Insolvency law
An agenda for reform

JUSTICE

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JUSTICE

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The Committee

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CHAPTER 1

Fairness

The Committee

The aims of JUSTICE are to uphold and strengthen the principles of the rule of law and, in particular, to assist in the maintenance of the highest standards of the administration of justice and in the preservation of the fundamental liberties of the individual. 1.1

The Committee was set up by the Council of JUSTICE in the summer of 1993 to produce a report on the workings of the present insolvency system, the aim being to complete the task within twelve months. During the course of its meetings, the Committee has been left in no doubt that some changes to the system will inevitably have to be made if an erosion of public confidence in it is to be avoided. 1.2

JUSTICE wishes to record its thanks to the invaluable contribution of all those who participated in the Committee, and in particular to those members from the fields of banking, accountancy and consumer affairs. 1.3

This is not the first occasion on which a Committee of JUSTICE has looked at aspects of insolvency law. Twenty years ago we published a report on bankruptcy which highlighted the unsatisfactory legal framework for dealing with the consumer debtor. It is a sad reflection on the slow progress of law reform that we must return to the subject in this report albeit in dramatically changed circumstances. More recently, in 1992, the JUSTICE report on the small investor drew attention to the poor dividend prospects for ordinary creditors upon the collapse of businesses in the financial services sector. 1.4

The 1986 reforms

The present insolvency system is based on a comprehensive reform package introduced seven years ago. It followed a White Paper 'A revised framework for insolvency law' issued by the Department of Trade and Industry (DTI) in February 1984. 1.5

The primary legislation is contained in the Insolvency Act 1986 and the Company Directors Disqualification Act 1986 supplemented by a mountain of rules, regulations, fees orders, practice directions and a plethora of guidance notes from a variety of government and professional sources. The 1.6

volume of material continues to grow apace and, in addition, there has already come into existence a large body of case law explaining the new regime.

1.7 The reform package was to a considerable extent inspired by the recommendations of the Cork Committee on insolvency law and practice set up in early 1977 and which reported in 1982. It must be said at once that certain significant and socially important aspects of the Cork recommendations were not implemented by the legislation and it is arguable that some, at any rate, of the concerns to which we draw attention in this report stem from such omissions.

1.8 The legislation received intense scrutiny during its passage through Parliament and a wide range of interests were consulted during the process. However, the high degree of attention given to the preparation of the package has not yet prevented subsequent adverse comment regarding drafting shortcomings and the inadequacy in certain respects of the consultation process.

Today's insolvency scene

1.9 The world of insolvency existing at the time of the preparation of the Cork Report is markedly different from today's scene. There were, for example, in the early 1970s no more than about 4,000 bankruptcy cases each year, a situation which is in sharp contrast to the present. In 1992 there were nearly 38,000 cases rising to over 40,000 in 1993. Today's extremely modest dividend prospects for ordinary creditors are no better, probably worse, than in years gone by.

1.10 The old insolvency system was based on a legislative framework devised in the last quarter of the 19th century against a background of late-Victorian commercial needs and social values. The present system is without doubt an overwhelming improvement over its predecessor, though it is arguable that it is not necessarily completely in tune with today's requirements.

The strengths of the present system

1.11 The new package has already had some remarkable achievements, the most spectacular probably being the growth of a professional body of insolvency practitioners to administer the system. The standards of independence and objectivity required from this modern breed of professional are extremely high and although there have inevitably been some lapses the situation is far superior to the previous unregulated position. These improvements have, however, been obtained at a price, in the shape of additional costs and expenses which have by and large fallen

upon the insolvent estate to the ultimate financial detriment of the general body of creditors.

1.12 The new system has also had other important repercussions. The automatic discharge of the bankrupt after no more than three years has removed from that procedure much of its traditional stigma and disgrace. In comparison, it is arguable that the legislation regarding the disqualification of directors has not achieved its anticipated goals. From the end of 1986 until 1993 the total number of disqualification orders was only 2,023, of which 419 were made in the last year.

1.13 Another beneficial and constructive aspect of the legislation has been the impetus given to the promotion of a rescue culture, though there are signs, at any rate in the more economically significant cases, that rescue operations are being conducted by banks and the commercial community entirely outside the confines of the insolvency system. There is very little empirical evidence to suggest that any appreciable number of businesses are being saved under existing insolvency procedures or that any modification to the relevant statutory provisions would bring about a substantially greater number of successful rescues.

1.14 The legislation has had far more success in the promotion of the concept of the voluntary arrangement for the individual debtor as an alternative to bankruptcy. Its advantages seem to be particularly apparent to the more sophisticated type of debtor: such as professionals in private practice with the prospect of some continuing income or directors faced with large guarantees on behalf of an insolvent company. What is abundantly clear is that in practice the procedure is of little or no use to the small consumer debtor who commonly has no meaningful assets or any income from which to make contributions towards past debts.

1.15 The package has been in operation for seven years and encouraging progress has been made towards achieving the original aim of modernising insolvency law and harmonising the approach to corporate and individual insolvency. But taken as a whole there is no room for complacency.

The weaknesses

1.16 In our view the system under the Insolvency Act contains a considerable number of unsatisfactory features which will inevitably have to be remedied if it is to command continued public confidence and respect. Some striking areas of concern are as follows:

i) the lack of appropriate alternative procedures compels far too many individual debtors to resort to bankruptcy;

ii) the system confers excessive financial advantages upon the

government in consequence of fees and other expenses levied on insolvent estates;

iii) the insolvency process generally produces minimal returns for ordinary unsecured creditors;

iv) the insolvency system, though ostensibly intended to provide the debtor with a collective process of relief from creditor pressure, contains an undue proportion of adversarial characteristics frequently occasioning needless litigation and a consequent waste of judicial resources;

v) the insolvency process is generally perceived to be excessively costly to administer, but lacks any adequate machinery for the speedy and efficient resolution of complaints against practitioners;

vi) the system contains anomalies and inconsistencies which, if not corrected, will gradually undermine confidence in its operation and, looking to the future, may prejudice its acceptability in a European and international context.

1.17 The procedure under the Company Directors Disqualification Act has also failed to achieve its goals, as is evident from the comparatively small number of cases where disqualification orders have so far been made. A review of the process needs to be put in hand to reduce delay and to give the court greater discretion as to how unfit directors should be dealt with. At present, once a finding of unfitness is made, the court is compelled to impose a period of disqualification of not less than two years.

1.18 Furthermore, the workload of the Insolvency Service in handling such cases should be reviewed and consideration be given to the possibility, for example, of transferring responsibility for some of its provincial work to outside practitioners.

The road to improvement

1.19 Whilst no case exists for any drastic reconstruction of the present insolvency system, there do appear to us to be many areas which could be profitably improved either by parliamentary intervention or, more promisingly, by other approaches.

1.20 In the United States steps are currently being taken by the Congress to set up a permanent commission to keep insolvency law under review and to advise the President on reforms. The dramatic growth in insolvency in this country since 1986 would clearly justify the establishment of a similar specialised committee in this country capable of representing a broad spectrum of judicial, professional, commercial and social interests.

1.21 The activities of such a body might be far-ranging particularly in those areas where at present little information appears to be generally available. It could usefully have responsibility for the following:

i) devising a national insolvency strategy;

ii) encouragement and co-ordination of a programme of research into insolvency issues;

iii) keeping under review insolvency developments in Commonwealth, European Union and other countries;

iv) monitoring the cost-benefits of insolvency procedures;

v) exploring the concept of an Insolvency Ombudsman and a Creditors' Charter.

1.22 This report sets out the main problems for the small consumer debtor and creditor and suggests some of the solutions. It is the intention of JUSTICE to pursue these specific concerns and other aspects of insolvency in greater detail and to hold a seminar on the subject later.

1.23 Meanwhile the Committee has prepared a response to the recent Consultative Document about improvements to corporate rescue procedures issued by the DTI. That response is appended as an Annex to this report. The document undoubtedly addresses extremely important issues but in terms of insolvency law and practice as a whole it is narrowly focused. Recent information suggests that the number of cases where rehabilitation stands any real prospect of success are comparatively small and that a success rate of about 50% is more than generous. Our response to these issues should be read in conjunction with this report.

