provision. By focusing the attention of the industrial tribunals on the *objective* 'requirements of the business' post-transfer it ought to be possible to extract a principled and reasoned decision as to whether the State or the transferee is the most appropriate contributor where employees' claims are concerned.

6.3 Article 4a(2)(b): harnessing the goodwill of employees?

"...Member States may provide that:

(b) the transferor, transferee, or a person or persons exercising the transferor's functions, on the one hand, and representatives of the employees on the other hand, may agree alterations, as far as current practice permits, to employees' terms and conditions of employment designed to safeguard employment opportunities by ensuring the survival of the undertaking, business or part of the undertaking or business."²⁶⁶

This provision seems aimed at effecting a rescue through negotiation. It would appear to contemplate employees ceding some, or all of their rights in order to smooth the progress of a transfer. It would be open to an insolvency practitioner, potential purchaser of the undertaking and its employees to attempt to reach an agreement whereby the latter relinquish some of their rights in order that their employment continue in the transferred business.

The wording of the Article is remarkably obscure. Clearly, where a transferee is concerned about the level of salary paid to employees, and the employees themselves are willing to take a cut in pay so as to safeguard their jobs, the provision would

²⁶⁶ Directive 98/50/EC, Article 4a(2)(b).

permit this. Presumably, the employees' "terms and conditions of employment" would include stipulations as to redundancy entitlements, in which case it would be open to the parties to agree that these too will be sacrificed on a transfer. Other than that it is impossible to estimate the Article's scope.

Leaving aside questions of whom, on the employees' side, should be competent to conduct negotiations, the potential for confusion inherent in Article 4a(2)(b) is conspicuous. In particular, who must show that the modification of terms and conditions were "designed to safeguard employment opportunities by ensuring the survival of the undertaking", the transferor or the transferee?

It would appear that where an employee considers an agreement to be contrived there will be an opportunity to challenge it *ex post*. Nevertheless, if this provision is ever enacted, and subsequently litigated, the question of whether an alteration of terms and conditions was *designed* to safeguard employment opportunities by ensuring the survival of the undertaking will surely prove immensely troublesome to the courts and tribunals asked to decide the matter. In some circumstances it will almost certainly entail the court in question making something resembling a 'business judgment', on the issue, a possibility that has consistently been condemned in the past.

A further objection to this Article is that it leaves employees and their representatives open to pressure that might, in extreme cases, amount to coercion. Davies points out:

"...it must be remembered that an agreement deprives individual workers of legal entitlements which, in the absence of agreement, they would be able to assert. Even if the agreement is overall to the benefit of employees, some individuals may be considerably worse off as a result. The Directive makes no provision for judicial review of the fairness of an agreement arrived at."²⁶⁷

²⁶⁷*Supra* n 254, 370.

Further, there is a possibility that some employees, thinking better of their altruistic conduct *ex post*, might choose to attack any agreement on the grounds of duress²⁶⁸. Nonetheless, if appropriate safeguards are built into the provision it has some merits, not least that it will ensure transparency as between the insolvency practitioner conducting the negotiations, the potential purchaser of the business and the employees. There remains the question, however, of whether it effectively enriches secured creditors at the expense of employees.

In conclusion, it appears that an enactment of one or all of the provisions listed above may have the effect of tilting the balance back in favour of secured creditors where their receivers are inclined to attempt to sell the business as a going concern. It is to be hoped that consultation on the amended Acquired Rights Directive will finally address the troubled question of whether that balance actually needs realignment.

²⁶⁸ The possibility of a new role for the doctrine of promissory estoppel arises.

CHAPTER 5

RECEIVERSHIP, RESCUE, REFORM AND REALITY

Introduction

The preceding Chapters have attempted to describe and to analyse a 'body' of 'receivership law'. In doing so, they have sought to illustrate the effects of receivership from a variety of perspectives, including those of the company, the appointor, other secured and preferential creditors, unsecured creditors and employees of the company. At the outset, it was suggested that contractual receivership remains essentially a debt enforcement regime, and that the law surrounding it has developed very much with this 'purpose' in mind. The contractual basis of the arrangement acts as a springboard from which the courts have been able to imply 'business efficacy' terms to give effect to the debt enforcement prominence of receivership. That same contractual foundation accords the debenture-holder 'proprietary priority' which in turn bolsters his claim to dominance over third party 'stakeholders' of the company in question. The outcome is a highly efficient mode of enforcing security.

At the same time, the process of debt enforcement through receivership may have wider opportune consequences. One such derivative is a form of 'corporate rescue', whereby the whole or part of the company concerned is salvaged and left, to some extent, intact. This may be achieved by a period of successful trading which generates sufficient profits to discharge the secured debt, or, more typically, via a going concern sale of all or part of the business. As a corollary of such an outcome, it may be that jobs are preserved, either in the original, surviving enterprise or by the operation of a TUPE transfer of employment to a purchaser of the company's

business¹. To the extent that 'rescue' is effected during receivership, the institution serves more than merely the appointing debenture-holder.

Whether receivership is best viewed as enforcement or a rescue mechanism, it will have considerable bearing upon the interests of those not immediately involved in its implementation. The perceived wisdom is, and has been for some time, that receivership is a less than benign regime for all but the appointor. The legal framework is constructed generously as regards secured creditors, but, some would argue, at the expense of other corporate 'stakeholders'. In some circumstances this introduces an enforcement/rescue polemic, in others the conflict is between the secured appointor and the unsecured trade creditors. The populist vote, in both of the above engagements, would be for the 'underdog': the struggling company tipped over the edge into terminal insolvency by its pitiless bank, or the commercial innocent, supplying goods or services only to see them sequestered by a voracious floating charge holder through his rapacious receiver. However melodramatic this might sound, it probably accurately represents the opinion of a significant number of 'players' in the insolvency world, not to mention the general public.

Disenchantment is more likely to be of significance during periods of reform. In this regard, the fairness or otherwise of receivership law is very much a live issue, as the legislature has recently shown some inclination to re-examine insolvency law. The signs are that a wholesale review is imminent, and that this will be predicated on the basis that current UK insolvency procedures do not adequately promote corporate rescue. Whether receivership emerges unscathed from such an appraisal remains to be seen, although there are already indications that the current regime will be the subject of intense scrutiny in the coming months.

¹ See Chapter 4.

It is with these issues that this final Chapter is concerned. It opens with a brief synopsis of the ‘emphasis’ of receivership law, as described in previous Chapters, then moves on to consider the current climate as regards reform. The ‘rescue’ ideology that appears to be informing Government thinking will be examined, and the contribution or otherwise of receivership to this dogma assessed. Throughout the Chapter, regard will be had to ‘practice’. It is often the case that the view through an exclusively ‘legal’ lens will be unrepresentative of the whole picture. A more holistic approach will better highlight the nature of the issues involved, and empirical work is invaluable in this regard. Such work can similarly inform as to the value or otherwise of reform proposals, or at least suggest further avenues of enquiry to be explored before such proposals crystallise into statutory provisions.

1. The ‘emphasis’ of receivership law

1.1 The secured creditor’s procedural ‘monopoly’

“English law is remarkably tender towards secured creditors when it comes to enforcement of their security rights...”²

Before reviewing the substantive ‘law’ of receivership it is important to appreciate its factual eminence as regards insolvency procedures generally. Of the four ‘formal’ corporate insolvency procedures available in English law, receivership enjoys what amounts to overriding status³. A debenture-holder cannot be prevented from appointing a receiver by management tactics, such as petitioning for an

² Goode, *Proprietary Rights and Unsecured Creditors*, in *The Realm of Company Law*, Rider ed. (1998 : Kluwer International : London), 191.

³ See Armour and Frisby, *Rethinking Receivership*, (1999) ESRC Centre for Business Research, University of Cambridge Working Paper No. 159, 5

administration order⁴ or attempting to put in place a company voluntary arrangement (hereinafter 'CVA')⁵.

Administration and CVAs will frequently be debtor-led, and to the extent that they are properly perceived to be more 'rescue-oriented' regimes than is receivership⁶, the above structure unmistakably promotes enforcement over rescue. Liquidation is generally viewed as an unsecured creditors' remedy, and it too is factually demoted behind receivership. Whether a receiver is appointed before or after a liquidator, he has dominion over all charged assets⁷, leaving the liquidator a bit-part player until the receivership ends. Whether, therefore, an alternative regime would sponsor rescue or the betterment of unsecured creditors, it cannot be instigated *unless* a debenture-holder cedes his control rights, either to the appointment procedure or the charged assets.

This position is very much a harbinger to the state of affairs *during* receivership. The secured creditor's supremacy as to *how* formal insolvency should be activated is an intrinsic feature of the insolvency regime, and is sanctioned by the legislature. It is but a short step to infer a similar 'intention' or 'policy' as regards the *conduct* of receivership. Receivership 'law' was relatively well established prior to the Insolvency Act, and its perceived inequalities left very much in place⁸. It should therefore come as no surprise that the secured creditor's ascendancy as to the *mode* of enforcement should spill over into the question of how *the practice* of

⁴ The appointment of a receiver will mean that any such petition must be dismissed; Insolvency Act s 9(3) (hereinafter 'IA').

⁵ A creditors' meeting called to vote on a CVA may not approve any proposal affecting the right of a secured creditor to enforce his security, unless such a creditor consents - IA s 4(3).

⁶ A question that is examined further at p. 480.

⁷ See, e.g., *Re Crigglestone Coal Co* [1906] 1 Ch 523; *Re Potters Oils Ltd* [1986] 1 WLR 201.

⁸ With a few exceptions, most notably the imposition of personal liability in relation to contracts of employment; Chapter 4.

enforcement should be approached once a receivership appointment had taken place.

1.2 The enforcement function

The previous four Chapters have focused on those aspects of the law of receivership which directly affect the manner in which the primary function, the enforcement of the secured debt, may be accomplished. When these are scrutinised collectively, it can be seen that both statutory provisions and decided cases contribute significantly to the effectiveness of receivership in this regard. The nature of the receiver's agency is a case in point⁹. The jurisprudence in this area unmistakably reveals the bespoke quality of this agency, and departures from the doctrinal model are designed to promote the enforcement purpose. This *agency of convenience* is manifestly customised to achieve the objective of a superlative environment in which the enforcement mission can be completed.

As regards the tripartite relationship outlined in Chapter 2, the balance is clearly in favour of promoting the primary purpose of receivership. The transfer of power from the company's board to the receiver illustrates this, as does the duty of care owed by receiver to appointor in relation to the entirety of his activities. The imposition of a limited *equitable duty of diligence* owed to the company¹⁰ does not, it is submitted, represent a divergence from the general trend. It does not *require* a receiver to prefer the company's interests to those of the appointor and, unless imprecisely interpreted in future, will have no impact upon a receiver's business judgment as to whether continued trading is an appropriate course or not¹¹.

⁹ See Chapter 1.

¹⁰ *Medforth v Blake* [1999] 3 All ER 97.

¹¹ See Frisby, *Making a Silk Purse out of a Pig's Ear* (2000) 63 MLR, 413, 422.

Even the potentially detrimental effect of receivership on third parties¹² has not particularly encumbered the enforcement process. Whilst preferential creditors represent a 'drain' on the realisations attained, they only have recourse to floating charge assets and the courts have displayed no inclination to closely scrutinise the practice of locating 'productive' asset groups such as book debts in the fixed charge portion of the security. Further, it seems that a receiver is under no obligation to pay over floating charge realisations as soon as he collects them, and may, therefore, use either the assets or their proceeds in the trading process if he considers it necessary for the long-term maximisation of realisations.

Statute has eroded the right of senior chargees to enforce their security if the realisation process would be inhibited¹³, and junior chargees and guarantors are protected against 'negligence' only to the same extent as the company itself. Utility suppliers have been deprived of their ability to extract a 'priority' payment by threatening to discontinue supplies¹⁴, and administrative receivers, as office holders, are both protected and empowered by those provisions of the Insolvency Act enabling them to 'get in' the company's property¹⁵ and investigate its affairs¹⁶.

Unsecured creditors are postponed to the rights of the secured appointor as far as their monetary claims are concerned, and have no control or influence over the decision-making process. The sterility of the s 48 meeting, and any creditors' committee established under it, is evidenced by the fact that the receiver is under no obligation to consider their position in the performance of his functions. A receiver's immunity from suit for causing the company to breach pre-receivership

¹² See Chapter 3.

¹³ IA s 43.

¹⁴ IA s 233.

¹⁵ IA s 234.

¹⁶ *Ibid.* ss 235-237.

contracts further insulates both receiver and appointor, seemingly to the detriment of those contracting parties who find themselves with an unsecured damages remedy as a result of such a breach.

The lack of a moratorium on the enforcement of claims during receivership has not proved especially prejudicial to the secured appointor's position. The decision in *Lipe Ltd v Leyland DAF Ltd*¹⁷ has bolstered the position of a receiver faced with an 'awkward' retention of title creditor, as have recent developments in the law relating to the courts' equitable jurisdiction to grant relief against forfeiture¹⁸. The effect of these trends is to 'flesh out' the *de facto* moratorium that results from the receiver's dominion over the *company's* assets and to extend it to assets which do not belong to the company but which are crucial to the realisation process. Thus the debenture-holder enjoys the best of both worlds, in that his appointee, unlike an administrator, is put in place to promote his interests, yet enjoys a moratorium at least similar to that which subsists during administration.

Cumulatively, the above features of receivership law are facilitative of the enforcement process, and ostensibly to the exclusion of other legitimate interests. What is particularly conspicuous is the extent to which a receiver's freedom of action in relation to his deployment of charged assets is unconstrained by the position of parties other than his appointor. When one considers that a predominant element of receivership is the marshalling of 'value', it is clear that a premium will be placed on the ability to undertake this exercise with relative autonomy. The law has, and continues to develop a *laissez-faire* approach, so that a receiver will be unrestrained in the making of commercial decisions which, by definition, will be

¹⁷ [1993] BCC 385.

¹⁸ See *Transag Haulage Ltd v Leyland DAF Finance plc* [1994] BCC 356; *On Demand Information plc v Michael Gerson (Finance) plc*, Unreported, 31 July 2000.

informed by the welfare of the appointor. The courts have, of course, gone further: not only do they effectively deny jurisdiction over a receiver's management decisions¹⁹, but, where jurisdiction exists, it is most commonly exercised in favour of the receiver where the maximisation of realisations is at stake. Thus the enforcement function has been statutorily and judicially vindicated, to the extent that it effectively suppresses other, more inclusive initiatives where the two cannot coexist.

2. Reform initiatives: an overview

2.1 The Insolvency Service's Consultation Document

"...the principal areas of focus for the review should be:

- The further development of the rescue culture
- A reassessment of the relative rights and remedies of secured and unsecured creditors in insolvencies to include the Crown as a preferential creditor..."²⁰

In his foreword to the Insolvency Service's Review Document, The Secretary of State for Trade and Industry²¹ intimates that the concrete proposals contained therein are merely the beginning of renewed crusade towards the facilitation of corporate rescue. It is readily apparent that the fairly modest statutory reforms envisaged in the document itself will lead to further, and perhaps more ambitious programmes in the future. The Review takes an unusually expansive approach. Rather than focus on 'single issues' and their minutiae, it outlines the current law only briefly, and then poses questions to which responses are invited. It appears that

¹⁹ Except, perhaps, to the extent that *Medforth* prescribes that these should be taken with a degree of care.

²⁰ *A Review of Company Rescue and Business Reconstruction Mechanisms*, (hereinafter *The Review Document*) The Insolvency Service (1999 : The Stationery Office), para. 1(b).

²¹ The Right Honourable Stephen Byers MP.

the next step along the reform road will be informed to a significant extent by those responses²².

The Review goes on to identify its focus as follows:

“The task of this review is to explore ways in which the law and practice might be further developed in order to enable rescues to be attempted where that course will benefit those who have a stake in the company’s affairs. This means trying to ensure that companies, which are viable in the long-term, survive. In terms of creditors, this means trying to achieve higher recovery rates.”²³

The Insolvency Service’s views and proposals will be examined throughout this Chapter, but for the present the following particulars are worth noting. As far as receivership is concerned, the Review’s authors are in no doubt as to its value as an *enforcement device*:

“[Administrative receivership is] an effective way for secured creditors (holding both fixed and floating charges) to realise their security and must therefore provide some encouragement to secured lending to business.”²⁴

The idea of receivership as a *rescue mechanism* is treated rather more cautiously:

“Administrative receivership is not a collective procedure and the holder of a floating charge can initiate it at any time ... An administrative receiver owes a duty of care to his/her appointor but little in the way of obligations to others. A receiver would appear to have *little incentive to maximise returns on assets over and above those required to repay the lender and discharge the expenses of the receivership...*”²⁵

Further on, a modification to the current receivership regime is overtly canvassed:

“If collective procedures are thought to provide better outcomes for creditors generally there are a number of ways in which they might be enhanced, for example:

²² In the Foreword to the Review, the Secretary of State explicitly states that an ‘important part’ of the process is the invitation of the views of professionals and academics. Further, the pilot nature of the Review is acknowledged.

²³ *Supra* n 20, para. 3(d).

²⁴ *Ibid.* para. 6(f).

²⁵ *Ibid.* para. 6(g) (italics added).

- Removal of the right of a floating charge holder to veto an administration.
- Ensuring that the enforcement of floating charge security is by way of a court appointed receiver with wider duties to all creditors.”²⁶

Receivership, therefore, has clearly infiltrated the legislature’s consciousness, but it should be re-emphasised that the above appears to be no more than a ‘thinking aloud’ exercise, intended to provoke discussion from which further tangible proposals will follow. This is confirmed by the Second Report of the Select Committee on Trade and Industry:

“The company rescue review ... published a consultation paper in September 1999 seeking responses by 12 November 1999. The report to Ministers is now due by the end of December 1999, and Ministers have given an undertaking that a further consultation document, presumably containing specific proposals, will be published thereafter.”²⁷

A consideration of the more exploratory ideas presented by the Insolvency Service is saved for later.

2.2 The Insolvency Bill 2000

The contents of the Insolvency Bill 2000 were a *fait accompli* by the time the Review Document was prepared. For present purposes, its most significant inclusion is the introduction of a moratorium on the enforcement of rights in order to allow the directors of financially troubled companies to instigate a CVA. This initiative is by no means a novel one: it was first proposed in a 1993 Insolvency

²⁶ *Supra* n 20, para. 10(e).

²⁷ The full text of the Report (hereinafter *The Second Report*) is published at: <http://www.parliament.the-stationeryoffice.co.uk/>.

Service Consultation Paper²⁸ similarly aimed at facilitating corporate rescue, and resurfaced in 1995²⁹.

The 2000 Bill enshrines a formula whereby the directors of *small companies*³⁰ may seek the approval of a nominee for the terms of a proposed CVA with creditors. The nominee certifies as to the viability of the proposed voluntary arrangement and both sets of documents are filed with the court, activating an initial 28 day moratorium during which creditors may not take action against the company without leave of the court³¹. During this moratorium, the nominee will undertake a monitoring function and will summon meetings of the company and its creditors in order to consider and implement the proposed voluntary arrangement. The moratorium may be extended by a further two months at the behest of the creditors' meeting³².

The moratorium procedure is intended to address what is widely perceived to be a flaw in the CVA procedure, as identified in the Explanatory Notes to the Insolvency Bill 2000:

"The absence of a moratorium means that, until the arrangement is formally approved, any creditor can take legal action against the assets of the company and so jeopardise the prospects of the voluntary arrangement succeeding. The addition of an optional moratorium to this procedure will offer the management of a small company a short time within which to put a rescue plan to creditors."³³

²⁸ *Company Voluntary Arrangements and Administration Orders: A Consultative Document*, The Insolvency Service (1993 : HMSO : London). See also Milman and Mond, *Security and Corporate Rescue*, 44 for a history of the moratorium proposals.

²⁹ *Revised Proposals for a New Company Voluntary Arrangement Procedure*, The Insolvency Service (1995 : HMSO : London).

³⁰ As defined by s 247 Companies Act 1985.

³¹ See Insolvency Bill 2000, clauses 2-13. For fuller surveys of the effects of the moratorium provisions see: Steiner, *The Insolvency Bill 2000: Rescue Culture in the New Millennium*, [2000] JIBL 61; Rutstein, *Corporate Failure: A Change of Direction* [2000] JIBL, 71.

³² Insolvency Bill 2000, clauses 22-30.

³³ See also *The Review Document*, *supra* n 20, para. 6(c); Goode, *Principles of Corporate Insolvency Law*, 2nd ed (1997 : Sweet and Maxwell), 336.

It seems likely that the moratorium procedure will navigate the various legislative stages without substantial amendment.

It should be noted that a closely related initiative which appeared in the Review Document was dropped from the Bill with little ceremony. Clause 10 of an earlier draft would have given the Secretary of State power to require secured creditors to afford the company notice of their intention to appoint an administrative receiver³⁴. This innovation was designed to complement the moratorium procedure by alerting directors to the possibility of an appointment in time to allow them to pursue a more overtly rescue-inclined course. It was widely criticised in the consultation period following the publication of the Review Document, and the Select Committee on Trade and Industry recommended its exclusion from the legislation³⁵. However, whilst the proposal's opponents may have seen off the immediate threat of the imposition of a warning notice procedure, celebrations over its demise would be somewhat premature. The Select Committee does not rule out its introduction "in other legislation, following consultation and full discussion..."³⁶. Perhaps more ominously, the Secretary of State has intimated that he will be observing financial institutions closely in future, and Rutstein perceptively infers from this announcement that the warning notice procedure is in abeyance only, and may yet be resurrected³⁷.

³⁴ The 'Warning Notice Procedure'. The precise period of notice was not specified, although earlier versions, in the 1993 and 1995 Consultation Papers, *supra* nn 28 and 29, suggested 7 and 5 days notice respectively.

³⁵ *Second Report*, *supra* n 27, para. 27.

³⁶ *Ibid.*

³⁷ *Corporate Failure: A Change of Direction*, *supra* n. 31, 73-74.

