ARTICLE

The Harm Done by Administrative Receivership

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Introduction

Under the law as it existed in the UK before the coming into force of the Enterprise Act 2002, administrative receivership was the preferred mode of debt enforcement against distressed companies by banks holding fixed and floating charges over substantially the entire estate of the debtor.[2] The debenture creating these charges reserves to the chargee the right to appoint an Insolvency Practitioner (IP) to manage the company and apply either its income, or the proceeds of sale of the company's business, towards the discharge of the secured debt. Perhaps the most distinctive feature of receivership is the fact that the receiver – while regarded as the debtor's agent – owes his primary (in some important respects, exclusive) obligations to the chargee.[3] He may choose to deal with the company or its assets in a way that directly inflicts harm on junior claimants, as long as he acts in good faith in the chargee's interests.[4] While security packages carrying the right to appoint an administrative receiver are held by a variety of creditors, banks and other financial institutions are by far the most important players in this respect, so it would be convenient to refer to creditors holding such global security generically as 'banks'.

It is because administrative receivership was regarded as not giving troubled but essentially viable companies or businesses a sufficient chance to be rescued that the Enterprise Act has severely restricted its availability. In the White Paper preceding the Act, the Government noted 'widespread concern as to the extent to which ... receivership as a procedure provides adequate incentives to maximize economic value' by helping out distressed but viable businesses. The ability of the floating charge holder to block initiation of the pre-Enterprise Act administration procedure[5] by appointing a receiver was taken as an important reason for the low uptake of administration. This was regarded as undesirable because (even) the old administration procedure was a self-consciously 'rescue'-oriented mechanism. The White Paper also highlighted concern about whether receivership provided 'an acceptable level of transparency and accountability to the range of stakeholders with an interest in a company's affairs, particularly creditors.'[6]

This paper asks whether the Government was right to accept that receivership was inadequate both as a rescue mechanism and in providing transparency and accountability for junior claimants (viz., those ranking behind the security-holding bank in the

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2 Insolvency Act 1986 (hereafter, IA), s. 29(2).

3 See *Downsview Nominees Ltd v. First City Corporation Ltd* [1993] AC 295; compare *Medforth v Blake* [2000] Ch 86; but see now *Silven Properties Ltd v Royal Bank of Scotland* [2003] EWCA Civ 1409 (CA).

4 For a recent example, see *Silven Properties Ltd v Royal Bank of Scotland* [2003] EWCA Civ 1409 (CA).

5 For an analysis of this procedure, see R. Goode, *Principles of Corporate Insolvency Law* (2nd edn, Sweet & Maxwell, London, 1997), Ch. 10.

6 White Paper, *Productivity and Enterprise - Insolvency: A Second Chance* (HMSO, London, 2001), para. 2.2.

distribution of value from the insolvent estate). These questions are important because the Government provided no evidence that this was *in fact* the case, and because several commentators have strenuously rejected such slurs on receivership.[7] Also, if receivership was doing a good job in rescuing businesses, then the massive costs of consultation, legislation and displacement of familiar legal institutions and practices were and are entirely unjustified. What is more, the new administration procedure introduced by the Enterprise Act involves mechanisms of consultation and accountability to a variety of claimants which stand in stark contrast to the receiver's single-minded dedication to the bank's interests. Keeping that in mind, suppose that the law governing receivership was efficient in rescuing viable businesses and doing so cost-effectively. In that case, the switch to administration will increase the costs borne by the claimants as a group (as the administrator goes about complying with his more demanding duties to a broader range of stakeholders) while bringing (*ex hypothesi*) few additional benefits in terms of additional businesses saved from unnecessary liquidation.

Business or company: what should be rescued?

Therefore, it is worth looking a little more carefully at the expressed rationales for the reforms. In relation first to the 'rescue culture', did the low take-up of administration necessarily mean that 'rescues' did not occur? In order to answer this question, we need to be clear about what constitutes corporate rescue. It is important here to distinguish between a company, the legal entity that is created for the purpose of carrying on a business, and the productive assets constituting that business itself. The *company* does not itself make products, create jobs, or produce revenues. That is what the actual *business* is all about. So on one understanding of 'corporate rescue', all that is required is that assets which are more valuable as a cohesive productive unit than they would be if split apart and sold off piecemeal, should in fact be kept together. The business can continue to trade either under the ownership of the original corporate entity *or* through the sale of the productive assets as a going concern. Now whilst administrative receivership necessitates the closure of the corporate entity, its defenders endlessly point out that this does not necessarily imply the closure of the business. The available empirical data suggest that a significant proportion of receiverships result in *business* rescue. Indeed, under the old law – where administration was deliberately designed as a secondary mechanism to cover situations where receivership would not be available[8] – this proportion was comparable to that achieved in administration.[9] On this view of 'corporate rescue', it would appear misleading to suggest that the ability of a floating charge holder to block the appointment of an administrator impedes the successful operation of the 'rescue culture'.