CHAPTER 2

Public disquiet

The fairness of the system

2.1 The Committee was established against a background of general unease in the community at large about the working of the present insolvency system and its fairness but also in the light of certain specific factors:

i) the dramatic changes in the insolvency scene during the last decade;

ii) the disparity between the large number of individual debtors being made bankrupt and the relatively small number of disqualification orders against company directors;

iii) a perception that the present unsatisfactory treatment of the consumer debtor might to some extent be attributable to a failure to implement recommendations in this respect in the Cork Report and that in turn the situation may have been aggravated by an unacceptable division of responsibility for the matter between government departments;

iv) a growing concern regarding the unsatisfactory working of the procedures for rescuing insolvent businesses and, in particular, whether the interests of employees in relation to matters so vitally affecting them and their families were being adequately safeguarded, issues which in the event are largely address in the Consultative Document circulated by the DTI in November 1993;

v) a distinct feeling that the heart of current dissatisfaction may well be found in a degree of imbalance of power. On the one hand there is the new breed of professional insolvency practitioners (by whom, together with the Insolvency Service, a government executive agency, the procedures are largely conducted), and also banks and other financial institutions with the benefit of a high level of secured debt. At the opposite extreme, there is the body of ordinary trade and other unsecured creditors whose prospects of anything more than a nominal dividend at the end of somewhat protracted proceedings may not have significantly improved since the JUSTICE report on bankruptcy was published in 1975; indeed, in all probability, they are worse.

Public comment

2.2 There has been during the last year or so a considerable amount of public attention given to the shortcomings of the present insolvency system, and a mass of ideas for improvement. A survey of the press in one week alone, at the end of July 1993, revealed an avalanche of suggestions from a variety of responsible sources.

2.3 The CBI made the following comments and suggestions:

a) insolvency practitioners should be required to concentrate on rescue operations;

b) it should be easier to obtain administration orders, which, when granted, could be used to keep companies afloat;

c) companies should be allowed a defined period of grace while rescue plans are drawn up;

d) there should be a revision of bank collateral rules to give unsecured creditors better treatment; in this connection attention was especially drawn to the fact that the average payout for unsecured creditors following receiverships in the UK is roughly 2p in the pound, but the banks were alleged to be understandably opposed to a lessening of the distinction between secured and unsecured creditors;

e) unsecured creditors should be able to recover goods they have delivered unpaid to an insolvent company;

f) there should be more vigorous enforcement by regulators against directors of 'phoenix' companies that go into liquidation but rise again under a new name without paying their previous creditors;

g) the Crown's right to rank ahead of other unsecured creditors should be abolished.

2.4 After drawing attention to the CBI's proposals, The *Independent on Sunday* on 25 July 1993 put forward its own additional suggestions:

a) investigating accountants to a company should be barred from subsequent appointment as receivers or liquidators to the same company; alternatively, an independent body should decide whether troubled companies survive or not;

b) insolvency practitioners should be required, before they take a case, to supply a written quotation for their fees which can only be modified under agreement with creditors;

c) liquidators and receivers should be required to provide regular written details, perhaps on a standard form, to inform directors how they are getting on with the case, dealing in particular with how much money they recovered and at what cost;

d) there should be created an independently funded office for an insolvency Ombudsman;

e) the DTI should be encouraged to give consideration to easing company voluntary arrangements to achieve rescue deals that are cheaper than administration.

2.5 Two articles in the *Daily Telegraph*'s Money-Go-Round section on 31 July 1993 drew attention to the following:

a) alternatives to bankruptcy such as what it described as the little-used option of the administration order in the County Court where the debts are, as matters then stood, under £5,000;

b) bankruptcy costs, according to one insolvency practitioner, can consume around 40% of assets, about twice as much as an individual voluntary arrangement; the government takes the biggest bite, followed by the insolvency practitioner, with lesser amounts by selling agents and solicitors.

2.6 An article in *The Times* on 5 August 1993 continued the debate, in particular as regards the level of insolvency practitioner's fees.

Parliamentary recommendations

2.7 The House of Commons Social Security Committee in its Fourth Report in July 1993 dealt with the work of the Maxwell insolvency practitioners. It made a number of recommendations, including the following:

a) all parties involved in sorting out the Maxwell case should always consider the possibility of using mediation to resolve disputes before commencing the long road through the courts;

b) given the growing number of people in pension funds, and in the light of the Maxwell affair, the government should consider whether pension funds should be granted preferential creditor status over such institutions as the banks;

c) there should be a review of the current procedures for monitoring the progress of insolvencies and the appointment of independent monitors to all insolvencies which are over a certain value; furthermore, attention having been drawn to the then forthcoming Consultative Document regarding the extension of the voluntary arrangement system for small businesses, it was suggested that as a matter of further reassurance the work being undertaken in that regard should be broadened to embrace the entire UK insolvency code so as to incorporate all the lessons provided by the record number of insolvencies that had taken place during the recent recession.

Drafting shortcomings

2.8 In the course of a speech given to the European Forum, and reported in the *Financial Times* on 15 March 1994, the Director-General of the CBI drew attention to the general need for legislation to be subject to more thorough consultation and better drafting and scrutiny; as well as to the desirability of introducing a formal review procedure. The Insolvency Act 1986 would certainly have benefited had it been subjected to such processes.

2.9 A number of unsatisfactory features in the Act may be largely attributable to the rash of last-minute amendments introduced without any prior adequate consultation during the closing stages of the passage of the Insolvency Bill through Parliament.

2.10 Highly technical law-making involved in such complex and expert fields as insolvency highlights the need for detailed advanced discussion amongst those with the appropriate specialist knowledge and experience. A good illustration of what may happen if expert opinion is not sufficiently considered can be found in the somewhat tortuous language of section 426 of the Act, which contains extremely important and potentially far-reaching new provisions regarding cross-border co-operation with foreign courts exercising jurisdiction in insolvency matters.

2.11 The most striking example of the problem is now provided by the decision of the Court of Appeal in *Powdrill v Watson* (*The Times*, 1 March 1994), in relation to the personal liability falling upon insolvency practitioners for redundancy payments under section 19 of the Act when, acting as administrators, they are regarded as having adopted employment contracts. Legislation was rushed through to reverse the position for the future but this has left practitioners in an unenviable position as regards the past, although clearly the ambiguities in the section must now be clarified by the House of Lords.

2.12 The drafting of the subordinate legislation has also not been entirely free from criticism. The most notorious illustration in this respect is the Insolvent Partnership Order 1986 which was a byword for its opaqueness and obscurity.

Criticisms of the consultation process

2.13 Powerful criticism has been directed against the consultation process, particularly in connection with section 336 of the Insolvency Act. This contains important provisions regarding the circumstances in which a trustee in bankruptcy can obtain vacant possession of the bankrupt's home with a view to its sale in the interests of creditors, and the extent to which in such cases regard is to be paid to the needs of the family. The history behind these provisions, introduced at a late stage and never subjected to detailed explanation, much less discussion, is particularly instructive.

2.14 The Cork Committee's proposals in this regard did not find favour with those whom the DTI consulted and the government considered that the proposals were too heavily weighted against the interests of creditors. It was therefore at first decided that no provision be made in the insolvency legislation to deal with the matter at all, but during the passage of the Bill strong pressure was brought to bear on the government to change its mind. Accordingly the DTI issued a 'very short and very simple Consultative Document' to major bodies and others who had shown an interest in the matter.

2.15 Well over 30 replies (from the Law Society, the accountancy profession, Lord Denning and others) were received, but they did not reveal any consensus. The government therefore decided to introduce of its own accord the provisions now contained in section 336.

2.16 Professor Stephen Cretney, a former Law Commissioner, in an article *Women and children last* (1991: 4 Insolvency Intelligence 78), has drawn attention to significant shortcomings in those provisions in that they propound a test as to the circumstances for the postponement of a sale which is more stringent than is warranted. A greater degree of flexibility in such matters would not only have been conducive to justice in the broader sense but it would have reflected 'the preference which the law increasingly gives to personal over property interests'.