3. Investigating Insolvency: A Blind Spot?

3.1 The Call for Empirical Evidence

“A radical change towards an English version of Chapter 11 should not be undertaken without (a) empirical evidence that rescueable businesses, as opposed to companies, are being lost because of defects in the present system, and (b) empirical evidence that such businesses are usually saved in the United States. It is also imperative that any shift towards Chapter 11 should not be undertaken without a detailed study of the likely effect of bank lending to companies in the future.”³⁸

In an ideal world, legal reform should proceed on the basis of ‘best information’. A ‘problem’ that requires resolution may be identified by recourse to quantitative or qualitative ‘evidence’, and the same evidence may suggest the most appropriate solution. The information gathering process may take place within a number of sources, including practitioners in the relevant field, academics, and non-practitioners who nevertheless have direct experience of the issue in question. The systems of other jurisdictions may also serve to inform the debate. By embarking upon a reforming campaign without a preceding formal or informal investigative procedure, the legislature might justifiably be accused of conjecture.

In the context of insolvency reform, the difficulty is the current dearth of pertinent empirical evidence which might direct the general policy or its detail. In giving evidence to the Select Committee in Trade and Industry, Professor Julian Franks remarks:

“The amount of empirical research available is so scanty that you’re really having to rely on what academics call *a priori* reasoning ... or your own common sense.”³⁹

³⁸ JUSTICE, *Insolvency Law: An Agenda for Reform* (JUSTICE : 1994), para. 3.3.

³⁹ *Second Report*, *supra* n 27, response to question 135. Professor Franks and Dr Oren Sussman (both of the London Business School) are currently conducting research into rescue techniques utilised by banks in relation to business customers. Details of the nature and aims of the research are included in the *Review Document* (*supra* n. 20), para. 6(j), (k).

Others have commented on the fact that 'insolvency' is a neglected area as far as research is concerned. The Second Report of the Select Committee notes the observation of the Deputy Inspector General of the Insolvency Service:

"...there's very little evidence about anything in the insolvency world. There's a marked absence of any empirical data whatsoever."⁴⁰

This is not a recent insight. The Insolvency Service's 1993 Consultation Paper acknowledges a lack of data about insolvency procedures and calls for investigation into the causes of company failure, how many applications for administration orders failed and why, and the likelihood or otherwise of supplies being available during a CVA moratorium.

Similarly, Goode records the lack of figures on dividend distributions to unsecured creditors⁴¹ and similar information on the costs of administration as compared to receivership or liquidation⁴². Muir Hunter states that nothing is known about the post-discharge outcomes of insolvency procedures⁴³. Belcher, in addressing the general topic of corporate rescue, makes the point cogently:

"A *full* assessment of the workings of the Insolvency Act 1986 would include empirical results. Tests of the levels, trends and effectiveness of rescue activity in the UK would be appropriate. Comparisons of the costs of informal and formal procedures would be helpful ... a complete lack of data means that virtually nothing empirical can be said about the effectiveness of the Insolvency Act in terms of rescuing the "right" companies ... It is still being claimed that too few companies are being rescued and further reform is necessary. With access to the right sort of data, the results of empirical research could make a significant contribution to the debate."⁴⁴

⁴⁰ *Second Report, supra* n 27 (Minutes of Evidence).

⁴¹ *Proprietary Rights and Unsecured Creditors, supra* n 2, 197.

⁴² *Principles of Corporate Insolvency Law, supra* n 33, 323.

⁴³ *The Nature and Functions of a Rescue Culture* [1999] JBL 491, 517. See also Steiner, *The Insolvency Bill 2000*, *supra* n. 31, 64; Pond, *Rescuing Insolvent Companies via Administrative Receivership - Analysis of Qualitative Survey Data* (1997 : Loughborough University Banking Centre), 4.

⁴⁴ *Corporate Rescue*, (1997 : Sweet & Maxwell), 215.

There are, however, indications that the realm of insolvency is engendering empirically based research projects, some of which will be referred to in due course. Research assignments are increasingly being commissioned by interested parties *in response to* their approximations of expected future reform initiatives (either in order to provide additional support for an anticipated proposal or to counter it)⁴⁵. This is an advance which is to be wholly welcomed and encouraged, as are the perhaps unaccustomed levels of co-operation between ‘law’ and ‘practice’. As Katz puts it:

“It is generally recognised that corporate insolvency itself is an under-researched area and, because of its economic significance and interest to funders, it is likely to be the principal area for research in the foreseeable future. It is also recognised that there should be greater communication between academia and the profession generally regarding research projects that are undertaken in order to ensure their relevancy.”⁴⁶

In this regard, as far as more enterprising reform movements are concerned, the Select Committee have made their views clear:

“While we accept that the absence of objective data on the insolvency world makes life difficult for policy makers, the solution lies to some extent in their own hands. Before Ministers bring broad and more ambitious proposals before the House in the area of insolvency law, Parliament is entitled to see the results of a more extensive study than has hitherto been embarked upon into the realities on the ground.”⁴⁷

A recognition of the importance of an understanding of ‘practice’ is, it is submitted, an imperative step towards more productive policy reforms. Fortunately, it would appear that the Insolvency Service is prepared to acknowledge and facilitate the

⁴⁵ See Goode, *supra* n 33, 36-37. For an example of this development, see the work of Katz and Mumford on investigating accountants; *infra* 509.

⁴⁶ *Researching Insolvency*, Recovery, June 1999, 28.

⁴⁷ *Second Report*, *supra* n 27, para. 18. As noted earlier, the Review Committee has commissioned Professor Franks and Dr Sussman of the London Business School to research rescue activity carried out by banks (*supra* n 39).

quest for best information before devising more intrepid proposals for a 'new breed' of insolvency law and policy.

3.2 The Practitioner's Perspective: Interviews

One means of obtaining 'best' information is to seek the views of insolvency practitioners. In order to gain an insight into 'what happens' in receivership, the author conducted nine interviews (hereinafter the Interview Survey) with insolvency practitioners between June and September 1998, and, with the kind permission of the interviewees, these will be used to illustrate how, in simple terms, insolvency 'works on the ground'. More specifically, throughout this Chapter information obtained from the interviews will be drawn on in a number of ways. It may support or rebut particular assumptions upon which the current reform proposals appear to proceed, it may clarify or inform areas of doubt in relation to receivership, or insolvency in general, and it may form the basis of predictions as to how individual legal adaptations contemplated by the Review Document will influence the behaviour of players in the insolvency field.

3.2.1 Methodology

Nine interviews were conducted over a four-month period. The interviewees are all licensed insolvency practitioners practising in the East and West Midlands, and all have experience of liquidation, receivership, administration and CVAs. Each works for one or other of the major accountancy firms in the UK, and, as such, will usually have been appointed by one of the five leading clearing banks to insolvency-related engagements.

Candidates for interview were selected by searching an online database⁴⁸. It was decided to focus on practitioners employed by large accountancy firms because these were assumed to be more likely to have widespread experience, and, further, to have been appointed by financial institutions rather than private individuals. This, it was hoped, would advance enlightenment as to banks' practices in making insolvency appointments. The geographical concentration of the enquiry is due more to logistics than inclination⁴⁹, and it is acknowledged that, in this respect, the *type* of company dealt with may be especially prevalent in and peculiar to the East and West Midlands.

However, the interviewees reported that they dealt with a wide range of industry sectors, including manufacturing, clothing, retail, distribution, and service providers⁵⁰. Each of the interviewees has experience of dealing with companies of varying 'size'. Consistently with national trends, most appointments are over 'small' companies but four of the nine had acted as insolvency practitioner in relation to enterprises of significant size in terms of turnover and number of employees.

The interviews took place at the offices of each interviewee and were recorded, being transcribed subsequently. Confidentiality was assured at all times. The interview process was informal, and the order of questions largely dictated by the manner in which the interviewees responded. 'Prompting' was kept to a minimum and 'free association' welcomed. The length of interviews accordingly varied, the shortest lasting 35 minutes, the longest two hours and forty minutes. The interviewees were, perhaps unexpectedly, unguarded in their responses, and their

⁴⁸ See <http://www.insolvency.co.uk/cgi-bin/solvent/ipsearch.pl>.

⁴⁹ Both time and funding ruled out a wider geographical focus.

⁵⁰ Ranging from nursing homes to sports clubs to abattoirs.

reaction tends to belie the common perception that insolvency practitioners are a reticent breed. All nine expressed a desire for greater understanding of the work of their profession, on the parts of Government, company directors and the public in general, but conceded that the perceived wisdom, whilst, in their own view, mistaken, was probably understandable.

3.2.2 Significance

It is acknowledged from the outset that no significant statistical claims can be made about the interview responses. The sample is extremely small and restricted to one geographical area, and provides nothing in the way of quantitative evidence. Moreover, it is manifestly 'one-sided', in that only the insolvency practitioner perspective into receivership and insolvency is investigated. In this regard, the full impact of insolvency regimes cannot be gauged from the interview data, and this Chapter does not profess to present an all-inclusive portrayal of the insolvency process. Rather, it seeks to elucidate the commonly held views of a small group of practitioners who have administered insolvent entities in order to better understand their *modus operandi* and their concerns.

Furthermore, it is not claimed that the views expressed are definitive as to the merits or otherwise of receivership as an institution or, indeed the emphasis of UK insolvency law. Alternative arguments propounded by those with an interest in or experience of insolvency regimes will be presented. It is hoped that recourse to both academic and professional opinion will allow for a better-informed evaluation of both the current law and any potential developments for the future. In this regard, the interview data is offered as a relevant source of empirical detail and illustrative of the general practice of insolvency practitioners.

It is also conceded that this Chapter poses far more questions than it purports to answer. Throughout, suggestions are made as to the kind of information (whether quantitative, qualitative or merely anecdotal) that would usefully inform the debate as to an appropriate legislative response to the call for modifications of insolvency law. In the final analysis, the Chapter is primarily a springboard for future investigative work but, it is hoped, will contribute in some small degree to a fuller appreciation of the practice and potential of receivership.

The Rescue Ideal

1. What is meant by 'corporate rescue'?

"If rescue is defined as the avoidance of distress and failure, then managing companies can be thought of as constantly and repeatedly rescuing them."⁵¹

"In my opinion the true meaning of a company rescue is the saving of an entity in whole or in part by satisfying in some measure its unsecured creditors and enabling the company to continue in business. This will also in some measure preserve employment."⁵²

The above illustrates an initial difficulty in assessing the merits or otherwise of a rescue ideology. If 'rescue' is thought to be a worthy political endeavour it is necessary to determine what the expression encompasses in terms of outcomes. 'Corporate rescue' could, in fact, denote the achievement of a variety of results along a spectrum, and three scenarios will be put forward by way of illustration, each based upon the standard case of a company experiencing financial difficulties which threaten its continued existence.

The first might be described as *pure rescue*. This term signifies a state of affairs where the *corporate enterprise* is restored to solvency and remains substantially unaltered in terms of its operations, its workforce and, perhaps most significantly, its ownership. In other words, the *company* emerges from the rescue 'endeavour' to do the same things as before, with the same staff as before, under the same management as before and owned by the same people as before⁵³.

Partial rescue is a variation of the pure rescue concept. This term is used, in the

⁵¹ Belcher, *Corporate Rescue*, supra n 44, 236.

⁵² Davis, *The rescue culture in the United Kingdom* (1997) 2 Insolvency Litigation and Practice, 3, 4.

⁵³ In the small, owner/managed company these last two would amount to the same thing. See also, on the idea of 'pure' rescue, Belcher, supra n 44, 22.

first instance, to describe a situation where the company does not emerge unscathed from the rescue attempt, but is somehow constitutionally altered by it. This may involve a 'downsizing' of its activities. It might also denote the shedding of surplus employees, or the restructuring of management. In either case, there are casualties of the rescue exercise, but the corporate entity itself remains in existence, and its residual claimants unaffected, except to the extent that they now own a smaller undertaking.

Partial rescue might also allude to a qualitatively different outcome, whereby the corporate *entity* terminates but its *enterprise* survives, albeit under new ownership. The archetypal example of this phenomenon is the going concern sale of the *business* of a financially distressed company. The business, in this context, might comprise, *inter alia*, the company's premises, its tangible assets, its intangible assets and maybe even its employees. Thus, in contrast to the earlier notion of partial rescue, here the company's *activities* continue, but the future fruits of those activities fall into different hands. The 'company' loses its *raison d'être*, the company's residual claimants their investment.

At this stage the term *corporate* rescue begins to appear inappropriate, as the corporation, far from being rescued, is eradicated. Nevertheless, it should be acknowledged that, if the *undertaking* remains in existence, a rescue of sorts has been accomplished. Indeed, the Cork Committee implicitly accepted that the rescue philosophy envisaged as desirable would admit of this kind of outcome:

"In the case of an insolvent company, 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."⁵⁴

⁵⁴ *Insolvency Law and Practice : Report of the Review Committee*, Cmnd 8558 (1982 : HMSO : London), para. 193, (hereinafter the Cork Report).

This category of partial rescue might be described as a *corporate recycling*. It is appropriately designated as rescue to the extent that a viable *enterprise or activity* is reassigned and restored to productivity and profitability by its new owner when the alternative would have been total sterility. What distinguishes this case from those of pure rescue and the earlier example of partial rescue is that whilst the first two confer some advantage on the *ex ante* owners of the corporate enterprise, the latter will usually result in their investment becoming valueless⁵⁵. As the Cork Report avers, the preservation of the corporate enterprise may be a matter of public interest and benefit, and corporate recycling therefore conforms to a public policy ideal. It assists in the redeployment of valuable assets which will, in due course, inure to the benefit of society as a whole⁵⁶, but it does so at the expense of those who, in practice, previously owned those assets. Put simply, in the first two instances described above both society and shareholders have a *long-term* vested interest in the outcome of the rescue exercise, in the latter only society gains⁵⁷.

What emerges from the above is that a precise definition of 'corporate rescue' is difficult to isolate, and opinions as to what can properly be described as such will differ. A further point is that if corporate recycling is accepted as a true rescue, the current insolvency regimes contained in the Insolvency Act 1986 are all capable of producing such. Even liquidation may involve some degree of asset transfer and consequent employment preservation, and, as will be illustrated, receivership is a corporate recycling mechanism *par excellence*.

This is interesting. It is arguably implicit in the Review Document that receivership

⁵⁵ Unless the proceeds of the sale of the business are more than sufficient to discharge the entirety of the company's debts.

⁵⁶ In Law and Economics terms, corporate recycling achieves an *efficiency gain*.

⁵⁷ Other corporate stakeholders will, of course, similarly have an interest in rescue, however defined.

is not perceived as a 'rescue vehicle', and it has been intimated that future reforms may be geared towards an erosion of its current dominance in favour of more overtly rescue-orientated regimes. Such a shift in emphasis can conveniently be described as a sponsorship of the *rescue culture*, and the Review Document in this regard sets out its stall in the following terms:

"...there is a growing sense that, in many cases, rescue or reconstruction, whether informal or moderated through formal insolvency procedures, probably benefits everyone involved with a company and its business more than a liquidation. The basis of this belief is that the "fire sales" of assets that accompany such terminal procedures as liquidation inevitably reduce the values obtained whereas creditors will, over time, receive a better return where the company survives as a "going concern"."⁵⁸

This is an extraordinarily ambiguous statement. Is a 'rescue' simply an operation that produces a better outcome for 'everyone involved with a company'? Or is the aim to endorse the survival of *the company*? And, critically, are these twin aspirations of stakeholder welfare promotion and *pure* corporate rescue compatible in the majority of cases? The next sections delve rather more deeply into the rescue ideal, and considers its merit and its ramifications in the round.

2. Nurturing a 'rescue culture'

It is easier to describe what is meant by the development of a rescue culture than it is to define a rescue outcome. Where legislative activity is concerned, a rescue culture can be fostered by a commitment to compulsive or persuasive initiatives designed to achieve a rescue outcome, however that is delineated. This does not simply involve enacting provisions to make 'rescue' easier, but also promoting

⁵⁸ *Supra* n 20, para. 3(a).

widespread recognition of the beneficial aspects of its pursuit, so that those parties who may directly or indirectly impede or assist it chose to assist.

The Review Document states the position as follows:

“The term ‘Rescue Culture’ has a variety of meanings - or at least shades of meaning - depending on who is using it and the country in which it is being used. Despite that it is evident that over the last twenty years or so many countries have enacted changes to their insolvency law in an attempt to reduce the number of businesses and companies that are liquidated. Generally this has been done in order to ameliorate the consequences of an unfettered operation of the market, e.g. where the pursuit by creditors of their own individual interests would have led to the liquidation of businesses and companies. And in particular (but not exclusively) where there are substantial implications for employment i.e. to save jobs.”⁵⁹

A rescue culture, therefore, at the very least aims to moderate the amount of corporate liquidations that might otherwise take place if the market were left to its own devices and creditors were free to pursue their individual interests. As a policy goal this is nothing new. The Insolvency Act itself was intended as a corporate rescue vehicle. It appears, however, that that Act is now considered inadequate to accomplish its aims, and that more pioneering programmes are necessary.

It is at least arguable that the Review Document represents a subtle (or, indeed, palpable) shift in emphasis for UK insolvency law. Commentators have long identified, in this regard, a debtor/creditor polemic, and it is universally recognised that the UK insolvency regime is unequivocally ‘creditor friendly’:

“United Kingdom insolvency law is ideologically a creditor-orientated regime. This orientation has been shifted slightly by the innovations now contained in the Insolvency Act 1986, but the contrast with the debtor-oriented bankruptcy code in the

⁵⁹ *Supra* n 20, para 3(a).

United States remains marked. The main objective behind most of the UK insolvency procedures is the repayment of creditors.”⁶⁰

The United States ‘Chapter 11’ system is frequently cited as the prototypical ‘debtor-friendly’ approach to insolvency law policy. It is not proposed to examine its provisions in any detail⁶¹. In contrast to the *formal* UK insolvency regimes, however, Chapter 11 envisages a ‘debtor-in-possession’ structure for reorganisation, whereby the company’s existing management remain in control of its assets and strategy during the currency of the bankruptcy procedure. This is starkly contrary to liquidations, administrations and receiverships⁶², where an insolvency practitioner ousts the company’s management. Even where a CVA is in place a nominee occupies a supervisory role at all times. Further, and again as opposed to UK law, pre-insolvency entitlements *may be* subject to modification via the “cramdown” procedure under paragraph 1129 of the Bankruptcy Code⁶³, whereby, if one class of creditors votes in favour of a debtor formulated reorganisation plan, it is open to the court to confirm that plan, notwithstanding the objections of other classes.

Nothing in the Review Document appears to contemplate a realignment of UK law with its United States counterpart. Nevertheless, to the extent that the Review Committee implicitly regards both administrations and CVAs as more rescue-orientated than receivership, and to the extent that the former are to be actively promoted, one might detect the beginnings of a creep, if not a canter, towards a more debtor-friendly ideology. Whether such must be sought by persuasion or coercion, or can be attained costlessly remains to be assessed.

⁶⁰ Belcher, *supra* n 44, 13-14.

⁶¹ The reader is directed to Westbrook, *Chapter 11 Reorganisation in the United States*, in Rajak (ed), *Insolvency law: Theory and Practice* (1991 : Sweet & Maxwell : London).

⁶² The United States has no equivalent private debt enforcement arrangement to receivership.

⁶³ See Westbrook, *supra* n 61, 351; Belcher, *supra* n 44, 18.

3. In pursuit of corporate rescue - the participants

“We must establish a culture in which troubled companies, professional advisers, creditors and Government are committed to ensuring that troubled businesses, when essentially sound, survive periods of economic downturn.”⁶⁴

When one considers the proliferation of stakeholders in a financially distressed company, the sponsorship of a rescue culture clearly entails an element of persuasion, aimed at the entire constituency, to the effect that co-operation towards the rescue goal will produce the optimal outcome for all. Stakeholders, in this context, may be ‘internal’, including the company’s owners, management and employees, or ‘external’, comprising secured, unsecured and preferential creditors and, indeed, any insolvency practitioner appointed to oversee the ‘rescue’ activity.

A distinction can also be drawn between ‘formal’ and ‘informal’ rescue procedures, the former comprising the current insolvency regimes contained in the Insolvency Act 1986⁶⁵. Informal rescue activity takes place outside of this context, and a difference between the two is the fact that informal rescue will not require the official participation of a licensed insolvency practitioner⁶⁶. Both formal and informal rescue situations will usually necessitate a co-ordinated and affirmative response from all parties involved. This might amount to positive action, such as the advancement of funds with which to mount the rescue strategy, or forbearance from embarking upon self-interested actions which could stymie such a scheme. In essence, establishing a rescue culture will, to a certain extent, oblige those espousing it to convince a wide-range of interest groups that the cause is worth supporting.

⁶⁴ *Hansard*, House of Commons, Vol. 240, 1994, Mr Stuart Bell, col. 29.

⁶⁵ I.e. CVAs, administration, administrative receivership and liquidation, although there remains room for argument as to which of these is correctly described as a rescue mechanism.

⁶⁶ Although insolvency practitioners are frequently, if ‘unofficially’, engaged heavily in informal rescue activity; *infra* 490.

3.1 External players and formal insolvency: co-operation rather than coercion

The current insolvency regimes do not *compel* creditors to positively assist in the formulation and implementation of rescue schemes, although they clearly *allow for* such to occur. Across the range of insolvency procedures the freedom of creditors to pursue their individual interests at the expense of a rescue attempt is more or less pronounced, depending upon the regime in question⁶⁷. Leaving aside liquidation, once a CVA proposal has been implemented it binds all those with notice of the creditors' meeting and entitled to vote at such⁶⁸. Approval of the proposal requires a three-quarters majority in value of creditors voting on the resolution⁶⁹. Moreover, the meeting may not approve any proposal which affects the right of a secured creditor to enforce his security, unless the secured creditor consents⁷⁰.

There is, therefore, scope for those creditors so minded to vote against the approval of a proposal. Although the 'majority rule' emanation might be thought to resemble the 'cramdown' provisions of Chapter 11, a substantive distinction between the two procedures is the fact that Chapter 11 may be filed for as of right, whereas the decision whether or not a CVA goes ahead remains, in the first instance, one for the creditors. Even after the proposal has been approved, there remains the possibility of a challenge on the grounds of unfair prejudice or procedural irregularity in relation to the creditors' or members' meeting⁷¹. The operation of a CVA depends very much on the approach of creditors (and, to a lesser extent, members), and there is no provision in the legislation for 'forcing' the issue. Even the introduction of a

⁶⁷ What follows is an outline of certain features of various insolvency regimes pertinent to the discussion. For more detail, the reader is directed to Goode, *Principles of Corporate Insolvency Law*, *supra* n 33; Pennington, *Pennington's Corporate Insolvency Law*, 2nd ed. (1997 : Butterworths : London).