We should not stop here, however.[10] There is a more demanding notion of 'corporate rescue', where some value is placed on the preservation of the old corporate entity itself. Consider the following understanding of *company* rescue. The company is rescued as a going concern if the original legal entity continues to own all or at least a significant part of its pre-distress business. In practice, this would generally be a concomitant of a bargain or agreement whereby the shares in it, or at least a significant proportion of them,

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7 The British Bankers' Association claims that there is 'no evidence that debenture holders destroy viable companies through over-hasty appointment of receivers', and that 'receivership is a very successful method to transfer a business to new investors'; *BBA Response to the Report by the Review Group on Company Rescue and Business Reconstruction Mechanisms* <http://www.bba.org.uk/bba/jsp/polopoly.jsp?d=155&a=527>. The objections to receivership were described as 'dogma' in an Editorial in the Insolvency Practitioners' main trade journal; see *Recovery* (Autumn 2003), 2. For the most persuasive and coherent academic defence of receivership, see J. Armour and S. Frisby, 'Rethinking receivership' (2001) 21 OJLS 73.

8 The Cork Committee recommended the introduction of administration as a substitute for administrative receivership for companies that had not granted a floating charge to a bank or other secured creditor. The veto power given to the floating charge holder over the commencement of administration merely reflected the original conception of administration as a secondary route, which would only be pursued where no floating charge was in existence. See the Insolvency Law Review Committee, *Insolvency Law and Practice* (Cmnd. 8558, 1982), Ch. 9.

9 See the figures in the Association of Business Recovery Professionals' *R3 9th Survey of Business Recovery in the UK* (ABRP, London, 2000), 17. Very importantly, however, given the skewed way in which companies would end up in administration (viz., only when they were allowed to do so by the very party entitled to initiate receivership), the meaningfulness of comparisons between business rescue rates in receivership and pre-Enterprise Act administration is open to very serious doubt.

10 It is surprising to see how tempted some commentators have been to do so. The British Bankers Association probably went the furthest in expressing exaggerated incomprehension even as to the *possibility* that rescue procedures could have any other purpose: 'We … assume that there is a typographical error in the suggestion [contained in the Report by the Review Group on Company Rescue and Business Reconstruction Mechanisms] that the primary object of rescue is companies rather than businesses'! See *BBA Response to the Report by the Review Group on Company Rescue and Business Reconstruction Mechanisms*. A similar note of incredulity mixed with sarcasm can be detected (though with some exceptions) in the pages of *Recovery*. The suggestion that *companies* rather than merely businesses might be worthy of rescue has been described as 'the government's hang-up' (*Recovery*, Spring 2003, 31), and being based on little more than a 'surprisingly steadfast lack of distinction between the company and its business' (*Recovery*, Autumn 2003, 2).

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come to be owned by some combination of its original, pre-distress creditors and shareholders. Here is the intuition underlying this conception of corporate rescue. The primary determinant of whether to aim for a *company* rescue as opposed to a mere *business* rescue is whether a market sale of the company's assets is desirable. If it is not, then it would be in the interests of all the claimants as a group for those assets to (in effect) be sold to the company's pre-distress creditors and/or its pre-distress shareholders by way of a Company Voluntary Arrangement (CVA), scheme of arrangement or composition. This brings about a company rescue. A market sale of the company's assets might not be desirable in either or both of two situations: (a) the market for those assets might lack liquidity.[11] Or, overlapping with this, (b) it might be necessary, in order to derive the best value from those assets, to make them available to those with accumulated expertise in their use. This argues in favour of retaining (some of) the pre-distress managers of the company, who would often also be the company's pre-distress shareholders.[12] What constitutes a 'significant' proportion (of business and of shares) for this purpose, and what combination of pre-distress creditors and shareholders end up being shareholders in the 'rescued' entity, would of course depend upon the circumstances of the case.[13] What matters is that the original legal entity survives, and that it survives as a commercially trading entity.[14]