2.17 At the very least it could certainly have been expected that those who had originally influenced the government to think again on the issue would have wanted to explore whether the draft provisions gave adequate weight to the Cork Committee's emphasis on the welfare and education of the children, which had also constituted a fundamental element in the approach of the judges under case law prior to section 336.

2.18 Professor Cretney's trenchant conclusions are worthy of mention:

> 'What is much less easy to defend is the way in which these important provisions were enacted without proper consideration or discussion. There was a time when students were taught that Englishmen were ruled by law, and law alone. Then it became fashionable to say that this meant they were ruled by judges alone. There may be some who think that to be ruled by wide but structured judicial discretion would be better than being effectively governed by a handful of civil servants in one department of state – for what would the outcome of a full consultative exercise on this issue conducted by, say, the Department of Health or the Environment have been, one wonders? – basing themselves on what a – presumably junior – Minister chose to select of 38 conflicting replies to a hurriedly produced consultative document.'

Significant recent developments

2.19 There were at the end of January 1994 two further important contributions to the discussion in the shape of a report from the Society of Practitioners of Insolvency (SPI) regarding the success rate of corporate rescue procedures and an influential speech by an executive director of the Bank of England urging banks in relation to an insolvent customer to take far more into account the position of other creditors affected by the insolvency.

2.20 Such a formidable array of ideas, suggestions and recommendations from so many well informed and highly responsible sources cannot sensibly be ignored and each of them deserves careful consideration. Taken as a whole they may also be indicative of fundamental weaknesses or fault-lines in the present insolvency system. With a view to assisting the general debate and to enable these ideas and our own concerns to be evaluated more clearly we now turn to matters of principle.

CHAPTER 3

Principles

Insolvency as a collective process

3.1 The insolvency process, whilst incidentally giving relief to the debtor, is essentially collective by nature for the benefit of creditors. In this respect it is markedly different from ordinary civil litigation with its strong adversarial emphasis.

3.2 The primary purpose of the insolvency process, whether in respect of the individual or corporate debtor and in whatever manner commenced, should be the rescue or rehabilitation of the debtor's financial affairs or business activities or, failing that, the realisation of the debtor's assets in an orderly and efficient manner for distribution of the proceeds on a generally acceptable basis.

The Cork philosophy

3.3 The aims of a good modern insolvency law were propounded, in paragraph 198 of the Cork Report, in somewhat broader terms:

i) to recognise that the world in which we live and the creation of wealth depend upon a system founded on credit and that such a system requires, as a correlative, an insolvency procedure to cope with its casualties;

ii) to diagnose and treat an imminent insolvency at an early rather than a late stage;

iii) to relieve and protect where necessary the insolvent, and in particular the individual insolvent, from any harassment and undue demands by his creditors, while taking into consideration the rights which the insolvent (and where an individual, his family) should legitimately continue to enjoy; at the same time, to have regard for the rights of creditors whose own position may be at risk because of the insolvency;

iv) to prevent conflicts between individual creditors;

v) to realise the assets of the insolvent which should properly be taken to satisfy his debts, with the minimum of delay and expense;

vi) to distribute the proceeds of the realisation amongst the creditors in a fair and equitable manner, returning any surplus to the debtor;

vii) to ensure that the processes of realisation and distribution are administered in an honest and competent manner;

viii) to ascertain the causes of the insolvent's failure and, if and in so far as his conduct, or in the case of a company, the conduct of its officers or agents, merits criticism or punishment, to decide what measures, if any, require to be taken against him or his associates, or such officers or agents;

ix) to recognise that the effects of insolvency are not limited to the private interests of the insolvent and his creditors, but that other interests of society or other groups in society are vitally affected by the insolvency and its outcome, and to ensure that these public interests are recognised and safeguarded;

x) to provide means for preservation of viable commercial enterprises capable of making a useful contribution to the economic life of the country;

xi) to devise a framework of law for the governing of insolvency matters which commands universal respect and observance, and yet is sufficiently flexible to adapt to and deal with the rapidly changing conditions of our modern world; in particular, to achieve a system that

a) is seen to produce practical solutions to financial and commercial problems,

b) is simple and easily understood,

c) is free from anomalies and inconsistencies, and

d) is capable of being administered efficiently and economically;

xii) to ensure due recognition and respect abroad for English insolvency proceedings.

A reappraisal

3.4 The Cork principles are ambitious, challenging and far-reaching in their approach to insolvency. With the dramatic explosion of insolvency during the last decade the requirement that the framework of law governing insolvency matters should be sufficiently flexible to adapt to and deal with the rapidly changing conditions of our modern world must be seen as particularly perceptive and prophetic.

3.5 It is possible in this respect to detect a tendency in the present legislation towards imposing undue and needless restraint upon the court's discretionary powers. Three illustrations will be found in this report:

i) as respects the power to disqualify unfit directors (paragraph 1.16);

ii) as regards the postponement of a sale of the debtor's home (paragraph 2.13);

iii) as respects the lack of a satisfactory range of options as alternatives to bankruptcy (paragraph 4.23).

3.6 It is also significant that the Cork philosophy expected insolvency procedures to be capable of being administered efficiently and economically. In the event far too little public and professional attention has been given to evaluating the performance and practical results of the new system.

3.7 In the light of the tremendous expansion of insolvency law and practice under the new insolvency regime the Cork principles remain as valid as ever. Our concern, with hindsight, is that insufficient attention may have been given to the formulation of a limited number of fundamental or core principles to which others should in reality be treated as ancillary or subservient.

3.8 There is a risk that if the principles are enunciated independently and in such broad terms the true essence of the insolvency process may be lost and insufficient attention given to the proper priority of judicial, professional, social and commercial concerns. The time is perhaps ripe to ask whether the results justify so much efford and the extent to which, for example, it is desirable to expect an insolvency process essentially designed for the benefit of creditors also to undertake policing activities on behalf of the public interest.

3.9 In the concluding chapters of this report we shall endeavour to explore, albeit fairly briefly, some of the thinking behind our own major concerns which we identified in the first chapter. The additional material will, it is hoped, also help to clarify the growing public concern about the insolvency system as a whole.

CHAPTER 4

Bankruptcy abuses

The intensive use of the present system

4.1 The increasing bankruptcy population can usefully be divided into three main groups: self-employed businessmen and professionals; company directors; small consumer debtors.

4.2 The first category is made up of a substantial number of failures in the construction and transport industries, followed by retailing, hotels and catering and, more recently, business services. The basis of the second category, i.e. company directors, is mainly the guarantees they are accustomed to give on behalf of their companies to secure banking facilities. A proportion of the cases in these two groups (probably not statistically large) will involve a high level of indebtedness accompanied by conduct recognisable as commercially deplorable and unacceptable.

4.3 A most disturbing recent phenomenon has been the attractiveness of the bankruptcy process for so many small consumer debtors and a proportionate rise in the number of bankruptcy petitions presented by such debtors themselves as opposed to petitions instigated directly by creditors. The level of the deposit and fees (currently £135 and £20) has not in practice served as a barrier to the presentation of debtors' petitions. Various Citizens Advice Bureaux have received reports from local charities that they have been putting aside funds to help debtors find bankruptcy petition deposits.

4.4 Such astonishing developments must be regarded with grave concern. The bankruptcy process was historically never designed with the small debtor in mind and its frequent use for that purpose is therefore tantamount to an abuse of the system. Debtors accordingly become unnecessarily locked in to proceedings which are inappropriate and, what is more, which are at the end of the day of little or no benefit to ordinary creditors in terms of the size of any dividends they can expect to receive (see Chapter 5).

Appointment of experts to assist the court

4.5 There are provisions in section 273 of the Insolvency Act enabling the court, on the hearing of a debtor's petition, to appoint an insolvency practitioner as an expert to enquire about the feasibility of dealing with the debtor's affairs by way of a voluntary arrangement rather than by a bankruptcy order.

Appointments under the section do not appear to be particularly frequent, probably because the existing monetary limits restricting the circumstances in which an expert's view can be obtained are somewhat narrow and impractical.