⁶⁸ IA s 5(2).

⁶⁹ Insolvency Rules 1986, r. 1.19(1). The company's members also vote on the proposal, although only a 50% majority is required - r. 1.20(1).

⁷⁰ IA s 4(3).

⁷¹ IA s 6(1), (2).

moratorium, as provided for in the Insolvency Bill 2000, will not alter this feature of the CVA.

Administration can be 'blocked' by the appointment of an administrative receiver⁷², so that, initially, it is for any suitably secured creditor to determine whether an administration should ensue. Even when an order has been granted, and a moratorium is in place⁷³, it remains open to creditors to seek the leave of the court to enforce their security or to take other steps which might result in that moratorium being effectively overturned⁷⁴. The court may grant leave unconditionally, or subject to such conditions as it thinks fit, and the approach in this regard has been favourable to the applicant. In *Re Atlantic Computer Systems plc* Nicholls LJ had this to say:

"The underlying principle here is that an administration order for the benefit of unsecured creditors should not be conducted at the expense of those who have proprietary rights which they are seeking to exercise, save to the extent that this may be unavoidable and even then this will usually be acceptable only to a strictly limited extent."⁷⁵

It therefore appears that the ability of creditors to pursue their own interests is delayed rather than wholly circumscribed, notwithstanding that a rescue endeavour may be jeopardised. Again this is in contrast to the rather more 'rescue-mandatory' emphasis of Chapter 11. As Goode notes:

"It seems clear, then, that the courts in England do not regard administration in the same way as the courts in America view Chapter 11, where a cramdown is regularly imposed on secured creditors but their position is safeguarded by an allowance of interest on the value of their collateral."⁷⁶

⁷² IA s 9(3).

⁷³ *Ibid.* s 11(3)(c)(d).

⁷⁴ *Ibid.*

⁷⁵ [1992] Ch 505, 542.

⁷⁶ *Proprietary Rights and Unsecured Creditors*, *supra* n 2, 194.

Moreover, individual action within administration is countenanced by s 27 Insolvency Act 1986, which allows a creditor or member of the company to petition the court for an order on the ground of 'unfairly prejudicial conduct'. In the event, the courts have shown little inclination to make orders under s 27 in favour of the petitioning creditor or member. This is probably as a result of the restrictive approach of Millett J in *Re Charnley Davies Ltd (No 2)*⁷⁷, where he noted *per curiam* that allegations of negligence were not properly brought under s 27. Petitions have also failed in *Re Atlantic Computer Systems plc (No 1)*⁷⁸ and *MTI Trading Systems Ltd v Winter*⁷⁹. In the former the petition was dismissed on the ground that the loss in question was a result of the s 11 prohibition on the enforcement of security, and that s 27 was not intended to provide a remedy in such circumstances. In the latter the petitioning creditors found themselves in the minority when voting on a proposal to negotiate towards a sale of the company's business in conditions of complete confidentiality. Neuberger J remarked:

"It is inevitable, particularly where there are a large number of creditors, that important decisions reached at the creditors' meeting will be by majority and not always unanimous. In those circumstances there may often be creditors, sometimes a substantial body of them, who are unhappy with the decision that has been made, who feel that their interests are prejudiced, and whose interests are prejudiced by a specific decision. However, the administrators have to make commercial decisions. They may sometimes be wrong, but that does not mean that they are in any way capable of criticism."⁸⁰

This *dictum* is probably the closest one can find to a Chapter 11 creed in the administration context. In general, as evidenced by the courts' attitudes to

⁷⁷ [1990] BCLC 760.

⁷⁸ [1992] 1 All ER 476.

⁷⁹ [1998] BCC 591.

⁸⁰ *Ibid.*

applications under s 11(3)(c)(d), the scope for sovereign action within the regime remains ample. Whilst creditors may *choose* to assist, or more accurately not to impede a rescue strategy, they can rarely be constrained to do so.

This state of affairs is *a fortiori* in receivership. Whilst it was suggested earlier that a form of *de facto* moratorium exists during receivership, to the extent that the receiver attempts some form of rescue, it remains the prerogative of creditors to exercise whatever remedies appear expedient to them, without regard to the rescue. As far as obstructive and self-interested action is concerned, the routes remain open.

It will usually be the case that a rescue scheme will require not only the self-restraint of participants but also a positive contribution from them. Whichever regime is in force, there will almost certainly follow a continuation of the company's business. Given that the company's financial troubles have resulted in the onset of insolvency proceedings, it will be unlikely to have funds to hand with which to mount a trading tactic. Outside funding will be required, and the most likely sources of such are often the same parties to which money is already owed. Again, the significance of the attitudes of external participants is manifest. No bank can be forced to advance 'fighting-funds' in the pursuit of rescue, and no supplier can be required to continue supplies⁸¹. Customers may seek alternative sources of supply and employees may seek alternative employment. A rescue culture, therefore, is very much reliant upon the co-operation of the entire body of stakeholders. In the context of formal insolvency procedures, the task of fostering such will frequently fall upon the insolvency practitioner⁸². This is borne out by the comments of interviewees from the Interview Survey:

⁸¹ *Leyland DAF Ltd v Automotive Products Plc* [1993] BCC 389.

⁸² Where a CVA is in place, the onus may also fall on the company's management.

“Well, the secret of success in these situations is harnessing the goodwill of everybody ... What a good insolvency practitioner is good at is harnessing the existing support for the business ... because if we don’t keep the customers happy then we won’t have sales, so we won’t be able to keep the business trading, and that will restrict our ability to sell it as a going concern. If we don’t talk to creditors, then they won’t supply us ... so that will curtail, or even prevent us continuing to trade.”⁸³

Interviewee 6 explained the position in these terms:

“...in any case, you’re harnessing the employees’ goodwill, the suppliers’ goodwill, the customers’ goodwill, and that way you can achieve a result that sees everybody, to a degree, better off. Some of the employees will retain their jobs, some of the suppliers may get some of their money back, the customers will not be dropped in it by not having a supplier of the goods they’re after, so whilst it’s not wholly positive by any stretch of the imagination ... if you treat people fairly and reasonably ... then there’s no reason why you should fall out with people.”⁸⁴

The rescue value, therefore, will ideally be a shared one, and it will be the task of the insolvency practitioner to convince external stakeholders to subscribe to it. This is significant in two regards: first, it can be argued that insolvency practitioners are, or should be, the prime movers towards a propagation of a rescue culture. If they themselves are anything less than committed in this regard, formal insolvency procedures are unlikely to be productive of any meaningful rescue sponsorship. Secondly, given the indispensable nature of an accommodating regime, it becomes naive to perceive insolvency practitioners as mere conduits through which an insolvent estate passes. On the contrary, their role is likely to be infinitely more activist. It is not untenable to suggest that one of the essential features of a true rescue culture is an enthusiastic and skilled body of specialists called upon to

⁸³ Interviewee 1.

⁸⁴ Interviewee 3 stated that it was essential to get everybody “onside” within the first week of an insolvency appointment.

advance the rescue cause through their professional activities. Whether such a body already exists will be assessed further on.

3.2 Internal contributions to rescue

“...the best rescues and recoveries are those that are initiated by management early on, specifically by management...”⁸⁵

It is becoming increasingly recognised that, at least in the context of *informal* rescue activity, those in control of a financially distressed company have a pivotal responsibility as far as furthering the rescue cause is concerned. The onset of *formal* insolvency proceedings will often curtail the participation of the company's management. This is clearly the case in liquidation, receivership and administration: the powers and functions of the directors devolve to the insolvency practitioner, and except to the extent that he seeks their involvement they are effectively ousted. The CVA procedure, on the other hand, envisages an inclusive, if not controlling function for management, although the degree to which a supervisor of a voluntary arrangement influences its course will differ from case to case⁸⁶.

In the context of *informal* rescue, however, it is arguable that owners and managers should occupy the role of instigator. Belcher defines ‘rescue’ as “*a major intervention necessary to avert eventual failure of the company*”⁸⁷, and it can be cogently maintained that the promotion of a rescue culture entails the conscription of corporate managers as much as any other party. The necessary intervention should initially be theirs, whether this takes the form of an autonomous exploit or

⁸⁵ Delegate at the Conference on Insolvency Conference Law Reform, hosted by the Society of Practitioners of Insolvency, 5 October 1999 (hereinafter the Insolvency Conference).

⁸⁶ There is no empirical data on the approach of supervisors of CVAs. A good proportion of arrangements take place during an administration order, so the perceived wisdom that CVAs are a manifestation of the ‘debtor-in-possession’ system may be misplaced.

the quest for outside help. Of the *dramatis personae* associated with and essential to the success of the rescue culture, owners and managers are as critical as anyone else, and any attempt to enhance that culture would do well to investigate and address their failures and successes in this respect.

3.3 Informal rescue activity: an introduction

The prevalence and success of informal rescue activity is one of the most neglected themes as far as empirical data is concerned, and this is clearly a flaw that policy makers should address before formulating tangible proposals in the insolvency law realm. This section briefly introduces the main sponsors of, or impediments to, informal recovery devices. A more detailed scrutiny of the mechanics of such is left until later in the Chapter.

For present purposes, and adopting Belcher's 'major intervention to avert eventual failure' description of rescue activity, informal undertakings may clearly include those of management. A 'failing' company can be turned around by management without any outside intervention at all. This may involve the formulation of business plans, the cutting of costs, the focus on a viable 'core' business, the shedding of surplus staff or, indeed, the introduction of more proficient executives. Where management feel that independent action is beyond them, their pursuit of outside support is as much a 'rescue-minded' strategy as anything done purely internally. Who, though, of the company's external stakeholders, might be able to assist in this regard?

⁸⁷ *Corporate Rescue*, *supra* n 44, 12.

Informal rescue activity is most commonly associated with banks, and banks have long maintained that their support of the rescue culture is well-established, albeit largely unseen. In their own words:

“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.”⁸⁸

The Insolvency Review Committee cautiously endorses the general thrust of this assertion:

“A larger contribution [towards a rescue culture] may have been made by a change of approach over recent years on the part of banks, with greater attention being paid by them to the earlier identification of borrowers’ problems and support for their resolution.”⁸⁹

The insolvency profession is unequivocal in this regard:

“Outside formal insolvencies, the intensive care process rescues many businesses and saves thousands of jobs, largely as a result of the banks’ willingness to play an active part in allowing businesses to be reconstructed, rather than just cutting their losses. Contrary to the view of many business people, the banks are very reluctant to force businesses into insolvency, and will be patient and constructive if they are kept informed and presented with a viable business plan.”⁹⁰

Other, less ‘partisan’ commentators have made similar, if guarded remarks. A member of the Insolvency Law Sub-Committee of the Law Society states:

“Certainly my personal experience of banks is that they have employed what I would now call a rescue culture for some time. I think they are extremely sensitive to the public perception that they close businesses merely to try and recover their money, but the risk-taking which is involved very often in rescuing a company is, I think, alien to most banks.”⁹¹

⁸⁸ *Banks and Businesses: Working Together - A Statement of Principles* (British Bankers Association : 1997).

⁸⁹ *The Review Document*, *supra* n 20, para. 5(a).

⁹⁰ *The Ostrich’s Guide to Business Survival* (1997 : SPI), 9.

⁹¹ *Second Report*, *supra* n 27, ‘Minutes of Evidence’, question 77. See also the response of Professor Franks to question 138.

Not all observers accept that banks are 'rescue-orientated', however. Mond questions whether any current rescue-friendly approach is necessarily long-term:

"I also believe that the modification or abolition of secured creditor status will encourage banks to take a more positive attitude to business rescue. There is evidence that they are already doing this. I am not convinced that this behaviour would continue in the face of a severe downturn or recession."⁹²

Mark Phillips is even more outspoken in this regard:

"In short, in my view, the original concept of a 'rescue culture' has been, and continues to be, stifled by the insolvency professionals and the banks."⁹³

An evaluation of which of these two conflicting pictures most accurately represents the reality is saved for the next section, but it is to be noted that there is at least some evidence of a more pro-active and concurrently less confrontational approach on the part of banks.

Aside from banks, examples of other external participants facilitating informal rescue initiatives are less easy to come by. It might be thought that one class of creditor likely to respond sympathetically in such circumstances would be the Crown as preferential debtholder, and as an emanation of a State seemingly committed to the rescue ideal. Again, no empirical evidence exists as to whether the Inland Revenue and Customs and Excise are prepared to afford troubled companies leeway, but the Interview Survey suggests that such are at best ambivalent to the support of informal rescue. Some interviewees reported that, far from facilitating rescue attempts, preferential creditors were more inclined to tip defaulting companies over the edge into formal insolvency:

⁹² Milman and Mond, *Security and Corporate Rescue* (1999), 2. See also Sir Michael Grylls MP, *Insolvency Reform: Does the United Kingdom need to retain the Floating Charge?* (1994) 10 JIBL 391, 391-392.

⁹³ *The Administration Procedure and Creditors Voluntary Arrangements - The Case for Radical Reform* (1996 : Centre for Commercial Law Studies, University of London), 7.

“...I do feel that the Crown is often actually responsible for, or creates, the receivership, for they’re not always commercially minded. We have, quite frequently, situations where the company has, quite wrongly I do accept, got itself into a situation where its biggest creditor, apart from the bank, is the Customs or the Revenue. And they will approach the Customs or the Revenue for extended periods to pay, and the Customs or Revenue will on occasion give in, but more often they will say no ... If they adopt that attitude that may well be the final event that kills the business.”⁹⁴

Moreover, inconsistency of enforcement targeting may mean that the ‘wrong’ companies are being pursued:

“Time and time again you see companies with a very bad payment record getting away with murder. Companies with very good payment records, they forget one quarter, or one month’s PAYE deductions are not paid over and the Crown comes down on them like a ton of bricks. There are some companies with quite appalling payment records ... at the end of the day I have to say that they [the Crown] are not that good and not that consistent.”⁹⁵

It would further appear that preferential creditors might impede the instigation of *formal* rescue procedures. Interviewee 2 expressed some frustration in this regard:

“...government departments are undoubtedly difficult. They will often react late to proposals, they will not necessarily co-ordinate, so you might get Customs voting for a voluntary arrangement and the Inland Revenue voting against it, and you’ll often find them putting forward amendments to proposals that are totally unrealistic. We

⁹⁴ Interviewee 1. Interviewee 3 commented that an overly vigorous approach to enforcement could mean financial crisis for a company experiencing only minor cash flow problems. Interviewee 6 observed that the Crown was a more aggressive creditor than ordinary unsecured creditors, and would willingly protect its own position by seeking the winding-up of late payers, as did Interviewee 9.

⁹⁵ Interviewee 4. Interviewee 9 noted inconsistency between area offices in enforcement tactics, but considered that improvements were visible. Interviewee 7 reported a specific case of Customs and Excise agreeing to a deferred payment of VAT and then ‘forgetting’ to conduct follow-up checks, with the result that a debt of £700,000 was incurred. He also noted that arrears of three or four months (or quarters in the case of VAT) were commonly ignored.

would all appreciate it if they would standardise their response or put more time into dealing with these things than they do at the moment.”⁹⁶

He summed up his position in the following terms:

“What I would like to see from them is a more sympathetic view of rescue procedures, because they are acting against the government, to be honest, in voting against some of these proposals. All right, in fairness, some of them ought to be voted against, but when you get all the trade creditors voting for a set of proposals and then it is defeated by the Crown, it does beg the question of whether they know what they’re doing.”⁹⁷

Interviewee 6, on the other hand, felt that rescue proposals would be accepted if advanced at an appropriate point in the hierarchy:

“If you get to the right level within those organisations they are extremely commercial. They will cut a deal if they recognise that it is in their interests in the longer term. They have the power to precipitate a failure, of course. In the case of the Revenue, they tend not to like big debts rolling over into the next financial year ... On the whole, though, they’re very sensible. It’s all about getting to the right level, and usually they may have a big debt outstanding but they will be prepared to spread payment as long as you are not increasing the level of arrears going forward ... over the last five years they have been very sensible, very commercial, so long as you get to them at the right level.”

In light of the above, it is arguable that there exists no consensus between, on the one hand, the State as rescue facilitator and, on the other, the State as debt collector. It must therefore be questioned which of the two functions should concede ground.

⁹⁶ Interviewee 1 stated that, typically, the Crown’s agreement to a proposal for a voluntary arrangement was made conditional upon a return of 100p in the pound. The *Institute of Directors Business Comment (Insolvency and Corporate Recovery)* (IoD : 2000) reports the results of a survey of its members, attracting 380 responses. This notes that the Crown’s agreement to a CVA proposal is often conditional upon non-negotiable amendments to it.

⁹⁷ See also *Second Report*, *supra* n 27, response to question 26, for the very similar views of a leading banker on this subject.

Certainly the Review Committee is well aware of this dichotomy, but draws different conclusions as to the attitude of the Crown to rescue procedures:

“The revenue departments ... initiated 2223 insolvency proceedings in the year ending 31 March 1998, 17.6% of all proceedings in the period. Whilst therefore government commences a significant proportion of all insolvency proceedings (and certainly more than any other petitioner) its attitude to voluntary arrangements is likely to be positive. To an extent this is not surprising given that voluntary arrangements will usually provide for payment in full of preferential claims and must do so if unsecured creditors are to receive any money. Separate figures for CVAs show that in recent years the Inland Revenue and Customs and Excise have supported between 70% and 80% of proposals put to them.”⁹⁸

It is not immediately obvious that agreeing to a proposal that guarantees full payment is a ‘positive’ attitude, especially when one considers that others who acquiesce may well agree to accept substantially less than they are owed⁹⁹. Moreover, to the extent that the Crown rejects 20% to 30% of proposals placed before it, it must be open to the same criticisms levelled at banks, who are accused of being unaccommodating of voluntary arrangements. In other words, before the legislature considers coercive measures against secured creditors in order to prevent their impeding rescue, it ought at least to put its own house in order.

In fairness, it appears that measures to do so are already contemplated, and views are invited on the diminution or abolition of the Crown’s preferential status. The Review Document notes that such abolition would not necessarily benefit unsecured creditors or encourage them to support voluntary arrangements:

“In cases where a company had assets which were subject to a floating charge such removal would in the first-place benefit the floating charge-holder. Only if there were

⁹⁸ *The Review Document*, *supra* n 20, para. 8(c).

⁹⁹ A course which is equally open to a preferential creditor; 1A s 4(4).

sufficient funds to repay the charge-holder in full would unsecured creditors benefit at all.”¹⁰⁰

An obvious enquiry, therefore, is to what extent unsecured creditors *would* benefit if preferential status for Crown debts were abolished. The Review Document states that some £60 million to £90 million of preferential debt is recovered each year, but has no information as to how much is ‘contributed’ by secured and unsecured creditors respectively. Abolition is unlikely to prove much of an incentive to the latter to support voluntary arrangements or other rescue attempts if the fruits fall into the hands of the former, and the redistributive impact of abolition from State to bank is unlikely to be viewed as meritorious, particularly from the taxpayer’s point of view.

Moreover, abolition might have more sinister effects. The Inland Revenue and Customs and Excise have almost draconian powers of enforcement¹⁰¹. There is no reason to suppose that these would be abandoned along with the preference and so would remain available to Crown officers. According to interviewees, they are sporadically used at present, but four interviewees noted that Revenue and Customs officers are paid a bonus according to the level of debt they recover¹⁰². The existence of the preferential regime to some extent protects that payment against the event of corporate insolvency, and so officers can, quite literally, afford to be magnanimous in some circumstances. Whether, with their bonus threatened, they would simply choose to enforce more strictly prior to insolvency is at least worthy of consideration.

¹⁰⁰ *The Review Document*, *supra* n 20, para. 8(f).

¹⁰¹ See Chapter 3.

¹⁰² Interviewees 2, 4, 6 and 7.

4. Implications of a rescue culture

The foregoing sections suggest that a rescue culture is best described as a concerted attempt on the part of policy makers to advocate an inclusive and positive response to corporate distress. It may be advanced by the introduction of legislation to facilitate, in the first instance, the instigation of a rescue scheme¹⁰³ and, once the scheme is operative, to prevent its obstruction by individual and self-seeking actions¹⁰⁴. Evidently, given the thrust of the Review Document, the Government is prepared to countenance further incursions into the current balance of power that inures as between creditors and corporate debtors should responses and further consultation support such a move. It is therefore likely that the reputedly 'rescue-friendly' procedures, *viz.* administration and the CVA, may be bolstered so as to preclude even further hindrance of a rescue attempt.

It remains the case, however, that the strengthening of the *ex post* operation of either regime will not, of itself, guarantee a wider acceptance of the rescue ideal. At present a suitably secured creditor can effectively 'veto' entry into both administration and CVA processes, and, in any event, the latter is clearly dependent on the approval, by creditors *and* members, of an initial proposal. On the (speculative) assumption that future reforms might tend further towards the quasi-debtor in possession structure of the CVA, unless these involve an 'entry as of right' provision, the success of any such initiative will be determined by the extent to which its proponents can convince potential participants of its expediency.

¹⁰³ For example, the CVA with moratorium in the Insolvency Bill 2000.

¹⁰⁴ The 'binding' nature of a CVA proposal, once approved, illustrates this tendency, as does the s 11 moratorium in administration, although the extent to which it delays, rather than prevents independent action has been questioned above.

4.1 Enlightened self-interest

“However much shifting corporate bankruptcy law away from liquidation and towards reorganisation can ameliorate the costs of bankruptcy, such a change is not without its opponents. In general, such a shift is supported by managers, employees, and shareholders, but opposed by creditors. It is the latter who may lose even more money if reorganisation is unsuccessful, for reorganisations generally risk creditors’ money. Managers, shareholders, and employees, in contrast, have little left to lose. A successful reorganisation will save their jobs and investments, whereas failure can make matters no worse.”¹⁰⁵

There is, it is submitted, a risk of viewing the rescue ideal through rose-tinted spectacles. The Review Document itself could be accused of this, to the extent that it considers the accomplishment of corporate resurrection and increased returns for creditors as entirely compatible. In some circumstances, the two aims will be irreconcilable: rescue will *demand* that some, or all, creditors lose more money than they might have done through a liquidation of assets strategy. Conversely, the maximisation of recovery rates for creditors will inevitably consign the corporation to oblivion. As Belcher puts it:

“If a company finds itself in need of a major intervention to save it from failure then the process of rescue must involve a radical change in management, workforce, financing arrangements or the scope or level of its activities. This change will undoubtedly mean that a loss is incurred by someone: management, employees, shareholders, secured creditor, ordinary creditors, the government and the national economy are all possible losers.”¹⁰⁶

As far as external stakeholders are concerned, any losses they incur as a result of supporting a rescue attempt may be acceptable because they are *short-term*. Enlightened self-interest on the part of creditors may dictate a policy of tolerating

¹⁰⁵ Carruthers and Halliday, *Rescuing Business* (1998 : Clarendon Press : London) 71.