I suggest that there are at least two reasons why it is desirable for a regime dealing with corporate distress to aim for this type of company rescue, at least in the first instance. First, a rescue process that could be initiated without the need to demonstrate formal insolvency, actual or impending, would be initiated earlier during the distress cycle, when rescue efforts were more likely to be successful.[15] This also opens up the possibility, however, that the company made subject to the formal rescue proceedings, while distressed, is still solvent. By definition in this situation, the company's shareholders would have a real interest in the proceedings, which should be substantively recognized in the procedure by opening up the possibility that the company itself would be rescued as a going concern in the sense outlined above. Second and taking the same reasoning forward, it would often be the case that the company's directors are in the best position to sense impending crisis. There is great value in providing incentives – 'sticks and carrots' – for them to take action at that point. For whatever it is worth, the 'stick' already exists in the form of the wrongful trading provisions in section 214 of the Insolvency Act 1986.[16] One way of providing the 'carrots' would be to ensure that the directors – who, for companies most likely to become subject to formal insolvency proceedings, would also be significant shareholders – would have some hope of regaining control and residual claimant status if they act at the earliest appropriate moment. A procedure which aims in the first instance at company rescue could be expected to provide them the right incentives.[17]

Administrative receivership does not even purport to rescue companies. It therefore can not even claim to set up the correct incentives for shareholder-directors to initiate rescue proceedings.

How good was administrative receivership even in rescuing businesses?

Turning secondly to the concern with the inefficiency of administrative receivership: it is undoubtedly the case that a senior creditor – such as a bank – may have perverse incentives to close down a distressed business 'too quickly'. These perverse incentives arise most obviously where the bank is 'oversecured': in other words, where the value of the assets subject to its charges is greater, however they are sought to be realized, than the amount owed to the bank.[18] In this case, the bank will be concerned primarily with how quickly the assets can be sold, as opposed to selling them in the way that will produce the greatest returns overall. Yet if the bank is not oversecured, it might be

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11 This and similar factors are discussed in J. Armour and R. Mokal, 'Reforming the Governance of Corporate Rescue: The Enterprise Act 2002' (forthcoming).

12 This is discussed in Mokal, 'Administrative Receivership and Administration'.

13 In many equity-for-debt swaps, for example, the original shareholders might end up with little or nothing of the post-administration company's equity.

14 It is submitted that this is the notion of corporate rescue enshrined in the new administration procedure. See IA, Sch. B1, para. 3(1)(a).

15 For an explanation, see R. Mokal, 'The Floating Charge – An Elegy' in S. Worthington (ed.) *Commercial Law and Commercial Practice* (Hart, Oxford, 2003), Ch. 17, Section III. The new administration regime may be initiated without demonstrating insolvency; see IA, Sch. B1, paras 16 (out of court appointment) and 35(2)(a) (appointment by court order).

16 For an analysis, see R. Mokal, 'An Agency Cost Analysis of the Wrongful Trading Provisions' [2000] CLJ 335.

17 This was explicitly given as the reason for this feature of the Act; see Mr. Douglas Alexander, Minister for E-Commerce and Competitiveness, *Hansard*, 10 April 2002: Column 549; see also Lord McIntosh of Haringey, *Hansard*, 29 July 2002: Column 766. How tempting this carrot proves is however another question; see Armour and Mokal, 'Governance of Corporate Rescue'.

18 See Armour and Frisby, 'Rethinking Receivership', p. 90.

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thought that the perverse incentive vanishes. For example, if the bank is owed GBP 100,000, and the assets will realize GBP 80,000 on a break-up basis but GBP 120,000 in a going-concern sale, then the bank will prefer a going-concern sale regardless of whether this takes longer.[19] The extent of the perverse incentive problem is therefore an empirical question, depending on the relative frequency with which banks find themselves 'oversecured' and 'undersecured'. Now it is generally recognized that banks are often undersecured in insolvency proceedings.[20] This is supported by the results of the Association of Business Recovery Professionals' ('APRB') survey of its members, which reports that the average recovery by secured creditors – across all types of insolvency procedure – in 1997–98 was only 37% of the face value of their debt, and in 1998–99, 53%.[21] If banks do not recover in full, then it might be said they are by definition undersecured. It might therefore appear that the perceived inefficiency of administrative receivership had been significantly overstated.

However, this conclusion would be erroneous. There are several reasons to think essentially viable businesses are frequently closed down under the receivership system. First, note that it is less useful to look at the *mean* recoveries of banks, and quite crucial to examine the *proportion* of receiverships in which banks are oversecured.[22] It is easy to understand why. In any particular case, the bank is either under- or oversecured. In cases where the bank is undersecured, let us grant (contrary to what will be argued next) that the receiver has the right incentives to maximize value anyway. Consideration of the bank's average returns is therefore irrelevant. On the other hand, where the bank is oversecured, ruminating over the bank's average returns over thousands of insolvencies is unlikely to provide the receiver with additional reasons in *this particular one* to maximize value beyond the point at which the bank recovers fully. So the decisions of receivers, acting primarily on the bank's behalf, are predominantly affected not by the bank's average recoveries over many insolvencies, but by how much the bank is likely to recover in the particular receivership the receiver is conducting. It is that assessment which shapes their incentives about whether to go for an overly hasty 'fire-sale' of the business or its constituent assets.

