



Centre for Business Law & Practice
School of Law
University of Leeds



BUSINESS LAW & PRACTICE REVIEW 2003 - 2004



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ABOUT THE CENTRE

The Centre for Business Law and Practice is located in the School of Law at the University of Leeds and its aim is to promote the study of all areas of Business Law and Practice, understood as the legal rules which regulate any form of business activity. It seeks to promote all forms of research, including, doctrinal, theoretical (including socio-legal) and empirical research and to develop contacts with other parts of the academic world, as well as the worlds of business and legal practice in order to enhance mutual understanding and awareness. The results of its work are disseminated as widely as possible by publishing monographs, articles, reports and pamphlets as well as by holding seminars and conferences with both in-house and outside speakers.

Staff members have acted as consultants to law firms, accounting bodies and the International Monetary Fund. Research has been undertaken in many areas of business law including banking, business confidentiality, corporate (general core company law as well as corporate governance and corporate finance), employment, financial institutions, foreign investment, insolvency, intellectual property, international trade, corporate crime and taxation.

One of the primary functions of the Centre is to oversee the research undertaken at postgraduate level and to manage postgraduate taught programmes in International and European Business Law. In addition, the Centre offers several undergraduate business law modules to law and non-law students.

INTRODUCTION

This report covers the activities of the Centre for the period from August 2003 until August 2004. The Centre is gradually expanding the scope of its activities, and this is in evidence in the 2003/2004 year. While the development of the Centre was limited to some degree in the past year, due to staff shortages, new staff have been engaged and the future looks promising. Notwithstanding the staff shortages, the past year has been a productive year for the Centre in terms of activity of staff, research, research outcomes and growth of its postgraduate taught programmes. The publications of members of the Centre manifest the finalisation of some very high quality and relevant research work that spans diverse parts of business law. The number of Masters students recruited indicates the popularity and strength of the Centre's programmes and is testimony to the standing of the Centre's staff.

In accordance with the aim of the Centre to broaden its activities, within its remit, plans have been put in place for the Centre to host a significant seminar series to be conducted during the 2004/2005 academic year. High-profile speakers have agreed to present seminars on a variety of business law topics. Speakers will address such areas as money laundering in business, employment issues relating to the transfer of businesses and the various approaches across the world to dealing with debtor-creditor issues. The seminars have been designed to appeal to the legal profession, business professions (including bankers and directors), academics and postgraduate students. It is expected that we will attract a wide audience, including our own postgraduate students, whose learning experience will be enriched by being able to hear, and ask questions of, internationally acclaimed speakers on the relevant matters addressed.

The Centre has enjoyed links with the Leeds University Business School, including the sharing of Academic Fellowships and discussions on research objectives. Two members of the Business School act as members of the Executive of the Centre. The Centre has also been in dialogue with legal practitioners in Leeds in order to improve links between the Centre and practice and to establish how the Centre might serve the interests of those in the legal profession who practice in the business law field. There have been some discussions concerning the possibility of law firms sponsoring certain research projects.

RESEARCH DEGREES & TEACHING PROGRAMMES

A. Research Postgraduates

The Centre is keen to supervise postgraduate research students in any of the areas of business law in which it has expertise. Business law is a broad area of the law and the Centre is able to offer supervision in a broad range of business law and business law-related fields because its staff members have undertaken research in diverse fields and using various research methodologies. The Centre offers supervision at the level of Doctor of Philosophy (Ph.D.), Master of Philosophy (M.Phil) and Master by Research (M.Res). The Ph.D involves the writing of a major piece of research, namely a thesis of up to 100,000 words. The M.Phil also involves the writing of a thesis, but of up to 60,000 words. Finally, the M.Res involves the writing of a thesis of up to 30,000 words. Both Ph.D and M.Phil theses are written under the supervision of a member of staff with the appropriate expertise. We have excellent study facilities and the University provides for full training in all aspects of research. The Director of the Centre, Professor Andrew Keay (a.r.keay@leeds.ac.uk) is always happy to discuss a research proposal with prospective candidates.

B. Taught Postgraduate Programmes

The Centre offers several programmes, all majoring in International and European Business Law. The most popular are the Master of Laws (LL.M.) and the Master of Arts (M.A.). The LL.M is for those who hold an undergraduate law degree (commonly an LL.B) and the M.A. for those who hold an undergraduate degree in some discipline other than law.

In all programmes, modules are taught by seminars, and there are two 11 week semesters in each academic year. Assessments are by written work.

The numbers of people applying for entry into the LL.M and M.A. programmes has been increasing significantly over the past couple of years, as have the number of students actually registered. A high proportion of the students enrolled are foreign students.