¹⁰⁶ *Corporate Rescue*, *supra* n 44, 22.

short-term loss in the hope of long-term gains. Suppliers of insolvent companies, for example, would be better off accepting less than the full amount of their debt if such a tactic will mean the continued existence of a customer for the long-term future. Loan financiers, similarly, will balance the advantage of receiving full or immediate payment against the income stream they estimate can be generated if the customer remains active.

The perceived wisdom of the workings of a CVA proposal suggest that the forgiving of debt will frequently be a feature:

“In a CVA proposals are drawn up which may involved delayed or reduced payments of debt ... creditors must usually agree to accept less than they are owed and, usually, to be repaid over a longer period of time.”¹⁰⁷

Even the strongest supporters of voluntary arrangement type agreements do not pretend that immediate full recovery is a likely result, but stress the trade-off between short- and long-term outcomes:

“...Given that creditors will not be paid 100 pence in the pound, at least in the short term, the company and the creditors will need to agree how much, and when, the creditors are willing to accept to allow the company to trade on. If the company has a viable business, then in an ideal world, creditors with full information, acting reasonably, would recognise that their interests are better served by agreeing to a reduced or deferred payment plan than by immediate liquidation.”¹⁰⁸

The difficulty in counting on an approach of enlightened self-interest when seeking to procure creditor support for a rescue scheme is that it is difficult for creditors to estimate, *ex ante*, whether such will serve them better in the long-term. In the present context, legislative attempts to foster co-operation might be enhanced by

¹⁰⁷ *The Ostrich's Guide to Business Survival*, *supra* n 90. See also Pennington, *supra* n 68, 410; *Insolvency Reform in the United Kingdom; A Revised Proposal*, Aghion, Hart and Moore, Special Paper No. 65 (LSE Financial Markets Group : January, 1995), 3.

¹⁰⁸ See Phillips, *supra* n 93, 3.

statistical evidence of the long-term outcomes of CVAs (or, indeed, administrations) which, unfortunately, does not exist. Creditors asked to postpone or forgive debt can hardly be expected to be wholly altruistic. Given that there are no figures to show how many CVAs are successfully completed, or, indeed, the eventual fate of companies emerging from CVAs, it is not unreasonable for creditors to take a less than optimistic view of their long-term trading relationship with the company in question.

Moreover, given that it will regularly be the management of a stricken company formulating a CVA proposal in the first instance, and given the incentive for them to ensure that the proposal is approved, it is not unlikely that the case for an agreement may be somewhat overstated. Indeed, what little evidence there is suggests that the temptation to ‘over-egg the pudding’ may often prove overwhelming for management. In a questionnaire survey on insolvency conducted by the Institute of Directors, this very inclination is reported:

“Some respondents commented that where they had been induced to agree to voluntary arrangements in the past, on the basis of assurances that they would receive “up to 50 pence in the pound”, they eventually received nothing. There can be perfectly good reasons why initial estimates of the amounts available for unsecured creditors prove to have been optimistic, but such incidents make a cautious approach by creditors perfectly understandable.”¹⁰⁹

On the other hand, creditors, and especially unsecured creditors, may well estimate that their prospects remain healthier than would be the case under a different insolvency regime. This introduces a further dimension into the ‘enlightened self-interest’ perspective, and envisages not so much a debtor/creditor deviation of interests, but rather a conflict of interests of creditors *inter se*. Unsecured creditors

¹⁰⁹ *Business Comment*, *supra* n 96. See also *The Review Document*, *supra* n 20, para. 6(c).

will be inclined to support a CVA proposal that offers them, say, 50 pence in the pound when, in their judgment, a receivership would only result in a recovery of 20 pence in the pound. Conversely, a secured creditor presented with a CVA proposal that offers a lesser rate of recovery than a receivership will have a strong incentive to make an immediate appointment. Given that the secured creditor has control in such circumstances, it can be seen that enlightened self-interest militates *against* rescue.

This serves to emphasise the fact that there will be occasions when stark choices have to be made. Most notably, the question arises as to whether legislative intervention should take a mandatory and potentially redistributive stance by *obliging* secured creditors to submit to a rescue attempt that is ostensibly contrary to their interests. Two further questions originate from this. Firstly, to the extent that secured creditors already *do* relinquish control rights over the choice of insolvency regimes, what factors are persuasive? Secondly, and assuming that the decision to support rescue is in most cases a good one¹¹⁰, how can such favourable conditions be produced in the majority of cases? The next section examines each in turn.

4.2 Rescue as of right: a universally appropriate response?

“Do we *want* to prevent or cure failure? Or, on the contrary, should we be aiming to *increase* the failure rate? The question has to be asked since the concept of capitalism includes Darwin’s rule of survival of the fittest. In the capitalist system the resources of society are transferred from one application to another, deemed to be more useful, by the decline and failure of companies that are not using resources usefully and by the rise and success of companies that are. If we tamper with this mechanism by

¹¹⁰ A matter to be discussed later.

reducing the number of failures, are not we going to damage the efficiency of capitalism?...What I think we should try to do ... is not to ... prevent all failures blindly, nor mindlessly to increase them, but to ... *regulate* failure.”¹¹¹

“You’ve got to remember that in most cases the things you’re dealing with, the businesses you are trying to rescue, are some of the worst businesses around, so you’re trying to flog off something that has not worked. So there’s a lot to be said for some sort of Darwinian culling of poor businesses ... I think it needs to be recognised that you can’t save everything, because not everything is worth saving ... What we can do, and I think we do it well, is to get the most out of what we’re given to work with. The law, the system, it allows us to do that.”¹¹²

Argenti’s recognition that a system that countenances failure is not necessarily flawed remains valid today. Even the rescue-orientated Review Document does not advocate a policy of ‘rescue as of right’:

“...it should be emphasised that not all companies should be or are capable of being rescued. That being so it follows that a right on the part of a company’s management to insist that a rescue be attempted, no matter what the state of the company’s affairs, would be undesirable. The failure, insolvency and liquidation of some companies and businesses are inevitable in a market economy and provide a valuable discipline on those who manage such companies and on their use of the resources within those enterprises.”¹¹³

This echoes the approach of the Cork Committee, implicit in its statement that the aims of insolvency law should be:

“...to provide means for the preservation of *viable* commercial enterprises *capable of making a useful contribution to the economic life of the country*...”¹¹⁴

¹¹¹ Argenti, *Corporate Collapse: The Causes and Symptoms*, (1976 : McGraw-Hill : London), 170.

¹¹² *Interview Survey*, interviewee 3.

¹¹³ The Review Document, *supra* n 2; para. 3(b). See also *Hansard*, House of Commons, Vol. 240, 1994, col. 33, Mr Malcolm Bruce; *The Lex Column*, Financial Times, 22 November; *Hansard*, House of Lords, 4 April 2000, col. 1248, Lord McIntosh of Haringey.

¹¹⁴ *The Cork Report*, *supra* n 55, para. 198 (italics added).

The questions arise, therefore, *which* companies should be candidates for a rescue initiative, and *who* should be called upon to determine this matter. If *viability* is taken as the benchmark in this regard, this has certain implications for those corporate managers seeking to launch a survival drive for their companies. As it will principally be a matter for a secured creditor to adjudicate on the viability question, management have to establish that their company is worth the candle. This may involve not only convincing such a creditor to refrain from making a receivership appointment but, even more critically, persuading him to advance the necessary funding to see the rescue through to a successful conclusion.

Viability, in the first instance, will mean the existence of a sound core business and sufficient assets to allow it to continue operating¹¹⁵. If the company's product is obsolete, or its market diminishing rapidly, there will be little point in 'throwing good money after bad'. If, on the other hand, the company is intrinsically capable of functioning profitably, it is universally acknowledged that any rescue effort should be commenced as early as possible. The Review Document notes that one possible reason for the perceived inadequacy of the current insolvency regime is:

"The reluctance of directors and managers to consider alerting interested parties, such as banks, or to take professional advice from, say, insolvency practitioners, at an early stage of distress."¹¹⁶

Engel and Jones make the same point in somewhat stronger terms:

"...it may be more appropriate to seek [investment in business] by promoting an environment in which business failure is avoided by earlier remedial action and not last minute desperation ..."¹¹⁷

¹¹⁵ See Belcher, *supra* n 44, 130-131.

¹¹⁶ *Supra* n 20, para. 4(a).

¹¹⁷ *Making the Enterprise Culture Happen?* [1999] *Insolvency Bulletin*, 10, 11. See also *Banks and Businesses: Working Together*, *supra* n 88, Introduction, para. 3.

The consensus appears to be that there is a point of no return¹¹⁸ for financially troubled companies, after which rescue is increasingly difficult to envisage¹¹⁹. Accordingly it appears that management should recognise the necessity to consistently monitor their company and, if signs of distress are detected, implement a rescue strategy or seek the assistance of external advice *before* corporate meltdown is reached. One might question *why* directors and owner/managers are apparently unresponsive in this regard. A number of reasons suggest themselves. The Review Document acknowledges that inaction may be inadvertent, especially in smaller, owner/managed companies where management are responsible for day-to-day operations and so may lack both the awareness of financial crisis and the proficiency to competently address it¹²⁰. Belcher identifies another possible cause of management failure in this regard:

“For a company in distress the key questions are whether those in positions of power will act ‘rationally’, especially when facing a high level of adversity ... At times of rapid change or severe adversity [managers] do not have the time, money or ability to consider all paths of action ... this could mean that their actions become ‘irrational’ or that they are rational within a narrowed axiom of rationality where the available choices are only those which are perceived or investigated.”¹²¹

Such ‘irrationality’ may manifest itself in the form of management turning a blind eye to conspicuous warning signs¹²², or a phenomenon sometimes dubbed ‘the

¹¹⁸ See Goode, *supra* n 33, 336.

¹¹⁹ See, in the context of administration orders, Goldring, *Administrations - Practical Lessons of the First Two Years* (1989) 5 *Insolvency Law and Practice*, 2. In the receivership context see Hamilton, Howcroft, Pond and Liu, *Back from the Dead - Survival Potential in Administrative Receivership*, (1997) 13 *Insolvency Law and Practice*, 78; Doyle, *Administrative Receivership: Law and Practice* (1995 : FT Law and Tax : London), 57. In general see Campbell and Underdown, *Corporate Insolvency in Practice: An Analytical Approach* (1991) PCP : London), 61. Belcher reports that Nelson’s survey of Chapter 11 cases reveals a similar trend in the United States; *Economic Implications of Attempting to Rescue Companies*, in Rajak ed, *Insolvency Law: Theory and Practice* (1993 : Sweet & Maxwell : London), 248.

¹²⁰ *Supra* n 20, para 7(a).

¹²¹ *Economic Implications of Attempting to Rescue Companies*, *supra* n 119, 240.

¹²² See *The Ostrich’s Guide to Business Survival*, *supra* n 90, 7.

sunshine factor', whereby management adopt a Micawber-like attitude to their business's financial difficulties, refusing to acknowledge the severity of the situation, or expecting it to be magically alleviated by some positive development:

"A typical remark is, 'We only need another contract like the one from Ghana...'"¹²³

The above suggest that the responsibility for the relatively low 'take-up' rate for the CVA and administration procedures lies to some degree with management. To the extent that their inability to recognise the approach of financial crisis means that the viability of their company is compromised in the interim, any attempt to enhance the rescue culture will have to address this innate tendency. The same can be said for corporate managers who *do* recognise the symptoms of impending catastrophe but choose to ignore them out of unwarranted optimism, or even to hide them from external stakeholders so as to 'protect' their company or their own positions.

There is, however, a further dimension to this argument, which suggests that the structure of formal insolvency law in the UK is *itself* responsible for deterring early action on the part of management:

"When a company hits a tough patch, directors are afraid to scrutinise management accounts, assess their customer base, address organisational issues, acknowledge corporate weaknesses or develop a rescue plan. To do so would, they imagine, require an admission of individual and collective failure...Legislation has compounded the problem. Now that directors can be held personally liable for corporate failures, there is a tendency to panic and stampede towards a swift conclusion, rather than to seek viable long-term solutions."¹²⁴

Haig particularly identifies the fear of liability for wrongful trading¹²⁵, to which one might add an understandable trepidation at the prospect of proceedings under the

¹²³ Argenti, *supra* n 114, 33.

¹²⁴ Colin Haig, *When fear proves fatal*, The Times 2, July 13 2000, 37.

¹²⁵ IA s 214.

Company Directors Disqualification Act 1986, as a deterrent to taking positive and timely steps to address fledgling financial difficulties¹²⁶. Phillips goes further:

“The fact that an administration order requires the directors to pass effective management over to a licensed insolvency practitioner has had several consequences in practice:

(1) It has reinforced the reluctance of companies to use administration orders early enough. Directors of companies which are bordering on insolvency have tended to regard administration as a last resort. That is quite contrary to the spirit and purpose of the 1986 Act...

Why, in England, do we impose an expensive system onto insolvent companies the result of which is to make directors reluctant to restructure their companies early?”¹²⁷

There is some force in the argument that fear of loss of control on the part of directors may compound their initial reluctance to address problems early. In the majority of cases, rescue endeavours will be beyond the exclusive control of management and will require outside assistance, possibly in the form of extra funding. This, in practice, will involve informing the company's major financier, usually its bank. If directors' perceptions of the approach of banks, and, indeed, insolvency practitioners, is at all negative the outcome is all too predictable:

“One reason why directors do not seek to make more use of the formal rescue mechanisms may be that they are ‘insolvency’ procedures, set out in the Insolvency Act 1986 and administered by insolvency practitioners. There is a widespread belief that an insolvency practitioner is a financial undertaker whose task is to organise the burial of the company rather than to seek its restoration to health.”¹²⁸

It appears indisputable that psychological barriers exist which result in the disinclination of corporate managers to react to warning signals. Indeed,

¹²⁶ See also *Deciding when to pull the plug*, Financial Times, 21 September 1999.

¹²⁷ *The Administration Procedure and Company Voluntary Arrangements*, *supra* n 93, 16-17.

¹²⁸ *Review Document*, *supra* n 20, para. 7(c).

the Society of Practitioners of Insolvency has recently changed its name to the Association of Business Recovery Professionals in an attempt to address this very impasse. One effective way of promoting the rescue culture may therefore be through education of management as to the criticality of seeking early advice and assistance. This, in turn, would mean disavowing them of the notion that insolvency regimes amount to no more than a means of affording their companies a decent burial. Moreover, this process of enlightenment might also attempt to encourage management to approach the company's bank in a timely fashion by broadcasting the benefits of *informal* rescue mechanisms.

A policy of inducement will, however, backfire if management approaches to banks simply afford the latter an opportunity to exercise their control in a 'rescue-hostile' manner. Two questions therefore arise. The first is as to the nature of banks' responses to management initiatives towards rescue: if directors fear that alerting banks to problems will serve only to accelerate their company's downfall, are these fears substantiated? Secondly, given that receivership has been the focus of this thesis, and given that it is at least intimated in the Review Document that future reforms may strike at the present functional dominance of receivership, to what extent will this further the rescue cause?

This latter question is critical. It incorporates an enquiry into the factual outcomes of receivership, whether such outcomes contribute to the rescue ideal, and whether modifications of insolvency law are necessary to curb 'rescue-hostile' features of receivership. It is hoped that this investigation will at the very least suggest areas of enquiry for those charged with reviewing insolvency law, and, at best, may draw concrete conclusions as to the value or otherwise of receivership to the insolvency process.

Receivership and Rescue: Initial Impressions

1. Appointment trends

The number of receivership appointments has been declining steadily since 1992, this reduction being accompanied by a fall in the number corporate insolvencies overall. More significantly, receivership appointments as a proportion of all insolvency appointments is similarly in decline. The following tables illustrate this trend¹²⁹:

Table 1. Corporate Insolvencies by Procedure

Year	Liquidation	Receivership	Administration	CVA	Total
1992	24,425	9,256	179	76	33,936
1993	20,708	5,362	112	134	26,316
1994	16,728	3,877	159	264	21,028
1995	14,536	3,226	163	372	18,297
1996	13,461	2,701	201	459	16,822
1997	12,610	1,837	196	629	15,272
1998	13,203	1,713	338	470	15,724
1999	14,280	1,618	440	475	16,813
2000 Q1	3,637	454	89	124	4,304

Table 2. Procedure as percentage of total

Year	Liquidation	Receivership	Administration	CVA	Total
1992	72.0%	27.3%	0.5%	0.2%	100%
1993	78.7%	20.4%	0.4%	0.5%	100%
1994	79.5%	18.4%	0.8%	1.3%	100%
1995	79.5%	17.6%	0.9%	2.0%	100%
1996	80.0%	16.1%	1.2%	2.7%	100%
1997	82.6%	12.0%	1.3%	4.1%	100%
1998	84.0%	10.9%	2.1%	3.0%	100%
1999	85.0%	9.6%	2.6%	2.8%	100%
2000 Q1	84.5%	10.5%	2.1%	2.9%	100%

It should be noted that there will be some degree of overlap in the above figures. In particular, many, if not the majority of, receiverships will conclude in a subsequent liquidation. Moreover, some CVAs take place within an administration order.

¹²⁹ The figures used in these tables are produced by the DTI Statistics Directorate and can be found at: <http://www2.dti.gov.uk/sd/insolv/>.

However, the tables clearly illustrate that the ‘popularity’ of receivership is on the wane, whereas the proportion of administrations and CVAs is rising, albeit modestly. The proportion of liquidations¹³⁰ appears relatively stable. Chargeholders only have a ‘veto’ over administrations and CVAs, and cannot prevent a liquidation taking place. When, therefore, liquidations are taken out of the above picture a more pronounced trend away from receivership and towards administration and CVAs can be detected:

Table 3. Receiverships, administrations and CVAs as percentage of total

Year	Receivership	Administration	CVA	Total
1992	97.3%	1.9%	0.8%	100%
1993	95.6%	2.0%	2.4%	100%
1994	90.2%	3.7%	6.1%	100%
1995	85.8%	4.3%	9.9%	100%
1996	80.4%	6.0%	13.6%	100%
1997	69.0%	7.4%	23.6%	100%
1998	67.9%	13.4%	18.7%	100%
1999	63.9%	17.4%	18.7%	100%
2000 Q1	68.1%	13.3%	18.6%	100%

The above demonstrates a dramatic increase of the number of CVAs and administrations, and, of course, a corresponding decline in the proportion of receivership appointments. The precise significance of this table is difficult to gauge, largely owing to a number of unknown factors. For example, the figures do not include information as to the existence of a secured creditor able to veto an administration order or CVA. However, it is a reasonable assumption that such a creditor could have exercised that power in a large proportion of cases. This would seem to suggest, therefore, that chargeholders are becoming more inclined to refrain from making receivership appointments in favour of administration and/or a CVA.

Does this trend support the banks’ insistence that they are active proponents of the

¹³⁰ The figures include both creditors’ voluntary liquidations and compulsory liquidations.

rescue culture or not? It could be argued that receivership still holds dominion, given that appointments outnumber the cumulative administration and CVA figures by two to one, and that this hardly demonstrates a commitment to rescue. On the other hand, such an assertion assumes that receivership itself is not correctly categorised as a rescue mechanism, a point which is to be explored further on. A more fruitful enquiry is *why* it appears that secured creditors are displaying a certain forbearance when presented with the opportunity to control the course of a troubled company.

2. Towards the most productive solution: the attitude of the banks

“...if the customer puts forward a sensible plan, or a CVA that the bank thinks has a chance of working, then they’ll support it. They aren’t going to pull out of customers of any size if they think there is an alternative ... So if you’ve got a decent business with honest management, then the bank will be looking for a solution that avoids insolvency ... the banks have always had that mindset and if they can preserve the business then they will.”¹³¹

“If a business needs some kind of temporary protection from its creditors, so that it can restructure itself for the future, then that’s when we should be using the administration process or a company voluntary arrangement, and it’s only when those options aren’t really available that you look at receivership...”¹³²

Banks have long maintained that they do not arbitrarily exercise their veto over administrations and CVAs, and the above tables provide some support for that assertion. Much of the commentary on banks’ approaches is, however, somewhat

¹³¹ The Interview Survey, interviewee 6.

¹³² *Ibid.* interviewee 2.

‘partisan’. The Overview of the Conference on Insolvency Law Reform reports that:

“The majority of those present did not consider the veto to be a problem for the rescue culture and that, in practice, secured creditors needed to use the veto rarely. In particular it was noted that the clearing banks adopted a responsible attitude that produced a balanced response to a company’s difficulties.”¹³³

‘Those present’ included a number of bankers, a larger number of insolvency practitioners, and a few lawyers. Bankers will, it may be contended, defend themselves against an accusation of being hostile to rescue with an all too predictable response that they are not¹³⁴. Thus the collective assurance of banks that “We will add our support to a rescue proposition which we believe will succeed”¹³⁵ might be viewed with some scepticism.

The objectivity of insolvency practitioners in this regard might also be questioned on the ground that banks are the main ‘consumer’ of their services and that this promotes a certain allegiance between the two. However, it is not altogether tenable to suggest that insolvency practitioners have any ‘vested interest’ in corroborating banks’ claims to be rescue-friendly actors. Given that they enjoy a legally prescribed monopoly in relation to appointment to formal insolvency procedures, and, as will be illustrated, a *de facto* monopoly as regards informal mechanisms, it is not as though banks can take their custom elsewhere.

A degree of independent support for the banks’ declarations in this regard can be found. The Second Report of the Select Committee on Trade and Industry appears

¹³³ *Insolvency Conference*, *supra* n 85.