Looked at in this way, the position changes dramatically. Evidence, including that given on behalf of the banks themselves, indicates that they are oversecured in over half of all receiverships.[23] From what has been said above, it follows that acting on the bank's behalf, receivers do not have the correct incentives to maximize value in over half of cases.[24] On this evidence alone, receivership starts looking like a highly value-destructive institution: one in every two receiverships potentially allows a viable business to be broken up. It is hard to overstate the significance of this conclusion. As a mechanism for generating the correct incentives for the prevention of unnecessary job losses and resource misallocation, receivership is – on the facts as admitted by the banks themselves – as reliable as the toss of a coin.

In fact, things are worse even than this. The second reason for thinking that receiverships are socially harmful has a broader ambit yet. Remember that banks have often taken alternative forms of security to cover the debt owed to them. Most notably for our

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19 This is of course subject to the observation that, despite his obligation to obtain a 'fair' or 'proper' value when disposing of the charged assets, the receiver has little incentive to bargain for a price over and above that required to meet the bank's claim and his own costs. Remember that going concern sales are often all about sensing the movements of and searching through the market, and then about bargaining to obtain the best price available. In short, going concerns sales are about the right timing. However, the receiver is under no obligation to junior claimants with respect to the timing of the sale; *Silven Properties Ltd v Royal Bank of Scotland* [2003] EWCA Civ 1409 (CA). So on the facts assumed in the text, (a) if the receivership costs are fixed at, say, GBP 12,000, then the receiver has no incentive to search for and bargain towards a price higher than GBP 112,000, which results in a loss of GBP 8,000 to junior claimants (at least, since there might also be losses of idiosyncratic value), and (b) if the costs are not fixed in some way, the receiver would have an incentive to realize the assets at a higher price as long as he could capture the additional returns by inflating his costs. This is discussed further in the text, below.

20 Armour and Frisby, 'Rethinking Receivership', p. 96.

21 Society of Practitioners of Insolvency, *8th Survey of Company Insolvency in the United Kingdom* (SPI, London, 1999), 14–15; Association of Business Recovery Professionals, *R3 9th Survey of Business Recovery in the UK* (ABRP, London, 2000), 18. However, compare J. Franks and O. Sussman, *The Cycle of Corporate Distress, Rescue and Dissolution: A Study of Small and Medium Size UK Companies* (IFA Working Paper 306-2000, London, 2000) (hereafter, *Cycle*), p. 14.

22 Another way of making this point is to say that what matters is not so much the *means* as the *medians* of banks' recoveries in receivership.

23 See British Bankers' Association, *BBA Response to the Report by the Review Group on Company Rescue and Business Reconstruction Mechanisms,* ('Our own experience suggests that we obtain full recovery in something nearer to 50% of [receivership] cases'). This is reinforced by the finding by Franks and Sussman that the *median* recovery in receivership for one of the banks in their study was 100%; *Cycle*, p. 14. Even more directly, they found that the figures available *ex ante* to the banks themselves indicate that banks are generally (though not invariably) oversecured; see *Cycle*, p. 9, which shows that the collateral held by the banks as a proportion of what they were owed was 103.7%, 74.6% and 118.5%. Older, less reliable evidence – because it is based on surveys of insolvency practitioners rather than on the banks' records – comes from SPI (now, the ABRP), which reports that banks recovered fully in 19% of receiverships; *8th Survey*, p. 4.

24 Even the less reliable ABRP figure suggests receivers are under-incentivized in around a fifth of all cases – not exactly a negligible proportion.

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purposes, they extract personal guarantees from the shareholder-directors of over half the firms to which they lend.[25] Where such security has been provided, the receiver would have less incentive to ensure a value-maximizing disposal of the business, even in those cases where the bank is undersecured. Acting primarily in the bank's interests, he will expend time and resources attempting to seek a value-maximizing disposal of the business to the point where the net addition to the bank's overall recovery from doing so equals the net addition to that recovery through a personal action by the bank against the surety-directors. This effect is strengthened by another important factor: other things being equal, banks are likely to extract personal guarantees from directors *precisely* in those cases where they expect to end up undersecured. It follows that some value would be lost in overly hasty fire-sales even when the bank is not oversecured.[26]