The Master of Laws in International and European Business Law

For the LL.M, 180 credits must be obtained. The programme involves the completion of some compulsory modules (60 credits) that are taken in Semester 1, and some optional modules (60 credits) that are taken in Semester 2, with a dissertation (worth 60 credits) being completed in the Summer following Semester 2. In the compulsory modules students undertake a study of principles and rules that are able to provide foundations for both the study of more specialised modules in Semester 2, and the writing of the dissertation.

The compulsory modules consist of modules that are believed to form a critical base for the study of business law, nationally and internationally. Students have a broad choice when it comes to the optional modules, and this reflects the breadth of expertise in the Centre.

The dissertation, constituting 60 credits, is a compulsory and major part of the programmes, and reflects one of the aims of the programme, namely to foster research capabilities. The dissertation requirement permits students to engage in some detailed research of a particular issue that warrants investigation. Research for, and the writing of, the dissertation is undertaken in conjunction with a supervisor, who is a member of the law staff. The members of the law staff have a wide range of research interests and are able to supervise a broad spectrum of topics in different areas of the law.

The overall objective of this programme is to provide students with a firm grounding in many of the basic principles and rules regulating business activity in the UK Europe and around the world. The programme also aims to enable students to develop the following: analytical legal skills, ability to work independently, writing skills, and ability to undertake research. The compulsory modules are European Business Law, Business and Institutional Transactions Law, Insolvency Law and Research Methods.

The entry requirements are a good Honours degree in law.

The Master of Arts in International and European Business Law

The structure of the programme is the same as for the LL.M, with mandatory modules, optional modules and a dissertation.

The overall objective of this programme is to provide students with a firm grounding in many of the basic principles and rules regulating business activity in the UK, Europe and around the world. Also, the aim is for students to develop skills in legal analysis, writing and presentation, and independent research. The compulsory modules are European Business Law, Business and Institutional Transactions Law, Corporate Law and Research Methods.

The entry requirements are a good Honours degree in any discipline.

The Diploma in International and European Business Law

Students need 120 credits for the completion of the programme. The framework is the same as for the LL.M or M.A. except that no dissertation is written. The same entry requirements exist as for the LL.M or the M.A.

The Certificate in International and European Business Law

Students need to pass 60 credits for the completion of the programme. These credits are the compulsory modules for the Masters degree.

The same entry requirements exist as for the LL.M or the M.A.

C. Undergraduate Teaching

While the Centre does not run any undergraduate programmes, it makes an important contribution to teaching of the Bachelor of Laws degree, in particular. The Centre has developed modules that are taught to both law and non-law undergraduates. These modules have been very popular with students, and have attracted good enrolments. The modules that are taught in the Bachelor of Laws programme (although students from other programmes with the necessary prerequisites can enrol for them) are Business Law, Company Law, Banking and Finance Law, Intellectual Property Law, Employment Law, and Corporate Finance and Insolvency. Members of the Centre also either act as leaders, or contribute to the teaching, of the following modules : Law of Contract, International Law, Equity and Trusts, Constitutional Law, and Jurisprudence. Offerings to non-law students include Introduction to Company Law and Introduction to Obligations.

GENERAL ACTIVITY

There have been some notable achievements of members of the Centre in the past year, and not always reflected in a published piece, that are worthy of mention.

Andy Campbell has acted as Consulting Counsel to the Legal Department of the International Monetary Fund. In this capacity he has provided expert advice on the reform of bank insolvency laws. He also presented sessions on bank insolvency issues at the Financial Transactions for Lawyers Seminar held at the Joint Vienna Institute in April 2004, organised by the Legal Department of the International Monetary Fund and the IMF Institute. The participants were officials of central banks and government departments from a number of developing countries (mainly from the republics of the former Soviet Union and from south-east Asia). Andy Campbell has been a participant (on behalf of the IMF) in the "Global Bank Insolvency Initiative" (GBII) which was launched in January 2002 by the World Bank, International Monetary Fund, the Bank for International Settlements, the Financial Stability Institute, the Basel Committee on Banking Supervision and the Financial Stability Forum. The "GBII involves the participation of a wide range of countries at different stages of development and with different legal traditions, in an effort to achieve a high level of international consensus". Andy Campbell is the author of Chapter 6 of a draft report compiled by the GBII (on "Bank Liquidation"). He also co-founded (with Joanna Gray of the University of Newcastle), the Banking and Financial Services Law Subject Section of the Society of Legal Scholars, and has acted as the co-convenor of this Section.

A contract book, to which **Roger Halson** contributed (*Contract Law* (Butterworths Common Law Series, 2nd ed 2003, 1612pp), was published in 2003. It has been referred to by Lord Steyn of the House of Lords as "a major event in the development of our contract law. I will make constant use of it. I unreservedly commend it to practitioners, judges, academic lawyers and students."