¹³⁴ The immortal retort of Miss Mandy Rice-Davies during a certain criminal trial of the 1960s springs immediately to mind.

¹³⁵ *Banks and Businesses Working Together*, *supra* n 88, Principle 9.

to accept them¹³⁶, and the Confederation of British Industry, in a Memorandum submitted to the Committee, made the following comment:

“Our collective practical experience is that the appointment of an administrative receiver is, as a general proposition, the last thing a debenture-holder does. In the overwhelming mass of cases (particularly those involving banks as debenture-holders), the decision to appoint administrative receivers comes at the end of a long dialogue concerning the company’s prospects of survival.”¹³⁷

It remains the case, however, that others continue to question the banks’ commitment to rescue. Davis categorically denies the existence of a rescue culture in the UK, and lays the blame squarely with the existence of the floating charge and the control rights it affords its holder¹³⁸. Goode makes the following observation:

“By far the largest obstacle to rescue and reorganisation for the benefit of the general body of creditors is the free rein given to administrative receivership ... It is this factor above all which is responsible for the limited use of administration and CVAs.”¹³⁹

Whoever is nearest the truth in this regard, an essential question remains as to whether it is in the overall interests of all concerned for the promotion of the rescue culture to manifest itself in endeavours to encourage the use of CVAs and administrations over receivership. It seems clear that, while the chargeholder’s veto remains, there will be occasions when it will be thought appropriate to exercise it. In other words, a judgment may have to be made as to whether the current system, which places decision-making entitlement in the hands of secured creditors, should be altered. The following attempts to inform that fundamental debate.

¹³⁶ *Supra* n 27, para. 27.

¹³⁷ *Ibid.* Memorandum submitted by the Confederation of British Industry, para. 2.

¹³⁸ *The rescue culture in the United Kingdom, supra* n 52, 3-4.

¹³⁹ *Principles of Corporate Insolvency Law, supra* n 33, 337.

3. Procedural outcomes: some comparisons

There is very little information in circulation as to the outcomes of either formal insolvency procedures or informal rescue attempts. In order to measure the efficacy of the different processes as against each other it would be extremely helpful to have recourse to detailed figures showing, for example, recovery rates for different types of creditor, number of jobs saved, and costs of the procedure employed. These are but a few relevant factors in the quest for a conclusive determination of the 'best' rescue regime, and, unfortunately, they remain largely inaccessible.

One valuable source of 'insolvency information' is produced by the Society of Practitioners of Insolvency¹⁴⁰. For the past eight years it has published the results of a questionnaire survey carried out amongst its members and reflecting the results of their activities. The most recent survey, the eighth¹⁴¹, is based on the work of its members during July 1997 to June 1998, and a number of its findings will be briefly noted here.

The Eighth Survey attracted 996 returns, representing 6% of all recorded cases and 7.5% of all practitioners¹⁴², and is presented as a statistically representative sample. Confines of space preclude a full consideration of its findings. Instead it is proposed to focus on a few 'highlights' that are particularly germane to the emphasis of this Chapter, viz. the place of receivership within the rescue culture. In particular, a limited comparison of the 'success' of receivership as an insolvency regime with that of the CVA and administration procedures can be made.

¹⁴⁰ Now the Association of Business Recovery Professionals.

¹⁴¹ *Eighth SPI Survey of Company Insolvency*, (1999 : SPI : London), hereinafter the Eighth Survey.

¹⁴² *Ibid.*, 2.

3.1 Returns to creditors

Success, in this regard, could be demonstrated in a variety of ways. One of the most obvious is the level of returns to creditors. Given that the decision as to which insolvency regime will operate frequently lies with a secured creditor, one would expect such a creditor to prefer the regime most likely to result in the best returns to him. The Eighth Survey comprises a sample of 22 administrations, 30 CVAs, 137 receiverships, 50 compulsory liquidations and 632 creditors' voluntary liquidations (CVLs)¹⁴³. These figures, in proportionate terms, correspond roughly with those shown in Tables 2 and 3 above. The vast majority of companies comprising the sample were at the smaller end of the market, some 80% having a turnover of less than £1.5 million, and 89% of less than £5 million¹⁴⁴. Indeed, 73% of all receiverships occurred in companies with a turnover of less than £5m, as did 93% of all CVAs (figures for administrations are not given).

From this sample, some startling outcomes emerge. It is stated that:

“Secured creditors get all their money back in 23% of CVLs and 19% of receiverships compared with 44% of administrations and 80% of CVAs.”¹⁴⁵

However, secured creditors receive zero returns in only 9% of receiverships, as compared to 58% of CVLs and 22% of administrations, a zero return for CVAs being described as “very rare”¹⁴⁶. The pattern of *overall* returns to creditors is perhaps even more surprising. Receivership discharged 36.7% of total liabilities, administration 31.9%, CVAs 40.9% and liquidation 12.6%¹⁴⁷. It is also stated that

¹⁴³ *Eighth Survey, supra* n 141, 2.

¹⁴⁴ *Ibid.*, 7.

¹⁴⁵ *Ibid.* 4 (italics added)

¹⁴⁶ *Ibid.*

¹⁴⁷ *Ibid.* 17.

the average return to unsecured creditors from a CVA was 43%, with 25% from an administration¹⁴⁸.

Prima facie, then, it would appear that the CVA regime outperforms all others in the recovery stakes, and especially as far as secured creditors are concerned. What is perhaps most unexpected is the low percentage of receiverships that result in 100% returns for secured creditors (19%), the significance of which will be assessed further on. It is not clear from the Survey how many receivership appointments were used to ‘block’ proposed CVAs or administrations¹⁴⁹, so it is difficult to comment on the wisdom of secured creditors’ decisions as to which procedure would best serve their interests.

3.2 Outcomes for owners and employees

The Eighth Survey refers, perhaps confusingly, to ‘company preservation’ outcomes, which appears to encompass both ‘company’ and ‘business’ survival. In other words, preservation seems to include the recycling of the company’s business via the going concern sale route. Again the CVA procedure is most successful, with a “positive outcome” being reported in 63% of cases¹⁵⁰. Receivership similarly functioned respectably in this regard, with such an outcome being achieved in 53% of cases, as compared to 41% for administration¹⁵¹. The survival of the company itself, which would leave its *ownership* unchanged, was only achieved in 17% of all “positive outcome” cases¹⁵². Complete and partial going concern sales accounted

¹⁴⁸ *Eighth Survey, supra* n 141, 17.

¹⁴⁹ It was reported that banks resisted proposals to settle *outside of formal insolvency procedures*, which would not, of course, include CVA proposals, in only 3% of cases; *Ibid.* 18.

¹⁵⁰ *Ibid.* 14.

¹⁵¹ *Ibid.* 14-15.

¹⁵² *Ibid.*

for 44% and 38% respectively¹⁵³. However, positive outcomes occurred overall in only 20% of cases, with a break-up rate of 77%, and it is noted that such were much less likely in smaller companies.

Employment preservation is apparently becoming more difficult, with an overall figure of 29% of jobs being 'saved'. Interestingly, the star turn in this area is administration, in which a 44% employment preservation rate is reported, as compared to 37% for CVAs, 31% for receivership and 11% for CVLs¹⁵⁴.

3.3 Informal 'rescue' activities

The Eighth Survey is the first to include questions on informal procedures, which it refers to as "turnaround activities". Altogether 76 cases of this nature were considered. Whereas small companies dominate the CVA and receivership procedures, turnaround activities are spread across a range of company 'sizes', with 39% taking place within companies with a turnover of £5m or more. The most common turnaround 'techniques' are debt restructuring, cost reduction and improved financial controls¹⁵⁵. Of the 76 cases reported, 63.2% had succeeded or were still ongoing, with the remaining 36.8% ending in the commencement of a formal insolvency procedure¹⁵⁶. Where the project had failed, this was frequently attributed to either management inadequacy or the unavailability of extra finance (because of insufficient collateral)¹⁵⁷.

¹⁵³ *Ibid.* Breakdowns of the ratios of going concern sales to company survivals for each regime are not provided.

¹⁵⁴ *Eighth Survey*, *supra* n 141, 16.

¹⁵⁵ *Ibid.* 12

¹⁵⁶ *Ibid.*

¹⁵⁷ *Ibid.*

3.4 Gaps in the information

A consideration of the above figures invites an intuitive response to the effect that of all the *formal* options available in the event of financial distress, the CVA stands out as superlative. It appears to provide the best returns to creditors, an acceptable rate of employment preservation, and it performs well as far as saving the company or the business is concerned. Receivership fares poorly in comparison, so one might question the wisdom of secured creditors who choose to veto what appears to be a more fertile regime. However, it is unfortunately difficult to draw any positive conclusions as to the success of the various rescue regimes from an examination of the Survey itself, and this is in no way due to any deficiency in its methodology. It serves a valuable function as an indicator of trends, and does not claim to be of any use as a tool with which to make comparative evaluations of both formal and informal activities.

It would nevertheless be valuable to have access to information detailing the following:

- a) in what proportion of cases were CVA proposals or petitions for administration orders 'blocked' by the appointment of an administrative receiver;
- b) in what proportion of receivership, administration and CVA procedures respectively does the *company*, as opposed to its business, survive, whether in its original or a reduced form;
- c) what are the *long-term, post-discharge outcomes* for each procedure, i.e., what proportion of surviving businesses continue to operate for more than a year after the insolvency practitioner's discharge?

Overall the Eighth Survey appears to suggest that receivership is a less than optimal regime, and that those in a position to appoint a receiver might be better advised to

consider other, seemingly more prolific procedures, most notably the CVA. This appears to provide some empirical support for the Insolvency Review Committee's apparent appetite for measures that might increase the use of the CVA. It is therefore necessary to go behind the Eighth Survey results to examine whether or not receivership is quite as unsatisfactory as first impressions suggest.

Receivership and Rescue - A Fuller Picture

1. The Independent Business Review: informal rescue or receivership route?

“And really, one of the main tasks of the investigating accountant is to build a bridge between the bank and the company's management, to get everybody thinking in the same way, towards the logical conclusion in the circumstances, which may or may not be receivership.”¹⁵⁸

“The small business community has argued that a large number of them are unnecessarily placed into receivership ... When, due to recession and/or seasonality of cash flows, they fall behind in repayments, the banks usually appoint a reporting accountant to compile a report. If the reporting accountants conclude that the business does not have deep financial problems, they only receive a one-off fee payment. On the other hand, if the reporting accountants take a pessimistic view and recommend receivership, they can collect fees for many years.”¹⁵⁹

A receivership appointment will invariably represent the culmination of a period of monitoring, investigation and negotiation on the part of both bank and company. One element of this process is the Independent Business Review (IBR). This fascinating, if hitherto somewhat arcane phenomenon, is currently beginning to attract the attention of those with an interest in insolvency. Depending upon one's

¹⁵⁸ The Interview Survey, interviewee 4.

¹⁵⁹ *Insolvent Abuse: Regulating the Insolvency Industry*, Cousins, Mitchell, Sikka, Cooper and Arnold (2000 : Association for Accountancy & Business Affairs : Basildon).

perspective, it can be described as a valuable form of 'intensive care' strategy and an integral feature of the informal rescue or turnaround catalogue, or a deeply offensive and destructive tactic employed by insolvency practitioners to line their own pockets. A 'neutral' account of the process is as follows:

"...it has long been the practice of the banks to institute an investigation by an independent accountant when a customer is thought to be in financial difficulty. This will often involve an insolvency practitioner, perhaps in an advisory capacity as a member of the investigating team, particularly when it appears that a formal insolvency procedure will be one of the outcomes under consideration."¹⁶⁰

1.1 Instigating an IBR

It is trite to state that banks monitor their customers' financial circumstances. Provision for such monitoring will usually take the form of an obligation on the part of a corporate customer to provide regular information to the bank on its financial state and to comply with certain financial ratios¹⁶¹. A loan agreement may also entitle the lender to appoint an 'investigating accountant' to conduct an IBR¹⁶²:

"What usually happens is that if the company is in any way in breach of their agreement, say an overdraft facility or loan agreement, which will have some covenants in it, then if these are breached the bank would then be contractually entitled to appoint an investigating accountant. But even if the company hasn't breached any of those covenants, the bank can still ask, if it thinks that that's appropriate in the circumstances."¹⁶³

¹⁶⁰ Katz and Mumford, *Should investigating accountants be allowed to become receivers?* (1999 : ICAEW/Centre for Business Performance : London), 4.

¹⁶¹ For a general description of loan covenants see Day and Taylor, *Evidence on the Practices of UK Bankers in Contracting for Medium-Term Debt*, (1995) 9 JIBL 394. See also *Banks and Businesses: Working Together*, *supra* n 89, Principle 4

¹⁶² The term is of recent vintage, and is probably less ominous than its predecessor 'Investigative Report'.

¹⁶³ Interviewee Survey, interviewee 6. See also *Banks and Businesses: Working Together*, *supra* n 89, Principle 6; Pond, *supra* n 43, 6-7; Campbell and Underdown, *supra* n 119, 74.

Financial covenants are a common form of monitoring, but, equally, banks may be alerted to the possibility of danger by company requests for extended facilities or the simple event of default in the repayment schedule. Interviewees in the Interview Survey pointed out that banks' monitoring programmes have progressed since the recession of the early 1990s, and as a result of their substantial losses in that period:

“...they are...getting quite sophisticated in the monitoring process. They have computer programmes, and they can put in various bits of information on, say, how the bank account has moved, its profitability, their own assessment of management, and the programme will give out a risk factor...”¹⁶⁴

Should the bank's monitoring activities disclose disquieting indicators of future (or present) financial concern it may be considered advisable to request that an IBR be carried out. There is no legal requirement that such be conducted by a licensed insolvency practitioner, but where it is instigated by one of the major clearing banks the practice is almost invariably to use such a practitioner¹⁶⁵. Notwithstanding that the bank may be contractually entitled to demand an IBR, there may be a considerable temporal gap between the initial overtures and an appointment being made. This is in some part due to the reluctance of corporate owners and managers to subject their companies to the ‘ordeal’.

The disinclination of directors to take any steps which might eventually result in their losing corporate control has been referred to earlier, and in the context of the IBR process, the Interview Survey suggests that it is equally prevalent. A review will almost always be the result of intervention by the bank, even where the

¹⁶⁴ *The Interview Survey*, interviewee 3. This interviewee also pointed out that the systems were only as good as the information that was inputted, and that they could therefore be vulnerable to ‘fudged’ management information. Interviewees 1, 5, 6 and 7 also commented on the greater efficiency of monitoring procedures used by banks.

¹⁶⁵ Interviewees 5 and 7.

company's directors are aware of its precarious state. This is particularly conspicuous amongst small, owner/managed businesses:

"I've been doing this job now for seventeen or eighteen years, and in that time I can only think of a couple of occasions when directors have put their hands up and said, 'Can we come and see you for specific advice on how to turn things round?' ... It's funny to me that ... if you go to the larger, international companies they bring in advisers all the time to help them ... and yet you have this sector of the marketplace, the middle market, the small, owner/managed business, who will frequently avoid bringing in people to help them."¹⁶⁶

Interviewees considered that this tendency is not so much due to 'fear', but rather arises from a particular 'culture' prevalent amongst, especially, owner/managers:

"...[they] are probably more blinkered ... you have this 'leave it all to me' ethic in the owner/managed business, because it's *their* livelihood, so their focus is entirely different. They're probably more autocratic, less likely to take advice ... unfortunately it's a feature of small businesses that works to their disadvantage."¹⁶⁷

Interviewee 3 remarked:

"You see, people who are running their own businesses, they're generally fiercely independent people, they're quite proud people, and they're often convinced that their business is absolutely unique ... I think they regard us as just number-crunchers who don't understand industry..."¹⁶⁸

The preliminary stage of an IBR is therefore likely to be an approach by the company's bank, rather than its management. Once made, such an advance is often robustly resisted, again as a result of this attitude of autonomy, and, it appears, a

¹⁶⁶ Interviewee 1, Interviewees 3 and 4 confirmed that it was almost unheard of for advice to be sought by managers of small companies, 'Family' businesses were almost unanimously considered to be the most insular in this regard.

¹⁶⁷ Interviewee 5.

¹⁶⁸ Interviewee 4 reported that owner/managers frequently considered the suggestion that external advice might be valuable an insult to their own abilities.

preconception that the appointment of an investigating accountant is a harbinger of doom:

“It’s almost as though they would rather have sharp implements poked in their eyes than a bank’s investigating accountant come in. Perhaps that is because of the baggage people carry around with them, if that’s the right way of describing it, they just assume that there’s going to be a receivership.”¹⁶⁹

The same interviewee commented that opposition to an IBR would frequently delay an appointment, and that, in this regard, the banks were also guilty of procrastination:

“...they’ve been dealing with Mr X and his son for goodness knows how long, they haven’t put any pressure on them over the years, even when their performance has been declining, and it becomes difficult for them. There is a loyalty factor that affects banks, they feel some loyalty towards that customer, and so they may let things go on a bit further than they should...”

He illustrated this with the specific case of a bank spending two years trying to persuade the owners of a family business to undergo an IBR, during which time the company’s fortunes declined to the tune of £200,000. Moreover, banks were similarly subject to rather more pragmatic pressures:

“...when the market place is buoyant the threat of an investigating accountant is not managed quite as well as it could be. The customer can re-bank, so what the bank doesn’t want is to lose a relationship and the income from that relationship when they may not be as concerned about problems as the customer’s welfare at that stage, and they may feel that they’re adequately covered by lots of security. So what they’ll do is they’ll hold their hand in the short term until the situation becomes so serious that they might be at risk ...That, I think, is still a delicate balance. Initially they’ll tend to take a more softly softly approach, but when they get really worried they won’t stand any messing about. But by then that means that six or twelve months ago they *should* have

¹⁶⁹ Interviewee 6.

had somebody look at the business for the benefit of the *customer*, because at that stage he would have been at less risk of failure because his business was in a better condition.”¹⁷⁰

It appears, therefore, that the call for earlier action on the part of management to avert failure might also be directed at bankers. This, of course, in the context of the IBR process, assumes that such an investigation can correctly be described as a rescue-friendly exercise. The next section examines this idea further.

1.2 The focus of the IBR and the Investigating Accountant's Report

Given that a bank will usually commission an IBR, the focus of the investigation, leading to the preparation of a report, will usually be dictated by the bank's requirements¹⁷¹. Most commonly, the appointee will be asked to look into various aspects of the company's operations in order to make an assessment as to its viability:

“The terms of reference tend to be quite wide, but the basis is that we look at the viability of the business, what does it do, what sort of market is it in, what are its products like, what is its management like, and so on.”¹⁷²

Interviewee 9 stressed the importance of determining from the outset the client bank's particular needs:

“The key thing is to make sure that the banks give you instructions as to exactly what they want ... They have a lot of information, and if they instruct you to look at a particular area which is giving them concern that can often be beneficial compared to giving you a very broad brush, where you're asked to look at virtually everything and a report two inches thick comes back and costs quite a lot of money ... the key to the

¹⁷⁰ Interviewee 6. Interviewees 3 and 7 mentioned the reluctance of some branch managers to initiate steps towards an IBR as this would somehow impugn their own lending decisions.

¹⁷¹ For a comprehensive account of the process see Doyle, *supra* n 119, 41-46.

¹⁷² Interviewee 7. See also Doyle, *supra* n 119, 43; Pond, *supra* n 43, 6.

report is to identify the areas that are of concern to the bank and to the company of course.”

The best reviews are those carried out in collaboration with the bank, the company’s management and, in some cases, its employees:

“...you attempt to develop a consultancy with the bank and management whereby you try to get to the aspects of the business that are failing, for example, markets, management, products and processes ...”¹⁷³

Indeed, managers are well advised to participate in the information gathering process¹⁷⁴, in order to demonstrate their own acumen and their willingness to co-operate towards a mutually beneficial outcome. The BBA’s Statement of Principles also emphasises the two-way nature of the process, and makes a commitment to a ‘partnership’ ethos:

“If we ask for an independent review, we will explain our requirements to you and discuss the terms of reference, who should conduct the review and the nature of the costs you are likely to incur.”¹⁷⁵

Moreover, interviewees maintain that management are invariably given access to their reports, and invited to comment upon the contents, and especially on anything they consider to be factually inaccurate:

“...all our reports are discussed line by line with the directors of the companies concerned before they’re issued to the bank. That’s not to say that we’ll alter them according to their comments, unless we agree with them of course, but it does take out any factual inaccuracies and it does enable us to say what the feelings of directors are if they disagree with us.”¹⁷⁶

¹⁷³ Interviewee 1. Interviewee 4 stated that the management team was without exception invited to take an active role in the investigation.

¹⁷⁴ See Doyle, *supra* n 119, 46; *The Ostrich’s Guide to Business Survival*, *supra* n 90, 32.

¹⁷⁵ *Banks and Businesses: Working Together*, *supra* n 88, Principle 7.

¹⁷⁶ Interviewee 9. Interviewee 4 stated that it was routine to give management sight of the draft report.

According to the BBA's Statement of Principles, the commissioning bank will also enter into discussions with management over the contents of a report and an assurance is offered that no action will be taken without such¹⁷⁷.

1.3 Outcomes of Independent Business Reviews

An investigating accountant will usually make a recommendation to the commissioning bank as to the appropriate course of action, which could range from no action at all to the instigation of a formal insolvency procedure¹⁷⁸. Interviewees strongly assert that they conduct reviews without any preconceived notions as to the likely outcome:

"You don't necessarily go in with the view that insolvency is inevitable ... at the end of the day, the bank is asking for advice, the bank doesn't necessarily want you to recommend receivership but rather is asking, 'Do we support this business, do we lend it more money to see it through to the other side, or is it best for the protection of all parties to go for ... some form of insolvency, whatever form that is, at this juncture?'"¹⁷⁹

Interviewee 9 remarked that his recommendations often came as a pleasant surprise to both the bank and the company:

"I can think of quite a few cases where we have made constructive and helpful contributions towards businesses continuing, and in fact found situations where the banks have thought things were much more terminal than actually turned out to be the case."

Confines of space do not allow for a comprehensive discussion of the recommendations that could be made, or the subsequent role of the investigating

¹⁷⁷ *Banks and Businesses: Working Together*, *supra* n 88, Principle 8.

¹⁷⁸ See Armour and Frisby, *supra* n 3, 27.