The direct costs of receivership

We should also consider the direct costs of the process of receivership. For a long time, one of the main defences made of this mechanism was that it takes less time and costs less money. We now know that this popular prejudice was just that: a prejudice.[27] Receivership might have been quick but it was certainly not cheap. The procedure costs *on average* up to a quarter of the value of the insolvent estate.[28] I have pointed out elsewhere that a process that consumes such a large proportion of the estate it is meant to be distributing to a pre-determined group of claimants is intrinsically absurd.[29] The process sold for being cheap is hugely more expensive than comparable procedures elsewhere. It would be illustrative to make some quick international comparisons. Notice the distinction between 'debtor-in-possession' systems where the pre-distress management is left in charge of the company during the formal insolvency proceedings, and 'management displacement' systems where the pre-distress management is deposed or its powers suspended in favour of an outside expert (official or private). As a starting point, we can expect management displacement regimes to involve greater *direct* costs, incurred because of the employment of the new, distress-oriented manager.[30] Keeping this in mind, it would be fruitful to compare both types of regime with receivership. Receivership itself is of course a management displacement regime, so let us take such systems first. A well-known study reported results for a Swedish regime dealing with corporate distress. Here, the initiation of the formal proceedings immediately displaces the management in favour of a court-appointed trustee who owes fiduciary obligations to creditors. In this system, and for companies of a comparable size and other characteristics similar to those undergoing receivership in this jurisdiction, the total direct costs of the proceedings (including lawyers' and consulting fees and administrative costs) is 13.2% (median) of the value of the distressed company's estate.[31] And under a similar Finnish regime, a study of rescue proceedings concerning comparable companies showed that the total direct costs of the proceedings are 14.7% (median).[32] Turning now to the most famous debtor-in-possession regime, and focussing once again on

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25 *Cycle*, p. 9; the figures are 60.4%, 51% and 55% for the three banks.

26 Importantly, another effect of the existence of director guarantees is the contribution they make to the control of *director* misbehaviour. This leads to a decrease in the probability that a business would become distressed in the first place and thus enhances the value of all the claims against the company. This is explained in R. Mokal, 'The Search for Someone to Save' [2002] OJLS 687, and especially at 697–8, 708–15 and 721–7. It is of course an empirical question whether the social loss resulting from the first effect (fire-sales of viable businesses) is greater or smaller than the social gain resulting from the second (control of director misbehaviour). Either way, some viable firms are closed down because the primary beneficiary of receivers' duties has alternative ways of claiming on the debt owed to it. We therefore have reason to consider alternatives to receivership that would allow the positive effects of directors' guarantees to persist while reducing the perverse incentives of the IP responsible for dealing with a distressed business.

27 Nor was this prejudice universally shared; see e.g. Sir Gavin Lightman, 'The Challenges Ahead: Address to the Insolvency Lawyers' Association' [1996] JBL 113, 113–116.

28 *Cycle*, p. 14; J. Franks and O. Sussman, 'Resolving financial distress by way of a contract: An empirical study of small UK companies' (22 October 2000) <http://www.ifk-cfs.de/papers/franks.pdf> p. 19. This is a median figure, in recognition of the great variability of the findings. For the sake of completeness, the means for the costs for the three banks studied were 42.4%, 24.3% and 38.7%; ibid., Table 3, Panel D.

29 Mokal, 'The Floating Charge', p. 497.

30 Note however that the retention of pre-distress managers during the insolvency proceedings might create other problems, e.g. a bias in favour of rescue attempts even when the troubled company is economically distressed so that the rescue is doomed to failure, or where the company, while viable, has been brought into distress precisely because of the incompetence of its managers. The point is that while the *direct* costs of debtor-in-possession systems might be lower than those of management displacement ones, the *overall* costs to society of failed rescues or the continuation of economically distressed companies might well be higher.

31 K. Thornburn, 'Bankruptcy Auctions: Costs, Debt Recovery and Firm Survival' (2000) 58 *Journal of Financial Economics* 337, 355.

32 A. Ravid and S. Sundgren, 'The Comparative Efficiency of Small-Firm Bankruptcies: A Study of the US and Finnish Bankruptcy Codes' (1998) 27 *Financial Management* 28, Section IV.

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companies with characteristics similar to those undergoing receivership, the figure for total direct costs in US Bankruptcy Code Chapter 11 proceedings is 4.7% (median).[33]

In view of the empirical evidence discussed above, the finding that receivership costs are so significantly inflated should come as no surprise. Receivers owe primary obligations to banks. Banks are concerned with ensuring high recoveries for themselves. They recover fully in around half of receiverships. In many – perhaps most – others, they have methods of recovery (like directors' guarantees) that do not require the maximization of the value, net of costs, of the insolvent estate. So beyond the point at which the bank recovers fully, the costs of the receiver's actions – including grossly wasteful or negligent ones – falls not on the bank but on junior claimants. Junior claimants, however, while obviously affected by his actions, cannot hold the receiver to account.[34] They are vulnerable to gratuitous harm[35] inflicted by someone dealing with what in effect is *their* property[36] without having any meaningful remedy against him ... a situation unknown to the law except in this domain![37] And lest it be thought this suggestion of receiver wastefulness is merely theoretical, there is in fact strong empirical support for it. Evidence indicates that when receiverships are tendered out, costs fall dramatically, to around 14.5%.[38] Notice that this figure is very much in line with that reported above for other management displacement regimes. The effect of tendering out receiverships is of course to focus the burden of any wasteful behaviour onto the insolvency practitioner concerned. The striking reduction in costs – and the fact that the reduced costs align closely with those in systems where the outside manager owes duties to *all* the creditors – therefore indicates the extent to which the expenses of receivership (of the usual non-tendered out variety) are inflated because of receiver wastefulness.