4.6 The scope of the powers of the court under section 273 could usefully be broadened and there might even be a case for extending them to the hearing of creditors' petitions as well as introducing similar powers in relation to petitions for the winding up of companies.

4.7 The granting to the court of far more flexible powers for dealing with insolvency petitions accords with the general policy of the Lord Chancellor's Department of endeavouring to reduce the judicial workload by encouraging the movement towards alternative dispute resolution (ADR).

Misgivings regarding bankruptcy

4.8 In view of the limited options, apart from bankruptcy, open to the small consumer debtor faced with severe financial problems, it is hardly surprising that the bankruptcy route has become so attractive to an increasing number of such debtors. A typical example is the case of the mortgagor, facing a shortfall in the equity on the loss of his home, who is unlikely to have other substantial assets with which to meet continuing liabilities under the mortgage and otherwise.

4.9 The immediate advantages of bankruptcy in such circumstances are easy for the debtor to grasp. Creditors' remedies are abruptly halted and the debtor will normally obtain a complete discharge from his debts after a three year period with perhaps no more than a modest contribution to his trustee in bankruptcy out of any after-acquired income. The price to be paid is a surrender of the debtor's assets (with certain exceptions for reasonable living requirements) to a trustee in bankruptcy, but frequently these are of little or no real value. Until the recent decline in house prices the trustee might have reasonably expected to realise something by a sale of the debtor's home but this, of course, is frequently no longer likely to occur.

4.10 Such relief is clearly extremely advantageous to the debtor and far outweighs any disadvantage which the bankruptcy might appear to bring. During the three-year bankruptcy period he will be subject to disabilities such as an inability to obtain credit beyond a specified level without disclosing his status. In practical terms this may well severely affect his ability to obtain alternative accommodation for himself and his family, to obtain a continuing supply of the major utilities and to gain access to banking facilities which are for many purposes almost essential today. There are, however, other adverse consequences of bankruptcy which may not be immediately apparent.

4.11 The position as regards obtaining credit is perhaps in some respects more serious than the strict provisions of the Insolvency Act would suggest. Present credit rating arrangements are such that the fact of bankruptcy may well impede the debtor from obtaining credit for a period of six years, i.e. three years beyond the normal date of discharge. To this extent the statutory discharge does not in practice fully rehabilitate the bankrupt.

4.12 A further striking disability to which bankruptcy gives rise, although in the majority of cases this may not be of any real concern, is the inability of a bankrupt to be a company director or to participate directly or indirectly in the management of the affairs of a company without the leave of the court. Irrespective of the merits of his conduct, the bankrupt, by the very fact of being made bankrupt, is automatically barred from being a company director and this disability does not depend upon any investigation of his affairs. By contrast no such automatic disqualification is imposed upon any director of a company subject to formal insolvency proceedings until after some investigation and only then by court order.

Deficiencies in the bankruptcy system

4.13 There is disturbing evidence that where, appropriately or not, the debtor has chosen the bankruptcy route all may not be plain sailing. Some debtors appear to experience difficulty in having their petitions filed with the court and may even be confronted with considerable delay before obtaining a hearing. Administrative overload in these circumstances leaves the debtor in an unnecessary state of limbo and causes frustrations which a more appropriate and speedy procedure would avoid.

Misconceptions about the statutory demand

4.14 There is also some disturbing evidence regarding misuse in regard to the service of statutory demands upon debtors. Such a demand usually has to be served personally upon the debtor and requires him either to pay the debt in full or come to an arrangement for payment with the creditor within a three week period or, if not, to establish, if necessary in court, that the debt is not payable (for example because it is disputed on genuine grounds).

4.15 Non-compliance with a statutory demand is in effect regarded as a green light for the creditor to commence bankruptcy proceedings against the debtor.

4.16 If the service of a demand is genuinely used to persuade the debtor to face up to his or her financial position and to try to come to terms with the creditor, there can be positive advantages for the creditor, even though he

may have little intention of proceeding to bankruptcy in the event of non-compliance.

4.17 There are, however, some indications of misuse of statutory demands as a means of intimidating debtors to scare money out of them when a debt may not really be due. The demand is not necessarily founded on any court judgment and can be calculated to inveigle the unwary to pay in the belief that the document is court-inspired. There also appear to be some instances of demands simply being served by post and not personally, contrary to the spirit of the guidance contained in *Practice Note (Bankruptcy: substituted service)* No. 4/86 (1987) 1WLR 82.

4.18 In the absence of detailed statistics no clear view can be formed regarding the extent to which statutory demands are contested in court. Quite plainly, when they are so contested there is scope for the proceedings to be somewhat lengthy. This aspect of the matter becomes even more serious if the case goes to the appropriate appellate court, usually a single judge of the Chancery Division.

4.19 In January 1994 the daily case list for the High Court indicated that there were over 180 bankruptcy appeals outstanding and the belief is that the majority of these related to disputed statutory demands. The time taken to dispose of such matters is frequently quite lengthy because of the nature of the detailed issues, and may be as much as two days of judicial time.

4.20 It might well be desirable in these circumstances for there to be a more stringent test to be satisfied, for the issue of statutory demands, where they are not based on a judgment.

4.21 It may also be particularly expedient, in order to ensure that a debtor's affairs are directed to the most appropriate channel, that at the hearing of any bankruptcy petition, or in any proceedings raising a challenge to a statutory demand, evidence should normally be given regarding the general state of the debtor's financial position.

The Cork approach

4.22 Many of the problems identified in this chapter might have been avoided if the Cork recommendations for dealing with the small consumer debtor had been adopted. The report devoted considerable space to alternatives to bankruptcy such as an enforcement restriction order upon creditors' remedies or the making of a debts arrangement order. These ideas were seen as an integral part of the new insolvency framework. They were intended to provide a genuine alternative to bankruptcy for the consumer debtor and to be a replacement for the old-fashioned County Court administration order procedure.

Administration orders in the County Court

4.23 Administration orders in the County Court were introduced by the Bankruptcy Act 1883 for the benefit of debtors whose affairs were not sufficiently large to qualify for bankruptcy. The removal of the relevant provisions to the County Courts Act 1934 was accompanied by a transfer of responsibility for the system from the President of the Board of Trade to the Lord Chancellor's Department. The governing legislation is now contained in the County Courts Act 1984.

4.24 The procedure suffers from the fact that it can only be activated by the debtor where a money judgment has been obtained against him. JUSTICE in its report on bankruptcy in 1975 highlighted the need for modernisation and some faltering steps in this direction were taken by the Insolvency Act 1976.

4.25 Significant and welcome changes to the procedure were enacted by sections 13 and 14 of the Courts and Legal Services Act 1990. These important provisions have not, for whatever reason, yet been brought into force. The burden of handling the affairs of small insolvent debtors consequently has continued to fall to a disproportionate extent and inappropriately upon the Bankruptcy Court.

4.26 There is accordingly an urgent social need for a complete reassessment of the procedures for dealing with the affairs of insolvent consumer debtors. Without any such simplified and inexpensive alternatives any proposals for conferring upon the court more flexible powers, analogous to those under section 273, for dealing with a debtor's affairs would in fact be almost nugatory.

Failings of the investigative process

4.27 It is also a matter of concern that the present bankruptcy system, unlike its predecessor, does virtually nothing to segregate the more serious commercial failures from the generality of bankruptcy cases. The Cork Report envisaged that there would be a degree of differentiation in this respect. It is perhaps anomalous that, however culpable and blameworthy may have been the bankrupt's conduct and however damaging in moral and commercial terms, he will normally receive a discharge in the same way as the consumer debtor whose debts are relatively trivial and whose conduct is essentially without fault.

4.28 The White Paper of 1984, in which the DTI's own intentions regarding the forthcoming legislation were explained, expressly envisaged that in future the Insolvency Service's Official Receivers would be in a far stronger position to concentrate on their protective and investigative duties. If malpractice rather than misfortune appeared to have been the cause of

liquidation or bankruptcy, there would be adequate machinery for the affairs of insolvents to be investigated so that undesirable commercial or individual conduct might be sufficiently deterred. By virtue of the massive increase in the case load for which the Insolvency Service now has responsibility, the resources for undertaking this work satisfactorily have fallen, comparatively speaking, to a very low level.