¹⁷⁹ Interviewee 7. Interviewees 1, 2, 4, 5, 6 and 8 similarly claimed that the approach was always wholly objective and without any predetermined views as to probable recommendations.

accountant in ensuring their implementation. Very briefly, interviewees suggested that a variety of techniques could be utilised in the case of a company experiencing only minor difficulties, including cost-cutting, the introduction of more efficient financial controls, the rationalisation of products and lines and the tightening up of credit control¹⁸⁰. Some of these were recommended to management, and it was left to management to implement them and the banks to monitor the implementation process. In more serious cases the bank might request the investigating accountant to continue to monitor the situation on a periodical basis or to assist in the execution of recommendations¹⁸¹. Most significantly, some interviewees claimed that the majority of IBRs are not followed by receivership, or by any other formal insolvency procedure:

“From what I’m seeing at the moment, I would say that maybe one in six or seven investigations ... actually end up in receivership. It’s quite rare, then, and if you were to look back four or five years it was the other way round, one in five *didn’t* go into receivership.”¹⁸²

This appears to be confirmed by the findings of the SPI’s Eighth Survey, which reports a success rate of 63.2% for informal ‘turnaround’ strategies¹⁸³.

Overall, the Interviewee Survey suggests that the Independent Business Review procedure is a significant element of the informal rescue framework. This may not be the perception of corporate managers, but interviewees were adamant that their work as investigating accountants was driven by a desire to avoid insolvency wherever possible. Moreover, they considered that their success in the majority of cases is infrequently acknowledged:

¹⁸⁰ See, also, Smith, *Intensive Care*, 1997 *Insolvency Practitioner*, 24, 25.

¹⁸¹ Interviewees 4 and 6.

¹⁸² Interviewee 4. Interviewee 2 suggested that 60% of cases escaped formal insolvency procedures, interviewee 7 estimated that 40% to 60% of businesses survived intact.

¹⁸³ *Eighth Survey*, *supra* n 141, 12. See also Smith, *supra* n 180, where it is reported that 57% of bank-led cases do not result in a formal insolvency procedure.

“The public doesn’t see much of the reconstruction that goes on behind closed doors ... they don’t see the successes. People just don’t go out and say ‘ Hey, I was nearly insolvent six months ago, but I’m doing all right now, and it’s because I took people in.’ They’re not going to want that to be advertised.”¹⁸⁴

Of course, independent corroboration of the generally positive outcomes of IBRs and related informal rescue mechanisms would be valuable, not least because the publication of the supportive nature of the process might help to counter the perhaps understandable fears of corporate managers in this regard¹⁸⁵. Banks and insolvency practitioners appear to be attempting to allay reservations through the publication of such pamphlets as *Banks and Businesses: Working Together*¹⁸⁶ and *The Ostrich’s Guide to Business Survival*¹⁸⁷. It seems that the positive message is not getting through, and one interviewee noted that further ‘cosmetic surgery’ is called for:

“In the last two years ... there has been a learning curve, with us trying to explain to both the providers of work, the banks, and the customers, the clients, that there is a benefit to all of us, but words like ‘investigating accountant’ don’t open doors for you, you have to look at terms like ‘business reviews’, independent reviews’, ‘rescue options’, terms people would prefer to use. We’ve been saying for years that if you get us in too late there’s going to be nothing we can do about it.”¹⁸⁸

Of course, this presupposes that the psychological barriers to external intervention that are alleged to exist amongst corporate managers are based on ungrounded qualms. The above discussion has presented the IBR as a benign exercise which has much to offer troubled companies and their finance providers in the way of

¹⁸⁴ Interviewee 1.

¹⁸⁵ It will be interesting to see whether the findings of Professor Franks and Director Sussman’s research authenticates the general thrust of the Interviewee Survey; see *supra*, n 39.

¹⁸⁶ *Supra*, n 88.

¹⁸⁷ *Supra*, n 90.

¹⁸⁸ Interviewee 5.

rescue-orientated solutions. Perhaps inevitably, there is an opposing view of the role of investigating accountant, and one that is likely to be stridently aired in the next round of the consultative process.

1.4 Independent Business Reviews: A Darker Side?

“Ministers subsequently asked that the review examine specifically the question of whether insolvency practitioners should by law be prohibited from accepting appointment as administrative receivers of a company whose affairs they had previously been asked to investigate, usually by the company’s bankers.”¹⁸⁹

One feature of an IBR that might tend to militate against the generally positive view propounded by insolvency practitioners and banks is that it is the company which has to pay the investigating accountant’s fees¹⁹⁰:

“...that’s the other part of the resistance, in that the company says, ‘Well, I’m going to have to pay for this, but, potentially, I’m not going to get anything out of it. Can you guarantee me a positive outcome?’ And the answer’s going to be ‘No we can’t. We don’t know the first thing about it yet, we’re not in a position to say it’ll work out well.’”¹⁹¹

A more worrisome objection is that IBRs are being used to indirectly swell the income of the investigating accountant’s firm. This allegation arises out of the habitual practice of banks of appointing an investigating accountant as receiver of the company, where such an investigation has resulted in a recommendation of receivership (hereinafter ‘follow-on’ appointments)¹⁹². The core contention of those who advocate that this practice should be proscribed is that investigating

¹⁸⁹ The Review Document, *supra* n 20, para. 1(c).

¹⁹⁰ See *The Ostrich’s Guide to Business Survival*, *supra* n 90, 32.

¹⁹¹ Interviewee 6.

¹⁹² The ‘follow-on’ appointment procedure is universally, and openly, acknowledged; see Doyle, *supra* n 119, 43-44. Interviewees confirmed that, with one exception, they would expect to conduct any subsequent receivership.

accountants have a clear incentive to recommend receivership in order to maximise their fees, and that they will do so even where such a recommendation is inappropriate. This 'moral hazard' argument has been proclaimed in uncompromising terms:

"Through the greed and questionable practices of [insolvency] practitioners, operated with impunity, many small and medium-sized companies are needlessly closed; their directors - who have frequently put all their personal assets on the line - thrown out of work; and their families thrown on to the streets to become an extra burden on the taxpayer."¹⁹³

Academic commentators have also drawn attention to this 'conflict of interests', albeit in somewhat more moderate language:

"...the corporate recovery sections of the big six [accountancy firms] usually handle material investigations for the banks. Without wishing to impugn their integrity, it would be fanciful to suggest that they never have any further interest in the outcome of an investigation. Where matters are clear-cut, this may make no difference to the bank's decision, but it may well do so at the margin."¹⁹⁴

Protagonists of the moral hazard case support their thesis by highlighting a number of features of the IBR process. First, it is alleged that reviews are carried out as 'loss leaders':

"Some accountancy firms do not even charge for an initial investigation into a company in the belief that they will become receiver of the company - a judgment

¹⁹³ *Hansard*, House of Commons, 7 May 1999, col. 1266, Rudi Vis. See also *Hansard*, House of Lords, 26 January 1999, cols. 942 (Lord Sudeley) and 943 (Lord Evans of Watford); *Hansard*, House of Commons, 3 February 1999, col. 933 (Richard Page); *How "Rip-Off" Receivers Cash in on Carve Ups*, Evening Standard, 25 November 1999.

¹⁹⁴ Davis, *supra* n 52, 5. See also Milman and Mond, *supra* n 92, 20; Pond, *supra* n 43, 14. See also The Independent on Sunday, 25 July 1993.

they reach before even considering the facts and figures of the potential victim...”¹⁹⁵

Moreover, it is argued that even if abuse is confined to the periphery of the insolvency profession, or does not take place at all, the public perception of a potential conflict nevertheless requires action. Katz and Mumford sum up this thus:

“...the profession, the banks or the legislature may consider it desirable or necessary to change the rules in response to public concern about conflict or moral hazard, regardless of any factual evidence on this ... Even if it could be shown that any abuse is rare or non-existent, it is very difficult to eliminate public concern that moral hazard or conflict is inherent in the present regime.”¹⁹⁶

Finally, one commentator suggests that a policy forbidding ‘follow-on’ appointments would enhance the prospects of rescue-based recommendations:

“It may even lead to the investigating accountants being much more objective in their assessment of a company, knowing that a rival firm would be looking at their work and conclusions.”¹⁹⁷

A monograph produced for the Association of Accountancy & Business Affairs¹⁹⁸ considers the issue of moral hazard at length, and represents probably the most damning indictment of the insolvency profession available in this and other regards. It gives factual details of eleven cases of alleged malpractice during the investigation procedure or the subsequent insolvency appointment. If made out, they give considerable cause for concern, but it should be added that the Regulatory Bodies concerned appear not to accept that any abuse has taken place¹⁹⁹. It should

¹⁹⁵ House of Lords Hansard, *supra* n 193, col. 937, Baroness Dean of Thornton-le-Fylde. Interestingly, interviewee 5 accepted that this practice had indeed occurred in the past, but suggested that it was confined to smaller, independent practitioners whose services were no longer engaged by banks. Interviewee 6 conceded that it was possible to make a loss on an IBR, largely because such are conducted on a fixed fee basis, but added that he had seen little evidence of deliberate malpractice even amongst smaller firms, and none at all amongst the big firms.

¹⁹⁶ *Should investigating accountants be allowed to become receivers?*, *supra* n 160, 9-10.

¹⁹⁷ Davis, *supra* n 52, 5.

¹⁹⁸ *Insolvent Abuse*, *supra* n 159.

¹⁹⁹ The authors put this down to a want of independent regulation.

also be noted that five of the cases reported concern investigating accountants from the 'big six' accountancy firms²⁰⁰, and so tends to rebut the remarks of interviewees that abuse, if it takes place, is confined to the margins of the profession.

To the extent that the *Insolvent Abuse* monograph represents conclusive evidence of malpractice it embodies a compelling case for urgent reform. Its authors advocate a complete overhaul of the regulatory system for insolvency practitioners but, failing that, are plainly in favour of legislation to veto the current practice of investigating accountants accepting 'follow-on' receivership appointments²⁰¹. They cite, in this regard, the policy of the Royal Bank of Scotland, which has adopted a guiding principle of not appointing to receiverships those practitioners who have conducted an investigation beforehand. This approach is lauded as best practice, and it is urged that either other banks adopt it voluntarily or that the Government legislate with a view to making it mandatory.

At first sight such a proposal seems relatively innocuous. Even if the cases presented in the monograph turn out, on closer examination, to be less damning of the insolvency profession than they there appear, it remains the case that the current system discloses a real potential for conflict. The more public this potential becomes, the more the universal call for early action on the part of corporate managers is dealt a severe blow. Directors are hardly likely to seek the assistance of a practitioner who, in their judgment, has an incentive to usurp their control of the enterprise and a means of achieving that ambition. There would, therefore, appear to be a forceful argument for the legislature to intervene, if the banks and the insolvency profession refuse to compromise in this regard.

²⁰⁰ One of these cases, that of Heritage plc, has been taken up by Rudi Vis MP in Parliamentary Debates; see *supra* n 193.

²⁰¹ *Insolvent Abuse*, *supra* n 159, 66.

1.5 Follow-on Receivership Appointments: the Counter-offensive.

Insolvency practitioners concede the appearance, if not the factual existence, of a conflict of interest in the area of follow-on receivership appointments. The practice is bank-driven, and so any intercession to modify it would represent an incursion into the control of the insolvency process currently enjoyed by them. This of itself is not a strong argument against change. There are, however, some persuasive contentions that follow-on appointments are actually beneficial both to banks and, more importantly, to those businesses which go into receivership following an IBR. These contentions, when coupled with the assertion that abuse is in any event negligible, provide a cogent defence to those who sponsor a revision of the law.

1.5.1 Deterrents to abuse

In the first instance, both banks and insolvency professionals refute the allegations of misconduct in this regard. One independent commentator notes that the investigating accountant's duty of care to an appointing bank, and his interest in preserving a good reputation, would tend to militate against the making of inappropriate receivership recommendations simply in order to pick up fees:

“Practitioners must establish and maintain a reputation for competence and objectivity in developing recommendations that are well-supported, in order to ensure a continuing flow of work from the banks.”²⁰²

Two interviewees similarly suggested that it would amount to professional suicide to make recommendations based on fee-earning potential rather than an objective appraisal of what would best serve the bank, and, indeed, the business in question:

“I can quite understand the public perception of going in as investigating accountant and then recommending receivership, you get the job so you're hardly going to

²⁰² Katz and Mumford, *supra* n 160, 12. See also Pond, *supra* n 43, 14.

recommend anything else. But the answer is, of course, that we get the majority of receiverships and investigation work from the five or six big banks in the UK ... So we can't afford to mess about, to give the wrong advice. They are very astute, they know precisely what the possible conflict is and they are very aware of this, and if we recommend a procedure wrongly they would spot that and it would be the last job we got. I can understand the perception, and I think that the Royal Bank of Scotland's approach is largely a matter of public relations. I'm not convinced it gets the best results, but it is something, when they're marketing, that they can tell their customers, that they won't be exposed to that sort of risk if things go wrong. But is it a real risk? I don't think it is."²⁰³

Interviewee 1 made the same point:

"The reality of it is that accountants are professional enough to know that if they were to do investigations and then merely tip companies into receivership, the banks would get wise to it and say, 'Look, this is not what we want. We don't want to know that when you use Fred Bloggs all he's ever going to say is 'receivership.'"

Interviewee 5 commented that he considered suggestions that insolvency practitioners routinely based their recommendations on their own financial interests to be "extremely insulting to the profession". Moreover, prohibiting follow-on appointments would not address self-interested behaviour, because only licensed insolvency practitioners can accept receivership appointments, and the major clearing banks generally appoint from a fairly restricted 'panel' of firms:

"...it wouldn't make much difference because if one person can't do it then somebody else can and will do it, and if the answer is receivership then it doesn't really matter, it's all going round in a big circle..."

A version of this argument was raised at the SPI's Insolvency Conference by one of the delegates:

"...if there are people doing this then they are dishonest people ... and if they are that dishonest, and they are not able to take the appointment as receiver, won't they just

²⁰³ Interviewee 4.

recommend that the company should not go into receivership and then do the monitoring job instead? And make sure that the report ... makes the recommendations which keep them in a fee-earning situation? Won't it just change the nature of the problem?"²⁰⁴

The overall thrust of the above is that the moral hazard is more imagined than real, and that there are significant practical restraints on the making of calculated recommendations, not least the risk of the appointing bank detecting such behaviour. Clearly, any practitioner guilty of this kind of malpractice would similarly take the risk of being reported to his regulatory body and, at the extreme, having his licence revoked. Confines of space do not allow for a detailed examination of the regulatory framework of insolvency practitioners, but it should be noted that its 'self-regulation' basis has been scathingly criticised in the *Insolvent Abuse* monologue²⁰⁵ as ineffective and, more seriously, collusive. To the extent that the views presented therein are accurate, the prospect of sanction in the event of misconduct may be seen as so remote as to be no real deterrent.

On the other hand, the Insolvency Regulation Working Party has recommended the establishment of an Insolvency Practices Council, which would be made up of a majority of lay members and which would, *inter alia*, "consider whether professional and ethical standards are satisfactorily enforced and observed."²⁰⁶ If the Insolvency Practices Council is to act as a general overseer of the self-regulatory activities of the RPBs, it would be in a strong position to ensure that 'rogue' practitioners are suitably censured.

²⁰⁴ Insolvency Conference, *supra* n 85. See also Katz and Mumford, *supra* n 160, 13.

²⁰⁵ *Supra* n 159.

²⁰⁶ Insolvency Regulation Working Party, *A Review of Insolvency Practitioner Regulation* (February 1999), Sections 14 and 15. The Working Party was established by the Insolvency Service of the DTI and the Recognised Professional Bodies responsible for the authorisation and regulation of insolvency practitioners.

1.5.2 The benefits of follow-on appointments

“I first got involved in a [change of appointee] situation with the Royal Bank of Scotland, where somebody else had done the investigation and I was asked to tender for the receivership. It was a construction case, and by the time I was appointed the assets had been very badly dissipated ... I think the loss in assets was perhaps as much as £100,000.”²⁰⁷

“We have done some work for the Royal Bank of Scotland on the investigation side, and then it’s gone into receivership, or the other way round, we’ve done the receivership when somebody else has done the investigation, and in that situation you really do almost have to start from scratch...”²⁰⁸

A counter-productive outcome of the proscription of follow-on appointments is that it inevitably involves, on the one hand, a delay between recommendation and appointment during which the company’s fortunes decline even further and, on the other, an expensive duplication of effort. Certainly the cost implications of engaging a ‘fresh’ appointee should be taken seriously. Although he would have his predecessor’s report available, it is not unreasonable to expect a subsequently appointed receiver to spend at least the first few days of his engagement confirming its contents and, perhaps, making additional or different enquiries as to the nature and circumstances of the business.

A more compelling contention put forward by those in favour of follow-on appointments is that these actually enhance the prospects of a positive outcome in receivership. This is because conducting the investigation avoids the sharp learning-curve that would otherwise be faced at the outset of receivership:

“If the business is heading towards receivership when you are doing the investigation, doing that investigation allows you to assess the risks in the business of continuing to

²⁰⁷ Interviewee 2.

²⁰⁸ Interviewee 6.

trade, what sort of reaction you're going to get from creditors, what sort of reaction you're going to get from management, whether there's a business to save. You inevitably start to think through a strategy, how you might run and sell this business in receivership..."²⁰⁹

All nine interviewees made the point that familiarity with the business can be critical to its survival potential inside receivership. Some of their comments are worth recounting at length:

"The most valuable commodity in trying to help a business, or trying to help realisations, or trying to sell it in future is *time* ... very often you go into a business as investigating accountant, recognise that it's clearly insolvent, but that it's saleable, so you'll see that there's an opportunity of selling the business ... *provided* that you act quickly on appointment so that it doesn't get any worse..."²¹⁰

"...[having done the investigation] could also effect very significantly the outcome of receivership, and that's far more important than the costs savings ... you will be much more risk averse when you go into a situation you don't know, and sometimes the decision as to whether to shut the firm down, whether to continue trading can be a very fine one. If you've already had a couple of weeks exposure to the company, the personalities, the management ... sometimes that tips you in favour of going for it, rather than playing it safe."²¹¹

"We know the people, we know the business, we know the cash-flow. All that knowledge is tremendously useful, it makes trading on towards a sale a realistic target..."²¹²

²⁰⁹ Interviewee 1.

²¹⁰ Interviewee 2.

²¹¹ Interviewee 4.

²¹² Interviewee 8.

“You get a very good view of what is possible in a receivership simply through doing the investigation.”²¹³

Identity of investigating accountant and receiver, therefore, is said to considerably augment the likelihood of a positive outcome, and, specifically, will render the prospect of a trading receivership and a subsequent going concern sale a more realistic one²¹⁴. What, then, is to be made of the debate as to the propriety or otherwise of ‘follow-on’ appointments? A recent, and influential contribution was made by Katz and Mumford, who, having rehearsed the arguments for both sides, presented empirical evidence which tended to support the insolvency practitioners’ perspective:

“Based on our review of prior research and the results of our own research, we do not consider that a factual case for proscribing the present regime of continuity [i.e. follow-on appointments] can be made out.”²¹⁵

This conclusion was based on the finding that the Royal Bank of Scotland’s policy of ‘change’ (i.e., no follow-on appointments) had not produced a significant reduction in the overall number of receivership appointments made by that bank. In other words, there was no evidence to support the ‘moral hazard’ contention. Moreover, a summary of prior research found nothing empirical to counter this, and some of the more lurid allegations made during Parliamentary Debates were exposed as unfounded:

“The proponents of change do not assist their case, or the debate as a whole, by making such overstated claims.”²¹⁶

On balance, it is submitted that the case that follow-on appointments should be prohibited is simply not established. On the contrary, there is a credible rationale

²¹³ Interviewee 9.

²¹⁴ See, to this effect, Katz and Mumford, *supra* n 160, 12.

²¹⁵ *Ibid.* 9.

²¹⁶ *Ibid.* 16. Nor, one might add, do they inspire confidence in those who make them.

for a policy of non-intervention, in that the present system affords investigating accountants who properly recommend receivership a better opportunity of achieving a superior outcome. It must be indisputable that there is a cost saving in a follow-on system, but this is overshadowed by the information gains of conducting an IBR which, in turn, enhance the prospects of a trading receivership to the possible advantage of more than merely the secured creditor. Moreover, the establishment of an Insolvency Practices Council will bolster the current regulatory regime, and so act as a further bar on sharp practice.

The insolvency practitioners in the Interview Survey were adamant that their 'best' work was performed against a background of early and unbroken involvement, and it is worth re-emphasising that a significant casualty of the abuse alleged to arise out of the present system would be the bank. As will be illustrated, receivership is often a less than optimal outcome for secured, as well as unsecured creditors; to deliberately misrepresent the position of a potentially viable company in pursuit of extra fees is not merely dishonest, it might well backfire on the practitioner concerned. In the light of the foregoing discussion, it is suggested that the Insolvency Review Committee would do well to resist the clamour for change, and that the proponents of change ought perhaps to reconsider the potency of their own case.

1.6 The IBR - some final thoughts

Leaving aside the 'follow-on' debate, it is useful to reflect on the wider implications of the IBR regime. The above examination has suggested that there are reasonable grounds for accepting the enduring insistence of banks and insolvency practitioners alike that informal, or 'behind-the-scenes' rescue is an established feature of their activities. It would appear that at least some rescue operations take

place within the context of the IBR and it would be fascinating to discover precisely how many informal rescue attempts are mounted each year, and how many succeed. This is a question to which the legislature should give some consideration.

Corporate failure is, unfortunately, a vicissitude of commercial life, and the Review Committee accepts there is no magic bullet to counter this. The rescue culture is, or should be, directed firstly towards ensuring that viable candidates for rescue attempts are identified in a timely and accurate manner, and, secondly, that appropriate and effective procedures are then available. The above analysis suggests that one way of achieving the former is to challenge both corporate managers and their bankers to respond more speedily to the first signs of financial distress. This may in turn involve the exploding of a few myths as to the implications of seeking external and expert advice.

The latter is more open to controversy, in that at present the decision as to *what* is an appropriate response is placed firmly in the hands of secured creditors. One therefore returns to the fundamental hypothesis of this Chapter: to the extent that a promotion of the rescue culture *demand*s that control rights be relocated, it should be clearly established that those currently in control, the banks, are making *objectively inappropriate decisions* in exercising that control.