Andrew Keay gave evidence in August 2003 to the Australian Parliamentary Joint Committee on Corporate and Financial Services, in relation to the Committee's investigation into Australia's corporate insolvency laws. The evidence was given at the Committee's request. The subsequent report published by the Parliament (*Corporate Insolvency Laws : A Stocktake* (30 June 2004) and accessible at http://www.aph.gov.au/senate/committee/corporations_ctte/ail/report/ail.pdf) specifically refers to Andrew Keay's evidence on several occasions. Andrew Keay has acted as an associate of the Centre for Advanced Corporate and Insolvency Law at the University of Pretoria (South Africa).

John McMullen was appointed by the Secretary of State for Trade & Industry to the Council of the Advisory Conciliation and Arbitration Service. He was appointed as editor, of the Oxford University Press' *Employment Practitioner Series*.

Surya Subedi acted as a consultant to : Mishcon de Reya, a commercial law firm in the City of London on international law of trade and investment matters; Associates for Research & Resources Development Ltd. (London) on Foreign Investment Law and Policy in Africa; the Ministry of Foreign Affairs of Indonesia on the strengthening of the teaching of international law in Indonesia; the Nepalese Ministries of Law and Justice and Foreign Affairs in relation to treaty-making law and practice. Surya Subedi

also acted as a member of the International Law Association's Committees on International Law on Sustainable Development, and Water Resources.

Jane Frecknall-Hughes has acted as academic adviser to the National Audit Office, with reference to their proposed programmes of auditing various streams of taxation revenue. In January 2004 she was appointed as President of the Tax Research Network (TRN), which is the only academic network of tax researchers in the UK, its key aim being to promote taxation research. The TRN comprises approximately 400 members, including 180 UK tax academics, 80 representatives from the Inland Revenue and HM Customs & Excise, including heads of departments and government policy advisers. It also includes 50 members from the accounting institutes, policy-makers, and 90 leading tax academics from overseas.

RESEARCH OUTCOMES

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- *Brightwell v RFB Holdings Ltd* (2003) NSWSC 7 at para 61;
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EDITORIAL WORK

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Keay, A., Member of Editorial Boards of *International Insolvency Review* (Wiley) and *Insolvency Law Journal* (Law Book Co).

Keay, A., Member of the Advisory Boards of *Insolvency Intelligence* (Sweet and Maxwell) and *QUT Journal of Law and Justice* (Queensland University of Technology).

McMullen J., General Editor, *Employment Practitioner Series*, Oxford University Press.

Subedi, S., General Editor, *Asian Yearbook of International Law* (Martinus Nijhoff, the Netherlands).

Walker, C., Member of the board of editors, *International Journal of Risk Management* (Perpetuity Press).

WORKING PAPERS

Working Paper – January 2004

Protecting Bank Depositors: Some International Comparisons

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Introduction

‘A bank lives on credit. Till it is trusted it is nothing; and when it ceases to be trusted it turns to nothing’ *Walter Bagehot*

While bank failure is relatively rare in the United Kingdom the 1990s witnessed two significant banking failures. First, Bank of Commerce and Credit International (BCCI) collapsed spectacularly in 1991 and this was followed by the collapse of Barings Bank, probably the oldest merchant bank in the City of London, in 1995¹. Globally, however, the final quarter of the twentieth century has witnessed a massive level of bank failure². The banking crisis in the United States in the 1980s and early 1990s was so severe that almost three thousand banks failed. Most of these were relatively small savings and loans banks which are similar in many respects to building societies in the United Kingdom but some were substantial commercial banks³.

This paper is concerned with the role played by schemes which are designed to provide protection to bank depositors when the banks in which they have placed their savings are unable to meet requests for withdrawals by depositors who have made a legal demand for repayment. This apparently uncomplicated subject has been a topic of considerable controversy since the wave of bank failures in the United States, and some other countries, in the early 1930s and the subsequent introduction, despite considerable political opposition, of a federal deposit insurance scheme⁴. Despite the apparent success of such schemes in many jurisdictions there continues to be considerable opposition from many quarters and much has been written,

¹ Barings was purchased by the Dutch bank ING but BCCI was so hopelessly insolvent that it had to be liquidated.

² Many countries suffered banking crises in the last twenty years of the twentieth century. Statistics from the International Monetary Fund in 1996 showed that approximately 130 countries had experienced banking crisis between 1980 and 1996. (International Monetary Fund, Washington, D.C., 1996)

³ For an overview of the banking crisis in the United States see Campbell, A. & Cartwright, P. *Banks in Crisis: the Legal Response* (Aldershot: Ashgate, 2002) at 187 -189. For readers who want a detailed history see Olson G N, *Banks in Distress: Lessons from the American Experience of the 1980s* (London: Kluwer, 2000). This is an excellent book which provides an extremely detailed account of the banking crisis in the United States.