Arguably, Parliament saw the potential for just this type of motivation cost to be acute in the institution of receivership when it provided a power for the liquidator to approach the court to set the receiver's remuneration.[39] However, the courts (here as in so much else to do with receivership) destroyed the usefulness of this provision by insisting that they would only intervene if the level of remuneration set in the debenture was plainly excessive.[40] Given that standard terms in debentures provide that the receiver's remuneration would be fixed by reference to the charging practices of the receiver's firm,[41] and given also that the motivation costs mentioned above could be expected to be endemic within the institution of receivership regardless of the receiver's firm,[42] the practical effect of this approach was to render the statutory provisions nugatory.[43]

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33 S. Ferris and R. Lawless, 'The Expenses of Financial Distress: The Direct Costs Of Chapter 11' (2000) 61 *University of Pittsburgh Law Review* 629, 651. This is consistent with our initial surmise that the direct costs of debtor-in-possession systems would be lower than those of management displacement ones.

34 See now *Silven Properties Ltd v Royal Bank of Scotland* [2003] EWCA Civ 1409.

35 'Gratuitous harm' in the sense that its infliction is not required, on any reasonable view, in order for the receiver to obtain the best outcome for his appointor. A recent example is provided both by the facts and the decision in *Silven Properties Ltd v Royal Bank of Scotland*.

36 See e.g. *West Mercia Safetywear Ltd. (in liq.) v Dodd* [1988] BCLC 250, 252-3 and IA, s. 214 etc.

37 Contrast, e.g., the position of company directors, trustees, mortgagees in possession, ordinary agents dealing with their principal's property, bailees, etc.

38 Franks and Sussman, 'Resolving financial distress', p. 33.

39 IA, s. 36 (this provision makes no explicit reference to indemnity or reimbursement, though the argument in the text here applies to these as much as it does to the receiver's remuneration); see also Companies Act 1948, s. 371(1).

40 *Re Potters Oils Ltd* [1986] 1 WLR 210.

41 J. Lingard, *Bank Security Documents* (3rd ed., Butterworths, London, 1993), para. 7-04.

42 Since the oversecured bank 'without risk can afford to be generous' in agreeing costs with the receiver when they are to be paid out of money otherwise destined for 'the open unguarded pocket' of the distressed company's unsecured creditors; G. Lightman, 'The Challenges Ahead', pp. 115–116.

43 For consideration of a preferable approach, see Mokal, 'Administrative Receivership and Administration'.

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Receiver opportunism

Receivers are also now known to engage in opportunistic behaviour on behalf of their appointor by attributing some costs to the floating charge instead of the fixed one, with a view to inflating the recoveries under the latter.[44] This is a practice which does cause loss to be moved from the party best placed to deal with it *ex ante*,[45] to those worse placed to do so.[46] This is doubly the case since it is unpredictable *when* such behaviour might benefit the bank and when in turn a receiver might resort to it. So the fact that it might happen is unlikely to bring any (even theoretical) compensating benefits, in the form of lower interest rates from the bank, say.

A market solution?

Finally and most broadly, let us postulate that one of the services provided by banks is a system to reduce the sort of shirking and incompetence on part of receivers that might lead to the closure of essentially viable businesses, and receiver wastefulness that results in the inflation of costs.[47] The social value of this service exceeds its private value to the bank (a) in those cases where it is oversecured, and (b) in those cases where it is undersecured but has the benefit of directors' guarantees, beyond the point where it would find it cheaper to pursue a personal claim against the directors than to ensure a value-maximizing disposal of the business. The bank charges for this service by adding a premium to the cost of credit. Companies have an incentive to pay this premium because, as noted, their directors have often guaranteed the bank's debt, and because they would also have lent significant amounts to their company.[48] Therefore, they would wish to ensure that should insolvency occur, the maximum value would be squeezed out of the business. It would not necessarily matter that guarantors and junior creditors could not proceed directly against the receiver if they suspected misbehaviour (overly hasty liquidation, inflation of costs, etc.) on his part. As a group, directors in the market for this service would simply shop around for banks which had invested in building up a reputation for hiring the right sort of receivers, and in exercising an appropriate level of control over them.