The IBR system throws some light on this enquiry, in that it discloses that banks are in the position to make an informed choice as to the appropriate course for a troubled company²¹⁷. If receivership is recommended, one could argue that that is because other, ostensibly less terminal procedures have been considered and found to be unrealistic. Insolvency practitioners have no particular incentive to prefer receivership over, say, a CVA or administration: both require the

²¹⁷ See, for a further exposition, Armour and Frisby, *supra* n 3, 25.

involvement of a licensed insolvency practitioner and the follow-on appointment regime applies equally to CVAs and administrations as it does to receivership. The banks, on the other hand, have every incentive to prefer CVAs if the enhanced return rates reported in the SPIs Eighth Survey are anything to go by. Yet it remains the case that receiverships account for just over two thirds of appointments to 'non-liquidation' insolvency positions.

This may be explicable by reference to a number of variables. It may be that by the time an IBR is conducted, the point of no return has been reached, and again this raises the question of how to ensure that difficulties are addressed at the earliest possible opportunity. In such circumstances a CVA might be considered unworkable and unlikely to attract the requisite creditor support, particularly if the Crown is owed substantial amounts. Similarly, it must always be borne in mind that all insolvency procedures will, to a greater or lesser degree, require some form of funding. If this is unlikely to be forthcoming then a liquidation strategy, whether through receivership or otherwise, will be the only realistic option. In this regard, administration will very often be ruled out quickly, given that the procedure, with its greater involvement of the courts and creditors, is acknowledged as more costly. Whatever lies behind the recommendation of receivership, it is tentatively suggested that it will be made in an objective and informed manner and by an individual with both experience of and expertise in alternative strategies. In short, the current system places decision-making power with the party best placed to exercise it effectively. If CVAs and administrations are less prevalent than receiverships it is because, *in the individual circumstances of each case, the former are correctly adjudged not viable propositions*. This notion warrants further analysis.

6. Evaluating receivership

6.1 An easy option?

There remains a perception that receivership is, for banks, an ‘easy option’. The impression that receivership predominantly involves a kind of ‘asset-stripping’ exercise, with the beneficiary bank claiming the cash and leaving other creditors to pick their way through the detritus, has never wholly been laid to rest:

“Corporate bankruptcy should involve striking a balance between creditors and shareholders - secured creditors of smaller companies generally care nothing about the fate of the business, as long as enough of its assets can be sold to repay the cash they have lent.”²¹⁸

This suggests that the debt-enforcement function of receivership is inevitably at variance with rescue-friendly initiatives:

“There are ... serious drawbacks to receivership ... the receiver’s prime responsibility is to the bank. Yet the bank has only a fixed claim, which means there is a ceiling on how much the bank can get out of the company. As a result, the bank - quite legitimately - may decide against keeping a good company going because it does not see the upside potential.”²¹⁹

In other words, when a bank, through its receiver, can recover enough to discharge the secured debt through an asset sale there is a disincentive to embarking upon a riskier, more rescue-orientated procedure.

Prima facie this is a cogent affirmation. Certainly, as far as a receiver is concerned, his cardinal duty to his appointor would direct that an asset-realisation strategy that will discharge the secured debt *must* take precedence over a trading or a going concern sale scheme. This will be *a fortiori* where the latter involves an element of

²¹⁸ Grylls, *Does the United Kingdom Need the Floating Charge?*, *supra* n 92, 391.

²¹⁹ *Insolvency Reform in the UK; A Revised Proposal*, *supra* n 107, 6-7. See also Webb, *An Economic Evaluation of Insolvency Procedures in the UK : Does the 1986 Insolvency Act Satisfy the Creditors’ Bargain?* [1991] Oxford Economic papers, 144.

risk which, if realised, will result in a portion of the secured debt remaining unsatisfied.

The perspective of the secured creditor is perhaps more ambivalent. Two factors in particular might tip the balance in favour of a rescue-orientated approach, even where a break-up asset sale would clear the debt. The first is that the survival of the company would secure a future income stream for the bank in question. However, a going concern sale of the *undertaking of the company* to a third party would not guarantee such an outcome. Moreover, in the larger scheme of things it is highly unlikely that a bank would forego the prospect of a rapid return on its investment in favour of the less than assured possibility of the account remaining profitable. It should be added that the smaller the company the less imperative is maintaining it as a client, and, as was noted earlier, the vast majority of companies entering receivership (and, indeed, CVAs) are small. It is therefore submitted that the preservation of a revenue source will be, at best, an inconsequential issue once receivership has transpired²²⁰.

A more tangible concern for banks in this regard might be their own reputations amongst the commercial community and the general public. Certainly banks, especially the major clearers, are subject to reputational dynamics, but the extent to which these influence decision-making *in receivership* is difficult to quantify. Interviewee 3 in the Interview Survey agreed that the fact of the appointment of a receiver might generate bad publicity for a bank, but added that that was a very temporary state and that subsequent negative reports were more often directed at

²²⁰ Indirect costs can, of course, extend beyond the loss of income from the company itself. Insolvency can have a 'domino effect', the failure of one enterprise taking others with it. However, such indirect costs will have been taken into account long before the decision to appoint a receiver is made.

the receiver. Interviewee 5 suggested that banks had regard to public relations, and would expect their appointees to bear that in mind:

“ The banks are mindful of the publicity, and they are equally mindful of their ability to affect a community, as indeed are insolvency practitioners.”

Nevertheless, other interviewees suggested that reputational factors would have rather more bearing on the question of whether to opt for receivership *in preference to* a procedure more likely to be viewed sympathetically by the public:

“...from a publicity point of view, a number of large groups have gone into administration over recent years and the banks have let them go into administration rather than appoint receivers. That’s because if you appoint receivers the publicity states “Bank X appoints receivers”, whereas if it goes into administration then the court does the appointing.”²²¹

Interviewee 8, on the other hand, opined that any qualms the banks had in this regard were misguided:

“...they probably take it into account, but I’m not sure why. 99% of the public have no idea of the difference between administrative receivership and administration.”

It is, therefore, difficult to maintain that the possibility of adverse publicity might influence the outcome of a receivership. More specifically, it is unlikely to persuade an appointor to sacrifice immediate and full recovery from a break-up sale in order that his receiver attempt to improve realisations by trading or selling the business as a going concern.

The intrinsic ‘flaw’ of receivership, therefore, is that by locating the primary allegiance of the receiver with the appointor it involves a classic example of a perverse incentive. The welfare of the totality of external stakeholders demands a

²²¹ Interviewee 6. Interviewee 7 expressed a similar opinion, especially in relation to high profile cases. Interviewee 2 remarked that some businesses had a greater “aahhh factor” than others, citing nursing homes and football clubs. See also Armour and Frisby, *supra* n 3, 29.

policy of *maximisation of realisations*, whereas that of the appointor pulls in the another direction. Does this necessarily mean that the reformers should address what appears to be a clear inequality? If so, what amendment would best serve the macro-interest? Some would advocate the complete abolition of receivership as a secured creditor's remedy²²², others sponsor a widening of the receiver's constituency²²³. The next section considers the extent to which receivership in fact engenders substantial injustice, and, as a corollary, whether reform is warranted.

6.2 Receivership in Practice: A Last Resort

“Banks make money out of ongoing businesses and they do not make money out of businesses that get into receiverships and, sometimes, voluntary arrangements. It is very rare for banks to recoup, not matter how well secured they are, their debts out of a receiver situation.”²²⁴

The notion that banks expect receivership to result in a complete discharge of the secured debt is not supported by any statistical or qualitative evidence. It is worth recalling yet again the finding of the SPI's Eighth Survey that receivership results in a 100% return rate to secured creditors in only 19% of cases²²⁵. The fact is that banks generally lose money in receiverships. Moreover, they expect to lose money, and so will only make appointments when there is no alternative recourse:

“Receivership ... is always the last resort. The bank will always look at other options first ... because the bank will tend to lose money in a receivership.”²²⁶

There is a simple explanation for this. By the time a receivership appointment is

²²² See Phillips, *supra* n 93.

²²³ See Milman and Mond, *supra* n 92.

²²⁴ *Second Report*, *supra* n 27, Examination of Witnesses, response to question 19.

²²⁵ *Supra* n 141, 4.

²²⁶ Interviewee 1. Interviewees 2, 4, 5, 6, 7 all confirmed that it was unusual for a receivership to fully discharge the company's indebtedness to the bank.

made the security cover represented by the value of the company's assets is less than the amount owed to the bank. In other words, the bank, at the time of appointment, is under-secured.

This fact to some extent neutralises the argument that the central defect of receivership is that there is no incentive to maximise realisations. In the majority of cases receivers will *perforce* attempt to achieve this end in order to discharge their duty to act in the best interests of the appointor. A break-up sale of assets will not realise sufficient cash to pay back the secured debt, and therefore, if the receiver is to promote the secured creditor's welfare, he must examine other options which might enhance or maximise realisations. Such deliberations rule out the immediate closure of the company's operations, so that a strategy of trading on will usually recommend itself.

To what end trading is sustained will depend upon a variety of circumstances. It may be that the mere completion of work-in-progress and/or the satisfaction of outstanding contracts will adequately bolster the value of the company's assets as far as satisfying the secured debt is concerned²²⁷. As interviewee 1 puts it:

"...it's a cash driven process. Receivership is not as such a profit driven process. It's to do with, 'Can I make more money by trading or not? Can I turn stock, for example, or work-in-progress into sales so that I can make more money than just by selling off the stock as it is?'"²²⁸

Trading may assist in the collection of book debts or avoid incurring even further liabilities:

"...it's beneficial to be able to carry on for a short period so as to meet ongoing contracts, and to be able to collect the debts as ongoing ones. There will be a debtors'

²²⁷ See Lightman and Moss, *The Law of Receivers of Companies*, 2nd ed. (1994 : Sweet & Maxwell : London), para. 8-07.

²²⁸ Interviewee 4 remarked that, "...work-in-progress is absolutely valueless, so it's in everybody's interest to enhance the value of it by completing it".

ledger, and if you stop trading on day one and cease supplies then those old debtors won't pay, they say, 'Look, we were relying on a supply from you, we didn't get it, we had to go somewhere else and that cost us money, which we're going to set off'. The result is that you don't see any debts, or you see a big reduction in the amount of debts that you would have collected. Plus the fact that if you don't carry on, especially in some industries, there may be very heavy and substantial penalties..."²²⁹

Trading, therefore, of itself tends to increase the level of realisations that can be attained in receivership. However, the completion of work-in-progress and contracts, and the collection of book debts, remain very much characteristics of the break-up sale approach so commonly associated with receivership. Moreover, it is unlikely that a short-term trading strategy will wholly resolve the problem of the under-secured appointor. In the first place, the completion of work-in-progress will almost certainly involve the use of *floating charge assets*, and therefore, as suggested in Chapter 3, the primary beneficiaries will be the preferential creditors. More fundamentally, the shortfall between the value of assets sold on a break-up basis and the level of secured debt will usually be sizeable, and the extra value that can be captured by the completion of outstanding operations unlikely to reduce it to any significant extent. Trading on in order to sell *assets*, therefore, may *increase* realisations, but will be of only marginal benefit to the appointor. Receivers might therefore be expected to consider more ambitious techniques which will *maximise* realisations. The next section identifies and describes the prevalent tactic in this regard.

²²⁹ Interviewee 9. Interviewees 6 and 7 affirmed that even a short-term trading strategy will be indispensable to the collection of book debts.

7. Receivership - making the best of a bad job?

7.1 Receivership and Recycling: the Going Concern Sale

Receivership is usually, and correctly, rejected as a 'pure' rescue vehicle. If a *company* survives the process it will usually be entirely fortuitously, and not as a result of the receiver embarking on trading activities that restore it to solvency and profitability. Only one interviewee in the Interview Survey recalled such an outcome:

"In one instance we sold a freehold property and were able to pay off the bank out of that, then we put the company into leasehold premises so that it could continue to trade, and it still survives to this day."²³⁰

This does not, however, irrefutably condemn receivership as a debt enforcement procedure only. The reality being that a break-up sale of corporate assets will not realise nearly enough to discharge the secured debt, a more elaborate strategy is called for. The epitome of such a scheme is the sale of the company's *undertaking* as a going concern:

"There is in most cases a world of difference between the value of a company's undertaking as a going concern and its scrap value. It is for this reason that creditors seek floating charges on the undertaking as well as specific charges on certain assets of the debtor company."²³¹

The practice of selling a *business* as a going concern has been described earlier²³². Because it almost invariably results in higher realisations it will be in the best interests of a secured creditor that his receiver at least attempts to achieve a going concern sale. Moreover, there may be additional benefits for other corporate

²³⁰ Interviewee 2.

²³¹ Lightman and Moss, *supra* n 227, para. 2-07.

²³² See, especially, Chapter 4.

stakeholders, and it is proving increasingly popular as a receivership ‘device’. As Goode comments:

“At one time the normal practice of receivers was to dispose of assets on a break-up basis and hand back what was left of the company to its directors. But the modern receiver tends to take a broader view of his responsibilities and, though putting the interests of his debenture-holder first, also has regard to the interests of creditors generally and of employees. If the business is inherently sound and capable of being restored to profitability the receiver may find that he will secure a better return by continuing to trade with a view to disposing of the business as a going concern.”²³³

Interviewee 8 confirms this proposition, and amplifies upon the benefits of a going concern sale strategy:

“In very simple terms, what you’re trying to do is to maximise the amount of money that you generate from all the assets that are under your control. That is almost always, with a few exceptions, done by selling the business as a going concern, as a whole, or different parts of the business, rather than by shutting it down and selling the assets singly. You get a better price for the assets by selling them that way. That also saves jobs, and it assists us in collecting what is usually the biggest asset in the security, which are the book debts. It’s a lot easier to collect the book debts if the business is going to be sold, if it’s still operative, and if there’s continuity there.”

Indeed, interviewees were unanimous in their approbation of the going concern sale as a means of maximising realisations:

“...in most cases I’ve been able to sell the *business*, or at least a good part of it. My first priority is maximum return to the bank, but the best way to achieve this, often the *only* way, is to keep the business intact, so that’s what I aim to do. And that’s going to preserve jobs, obviously, and that’s very satisfying ... If I can do that, and I frequently can, then that, to me, is the best result possible.”²³⁴

²³³ *Principles of Corporate Insolvency Law*, *supra* n 33, 15-16. See also Campbell and Underdown, *supra* n 119, 13.

²³⁴ Interviewee 1.

“I think the way we would approach it is to get the best out of the company. You normally do that by a going concern sale ... It’s just common sense, and nine out of ten practitioners will get far more of a kick out of doing that, rather than just going in and winding it up. That’s really the skill of the job, getting the most out of it ... It’s the idea of making the most that you can out of a bad situation, it’s a professional challenge, so if there’s just a chance to do that, then you go for it.”²³⁵

“The beauty of the going concern sale is that you get enhanced value - you get it for plant and machinery, maybe something for goodwill, for intellectual property rights, there will be a decent market for your property, vehicles, fittings, all that sort of stuff, so there’s a real point to trading.”²³⁶

The incidence of going concern sales is not well-documented, but Pond, who conducted a specific study into the outcomes of administrative receivership, made the following noteworthy finding:

“Of the 99 companies in the sample, the businesses of 61 (63.6%) survived in whole or in part following the administrative receivership. In these cases clear judgments were made by debenture holders, insolvency practitioners and purchasers that viable businesses could be rescued. Many troubled companies conceal good core businesses that could be profitable in other hands.”²³⁷

Moreover, interviewees in the Interview Survey suggested that, when appointed as receiver, there is very often a ‘*presumption*’ on their part that they will attempt to secure a going concern sale of the business. The decision to continue trading is often made in order to ‘buy time’ during which that possibility can be assessed:

“Very often, the minimum you can do is to take it short-term and say, ‘The company’s

²³⁵ Interviewee 4.

²³⁶ Interviewee 7.

²³⁷ *Rescuing Insolvent Companies via Administrative Receivership*, *supra* n 43, 2. The SPI’s *Ostrich’s Guide to Business Survival* puts the figure for going concern sales at 50%, *supra* n 90, 34. The SPI Eighth Survey does not give a separate figure for going concern sales in receivership, but notes that out of all formal insolvency cases in which a “positive outcome” was achieved, 82% involved a complete or partial going concern sale, *supra* n 141, 199.

not trading profitably, I don't really know whether I can find a buyer or not, *but* we've got this work-in-progress, we've got stocks which we've got buyers for ... at least we can continue ticking over for two or three weeks' ... and that strategy buys you time, in the interim you've got a two or three week window in which to see if you might find a buyer. If you can't find a buyer, it's a case of, 'Well, I tried,' and if you *do* find a buyer, great you save some jobs as well. So often you can do that, at the very least..."²³⁸

"The attitude of most people that I've worked with has been that we'll try to trade anything and everything, because we like to sell businesses, we like that picture at the end of the day, we like to keep the thing going if that's humanly possible. There's nothing more depressing than closing a business, getting the auctioneers in and just seeing it languish ... Selling the thing, it lifts the hopes of the employees, it lifts the hopes of suppliers, it'll give them an ongoing line of supply for their business..."²³⁹

In this regard, interviewees claim that receivership can, and does, make a positive contribution to the rescue culture, in that a viable business is preserved via the going concern sale route:

"[Rescue and the enforcement of a secured debt] are definitely compatible. We hear a lot of talk about corporate rescue, but when it comes down to it the bank want their money back. But that doesn't mean the two are necessarily exclusive. If you can sell the business as a going concern then the business survives, and that normally also means better realisations..."²⁴⁰

"We don't approach it from the [saving the company] aspect, granted. We *will* approach it from the 'saving the *business*' viewpoint ... Foremost in our minds is

²³⁸ Interviewee 4. Interviewee 2 approved of keeping his options open until the last possible moment. Interviewee 6 agreed that he would operate on the assumption that the business would be sold until it became obvious that such was unfeasible. See also, as to the 'presumption towards a going concern sale', Armour and Frisby, *supra* n 3, 30-31.

²³⁹ Interviewee 7.

²⁴⁰ Interviewee 3.

whether there is a business to preserve here, with all the things that attach to that in terms of employees..."²⁴¹

Finally, this 'presumption' may operate when not strictly necessary to the welfare of the appointor:

"Provided that the bank is not significantly at risk by following that 'continuance of trading' strategy then you do it, and even though you might be able to repay the bank *without* continuing to trade, you still prefer to try that, to get the very best out of the company."²⁴²

"I don't think there's usually any tension between [corporate rescue and debt enforcement] ... There's usually a commonality between the two aims. The best way to enforce the debt is to rescue the business ... In most circumstances that's what we'll do, *regardless of the state of the security*."²⁴³

The 'corporate recycling' philosophy appears, therefore, to be intrinsic to receivership, if the Interview Survey is representative of a universal approach²⁴⁴. In this regard, it is possible to assert that receivership makes a positive contribution to the 'rescue' of insolvent companies. It is further salutary to recognise that a going concern sale has implications for more than just the appointor, although the extent of these is difficult to enumerate. However, the 'winners' may include the company's employees, to the extent that the TUPE Regulations ensure continued employment for them²⁴⁵. A going concern sale may even result in a level of realisations sufficient to discharge the secured debt and so provide something for unsecured creditors, although interviewees acknowledged that receivership

²⁴¹ Interviewee 5.

²⁴² Interviewee 4.

²⁴³ Interviewee 8.

²⁴⁴ The quantitative surveys referred to earlier may support this proposition.

²⁴⁵ Interviewees appear to equate going concern sales with employment preservation. On TUPE generally, see Chapter 4.

‘surpluses’ were the exception rather than the rule²⁴⁶. Such creditors might, however, benefit from the fact that the business itself continues in new hands, as it is not unlikely that such will provide an outlet for future supplies²⁴⁷. This aspect of receivership should perhaps, therefore, give the reformers pause for thought.

7.2 A ‘niche’ role?

The previous sections have attempted to inform the rescue culture debate in, essentially, two areas. Firstly, it is submitted that one of the most significant outcomes of the IBR procedure is that it will assist in identifying those cases where receivership is the most appropriate response to a troubled company. This proposition admittedly assumes that those insolvency practitioners conducting IBRs are both competent and sufficiently objective to make the correct recommendation. It is impossible to conclusively demonstrate that insolvency practitioners are the best arbiters of the prospects of a troubled company, although the trust resided in them by the banks in this regard may be said to count for something. Banks have a vested interest in ensuring that, wherever possible, viable *companies* survive intact, and it is to the insolvency practitioners that they tend to turn in an effort to assist in this aim.

A corollary of this contention is that where receivership is recommended it will be because alternative routes that might result in the survival of the company have been considered and rejected as unrealistic. The survival of the *business of the company*, with the benefits to employees and, possibly, other stakeholders that such an outcome entails, is not, however, ruled out by receivership. On the contrary, the

²⁴⁶ Although interviewees 1, 4 and 9 had been able to hand over excess realisations to a subsequent liquidator in several cases.

²⁴⁷ The bank will not invariably be a beneficiary in this regard; the purchaser may not be an existing customer.

approach of appointees appears to be to attempt to accomplish that survival wherever possible. Interestingly, it might be argued that of all the insolvency regimes, receivership is best adapted to accomplishing a going concern sale of the undertaking of an insolvent company.

A number of characteristics of receivership tend to support this proposition. One particular advantage of receivership in this regard is the speed with which an appointment can be made:

“The appointment of an administrative receiver will ... avoid the delay involved in drawing up, application for and implementation of an administration petition and order, and the accompanying uncertainty in the initial stages as to whether the court will be satisfied that an administration order should be made.”²⁴⁸

The speed with which an appointment could be made was also expressed as helpful by interviewees in the Interviewee Survey:

“Receivership has some advantages over administrator and CVAs in as much as it’s quick. The bank makes the demand, an appointment is made and you’re in there straight away, in there making decisions.”²⁴⁹

“[Receivership’s] big advantage over all the other procedures is that it can be invoked immediately, and for a lot of the work that we do ... that is a key benefit. In terms of CVAs and administrations, and other applications to court, you’re always talking in terms of longish periods of time, and, of course, uncertainty, in terms of who is going to be appointed at the end of the day ... I don’t think there is anything that receivership does that could be done better in another process.”²⁵⁰

Moreover, it is not merely speed that is important in this regard. Both the CVA procedure and administration are more creditor driven than receivership. In the

²⁴⁸ Doyle, *supra* n 119, 66.