⁴ For an account of the political background to the introduction of the federal deposit insurance scheme in the United States see Galbraith J K, *Money: Whence It Came, Where It Went* (London: Penguin, 1975) at 208 – 209.

particularly by economists, about the pros and cons of providing protection to bank depositors⁵. While these arguments will be considered it is important to point out that this work is concerned with providing a contextual analysis from a legal perspective. Accordingly, while readers will be directed to some of the relevant economic literature, this work will be focusing primarily on the legal issues⁶.

The Three Ways

The best way to protect depositors is arguably to ensure that banks do not fail but this would be an unrealistic aim in a market economy⁷. It should, however, be possible to minimise the level of bank failure by the provision of an effective system of regulation and supervision supported by the availability of a central bank which is able and willing to provide emergency liquidity financing to banks which are suffering from a lack of liquidity. The provision of such a financial safety net will not, however, ensure that no banks will ever fail. Indeed, the former Chairman of the Financial Services Authority in the United Kingdom has stated that “risk taking is an essential element in dynamic financial markets, and it would be both unrealistic and wrong to aim for a zero-failure regime. Regulators should, however, target a low level of failures which bring losses to retail savers and investors”.⁸ So if the financial regulator is not aiming for a zero failure regime then it arguably becomes necessary to provide some form of protection for bank depositors to ensure that in the event of their bank being unable to repay their deposits they will receive some degree of protection. Why should bank depositors receive such special attention? First, it should be noted that not everyone does indeed agree that any protection should be provided⁹. Depositors, it is often argued, must accept responsibility for their decisions and the decision to invest should be made after a careful assessment of the risks. From a consumer protection perspective this is an unrealistic suggestion for the vast majority of depositors as only those with adequate training in financial matters would be in a position to undertake such an assessment and even then it is likely that the information being used will be so out of date as to be unhelpful. The only body with the capability to have fully up to date information upon which to rely is the institution which is responsible for the regulation and supervision of the banking sector. In many countries bank regulators have not been in a position to ensure that they do have adequate and fully up to date information. Information flow failure has occurred in many countries, including the United Kingdom with BCCI and Barings, and the United States with its wave of bank failures in the recent past. For a variety of reasons even where the regulator has in its possession adverse information it is unlikely to make that information public as to do so would have the potential to exacerbate the problems.

Members of the public in the United Kingdom generally appear to assume that banks are a safe place to leave their savings and seem to have little idea of the inherently risky nature of the business of banking¹⁰. It can also be argued that due to the system of licensing (or authorisation) which exists any bank which is permitted to accept deposits from the public should meet minimum financial safety standards and it is for the bank regulator to ensure that

⁵ See, for example, Benston G J, ‘Deposit Insurance and Bank Failures’ (1983) Economic Review of the Federal Reserve Bank of Atlanta (March) at 8 – 9.

⁶ Relatively little has been written on this subject by lawyers but see Campbell A, and Cartwright P, ‘Banks and Consumer Protection: the Deposit Protection Scheme in the UK’ (1998) LMCLQ 128 and Campbell and Cartwright, *op cit* n 3. For examples of works by non-lawyers see Garcia G, *Deposit Insurance: Actual and Good Practices* (Washington DC: International Monetary Fund, 2000), Hall M J B, ‘The Deposit Protection Scheme: The Case for Reform’ (1997) National Westminster Bank Quarterly Review at 45, Macdonald R, *Deposit Insurance* (London: Bank of England, 1996).

⁷ It is generally argued that the costs involved in trying to provide a zero failure regime would be out of proportion to the benefits gained.

⁸ Howard Davies, Financial Services Authority Press Release, London 21/1/1999.

⁹ See, for example, Benston *infra* n 5.

¹⁰ For an interesting and accessible explanation see Latter T, *Causes and Management of Banking Crises* (London: Bank of England, 1997)

these targets are met at all times. According to the former Chancellor of the Exchequer, Nigel Lawson, “an effective system of banking supervision is as important as the banking system itself. Without it there would be no confidence and which sound banking depends – from the confidence of the individual depositor that his money is safe, to confidence in Britain as one of the foremost financial centres in the world, indicating the concerns at the highest level over the potentially far-reaching effects of a weak supervision system.”¹¹ Accordingly it can be argued from the consumer protection perspective that it is not for the depositor to undertake ‘due diligence’ of the deposit taker but for the institution responsible for the regulation and supervision of the banking sector. In the case of a jurisdiction where deposits can only be accepted from members of the public by institutions which are subject to a licensing requirement it has to be considered reasonable that members of the public should expect that the regulatory or supervisory authority will have access to up to date information. Such information cannot be expected to be made available to the average depositor.

It would appear to be generally accepted by bankers and policy makers that an effective system of regulation and supervision is a necessary precondition for the introduction of a system of deposit insurance. It is beyond the scope of this article to discuss issues of bank regulation¹² but it is worth noting that in some jurisdictions the deposit insurance agency also undertakes a regulatory and supervisory function¹³.

