Introduction to the second edition

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

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

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

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

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

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

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

[1] Council Regulation (EC) 1346/2000 of 29 May 2000, OJ 2000 No. L160/1, 30 June 2000, pp. 0001–0013, amended in 2005 by Council Regulation (EC) 603/2005 and in 2006 by Council Regulation (EC) 694/2006. See further I. Fletcher, 'Reflections on the EC Regulation on Insolvency Proceedings – Parts 1 and 2' (2005) 18 *Insolvency Intelligence* 49 and 68; Fletcher, *Insolvency in Private International Law: National and International Approaches* (2nd edn, Oxford University Press, Oxford, 2005) ch. 7; G. Moss and C. Paulus, 'The European Insolvency Regulation – The Case for Urgent Reform' (2006) 19 *Insolvency Intelligence* 1; P. J. Omar, *European Insolvency Law* (Ashgate Publishing, Aldershot, 2004) chs. 3, 5, 6–10; M. Virgos and F. Garcimartin, *The European Insolvency Regulation: Law and Practice* (Kluwer, The Hague, 2004); K. Dawson, 'Cross Border Insolvency: The EC Regulation and the UNCITRAL Model Law' in K. Gromek Broc and R. Parry (eds.), *Corporate Rescue: An Overview of Recent Developments* (2nd edn, Kluwer, London, 2006).

[2] See, for example, P. Omar (ed.) *International Insolvency Law: Themes and Perspectives* (Ashgate Publishing, Aldershot, 2008); J. Townsend, 'International Co-operation in Cross Border Insolvency: *Hill Insurance*' (2008) 71 MLR 811; J. Bannister, 'Universality Upheld: The House of Lords' Decision in *McGrath* v. *Riddell* Considered' (2008) 232 *Sweet & Maxwell's Company Law Newsletter* 1; H. Anderson, 'Legal Update – The Ruling in *McGrath* v. *Riddell and Others* [2008] UKHL 21' (2008) *Recovery* (Summer) 9; Fletcher, *Insolvency in Private International Law*; Fletcher, *The Law of Insolvency* (3rd edn, Sweet & Maxwell, London, 2002) ch. 31; Fletcher, '"Better Late than Never": The UNCITRAL Model Law Enters into Force in GB' (2006) 19 *Insolvency Intelligence* 86; Fletcher, 'The Quest for a Global Insolvency Law: A Challenge for Our Time' in M. Freeman (ed.), 55 *Current Legal Problems* (Oxford University Press, Oxford, 2002) pp. 427–45; UNCITRAL Model Law on Cross-Border Insolvency; Cross-Border Insolvency Regulations 2006 (SI 2006/1030); Dawson, 'Cross Border Insolvency'; J. Westbrook, 'Global Insolvencies in a World of Nation States' in A. Clarke (ed.), *Current Issues in Insolvency Law* (Stevens, London, 1991).

[3] For a discussion of key features of the insolvency systems in a selection of European jurisdictions see, for example, C. Laughton, 'Review of European Corporate Insolvency Regimes Part 1' (2004) *Recovery* (Autumn) 16; 'Part 2' (2005) *Recovery* (Summer) 20; B. Wessels, 'Europe Deserves a New Approach to Insolvency Proceedings' (2007) 4 *European Company Law* 253; E. Geva, 'National Policy Objectives from an EU Perspective: UK Corporate Rescue and the European Insolvency Regulation' (2007) 8 EBOR 605.

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

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

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

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

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

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

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

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

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

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

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

PART I

Agendas and objectives

1

The roots of corporate insolvency law

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

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

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

[1] See Cork Report: *Report of the Review Committee on Insolvency Law and Practice* (Cmnd 8558, 1982) ch. 1; see ch. 3 below.
[2] T. H. Jackson, *The Logic and Limits of Bankruptcy Law* (Harvard University Press, Cambridge, Mass., 1986) chs. 1, 2; see ch. 2 below.

Development and structure

The earliest insolvency laws in England and Wales were concerned with individual insolvency (bankruptcy) and date back to medieval times.[3] Early common law offered no collective procedure for administering an insolvent's estate but a creditor could seize either the body of a debtor or his effects – but not both. Creditors, moreover, had to act individually, there being no machinery for sharing expenses. When the person of the debtor was seized, detention in person at the creditor's pleasure was provided for. Insolvency was thus seen as an offence little less criminal than a felony. From Tudor times onwards, insolvency has been driven by three distinct forces: impulsions to punish bankrupts; wishes to organise administration of their assets so that competing creditors are treated fairly and efficiently; and the hope that the bankrupt would be allowed to rehabilitate himself.[4] Early insolvency law was dominated by punitive approaches and it was not until the early eighteenth century that notions of rehabilitation gained force. The idea that creditors might act collectively was recognised in 1542 with the enactment of the first English Bankruptcy Act which dealt with absconding debtors and empowered any aggrieved party to procure seizure of the debtor's property, its sale and distribution to creditors 'according to the quantity of their debts'.[5] This statute did not, however, provide for rehabilitation in so far as it did not discharge the bankrupt's liability for claims that were not fully paid.