²⁴⁹ Interviewee 2.

²⁵⁰ Interviewee 9.

latter, decision-making power is concentrated in the receiver, who may therefore exercise any of his powers autonomously, and without having to indulge in sometimes lengthy periods of consultation. Where the prospect of a going concern sale of the business arises, the agreement can be concluded quickly:

“As a rescue tool I think receivership’s very good, better than administration in a lot of ways. For instance, in administration there is the problem of the section 23 meeting, because you’re appointed, you want to make decisions, but those decisions have to be ratified. So you might have a buyer wanting to buy the company and you have to say, ‘Great, come back in a month or so,’ because there’s a fourteen day period in which to notify creditors. And what if he says, ‘No, I want it now?’”²⁵¹

In this regard, the position may have been somewhat alleviated by the decision of Neuberger J in *Re T & D Industries plc*²⁵². The learned judge accepted that, in cases of extreme urgency, administrators may dispose of the undertaking of the company without the approval of the creditors’ meeting or a direction of the court. However, it is clear from the judgment that this does not represent a *carte blanche* for administrators to effect such transactions without the kind of consultation that the Insolvency Act envisages. In particular, Neuberger J noted that there will be occasions where the proper route would be to activate an informal consultation exercise²⁵³, especially where there are limited numbers of creditors, or a concentration of voting power within such a limited number.

Re T & D Industries goes some way towards defusing the prejudicial element of delay as far as attaining going concern sales is concerned, but, it is submitted, does not place administrators in the same favourable position enjoyed by receivers in this regard. There remains room for doubt as to when an administrator should dispose of

²⁵¹ Interviewee 3. See also, to this effect, Doyle, *supra* n 119, 67.

²⁵² [2000] 1 All ER 333.

²⁵³ See also *Re Charnley Davis Ltd* (1988) 4 BCC 152; *Re Dana (UK) Ltd* [1999] 2 BCLC 239.

the entirety of the company's assets without first seeking the approval of either creditors or the court. Indeed, it could be contended that such a route is only properly open in the most exceptional of circumstances, given that the conception of administration is based squarely upon the notion of creditor participation in the decision-making²⁵⁴. Moreover, an administrator's decision to proceed without consultation is eminently more challengeable than a receiver's, both before and after the event. Any creditor who became aware of such a plan could petition the court under s 27 Insolvency Act, thus delaying the transaction, perhaps irretrievably. Further, that same section is available to disgruntled creditors who wish to complain of what they regard as an injudicious course of conduct that prejudices their position.

Receivers, therefore, appear to be in a superior position to administrators in terms of speed of appointment and action, both of which may turn out to be of pivotal import if a going concern sale of the business is to be pursued. A related advantage is that of cost. It is generally accepted that administration, because of the greater involvement of lawyers and the courts that it entails, is a relatively more expensive procedure than receivership. In particular, the costs associated with administration render it inappropriate for anything but the largest enterprises:

“...it has become apparent that the expense of the [administration] procedure prohibits its application to smaller companies.”²⁵⁵

Whilst receivership might be a less costly procedure than administration, it will still

²⁵⁴ See the remarks of Peter Gibson J in *Re Consumer and Industrial Press Ltd (No 2)* (1988) 4 BCC 72.

²⁵⁵ Goldring, *supra* n 119, 8. See also *The Review Document*, *supra* n 20, para. 6(e); *Hansard*, House of Lords, 4 April 2000, col. 1249, Lord McIntosh of Haringey. Interviewee 7 suggested that administration should only be contemplated if a surplus for unsecured creditors could be envisaged from the outset, otherwise costs incurred preparing the Rule 2.2 report would be wasted.

prove more expensive than the CVA regime²⁵⁶, but this is a red herring when it comes to adjudging the advantages of receivership in the pursuit of going concern sales. Such an objective will, it is submitted, hardly ever form the basis of a CVA proposal, which will invariably be directed towards the continuation of *the company*, which in turn envisages that the ownership of *the business* will remain located with the original shareholders²⁵⁷.

In conclusion, it is submitted that receivership is, of all the insolvency regimes, unsurpassed when it comes to the recycling of insolvent companies. Receivers have all the necessary powers to continue trading whilst the prospects of such an outcome are investigated, and can effect a wholesale disposition of the undertaking of the insolvent enterprise relatively quickly and relatively cheaply. It is perhaps ironic that those aspects of receivership 'law' which appear most inequitable actually assist in this process. The exclusion of corporate stakeholders from the decision-making course preserves the receiver's sovereignty and, as a corollary, his ability to act speedily and decisively. His ability to breach pre-receivership contracts of the company enables him to utilise assets that would otherwise be 'earmarked' for the performance of such, and to put together a bespoke 'package' for potential purchasers. The 'one-sided' nature of his obligations prevents an irreconcilable conflict between the interests of the debenture-holder, and, potentially, the unsecured creditors on the one hand, and those of the internal stakeholders arising: thus a receiver is not constrained by any 'duty' to the company's owners that would preclude a course of action likely to maximise realisations.

²⁵⁶ See Milman and Mond, *supra* n 92, 21

²⁵⁷ This is *a fortiori* where there is identity of ownership and management, as will frequently be the case in smaller companies.

It is therefore plausible to suggest that receivership, in this regard, is an integral part of the existing rescue culture in the United Kingdom. Corporate recycling will often be the best, or, indeed, the only alternative for a financially distressed company, and receivership is by far the best vehicle to effect this. The going concern sale itself maximises realisations, and the prospect of a going concern sale is maximised when the operative regime is receivership. Receivership law, whether by accident or design, has been moulded into a facilitative body that greatly assists in the attainment of what is, arguably, the optimal realistic outcome. This leads inexorably on to the final enquiry of this Chapter, which is, very simply, whether the legislature should accept the arguably 'hidden' merits of receivership and look elsewhere for initiatives when it comes to reforming insolvency law.

Receivership and Reform: Conclusions

1. Introduction

The above discussion focuses on the processes by which a decision to appoint a receiver is made and the positive outcomes that such a decision may engender. To summarise, it is suggested that the appointment decision is usually made after a considered review of the circumstances of the company in question, which, in turn, will have ruled out its survival potential as a corporate entity, either through an informal rescue attempt or a CVA. Once an appointment is made, the appointee will often attempt to maximise realisations via a going concern sale of the business. As an administrative receiver, he is unusually well equipped to achieve this end. In short, receivership can correctly be categorised as a rescue mechanism, and, further, both the legal structure of receivership and the attitudes of banks and insolvency practitioners facilitate this end.

It is acknowledged that this conclusion is based upon evidence that is almost exclusively drawn from statements of banks and insolvency practitioners themselves. It would be valuable to have such authenticated independently. Nevertheless, there is a certain inexorable logic in the assertion that banks are not ‘trigger-happy’ when it comes to making receivership appointments. This is particularly borne out by the findings of the Eighth Survey, which suggest that the CVA regime is more productive in terms of returns to secured creditors. Given that a *viable* CVA proposal is more likely to result in a greater return, it would be irrational for a secured creditor to veto it in favour of a receivership.

As a corollary, the more favourable performance of CVAs reported in that survey can be explained by reference to the ‘filtering’ process conducted by banks. Only the workable proposals get through the net, with unfeasible overtures rejected in

favour of receivership²⁵⁸. Once receivership has supervened, the receiver will generally have an incentive to pursue what is arguably the most productive outcome attainable in the circumstances, *viz.*, a going concern sale of the undertaking of the company. Whilst this may not realise sufficient to discharge *all* debts, it may result in a continuing business which will require supplies, and which may itself supply pre-receivership customers of the original entity. Moreover, the employment-saving potential of going concern sales has been canvassed in the previous Chapter²⁵⁹. From this perspective, receivership, *as it is currently conducted by insolvency practitioners*, is arguably the most effective method of achieving the best results out of those companies over which it is invoked. This, in turn, suggests that the legislature should reconsider those of its plans aimed at eroding the control rights of secured creditors which presently exist. It is to these that the final sections now turn.

2. The impetus for reform: the downside of receivership

“If collective procedures are thought to provide better outcomes for creditors generally there are a number of ways in which they might be enhanced...”²⁶⁰

With respect, the above somewhat begs the question. Granted, there is evidence to suggest that CVAs and, in some respects, administrations result in an enhanced outcome for corporate stakeholders overall, and, indeed, for the corporate entity itself. However, as noted above, those procedures have operated in the context of a screening system which serves to identify appropriate candidates for them. There is no evidence to determine whether collective procedures, which, by inference,

²⁵⁸ Or, of course, liquidation.

²⁵⁹ Whether such will inure if the TUPE Regulations are amended to reflect amendments to the Acquired Rights Directive is a moot point. Any erosion of the employment-protection effects of TUPE will, of course, equally affect other insolvency procedures.

²⁶⁰ *Review Document*, *supra* n 20, para. 10(e).

appear to exclude receivership, would produce the same positive outcomes if available to *all* financially distressed companies.

In particular, the long-term survival potential of companies emerging intact from a CVA is not documented. It would be fascinating to discover how many accepted proposals are actually adhered to once the nominee has vacated office. So too how many entities enjoy a trouble-free existence after the event, and do not later lapse into insolvency once again. The same, of course, could be said about receivership going concern sales: no records exist of their fate once they have been transferred into new ownership. This is the kind of information necessary to inform perfectly the debate and, unfortunately, it is not available.

However, given that the Review Committee are at least contemplating a promotion drive for ‘collective’ procedures²⁶¹, it should be acknowledged that receivership should be open to examination, as there remain ‘characteristics’ of that institution which give cause for concern. For example, whilst it has been suggested that the majority of receivership cases will be conducted on behalf of an under-secured creditor, at least some will involve the opposite situation. Where the value of the secured assets exceeds the amount owed to the appointor, the ‘perverse incentive’ problem arises.

How often this occurs is unknown. The Eighth Survey suggests that in 19% of receiverships secured creditors recover 100% of the debt²⁶². It is unclear whether, of this 19%, full recovery is achieved simply because the debenture-holder is over-secured. It might just as easily be the case that full recovery is achieved through a going concern sale, or, to put it another way, a maximisation of realisations

²⁶¹ Whether this ambition will be abandoned after the current round of consultation remains to be seen.

²⁶² See *supra* 489.

strategy. Information on this question is indispensable to a proper evaluation of receivership, and without it only speculative assessments can be propounded.

Nevertheless, to the extent that receiverships are appointed by over-secured banks, and to the extent that asset-sales are preferred over more rescue-orientated strategies, there is clearly an imbalance in the insolvency system which ought to be addressed. Some commentators have specifically noted this point:

“...the debenture-holder or his receiver is entitled to dispose of assets on a break-up basis even though more could be obtained by carrying on the business and disposing of it as a going concern. Further, he is, it seems, entitled to realise any asset of his choosing, even if it is equipment crucial to the company’s business and there are other assets available which would realise sufficient to cover the amount due.”²⁶³

This phenomenon represents, it is submitted, a genuine flaw of receivership²⁶⁴ and one which could sensibly be addressed by legislation. The point has been made in earlier Chapters²⁶⁵ that the jurisprudence on receivership is deficient in that it allows a receiver to discount the interests of company and other stakeholders when such is not necessary in the interests of his appointor. It bears repeating that this may happen only very rarely, but the potential for such imbalance is inherent in the law.

3. Promoting collective procedures: the ‘mandatory’ approach

It was suggested earlier that a promotion of the rescue culture would involve the *persuasion* of those stakeholders in a position to embrace or impede it. Where persuasion is fruitless it will be necessary to consider a more coercive approach. In the current context, this would require legislation inhibiting the exercise of control

²⁶³ Goode, *supra* n 2, 192.

²⁶⁴ In Law and Economics terms it promotes an *inefficient* outcome.

²⁶⁵ See Chapters 2 and 3.

rights presently enjoyed by floating charge holders which allow them to 'select' receivership over CVAs or administrations. The Review Document refers to two options in this regard, these being the removal of the veto to administration and a provision to the effect that security may only be enforced through a court-appointed receiver²⁶⁶. The latter suggestion is made upon the basis that the appointee would have "wider duties to all creditors"²⁶⁷. One might therefore question whether he is not, in fact, an administrator²⁶⁸.

A further 'procedural innovation' canvassed by the Review Document is a "Single Gateway" procedure:

"A Single gateway process might entail:

- a period of 'observation' by an insolvency practitioner appointed by the court to determine the true state of the company;
- during this period the company would be subject to a moratorium; and
- a report to the court (and the creditors) by the IP and a recommendation as to the procedure to be adopted (reconstruction or liquidation) subject to a creditor vote and court approval."²⁶⁹

This is described as "effectively ... a form of compulsory Administration..."²⁷⁰, and in this regard would appear to represent a further measure that would diminish the control rights of floating charge holders as to the particular insolvency procedure to be activated.

Quite how the single gateway procedure would operate is a matter for speculation. Critically, the manner in which it might be invoked is not addressed. The question

²⁶⁶ *Review Document*, *supra* n 20, para. 10(e).

²⁶⁷ *Ibid.* Milman and Mond make a similar proposal for reform, *supra* n 92, 7.

²⁶⁸ And, indeed, whether this 'new, improved court-appointed receiver' would enjoy similar powers to an administrator. If not, it is difficult to envisage a secured creditor ever having recourse to the procedure.

²⁶⁹ *Review Document*, *supra* n 20, para. 10(f).

²⁷⁰ *Ibid.*

therefore arises as to *who* could prompt entry into the procedure and at what point in the company's existence. The obvious answer to the first enquiry would be that the *company* would be able to initiate the process. The difficulty with this approach is the fact that, as noted throughout this Chapter, those in control of a troubled enterprise tend to avoid relinquishing control over it until the point of no return has been reached.

The single gateway procedure might also be open for invocation by the company's creditors. In practice, the one creditor likely to have the requisite information on which to base a decision to activate a single gateway is the company's bank. It is unclear as to whether a court application is envisaged, but an interesting point about a *bank-invoked* single gateway is its similarity to the IBR process described earlier²⁷¹. A period of "observation", conducted by an insolvency practitioner, who goes on to make recommendations mirrors the IBR almost perfectly. The single, and extremely important distinguishing feature is the moratorium that would operate during the observation period, an aspect that might well prove attractive to a secured creditor.

It appears that the single gateway is contemplated as a replacement for existing insolvency regimes, although this is little more than an impression and is not made explicit in the Review Document. In the same way that the 'entry point' is not addressed, nor is the mode of 'exit'. It is unclear whether the appropriate procedure, to be recommended by the insolvency practitioner, could include entry into one of the regimes currently in existence or not. The nearest the Document comes to specifying the options is "reconstruction or liquidation"²⁷². How either is to be accomplished remains unstated.

²⁷¹ *Supra* 490.

²⁷² *Review Document*, *supra* n 20, para. 10(f).

3.1 Countering the loss of control

The Review Document invites comment on a number of measures, described above, that would, to some extent, erode the current dominion of floating charge holders over the insolvency process. It has been suggested that the assumptions upon which the appropriateness of these measures is based may be incorrect, and warrant further investigation. An additional question arises in this regard. Secured creditors clearly value their existing control rights, and, if these are modified, may attempt to avoid the perceived deleterious effects of such modification. Any steps they might take to this end may either neutralise the impact of modification or may even engender an overall disadvantageous outcome. Precisely how financial institutions might react in this situation is a matter of conjecture. However, it is possible to tentatively predict a number of avenues that might be explored.

A perennial concern of policy makers is that intervention in the insolvency regime will provoke banks to increase the cost of borrowing. In other words, to counteract the losses they expect to have to bear in the event of redistributive measures being enacted, banks will simply put up their interest rates for all corporate borrowers. Whether such a result would transpire in the event of the enactment of one or other of the Review Document's suggestions is difficult to forecast. It may that competition for corporate customers amongst banks would forestall such a tactic²⁷³. Mond doubts that the erosion of bank privileges would increase the cost of borrowing:

"Competition between banks is always increasing. Banks are facing competition from other sources of business finance. They might miss their present privileged status, but they will not stop lending."²⁷⁴

²⁷³ Goode, in a different context, cogently argues that banks charge "what they consider the market will bear"; see *Principles of Corporate Insolvency Law*, *supra* n 33, 41.

²⁷⁴ *Security and Corporate Rescue*, *supra* n 92, 1. See also the remarks at page 11.

A possible *benefit* in this regard is that banks might be more disposed to scrutinise applications for credit more carefully than they do at present. In other words, it is argued that individual lending decisions should be taken by reference to the particular nature and viability of the business, and not simply the amount of collateral available. This weakness was identified as early as 1976:

“ When an intending entrepreneur approaches his bank for a loan to start a company the bank's concern is less for the probable viability of the company than for collateral.”²⁷⁵

It has been resurrected in more recent times as justifying the abolition of the floating charge:

“ Without the all-embracing safety net of the floating charge for the bank, lending proposals would inevitably be more critically assessed to the benefit of the banks and the businesses concerned.”²⁷⁶

In other words, confronted with the diminution of their privileges, banks might adopt a *productive* rather than a defensive approach.

Aside from the possible implications for the cost of borrowing, reforms adversely affecting the position of financial institutions might have other effects. If financially troubled companies are able to enter into an ‘insolvency’ regime in which its major lender has no confidence, that lender will hardly be likely to agree to fund such an initiative. Indeed, the question of funding for rescue is one the Review Document explicitly raises, and is outside the scope of the current enquiry. For the present, it is sufficient to note that one of the advantages of receivership as a regime is that there will usually be funding available from the appointing bank if the receiver so requests it²⁷⁷.

²⁷⁵ Argenti, *Corporate Collapse*, *supra* n 111, 171-172.

²⁷⁶ Grylls, *Does the UK Need to Retain the Floating Charge?*, *supra* n 92, 392. See also Milman and Mond, *supra* n 92, 52.

²⁷⁷ This was confirmed by all nine interviewees in the Interview Survey.

Moreover, research into the incidence of requiring company directors or owners to provide personal guarantees of their company's borrowings should also be considered. An astute banker, faced with a recalcitrant director threatening to invoke a protective regime to which the banker is opposed, will have a potentially weighty bargaining chip if that director has personally guaranteed the loan. A further 'avoidance technique' would be to continue to finance commercial entities, but by different methods, methods which are perceived as immune to legislative intervention. Receivables financing springs to mind in this regard, and, to the extent that the enforcement of security during a statutory moratorium remains a possibility, asset-based financing.

It should be emphasised that the above discussion is entirely speculative. In the event of the enactment of mandatory measures it is equally possible that financial institutions would not respond negatively at all. However, banks have proved particularly resilient to previous initiatives which appear ostensibly adverse to their position²⁷⁸. Their determination and ingenuity²⁷⁹ in this regard should not be overlooked by reformers.

4. Closing remarks

In the final analysis, a concrete conclusion as to the need for reform, or, indeed, its implications is difficult to draw. As has been noted on several occasions, not enough is known about the processes and outcomes of the various insolvency procedures under examination to state with confidence that they adequately promote a realistic embodiment of a rescue culture in the United Kingdom. This

²⁷⁸ As an example in the current context, the preferential debts regime has to some extent been countered by the advent of the fixed charge over book debts.

²⁷⁹ Or that of their lawyers.

Chapter has, however, presented a rather more favourable perspective of receivership than a perusal of the law reports would engender. In some respects, and when viewed in conjunction with the 'pre-insolvency' practices of those who conduct it, receivership can, it is tentatively submitted, represent an appropriate and constructive response to a distressed company.

There remain concerns, most particularly the problem of the over-secured debenture-holder. This, it is suggested, is the most obvious defect of receivership, and one which ought to be remedied. This could be achieved, however, without any erosion of the existing control rights afforded floating charge holders. It is at least arguable that reform of an area about which so little is known should proceed upon the basis that the minimum measure to remedy the particular mischief is an appropriate one.

In the case of the over-secured debenture-holder, such a minimum measure might involve allowing directors of the receivership company to petition the court for an injunction where a receiver is proposing to sell assets on a break-up basis. It would then be for the receiver, or, indeed, his appointor to demonstrate to the satisfaction of the court that the secured creditor would be disproportionately prejudiced by a longer-term strategy which might result in the maximisation of realisations²⁸⁰.

It should be noted that it is only in the above scenario that unsecured creditors of a receivership company are prejudiced *by receivership itself*. Their particular plight is not so much a product of that institution, but rather of the fact of it remains possible to take global security over the entirety of a company's assets. That security has to be respected, and the secured creditor paid first, whether receivership, administration or liquidation is involved.

²⁸⁰ For a more ambitious version of this idea see Milman and Mond, *supra* n 92, 7.

The position of unsecured creditors is clearly one giving rise to concerns, although again more information on the implications of that status would be valuable. It is not necessarily the case, however, that modifications to receivership law would improve their position, nor indeed, that measures intended to promote corporate rescue would have that effect. Rescue does not, it is submitted, *inevitably* further the cause of unsecured creditors: to the extent that it requires them to forgive debt, and to the extent that it proves to be a short-term solution only, it may well be that the true beneficiaries are corporate owners and managers.

In this regard, corporate rescue as an aim should not be perceived as a panacea. If the plight of unsecured creditors is considered sufficient to warrant intervention, rescue-facilitative programmes will not of themselves be sufficient. Nor will the abolition or less radical modification of receivership. It is beyond the scope of this work to address the question in any depth, but it may be that reformers should, if they are serious about improving the lot of unsecured creditors, confront the possibility that this can only be achieved by redistributive measures *of a financial nature*.

Receivership is a much-maligned institution, and, it is submitted, unfairly so. A structured and informed consultation and review procedure might support this proposition. It might, on the other hand, suggest that there is room for a redressing of the balance in favour of distressed companies, which, in turn, would inevitably require some modification of receivership law. Until such a process has been carried out, however, the legislature might do well to hold its hand as to such reform. At the very least, the effect of the Insolvency Bill 2000, with its CVA with moratorium provisions should be monitored before more ambitious schemes are put into action.

Corporate insolvency will never be eradicated. Companies will continue to get into financial difficulties, and, in some cases, these will prove terminal. In some cases, receivership may remain the best and most productive option. Its worst excesses can be addressed without major surgery, and its latent benefits preserved in the process. At the very least, those calling for reform might like to consider this possibility.

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