In theory having in place an effective system of regulation and supervision should assist in a reduction in the number and severity of banking crises which will lead to less pressure on the deposit insurance fund but the experience in the United States and some other countries suggests that this is not necessarily the case. It can, of course, be argued that the number and severity of these crises would have been far greater had the regulatory framework not been in place. One of the greatest risks is that a failure to have in place such a system could lead to the bankruptcy of the deposit insurance fund in a banking crisis and this could create the need for state intervention with public funds being used to bail out insolvent banks¹⁴.

Another important and necessary precondition for the establishment of a deposit insurance scheme is that there should already be in place a framework for emergency liquidity financing from the central bank which can be made available to banks which are illiquid but solvent¹⁵. Banks which are suffering from liquidity problems may find that the situation can quickly deteriorate so it is necessary to have a sufficiently well-funded central bank to be able to provide emergency liquidity financing. Where a country does not have in place a workable framework for emergency liquidity funding from the central bank¹⁶ the potential for bank

¹¹ Foreword to *Banking Supervision* Cmnd. 9695. (London: HMSO, 1985) at 1.

¹² For further information on bank regulation and supervision

see the Basel Committee’s *Core Principles for Effective Bank Supervision* (Basel: Bank for International Settlements, 1997) and the following, Cranston R, *Principles of Banking Law* Second Edition (Oxford: Oxford University Press, 2003), Wadsley J, and Penn GA, *The Law Relating to Domestic Banking* Second Edition (London: Sweet & Maxwell, 2000) and Ellinger EP, Lomnicka E, and Hooley RJA, *Modern Banking Law* Third Edition (Oxford: Oxford University Press, 2002).

¹³ For example, the United States and Nigeria.

¹⁴ A bankrupt deposit insurance fund is a potential problem and one which faced the United States in the recent past. The funding of schemes is considered later in this article.

¹⁵ In the banking literature this is usually referred to as ‘lender of last resort’ but the term ‘emergency liquidity funding’ more accurately describes, in the opinion of this writer, what actually takes place. For a discussion of emergency liquidity funding see Delston R, and Campbell A, ‘Emergency Liquidity Financing by Central Banks: Systemic Protection or Bank Bailout?’ at

www.imf.org/external/np/leg/sem/2002/cdmfl/eng/delst.pdf (forthcoming in *Current Developments in Monetary and Financial Law* Third Volume (Washington DC: International Monetary Fund, 2004) and Lastra. RM, *Central Banking and Banking Regulation* (London: Financial Markets Group, 1996).

¹⁶ Or other public sources such as the Ministry of Finance.

failure is inevitably greater and the potential for abuse of a system of deposit insurance is significant.

In this respect the United Kingdom has a long tradition of central bank emergency liquidity funding through the Bank of England. While this is not set out in statute the former Governor of the Bank of England, Sir Edward George, has indicated the basis on which the provision of such funding would be available¹⁷. To ensure that there is no increase in moral hazard the use of such lending must be discretionary and available only in exceptional circumstances. This is recognised in a Memorandum of Understanding between the Bank of England, the Financial Services Authority and HM Treasury¹⁸. The lender of last resort function is to be used by the Bank of England only in cases of emergency when there is a need for an immediate injection of liquidity and where this cannot be obtained from other sources. It is singularly important that funding of this type be used sparingly in order to ensure that moral hazard is kept under control. In practice, it will often be difficult, if not impossible, to decide whether a bank is actually merely illiquid rather than insolvent at the time the emergency funding is required and although in theory help should only be provided in situations of illiquidity it will sometimes be discovered that bank which has received assistance was in fact insolvent at the time. This is a risk which is unavoidable if the protective framework for the banking system is to operate effectively.

Where all three of these protective elements are present and operating effectively it should be the case that depositors as consumers have an adequate degree of protection. However, much will depend on the type of scheme which is introduced and the degree of protection it provides. These aspects are discussed later in this article.

Systemic Risk, Banking Crises and the Protection of Depositors

Banking crises can affect individual banks or, in more serious situations, can affect an entire section of the banking industry, and in the most serious crises the entire banking system of a country can be affected. One of the features which make banks different from other types of business organisation is their susceptibility to systemic risk¹⁹. Banks, as Macey and Miller note, are different from other businesses in at least three ways. First, their susceptibility to runs and panics. Second, the role they play in the supply of money and third, the role they play in the payments system.²⁰ Banks therefore depend on confidence but actually operate on the basis of fractional reserves. This basically means that banks will, at any given time, keep only a small percentage of their total deposits in liquid form. Should pressure build to repay depositors a liquidity crisis can occur and if a bank finds itself unable to repay depositors it is quite possible that a panic will develop and that this may spread to other banks. In the classic scenario a run will develop and a systemic crisis may result. Bank runs, as any film buff will no doubt know²¹, have been a feature of the banking system in the United States but have not generally been a problem in the United Kingdom²².