The future of bankruptcy

4.29 The personal insolvency regime risks falling into disrepute. It is becoming more widely known that resources are not available for investigations. Debtors who have found the process to be relatively 'soft' spread the word that bankruptcy is not so bad, and thus more and more debtors opt for bankruptcy. Greater numbers stretch available resources still further, and even less investigation is undertaken. This trap means that individual voluntary arrangements become marginalised, and there must be a population of debtors who seek to exploit bankruptcy as an easy means of ridding themselves of unwanted creditors. The social implications of any such step need to be widely debated: in particular, the extent to which we are content to embrace the American approach whereby over one million individuals file for bankruptcy annually. Though this has never been debated in Parliament, there is a risk that it is happening nevertheless.

4.30 It must be arguable that the existing framework places too few disciplines upon debtors and could result in a culture of fecklessness. We understand that the Insolvency Service seeks fewer than 200 income payments orders a year, for example. This relaxed regime can only encourage debtors who started out as essentially honest people to repeat the process. We are aware that some tentative evidence is beginning to emerge of an increase in second bankruptcies amongst the population of people who first went bankrupt under the 1986 regime and who are probably unaware that they will not get an automatic discharge twice. There is a danger that just as prisons have been described as 'universities of crime', the bankruptcy process could become the further education college for debt avoidance.

4.31 We do not advocate indiscriminately tightening up the existing regime, which would cause unnecessary hardship. Pressure on scarce resources could be alleviated by recognising that not all bankrupts are the same. There is growing public unease about the 'easy ride' enjoyed by, say, fraudulent bankrupts with multi-million pound debts, and the comparative harshness of using the full panoply of the bankruptcy regime, with its attendant stigma, for honest debtors who may be guilty of nothing worse than having had the misfortune of losing their jobs, and therefore their ability to service consumer debts. It is also true to say that, for many debtors, bankruptcy has become the remedy of choice, and that neither they nor their creditors would necessarily be better served by a reformed county court administration order procedure.

4.32 All of these factors indicate that a two-tier bankruptcy system would be socially desirable, with appropriate ladders between the two tiers for undoing any problems arising from cases starting in the wrong regime. The 'serious' tier should perhaps have a less relaxed automatic discharge regime, buttressed by positive requirements that the debtor should be seen to make some effort to rehabilitate himself, e.g. by making regular payments out of income. The 'non-serious' tier could have little or no investigatory function, and could perhaps benefit from automatic discharges taking place in as little as 12 months. The term 'bankrupt' should be reserved for serious cases, and should indeed carry a degree of stigma, but the less serious cases could benefit from a new title such as 'enforcement restriction order'.

CHAPTER 5

Creditor disillusionment

The bankruptcy of the insolvency process

5.1 Assuming that there is no prospect of rescuing the debtor's affairs or effecting a voluntary arrangement with creditors, the process of bankruptcy or liquidation will follow inexorably. The assets will be realised and in due course the proceeds will be distributed according to well-established principles, which will in effect take the following order of priority:

i) first to be paid are the costs, charges and expenses of, and incidental to, the administration of the estate;

ii) next, individual secured creditors receive the proceeds of any securities to which they are entitled;

iii) specified preferential creditors' claims are then discharged on a *pari passu* basis;

iv) the balance of any free assets left is distributable amongst the ordinary creditors also on a *pari passu* basis;

v) any surplus thereafter is returnable to the debtor.

5.2 In the practical world of insolvency the overwhelming majority of cases fall to be handled each year in accordance with such principles. If individual and corporate insolvency cases are combined, then in excess of 60,000 cases annually join this category.

5.3 It has to be faced that the outcome of the insolvency process is, broadly speaking, of little financial significance to the generality of ordinary unsecured creditors. The CBI in particular has drawn attention to this unsatisfactory situation: see paragraph 2.3(d). Any further deterioration in the position must inevitably lead to 'the bankruptcy of bankruptcy'.

5.4 The causes of the problem stretch back well over 150 years and any fundamental remedies would require a complete reappraisal of many ingrained and entrenched attitudes to commercial matters. The root of the problem lies with the floating charge, a central and almost unique form of security generally used for the financing of corporate business in this country and without parallel in other European Union countries. The Cork Report, in paragraphs 106 and 107, not only described the widespread and long-standing sense of grievance in the commercial community regarding

the floating charge but also went on to express astonishment that such a device should ever have been invented by a Court of Equity. The principal mischief arises from the ability of the floating charge to extend beyond existing tangible assets to embrace all future property. The injustice voiced by the CBI is far from new.

5.5 From the time of the first Bankruptcy Act in 1542 and in each subsequent piece of legislation dealing with insolvency, the concept of the rateable distribution of the estate amongst ordinary creditors has received a prominent position. With the passage of time, however, the rights of a secured creditor in relation to particular assets of the debtor have been judicially sustained and continue to be protected and affirmed by the courts. Very recently a second fixed charge on book debts has been so treated by the Court of Appeal: *Re New Bullas Trading Ltd.* (1994) BCC 36.

5.6 It is extremely doubtful whether, in the absence of some radical and far-reaching changes to the insolvency process, any dramatic improvement will ever be achievable as regards the size of the dividend which creditors can realistically expect to receive from an insolvent estate. We simply wish to highlight three matters of concern which, if addressed constructively, might go some way to allay the disillusionment felt by so many ordinary creditors. It is true that some may have remedies entirely outside the confines of the insolvency system (such as resort to professional or industry compensation funds), but overwhelmingly this type of consolation will not be available.

The government's advantageous position

5.7 A matter of concern derives from the fact that for well over a hundred years there has been a requirement for the payment of funds realised in bankruptcy cases, as well as in all types of liquidation, to be paid into what is now the Insolvency Services Account maintained by the DTI at the Bank of England. Scale fees are payable upon the deposit of funds into this account. Statutory provision is made for the transfer of any excess for the time being held on this account to an Investment Account kept by the National Debt Commissioners at the Bank from where it may be invested by the Commissioners in accordance with directions by the Treasury.

5.8 Although interest at 3.5% pa gross (i.e. subject to taxation) is payable on individual estate balances over £2,000 at the request of liquidators and trustees and facilities exist for them to invest in treasury bills, such investment is subject to the imposition of a fee of 0.625% on the occasion of each investment or re-investment, and consequently the return rarely matches commercial rates. The Insolvency Service Annual Report 1992/93 (page 25) discloses that the government derived an income of £50.6 million from these banking fees and investments during the year and gained a surplus of some £9 million after setting off the costs of running the Insolvency Service.

5.9 A decade or so ago, when the number of insolvencies was comparatively small, the amounts earned by the government by such means were already a matter of concern but were seen to a large extent as a means of financing the government's insolvency service. Changing circumstances such as the explosion of insolvency cases during a period of abnormally high interest rates have simply meant that the government has been making a substantial profit from the operations of the Insolvency Services Account.

5.10 What is, to say the least, troublesome is that such windfall profits have in effect been made at the expense of ordinary creditors. Estimates of the profits vary but there is no doubt that they have been substantial.

5.11 The time is now right for a fundamental reappraisal of the funding of the Insolvency Service with a view to the removal of such an important grievance on the part of the general body of creditors.

Funding advice for the small debtor

5.12 Furthermore, there is a strong case for the government to make a financial contribution to the cost of providing advice to individual small debtors to enable them to choose the appropriate form of insolvency proceedings suitable for their needs. Given that such proceedings will exist as and when section 13 of the Courts and Legal Services Act 1990 comes into effect, the burdens at present imposed on the Insolvency Service and the Courts by the surge in the number of bankruptcies should be reduced.

5.13 It is also for consideration whether insolvency practitioners as a whole should be encouraged as part of their professional responsibilities to undertake a certain amount of *pro bono* work, again with a view to directing debtors towards the appropriate procedure.

Curbing the *pari passu* rule

5.14 A second matter for concern arises from the all-embracing nature of the *pari passu* doctrine. The principle is based on fundamental concepts of equity and justice but changed circumstances may sometimes demand the exclusion of certain situations from its broad ambit.