Elizabethan legislation of 1570 then drew an important distinction between traders and others, including within the definition of a bankrupt only traders and merchants: those who earned their living by 'buying and selling'.[6] Non-traders could thus not be declared bankrupt. As for

[3] On the history of insolvency law see Cork Report ch. 2, paras. 26–34; D. Milman, *Personal Insolvency Law, Regulation and Policy* (Ashgate, Aldershot, 2005) pp. 5–12; I. F. Fletcher, *The Law of Insolvency* (3rd edn, Sweet & Maxwell, London, 2002) pp. 6 ff.; B. G. Carruthers and T. C. Halliday, *Rescuing Business: The Making of Corporate Bankruptcy Law in England and the United States* (Clarendon Press, Oxford, 1998); G. R. Rubin and D. Sugarman (eds.), *Law, Economy and Society: Essays in the History of English Law* (Professional Books, Abingdon, 1984) pp. 43–7; W. R. Cornish and G. de N. Clark, *Law and Society in England 1750–1950* (Sweet & Maxwell, London, 1989) ch. 3, part II; V. M. Lester, *Victorian Insolvency* (Oxford University Press, Oxford, 1996).

[4] See Cornish and Clark, *Law and Society*, p. 231.

[5] Stat. 34 & 35 Hen. 8, c. 4, s. 1; see Fletcher, *Law of Insolvency*, p. 7; W. J. Jones, 'The Foundations of English Bankruptcy: Statutes and Commissions in the Early Modern Period' (1979) 69(3) *Transactions of American Philosophical Society* 69.

[6] J. Cohen, 'History of Imprisonment for Debt and its Relation to the Development of Discharge in Bankruptcy' (1982) 3 *Journal of Legal History* 153–6.

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

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

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

[7] Crompton, *Practice Common-placed: Or, the Rules and Cases of the Practice in the Courts of King's Bench and Common Pleas*, LXVII (3rd edn, 1786); J. Dunscombe, 'Bankruptcy: A Study in Comparative Legislation' (1893) 2 *Columbia University Studies in Political Science* 17–18.

[8] W. Blackstone, *Commentaries on the Laws of England* (8th edn, Clarendon Press, Oxford, 1765–9) vol. II, no. 5: Cohen, 'History of Imprisonment', pp. 160–2; Cornish and Clark, *Law and Society*, p. 232; Cork Report, p. 33.

fraud.[9] The bankruptcy system, moreover, was liable to manipulation by creditors and laid open to the 'eighteenth century penchant for malign administration'.[10] Nor was it the case that all traders were in practice brought within bankruptcy proceedings. The Erskine Commission of 1840 noted that the common law insolvency processes were frequently being used for small traders whose creditors were owed too little to justify bankruptcy proceedings (two-thirds of those before the Insolvent Debtors Court in 1839 were traders).[11]

Pressure for reform grew alongside dissatisfaction with the confinement of bankruptcy to traders. During the nineteenth century, attitudes towards trade credit and risk of default changed. A depersonalisation of business and credit was encouraged by Parliament's enactment of the Joint Stock Companies Act 1844 together with notions that credit might be raised on an institutional basis and capital through stocks rather than both of these dealt with as matters of individual standing.[12] Such changed attitudes rendered increasingly questionable Blackstone's view that it was not justifiable for any person other than a trader to 'encumber himself with debts of any considerable value'.[13] The distinction between traders and non-traders was finally abolished in 1861 when bankruptcy proceedings became available for non-traders. Soon afterwards the Debtors Act 1869 abolished imprisonment for debt.

The origins of corporate insolvency law are to be found in the nineteenth-century development of the company. The key statute was the Joint Stock Companies Act 1844 which established the company as a distinct legal entity, although it retained unlimited liability for the shareholders. From 1844 onwards corporate insolvency was dealt with by means of special statutory provisions[14] and the modern limited liability company emerged in 1855, to be followed seven years later by the first modern company law statute containing detailed winding-up provisions.[15] Only from 1855 onwards, therefore, was the concept of the limited liability of members for the debts incurred by the company established in law. Members of incorporated companies could limit

9 See Cork Report, paras. 37–8; Fletcher, *Law of Insolvency*, pp. 8–9.
10 Cornish and Clark, *Law and Society*, p. 232. 11 Ibid., p. 234.
12 On depersonalisation of business and credit in the USA see Rubin and Sugarman, *Law, Economy and Society*, pp. 43–4.
13 Blackstone, vol. II, no. 5, p. 473.
14 See e.g. Companies Winding Up Act 1844; Joint Stock Companies Act 1856; Companies Act 1862; Companies (Consolidation) Act 1908; Companies Acts of 1929, 1948 and 1985.
15 Limited Liability Act 1855; Companies Act 1862.