Deposit Insurance Schemes

The remainder of this paper focuses on the third of the methods referred to above. This is the introduction of specific schemes which aim to protect depositors when the bank, or banks, in

¹⁷ George E, 'The Pursuit of Financial Stability' (1994) Bank of England Quarterly Bulletin at 60 -66.

¹⁸ The Memorandum can be found at www.bankofengland.co.uk/legislation/mou.pdf

¹⁹ Systemic risk is considered in some detail later in this article.

²⁰ Macey J R, and Miller G P, *Banking Law and Regulation* Second Edition (Aspen, 1997) at 53.

²¹ Films such as "It's a Wonderful Life" where James Stewart struggles to keep the family bank afloat indicate that bank runs have been very much a part of American life in the 20th century.

²² For a detailed account of bank runs and their effect on the US banking system see White E, *Deposit Insurance*. Policy Research Working Paper Number 1541 the (Washington DC: World Bank, 1995) and Galbraith JK, *The Great Crash 1929* (London: Pelican, 1975).

which their deposits are held are unable to repay those depositors due to financial difficulties. In some countries these are referred to as deposit insurance schemes while in others the term deposit, or depositor, protection is used. Both terms have the same meaning and are often used interchangeably.

It has already been noted that there must be an effective legal framework for the regulation and supervision of the banking industry already in place in a country before the introduction of a depositor protection scheme is contemplated. An important question which also has to be considered when thinking about the introduction of deposit insurance is when should such a scheme be introduced.

In a number of jurisdictions there have been attempts to introduce a deposit protection scheme either during a systemic banking crisis or immediately after things have returned to some degree of normality. This can cause a number of problems and it is preferable to design and implement the relevant legislation during a period of calm in the banking markets. In a number of developing countries there has been a rush to introduce such schemes at inappropriate times and this has led to a number of problems.

One of the major dangers during a banking crisis is that the government of the country will seek to provide a blanket guarantee that all bank depositors will be protected and that all their savings will be covered. This is problematic for a number of reasons. First, it will involve a commitment to spend an unquantified amount of public funds and this is not acceptable as the ultimate burden on the taxpayer will not become known until some time after the crisis has been resolved. Second, this will undoubtedly lead to an increase in moral hazard²³. Third, the government, whilst gaining short-term popularity for protecting the savings of those at risk, will in the longer term have to find ways of paying for the blanket guarantee given to those depositors. This may involve raising taxes or diverting public funds from other causes which in the longer term may wipe away the political gains achieved earlier. Perhaps the biggest problem of seeking to provide a blanket guarantee at a time of systemic crisis is that it is impossible to know how much this will deplete public funds and it is possible that this will cripple the economy of the country forcing it to turn to outside agencies for emergency assistance. For all of these reasons it is preferable that a formal explicit deposit insurance scheme which is funded by the banks, and which is clearly set out in legislation, be introduced at a time when the banking system is relatively stable²⁴.

The advice provided by the International Monetary Fund is that a deposit insurance scheme should not be introduced during a banking crisis and indeed such a scheme should not be introduced “until the banking system or its major banks have been restructured to acceptable financial soundness that is judged mainly in terms of their solvency and profitability”²⁵.

These aspects will be considered further below.

Objectives of Deposit Insurance

It would appear that there are two possible objectives of deposit insurance. First, the consumer protection objective and second the protection of the banking system itself. Which of these is the most important has been debated ever since the introduction of the deposit insurance scheme in the United States in 1933. According to Macdonald the direct rationale for the provision of deposit protection is consumer protection and that the reduction of systemic risk is an indirect rationale.²⁶ There is no doubt that the scheme in the United States was introduced to

²³ Moral hazard is dealt with in some detail below.

²⁴ See Garcia G, *op cit* n 6.

²⁵ Garcia *op cit* n 6 at 49.

²⁶ Galbraith *op cit* n 4.

protect the banking system by the elimination of bank runs by depositors²⁷. In the United States the fact that depositors are protected is generally regarded as a by-product of the main objective which is the reduction of systemic risk. The opposite is true in the European Union where the introduction of deposit insurance was viewed primarily as a consumer protection issue²⁸. It is the opinion of this writer that a well designed and properly funded deposit insurance system can achieve both of these objectives and as a result of this it is probably not of singular importance which of the objectives has primacy.

The Legal Framework

In the previous section the financial problems associated with attempts to provide an implicit protection scheme were considered to be one of the major problems but also of significance in this situation is the lack of a clear legal framework. This can lead to a number of uncertainties including, for example, who will be entitled to compensation, all types of depositors or limited to certain types of products; when is it to be payable, how is it to be payable and so on. Without a clear legal framework there will be no transparency nor will there be any advance knowledge of entitlement to compensation. Another problem is that there will be no legal rules relating to payment into the fund by the banks and this inevitably means that at the time of crisis there is no fund to draw upon.