5.15 The most significant inroad into the principle was the creation, primarily during the Victorian era, of an increasing number of preferential claims ranking in priority to those of the ordinary creditors. Parliament went some way, but not completely, to curb the tendency during the passage of the 1986 reforms, albeit in the face of considerable government opposition.

5.16 There have been other attempts to interfere with the operation of the *pari passu* principle by the device of subordinating what were considered to be less deserving claims to a position ranking behind that of the general

body of creditors. A prime modern candidate for such treatment might be inter-company loans. The present position is that a pre-existing agreement for subordination is binding in a liquidation, but the position does not seem to be so clear-cut where there is no such express agreement.

Complaints

5.17 A third matter of concern arises from the lack in insolvency proceedings generally of any speedy and cheap method for a creditor or a group of creditors to challenge the conduct of an insolvency practitioner in the handling of the estate and, in particular, to obtain an independent review of the costs, charges and expenses. The position of a debtor is, as a rule, in this respect far more disadvantageous, giving rise, all too frequently and irrespective of the merits of the case, to frustration and a sense of bitterness and injustice.

5.18 There are a multiplicity of routes whereby such matters can be raised in court under the Insolvency Act or other legislation or by way of complaint to an appropriate professional body. Since in any particular case, in addition to the insolvency practitioner, there may also be involved solicitors, estate agents and other professional advisers, the creditor contemplating the position may be somewhat confused. Hopefully the matter may have been satisfactorily resolved through the medium of any creditors' committee appointed to assist the insolvency practitioner but, even so, troublesome cases still occur.

5.19 A degree of rationalisation of the complaints system generally with regard to insolvency matters is long overdue. The JUSTICE report on bankruptcy made certain proposals in this direction and the Cork Report specifically recommended the establishment of an Insolvency Ombudsman. That recommendation was not adopted in the 1986 reforms. Yet, in view of the substantial growth in insolvency work since then, the need for such an appointment is even greater. The services of the Ombudsman should not only be at the disposal of creditors but also be available, with appropriate safeguards, to an aggrieved debtor or other interested party with a genuine interest in the matter.

5.20 It is also for consideration whether the formulation of a Creditors' Charter would alleviate some of the unease presently existing about the insolvency system. Although no guarantee of the payment of any dividend could be given, at least the creditor would know what his minimal rights are, including such elementary matters as the right to be given information on a regular basis about the progress of the case or to attend and participate in an annual creditors' meeting.

5.21 The three matters discussed in this chapter, if implemented, cannot be expected alone to enhance the size of dividend payments to any

appreciable extent. What they could do is to remove some of the considerable creditor disillusionment with the effectiveness of the present insolvency system. The initiative of the Bank of England mentioned in paragraph 2.19 is an important and welcome step in this direction.

CHAPTER 6

The future

The insolvency industry

6.1 The practice of insolvency has now become firmly established as part of the commercial and financial scene and is a substantial industry in its own right. The recovery of the economy may be followed for a time by a decline in insolvency work but there is surely no doubt that in the long run this new industry is here to stay.

6.2 The industry has developed a momentum of its own, accompanied by a steady increase of organisational bodies. At the judicial level there is a Rules Committee and a Court Users' Committee. There are six or so professional organisations representing the interests of accountants, solicitors, and others engaged in the practice of insolvency. It is particularly encouraging that a strong educational framework is emerging with its own examination system. The subject of insolvency is increasingly being taught at university level and is beginning to create, perhaps not sufficiently quickly, a valuable literature of its own.

6.3 These domestic developments are matched by a growing interest in how insolvency is dealt with in other countries. Insolvency practitioners are now alive to the opportunities which will gradually become available in the field of cross-border insolvency.

A national insolvency strategy

6.4 It is against this background that we put forward our proposals for the establishment of a specialised insolvency committee similar to that being set up by Congress in the United States (see paragraphs 1.20 and 1.21).

6.5 Insolvency is a matter which is not immediately confined to the debtor. Its tremors are also inevitably felt by the family, employees, creditors and ultimately the community at large. It is therefore vitally important for there to be a recognised insolvency policy capable of evolving with changing circumstances and responsive to the needs of society.

6.6 The various professional bodies have an important role to play in the evolution of insolvency policy. However, the obligations they have to their members may be perceived, even if unjustifiably, as detracting from their ability to be sufficiently responsive to the public interest.

6.7 At present the DTI has the major responsibility for the direction of insolvency policy, although by virtue of its own routine involvement in many aspects of insolvency procedures it cannot be seen as entirely independent and objective. The position is also complicated by the existence within government of some fragmentation of responsibility between the DTI, the Lord Chancellor's Department and other departments in relation to sensitive areas of social concern such as the appropriate machinery for dealing with the small insolvent consumer debtor or the family home, and, in the context of corporate rescues, employment implications.

6.8 The existence of a specialised permanent committee with responsibilities such as we have outlined would overcome some of those objections and provide the opportunity for placing insolvency law and practice on strong foundations for the future.

Conclusions: the need for flexibility

6.9 A comprehensive review of the workings of insolvency law is a monumental task. This report set out to explore what appear to be some of the more significant and urgent areas for concern and we have reached the conclusion that further intensive study of each of them will yield the details for a reform package. In this sense we have merely set an agenda.

6.10 During the course of our own discussions on the subject we have become acutely aware that there are many other areas of concern regarding insolvency to which we might have turned our attention. The following examples merely serve to indicate a few such important matters:

i) the need to examine the role of the government's Insolvency Service Agency in the context of present-day insolvency conditions;

ii) the emerging problem created by unlicensed advisers seeking to give assistance to unsophisticated small debtors;

iii) the extent to which recent developments in insolvency law curtailing the immunity of witnesses from self-incrimination are consistent with fundamental principles of the law of human rights.

6.11 Insolvency law and practice must be sufficiently flexible to be responsive to the changing needs of society. We hope that this report will help to stimulate an informed debate on what needs to be done and that within the foreseeable future the principal issues will be addressed in Parliament.

CHAPTER 7

Conclusions and recommendations

General concerns

7.1 The present system for dealing with insolvency matters requires some general reform and refurbishment as a matter of urgency to correct significant injustices.

7.2 The system as a whole is reasonably sound but the unprecedented recent expansion of the workload has subjected it to unusually heavy burdens for which it was never designed.

7.3 The framework on which the system was constructed in 1986 has proved in practice to be overly rigid and insufficiently flexible to respond to the rapidly changing needs of society.

7.4 The system, though ostensibly intended as a collective process of relief for the debtor from creditor pressure, contains an undue proportion of adversarial characteristics frequently occasioning needless and expensive litigation and a consequent waste of judicial resources.

7.5 The insolvency process is generally perceived to be excessively costly to administer, but lacks any adequate machinery for the speedy and efficient resolution of complaints against practitioners.

7.6 Insolvency is not an isolated and self-contained subject but regularly impinges on many other branches of the law, notably consumer affairs, employees' rights and the laws governing the creation of security in favour of lenders. So long as insolvency policy is developed in isolation from the mainstream of social problems and without reference to wider needs it will gradually cease to command general respect and confidence.

7.7 Although a primary aim of the system is the rehabilitation of businesses capable of being rescued, its expression is bedeviled by the existence of a multiplicity of complex, confusing, frequently competing, and costly procedures such as administrative receivership, administration orders, court-appointed receiverships, company voluntary liquidations, schemes, provisional liquidations. This unsatisfactory state of affairs calls for thorough rationalisation before it becomes, as recent developments indicate, quite unworkable.

7.8 The system, as originally conceived, anticipated the existence of a sharp distinction regarding the treatment of cases giving rise to serious commercial concern and, at the other extreme, the handling of the affairs of the

small consumer debtor. However, the position has in practice become completely blurred notwithstanding the statutory provisions in the Courts and Legal Services Act 1990 which were designed to correct the situation. Consideration needs to be given to the implementation of these provisions along with the introduction of a two-tier bankruptcy system with a second tier reserved for more serious cases deserving stiffer treatment (see paras. 4.25–6, 4.32).