At this point, however, we should notice the supply-side structure of the market in banking services in this country. This is highly uncompetitive, with the big four groups of banks exercising significant monopoly power by virtue of their control of around 80% of that market between them.[49] And under the receivership system, banks have significant monopoly power in the provision of the service described above not only because of the structure of the market, but also (as noted) because they are the primary and often effectively the sole beneficiaries of receivers' duties. As with any good or service supplied monopolistically, the implication is that the level of monitoring etc. of receiver misbehaviour provided by banks is lower than the social optimum and the price is higher. In other words, the result is the closure of some essentially viable businesses and the inflation of receivership costs, this time because the banks exercise a less than optimal level of control over receiver shirking, incompetence and wastefulness. And the control that does exist comes at a price which destroys more consumer (junior claimant) surplus than it adds to producer (bank) surplus. These are the dead-weight

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44 Franks and Sussman, 'Resolving financial distress' at 18. A simple numerical illustration would help in grasping this point. Suppose that assets subject to the fixed charge are sold for GBP 100, those subject to the floating charge fetch another GBP 100, and the receiver's total costs are GBP 50. Assume also that the secured creditor (holding both fixed and floating charges) and preferential creditors are owed GBP 200 each. Recall that costs attributed to realizing assets subject to the floating charge have to be paid in priority to statutory preferential debts. Suppose first that the receiver attributes half of his costs each to the realization of fixed and floating charge assets. In this case, the secured creditor receives GBP 75 (GBP 100 from the sale of fixed charge assets minus the receiver's costs of GBP 25), and preferential creditors get GBP 75 (*mutatis mutandis*). However, if the receiver attributes only a quarter of his costs to the realization of fixed charge assets and the rest to the realization of floating charge ones, then the secured creditor gets GBP 87.50 and preferential creditors receive only GBP 62.50.

45 Viz., the bank, which can adjust rates and other terms to compensate itself for expected losses.

46 The Crown in right of unpaid taxes, or employees in right of back pay, etc. Such parties cannot of course adjust the terms on which they become the company's creditors.

47 The constituents of this system would include, e.g., (a) a mechanism to pick an IP with the desired reputation, (b) a method of telling economically non-viable firms apart from those which, while distressed, are essentially viable, (c) a way of verifying this to the receiver and if necessary, before a court, (d) benchmarks for the sort of costs reasonably to be expected of particular types of receivership, and (e) a method of dealing with any additional risks created by the line of authority stemming from *Re Vimbos Ltd* [1900] 1 Ch 470 in attempting to control the receiver once receivership in underway.

48 *Cycle*, pp. 7–8.

49 See e.g. D. Cruikshank, *Competition in UK Banking* (HM Treasury, London, March 2000), Ch. 5, especially pp. 162–167; and the Competition Commission, *The Supply of Banking Services by Clearing Banks to Small and Medium-Sized Enterprises* (HMSO, London, March 2002), in particular, the Commission's conclusions on complex monopoly effects and the harm thereby done to the public interest at pp. 128–130 and 137.

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costs of tying receivers' duties to banks' interests.[50]

Enhanced accountability and its value

This discussion makes it clear very significant value was probably being wasted because of the perverse structure of receivership, in the form of unnecessary job losses, resource misallocation, and wastefully inflated costs. An improved mechanism for dealing with corporate distress would be geared towards salvaging this value. We can draw several lessons about the design of a less socially harmful mechanism for dealing with corporate distress. First, it would pay to orient the duties of the IP charged with ensuring a value-maximizing disposal of distressed businesses towards the *true* residual legal claimants in particular insolvencies. Second, the IP's duties should be shaped by the interests of a party not easily able to ensure repayment of its loan by means independent of (a) the maximization of the value of the insolvent estate, and (b) the control of the costs of the mechanism. Third and distinctly, the improved system would not tie the obligations of the IP (exclusively or even primarily) to the interests of the monopoly power-wielding banks. And finally, the IP should be effectively accountable, as to the discharge of his duties, to the parties for whose benefit those duties are imposed.

Evidence suggests that the first three requirements are primarily fulfilled by the shareholder-directors of the sort of companies that most frequently become subject to formal insolvency proceedings at the present, and which could be expected to be the most frequent entrants into the new administration procedure. Most such companies are small and closely held.[51] Recall that the shareholder-directors of these companies have guaranteed the bank's debt (in between 50% and 60% of receivership cases). They have also lent to their company sums that 'in absolute size ... may be significant' for them: evidence indicates that on average, something like 2.4% to 6% of the troubled company's debt is owed to its directors.[52] Shareholder-directors would often also have made idiosyncratic investments in the company, captured by the very useful clichés 'my name is on the door', or 'this is my life's work'. Given therefore that they are likely to consider themselves deeply tied up with the fortunes of the company, and given that they would often clearly be its residual claimants, shareholder-directors have every incentive to ensure that the company's value would be maximized. A system intent on maximizing the value of distressed companies and businesses would therefore orient towards them – at least presumptively – the duties of the IP presiding over the insolvency proceedings.