It is therefore vitally important that a legal framework, preferably set out in legislation, be provided at the time of the introduction of the scheme to ensure that depositors, and indeed the banks themselves, are fully aware of the legal rights and responsibilities which exist under the statute. Such matters as how much each bank should pay into the scheme, how much protection each depositor is to receive and what sort of event will trigger payments need to be set out clearly in the statutory provisions. In a number of jurisdictions problems have arisen with regard to exactly what the entitlements under the scheme are. For example, in the United States during the 1980s when many savings and loan banks failed it transpired that some of these banks offered a number of products which were not covered by the scheme provided by the Federal Deposit Insurance Corporation. The same was true in the United Kingdom when Barings collapsed in 1995 and certain bond holders discovered that they were not covered by the deposit protection scheme in the United Kingdom at that time.

Types of Scheme

The difference between implicit and explicit schemes has already been considered. The vast majority of opinion is that implicit schemes are problematic and undesirable and that it is better when a country is considering the introduction of a new scheme, or a re-examination of an existing scheme that the most appropriate way forward is to formally establish an explicit scheme which clearly sets out all the parameters including the level of protection to be offered to depositors, the situations when compensation will be payable, how the fund is to be funded and all other relevant matters to ensure complete transparency and also to ensure that all those affected by the fund are fully aware of the legal protection offered.

The advantage of this situation is that there is certainty in advance as to how the scheme operates and the events which will trigger it. The various options available include using public schemes or private schemes,

²⁷ Galbraith *op cit* n 4.

²⁸ It has also been suggested that in the context of the EU Single market depositor protection helps to achieve a 'level playing field' for cross-border banking services. See Andenas M, 'Deposit Guarantee Schemes and Home Country Control' in Cranston R, (Ed) *The Single Market and the Law of Banking*. Second Edition (London: Lloyds of London Press, 1995) at 107.

Co-insurance and Moral Hazard

Moral hazard, according to McDonald “refers to the adverse effects, from the point of view of the insurer, the insurance may have on the things you used from the point of view of the insurer, that insurance may have on the insuree’s behaviour.”²⁹

The idea that the person insured should share some of the risk is very common in general insurance contracts and some jurisdictions, including the United Kingdom, have introduced co-insurance into the deposit protection scheme for bank depositors. In fact when the deposit protection scheme was first introduced in the United Kingdom no degree of total protection was provided. In the United Kingdom the deposit protection scheme came into existence as a result of the Banking Act 1979. At first protection was limited to 75% of the first £10,000 per deposit per bank. The level of cover was increased to 75% of the first £20,000 with the introduction of the Banking Act 1987 but even after this reform all depositors were still subject to a 25% level of co-insurance regardless of how large or small their deposit. The level of co-insurance was subsequently reduced in 1995³⁰ with the raising of the level of cover to 90% of the first £20,000 on deposit. The current scheme was established under the Financial Services and Markets Act 2000 and instead of being an independent scheme only relating to bank depositors it is now part of the Financial Services Compensation Scheme which has responsibility for investments and insurance policies in addition to bank deposits. For the first time in the United Kingdom bank depositors receive 100% protection for their deposits but only for the relatively modest sum of £2,000. For deposits in excess of £2,000 an element of co-insurance continues to apply and 90% cover is provided for sums between £2,000 and £33,000. Although the introduction of 100% cover is welcome the actual level of cover provided is disappointing and this is something to which I will return later.

The primary justification for the use of an element of co-insurance is presumably that it can assist in preventing an increase in moral hazard. Moral hazard and the behaviour of those who are insured are thought to be inextricably linked. In relation to bank deposits the behaviour of those who manage banks is at least as important from the moral hazard perspective as the behaviour of the depositors. First, it is suggested that the behaviour of depositors who have a generous level of cover will be affected in that they will inevitably seek out the highest returns with no regard to the safety of the financial institution. This will be done in the knowledge that should the bank in which their deposits are held fail it will not matter to those depositors because they will be fully compensated by the deposit insurance scheme. This is, in fact, the position in some countries where very high levels of protection are offered with no degree of co-insurance being required. Second, is the effect on the management of the bank. It is also often suggested that the provision of a very high level of guaranteed cover will have the effect of increasing moral hazard in relation to the behaviour of those and manage the banks. The management may be more prone to take risks than would otherwise be the case and may, for example, offer higher rates of interest than competitors in an attempt to win business from them. It is possible that this may be the case but much depends on the general legal framework of the corporate laws in the particular jurisdiction. In the United Kingdom for example directors would risk losing both their income from their position as directors well as the possibility of being held personally responsible for wrongful trading³¹ and being disqualified from acting as a company director for a period of time³². Many jurisdictions have similar provisions to control the behaviour of company directors. In such a situation it is unlikely that management would take excessive risks simply because of the existence of a deposit insurance scheme.