7.9 The system, irrespective of its intentions, has entirely failed to remedy the long-standing and widespread sense of grievance in the commercial community regarding the minimal financial benefits which the ordinary unsecured creditors have grown accustomed to receive from insolvency procedures. The perceived unfairness is attributable to two main sources:

i) the substantial profits earned by the government, especially during the recent upsurge in the insolvency workload, as a result of its statutory responsibilities for holding the funds of insolvent estates;

ii) the much-criticised institution of the floating charge which places the banks and other lenders at a considerable advantage over the general body of creditors.

7.10 If the injustice sustained by ordinary creditors is not soon remedied, the insolvency system will be reduced to an empty formality and it will be appropriate to speak of 'the bankruptcy of bankruptcy'.

7.11 All these matters of concern and a host of others relating to the workings of the insolvency system need to be addressed without delay with a view to achieving change by parliamentary intervention, where necessary, but also by the encouragement of non-legislative approaches.

Specific proposals

7.12 **There is an urgent need to devise a national insolvency strategy**. As a first step it would be desirable to establish a permanent specialised committee, as has recently been done in the United States, capable of representing a broad spectrum of judicial, professional, commercial and social interests; with the task of keeping insolvency law under review and giving advice regarding reforms (paras.1. 20–21, 6.4).

7.13 The activities of such a committee would be far-ranging, particularly in those areas where at present little empirical information about the workings of the insolvency system is available. It could usefully have responsibility for matters such as the following:

i) encouragement and co-ordination of a programme of research into insolvency issues;

ii) keeping under review insolvency developments in Commonwealth, European Union and other countries;

iii) monitoring the cost-benefits of insolvency procedures;

iv) considering alternatives to the government's Insolvency Service Agency;

v) exploring the concept of an Insolvency Ombudsman and a Creditors' Charter.

7.14 There are a number of specific matters identified in the report which might be proceeded with in advance of the development of a national insolvency strategy and the establishment of a permanent insolvency review committee.

7.15 **In relation to personal insolvency it is recommended as follows:**

i) more stringent requirements should be introduced where a statutory demand is not based on a judgment (para 4.20);

ii) at the hearing of a petition (as well as when proceedings are taken to challenge the statutory demand), evidence should be given of the debtor's general financial position (para 4.21);

iii) the procedures for dealing with the affairs of insolvent consumer debtors should be reviewed and simplified, as recommended by the Cork Committee (paras 4.22 and 4.26);

iv) the introduction of a two-tier bankruptcy system would be socially desirable (para.4.32)

7.16 **More generally it is recommended as follows:**

i) a reappraisal should be undertaken without delay of the funding of the Insolvency Service (para 5.11);

ii) the case for the government to make a financial contribution to the cost of providing advice to individual small debtors should be considered (para 5.12);

iii) encouragement should be given to insolvency practitioners to undertake *pro bono* work (para 5.13);

iv) the rationalisation of the complaint system and the appointment of an Insolvency Ombudsman should be speedily carried out, the case for this now being even stronger than when called for in the earlier JUSTICE report and by the Cork Committee (para 5.19);

v) the formulation of a Creditors' Charter should be urgently undertaken (para. 5.20)

APPENDIX

Response to the DTI's Green Paper on corporate rescue

PART 1

The framework for rescue

Background

1.1 Receivership has undoubtedly played a significant role in preserving businesses and employment in the event of insolvency for the last 120 years.

1.2 The appointment of a receiver and manager is the customary method for the enforcement of a floating charge, the form of security over present and future assets which lies at the heart of most corporate financing in this country. Originally such appointments were normally made by the court, but by a gradual process provisions were inserted into the debenture creating the floating charge which enabled the lender to make a private appointment without any resort to the court at all. Such appointments now give rise to what is called administrative receivership.

1.3 Administration orders were introduced in 1986 at the suggestion of the Cork Committee for situations where no receiver under a floating charge could or would be appointed. An administrator was brought in as a kind of court-appointed receiver, but one that possessed the benefit of agency and powers similar to an administrative receiver.

1.4 Company voluntary arrangements were introduced as a simple form of binding compromise with creditors in order to supplement schemes under section 425 of the Companies Act 1985. Unlike schemes, company voluntary arrangements do not require class meetings or court applications.

1.5 Since 1986 receiverships, administration orders, company voluntary arrangements and schemes have each played a valuable role in the new rescue culture. The current issue is whether administration orders and company voluntary arrangements are under-utilised, and if so, why.

Principles

1.6 By and large the committee would prefer to build carefully on the existing system rather than to try radical solutions. Change should take into account the special history and culture of business lending and insolvency in England.

1.7 This phenomenon includes several distinct matters. It involves, for example, suspicion of directors of insolvent companies. This refers to directors who ran the company when it became insolvent, not 'company

doctors' and the like who are brought in subsequently.

1.8 Trust in courts is also of considerable importance. More recently reliance upon insolvency practitioners has become particularly prominent.

1.9 Radical changes based on alleged dissatisfaction with the present system should not be made until it is reasonably plain that businesses which could be saved are not being saved because of shortcomings in the legislation.

1.10 Likewise any change should not upset the widespread and long-established pattern of lending secured by debentures containing floating charges unless it is demonstrated by cogent evidence that some interference with that pattern is commercially desirable.

1.11 It is also vital that any change should not leave creditors and the public vulnerable to abuse by unscrupulous businessmen.

1.12 It is of paramount concern that any change should focus on saving viable businesses and jobs not insolvent corporate entities as such.

1.13 Similar policy considerations underlie Chapter 11 in the United States. In adopting the Bankruptcy Reform Act of 1978 the aim of the US legislature was to provide for a better means of realisation than liquidation in order to preserve 'jobs and assets' (H.R. Rep. No. 595, 95th Cong., 1st. Sess. 220 (1977)).

1.14 Our approach is to see what degree of improvement could be achieved without any legislation at all and what other areas for reform would require legislation.

PART 2

Reforms with and without legislative interference

Reform without further legislation

2.1 In small cases the judge could dispense with a rule 2.2 report and adjourn the administration petition pending the passing of a creditors voluntary arrangement. There are already sufficient powers in the legislation to do this and there would be a considerable saving in costs coupled with protection against creditors. Since a proper case would have to be made out to the judge and since creditors could apply under section 10, the risk of increased abuse would be minimal. Section 10 also allows the appointment of an administrative receiver, thereby protecting lenders' debenture rights. In those cases where there is a rule 2.2 report, judges could require it to deal with potential benefits or disadvantages to (a) directors, and (b) employees, so as to assist the judge in assessing the likely benefit of making the order.

The 1994 Practice Statement

2.2 During our own discussions of these matters there has been issued a *Practice Statement (Administration Orders: Reports)* (1994) 1WLR 160. The Statement emphasises that administration orders are intended primarily to facilitate the rescue and rehabilitation of insolvent but potentially viable businesses. It is accordingly of the greatest importance that this aim should not be frustrated by expense, and that the costs of obtaining an administration order should not operate as a disincentive or put the process out of the reach of smaller companies.

2.3 In the normal case the court will need a concise assessment of the company's situation and of the prospects of an administration order achieving one or more of the statutory purposes. The latter will normally include an explanation of the availability of any finance required during the administration. There are four such statutory purposes:

a) the survival of the company, and the whole or any part of its undertaking, as a going concern;

b) the approval of a company voluntary arrangement;

c) the sanctioning of a section 425 scheme;

d) a more advantageous realisation of the company's assets than would be effected on a winding up.

2.4 Every endeavour must be made to avoid disproportionate investigation and expense. In some cases, but by no means all, a brief investigation and report will be all that is required. In general a rule 2.2 report will be valuable as a safeguard in assisting the court to see whether the application has a sound basis. However there may be straightforward cases in which such a report is not necessary because it would provide little assistance.

2.5 In suitable cases the court may appoint an administrator but require him to report back to the court within a short period so that the court can consider whether to allow the administration to continue or to discharge the order. In some cases the court may require the administrator to hold a meeting of creditors before reporting back to the court, both within a relatively short period.

2.6 The *Practice Statement* seems therefore already to have effected part of the desirable changes which can be effected without any parliamentary intervention.