It is also interesting to study the position of the Crown. It is often a primary residual claimant in insolvency proceedings by virtue of the subrogation of the National Insurance Fund to a significant chunk of the preferential claims of employees,[53] and because of its claims for unpaid tax etc. As things stand, it is a 'non-adjusting' creditor, unable to exercise any influence on the size of its recoveries except by controlling IP misbehaviour and the costs of the mechanism dealing with corporate distress. And because the rates of tax, VAT and employer contributions to the National Insurance Fund etc. are not set in view of the likelihood of the insolvency of a particular company and thus of its need for monitoring of IP misbehaviour, the Crown cannot pass on its costs to any other party. It cannot therefore exploit any sort of monopoly power in the way it would exercise control over IP misbehaviour. It would therefore seem that in an improved corporate distress mechanism, the IP would be accountable to the Crown. This reasoning repeats itself (though with varying degrees of force) with respect to other parties fulfilling (to corresponding degrees) the requirements set out above.

Accountability to these parties can be increased through a variety of means: requiring that decisions be taken, or at least confirmed, by a creditors' meeting rather than the office-holder;[54] requiring court supervision of the office-holder's performance of his functions;[55] or by imposing duties on the office-holder to take into account the interests of different groups of creditors.[56] It is clear that none of these mechanisms is cost-free. However, I have explained above the very

Notes

50 While the analysis here is mine, this conclusion is entirely consistent with the Competition Commission's findings, referred to above.

51 ABRP provides evidence that 80% of the companies undergoing formal insolvency proceedings had less than 14 employees, and that both the assets and the liabilities of around 90% of these companies was less than GBP 5m. Further, only 2% of the companies engaged in an insolvency procedure were quoted on a recognized stock exchange, no share capital was held by institutional investors in 93% of the cases, and in only 2% of such proceedings had the insolvent firm benefited from a rights issue or other equity investment in the 12 months leading upto the insolvency proceedings; see *Survey of Business Recovery in the UK: 9th Survey* (2001) <http://www.r3.org.uk/pdf/09th_Company_survey.pdf>), pp. 7, 8, and 12.

52 *Cycle*, pp. 7–8.

53 By virtue of the obligation of the Secretary of State, through the Redundancy Payment Service, to make payments to employees from the National Insurance Fund.

54 See e.g. IA, Sch. B1, paras 50–58.

55 Ibid., paras 74–75.

56 Ibid., paras 3(2), 3(4)(b), 5, and 73.

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significant extent to which the lack of accountability in receivership can be expected to lead receivers to make decisions that fail to maximize the value realized from the sale of the company's assets and control costs. So the direct costs of increased accountability in an improved rescue procedure can be expected to be offset by savings from increased returns generated by more accountable office-holders. In addition, to the extent that a system which takes cognisance in some appropriate way of the interests of all those it affects is fairer than a system which does not, accountability is also a virtue worth pursuing precisely because it conduces to fairness.[57] And finally, the disregard in which receivership is held in other jurisdictions is both undoubtedly genuine, and linked as well to the accurate perception that it is not a 'collective' mechanism, that (*inter alia*) it does not ensure that the IP take into account the interests of all the creditors affected by his actions.[58] To the extent that value is placed in acquiring international acceptability – and respectability – for the English system of dealing with corporate distress, we get our final reason for ensuring that the system complies genuinely and substantively with the condition precedent (as it were) of gaining that acceptability.

Conclusion

The conclusion is clear. Administrative receivership was exploitative since it moved the costs of corporate distress on to those least able to protect their interests, was designed so as to destroy social value by closing down troubled but essentially viable companies and businesses, was wasteful in allowing the unnecessary inflation of costs, and was oppressive in not allowing any meaningful right to hold the receiver to account to most of those whose interests and property were under the receiver's control. The legal system is therefore better rid of it. The question now is whether the new administration procedure can be made to work any better.

Notes

57 See e.g. the discussion of accountability, regarded as an aspect of efficiency, and its relationship with fairness in R. Mokal, 'On Fairness and Efficiency' [2003] MLR 452.

58 See e.g. the EC Regulation on Insolvency Proceedings, conferring automatic recognition to collective insolvency proceedings throughout the European Union, but excluding administrative receivership from its ambit; Regulation 1346/2000 EC [2000] OJ L160/1, Annex A.

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