2.7 Winding up petitions are sometimes presented to protect the position of a company and its assets pending the formulation of a scheme under section 425 of the Companies Act 1985 (**see e.g. *Re Esal Commodities Ltd.* [1985] BCLC 450**). It would be desirable if administration petitions could be presented in appropriate cases to protect the position of a company and its assets pending the passing of a company voluntary arrangement without the necessity to proceed in the meantime with an application for the appointment of an administrator.

2.8 Some further additional risk of abuse cannot, however, be overlooked. This could be ameliorated by a requirement for some initial court perusal of petitions where a deferred hearing date was sought and also by requiring the certificate of an insolvency practitioner that the proposed company voluntary arrangement has a reasonable chance of success.

Changes requiring legislation

2.9 Two problems remain in such cases which could only be overcome through legislation, namely, (a) funding and (b) priority for new debts incurred during any trading while the petition is adjourned.

2.10 One possibility in respect of funding is to allow the directors, upon notice to any debenture holder, to use assets subject to a floating charge, and in the absence of a floating charge, to use uncharged assets. Priority over floating charge and free assets could be provided for by legislation giving priority to new creditors during the adjournment unless they have notice that the debt is not incurred for the benefit of creditors. Creditors should

have a right to apply for the appointment of an administrator or interim manager if there is evidence of misconduct by directors.

2.11 Another possible legislative change would be to provide for interim administrators and to make express provision for their status, role and powers. It seems that Scottish courts already appoint interim administrators under the present legislation. In England the courts do not permit interim administrators to be appointed but may allow interim managers to be appointed. Neither concept has any defined status or powers under the present legislation. There is also a practice in the case of insurance companies, where the legislation does not permit administration, for provisional liquidators to be appointed to hold the fort and provide a statutory stay. Such appointments usually lead to a scheme under section 425 and avoid liquidation.

2.12 There are further areas which may benefit from legislative changes. The statutory stay in the case of administration could be extended, e.g. to prevent termination of contracts solely on the ground of administration where the administrator was prepared to cause the company to perform the contract. Administrative receivership could be strengthened by having a statutory stay similar to section 11.

2.13 The ability of utilities to 'blackmail' insolvency practitioners by demanding the payment of pre-insolvency debts as the price of continuing essential supplies was terminated by the reforms introduced by the Insolvency Act 1986. Future supplies are now assured to insolvency practitioners on their personal undertaking to pay for them. Recent cases have, however, illustrated remaining difficulties of a similar nature with other types of suppliers. For example, in ***Leyland Daf Ltd. v Automotive Products*** [1993] BCC 389, administrative receivers were unable to ensure future essential supplies of spare parts for a manufacturing process without a demand by the supplier for payment of pre-receivership indebtedness. Consideration should be given to changing the law along the lines of the reforms in relation to utilities. It is recognised that this is a controversial area and any general reform would have to recognise exceptions, e.g. in relation to financial markets.

2.14 In the event that changes as a result of legislative reform are implemented, it would probably be sensible for there to be a 'settling-in' period to assess the impact of the changes.

PART 3

The Green Paper's case for radical change

Radical changes?

3.1 Obtaining a moratorium simply by a filing, as in US Chapter 11, would be an untested radical change alien to our culture. To the extent that the mere filing of a notice results in an automatic stay, it would go further than any other comparable insolvency procedure.

3.2 The lack of court supervision or effective insolvency practitioner control would leave the moratorium procedure wide open to abuse. The delay of debenture holders appointing a receiver may mean that the business would be lost in an attempt to save the company. This will be especially true of 'people' businesses such as advertising and estate agency where upon the moratorium being advertised, employees and customers are likely to depart within the first 28 days.

Reluctance to move towards Chapter 11

3.3 A radical change towards an English version of Chapter 11 should not be undertaken without (a) empirical evidence that rescuable 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 US. It is also imperative that any shift towards Chapter 11 should not be undertaken without a detailed study of the likely effect on bank lending to companies in the future. It has been suggested (by the TSB, as reported in the Press) that banks would be more reluctant to lend or would charge higher rates of interest or would further protect themselves by taking more personal security from directors.

3.4 Any Chapter 11 type change should not in any event restrict the appointment of administrative receivers under security taken prior to the change. It would be unfair to make a radical, as opposed to a gradual, change when the lending was agreed and priced on a very different basis.

The 28 day proposal

3.5 It does seem somewhat pointless to introduce new provision for 28 day administration. This period is too short for anything but an 'instant' pre-packaged rescue, but may be too long for uncertainty to last. In the case of a pre-packaged rescue, an adjourned petition can be used together, if need be, with the appointment of an interim manager. Alternatively, as the new *Practice Statement* suggests, in a suitable case the court could appoint an administrator but require him to report back to the court within 'a short period' so that the court can consider whether to allow the administration to continue or to discharge the order.

The false analogy with Chapter 11

3.6 Part of the thinking behind the Green Paper appears to lie in the idea that the proposals for a moratorium by filing a document emulate the Chapter 11 position in US Federal Bankruptcy Law.

3.7 The Green Paper, however, overlooks the fact that under Chapter 11 the filing is just about the only step that can be taken without court approval. All other material steps require court applications, hearings and approval. This provides essential safeguards. Sadly, the Green Paper seems to be raising the prospect of a moratorium by filing under Chapter 11 without the safeguards provided by the US system. A right on the part of individual creditors to apply to lift the statutory stay in relation to their individual claim would be no substitute for the close judicial supervision that is an essential feature of the US system.

3.8 Notwithstanding the fact that since Chapter 11 is based on constant judicial supervision it is a relatively expensive procedure, the US courts regard their supervisory role as an essential safeguard and their concerns have been to balance the safeguards against the expense. The point was trenchantly made in ***United Savings Association v Timbers of Inwood*, US Court of Appeals, 5th Circuit en Banc, (1987) 808 F2d. 363, 373, aff'd. (1988) 484 US 365**:

> 'Early and ongoing judicial management of Chapter 11 cases is essential if the Chapter 11 process is to survive and if the goals of reorganizability on the one hand, and creditor protection, on the other, are to be achieved. In almost all cases the key to avoiding excessive administrative costs, which are borne by the unsecured creditors, as well as expensive interest expense, which is borne by all creditors, is early and stringent judicial management of the case.'

Jobs and assets, not corporate entities

3.9 The policy behind Chapter 11, as already mentioned in paragraph 1.13, is to provide for a better means of realisation than liquidation in order to preserve 'jobs and assets'. The aim is to save productive business assets and employment, not, as one might have assumed from the Green Paper, to save insolvent corporate entities.

Reform of Chapter 11

3.10 The United States' Senate recently passed the Bankruptcy Amendments Act 1993. Amongst the numerous reforms it is not without significance that a new Chapter 10 has been introduced to allow the reorganisation of small businesses with liabilities not exceeding US $2.5m. The debtor would be given 90 days in which to put forward a plan for paying his debts out of future income. The court can confirm this plan without any vote by the creditors.

3.11 It is also material to note that Chapter 10 has been introduced on an experimental basis and initially will only be in force in eight United States judicial districts. At least one United States' commentator has queried whether introducing the law in selected districts only breaches the American Constitution: (1994) 7 Insolvency Intelligence 16.

3.12 The introduction of Chapter 10 tends strongly to suggest that it would be unwise to follow the Chapter 11 route or, indeed the new Chapter 10 route or any variants until there has been adequate time at least to see how the small business reorganisation provisions are working in the pilot districts.

3.13 We must, however, continue to emphasise that US methods for dealing with corporate rescue do not yet seem a suitable model to be followed in this country.

Conclusions

3.14 There is an important and urgent need in the whole field of corporate rescue for further reform which would balance the requirement for simplicity and cheapness on the one hand with adequate safeguards on the other. The Green Paper proposals suggest untested remedies for unproven ills.

3.15 What would be preferable is cautious progress based on existing remedies such as receivership and administration which have been shown to work. This response puts forward suggestions which would make the present system cheaper and more flexible. Some of the points do not even need legislation and therefore can be put into effect without undue delay. Other points are worthy of careful consideration with a view to new legislation building on the reforms of the Cork Committee and the Insolvency Act 1986.