The Role of the Deposit Insurance Agency

²⁹ Macdonald *op cit* n 6 at 7.

³⁰ See the Credit Institutions (Protection of Depositors) Regulations 1995. This implemented the Directive and came into effect on 1st July 1995.

³¹ Insolvency Act 1986 s 214.

³² See generally the Company Directors Disqualification Act 1986.

The actual role played by the deposit insurance agency is something about which there is no international consensus. In some jurisdictions the deposit insurance agency has a 'narrow' role and operates as a 'paybox'. This is, for example, the position in the United Kingdom where the Financial Services Compensation Scheme Ltd administers the scheme, collects premiums, invests the fund and pays out in appropriate situations. The operator of the scheme has no involvement in the regulation of insured banks or in the insolvency process of a failed bank, other than as a creditor.

However, in some jurisdictions the deposit insurance agency is given a 'broad' role and operates not only as a deposit insurer which provides the 'paybox' functions but also as a regulator of insured institutions and as a receiver of the failed bank. This is the position, for example, in the United States. This wider role does raise some issues of concern to a number of commentators. The major concern of many is the potential conflict of interest when the deposit insurance agency acts as a receiver of an insolvent bank. The conflict arises from the fact that the deposit insurance agency will also be a major creditor because of its subrogated claims against the assets of the insolvent bank. This has not been thought to be a problem in the United States, where the present system has been operating since the 1930s, but it is clearly considered to be an unacceptable approach in many other jurisdictions and indeed in some jurisdictions allowing the major creditor to be involved in the bankruptcy process as a receiver is considered to be unacceptable³³.

Many of the developing countries seem undecided about whether, when introducing a deposit insurance scheme, to give the deposit insurance agency a 'broad' or a 'narrow' mandate. Where a 'broad' role is to be undertaken it is necessary to ensure in advance that the agency will have at its disposal sufficient resources, both human and monetary to enable it to undertake its functions efficiently. It is suggested that in general the safer approach is to give a 'narrow' role to the deposit insurance agency and let it act as a 'paybox'.

Level of Protection

How much protection should be provided to depositors has always been a very difficult question to answer. In some countries full cover for all depositors has been offered but invariably this has been done on an implicit and unfunded basis. As has already been noted such cover is not generally thought to be desirable except in specific and limited situations e.g. in a systemic banking crisis³⁴.

In most jurisdictions where an explicit deposit insurance scheme has been introduced the approach taken has been to provide partial cover. This, of course, involves taking a decision about what the limit should be on total protection.

For example, in many jurisdictions the deposit insurance scheme provides complete cover up to a certain amount. Above that amount the choice is to provide no cover at all or, alternatively, to provide an additional tier of cover on a co-insurance basis. Some jurisdictions have made the decision not to provide total cover at any level. The UK has been typical of this approach although as will be seen below that situation has recently been changed³⁵ although co-insurance is still a feature of the UK system.

³³ This appears to be the case, for example, in most of the states of the former Soviet Union.

³⁴ Garcia *op cit* n 6 at ????

³⁵ In the year 2000 approximately 20 countries (e.g. Austria, Chile, Columbia, Germany, Ireland and the UK) chose this approach but it appears that many of these are considering the introduction of some element of total protection. Some, the UK for example, have already done so.

For reasons of moral hazard is often suggested that the level of protection should be kept to a relatively low level. The International Monetary Fund, for example, suggest that coverage should not exceed twice the per capita GDP of the country concerned³⁶.

Is there a relationship between the level of protection provided and a reduction in systemic risk? A significant factor when choosing the level of cover to be provided is what the primary objective of the fund is. A relatively low level of cover coupled with co-insurance is unlikely to have much effect on a systemic banking crisis, so where the primary purpose of the deposit insurance scheme is the protection of the banking system it will be necessary to provide a sufficiently generous level of cover in order to have an effect on depositor behaviour. Where the primary purpose of the scheme is to protect consumers it may be possible to set cover at a lower level and still achieve this goal. The approach taken by various jurisdictions to levels of protection will be considered later in this article.

Funding of Schemes

Another issue upon which there is no standard approach is how to fund deposit insurance schemes and there are a number of matters which have to be considered in this respect. The first is whether there is any need for a funded scheme at all. This is obviously the approach taken by those jurisdictions which offer only an implicit guarantee³⁷ but this is generally not considered to be good practice. Where there is an explicit deposit protection scheme it becomes necessary to consider the funding options. Such questions as who should pay, how much and when have to be considered. First, the question of who should pay. This effectively means whether or not the funding should be public or private. The general consensus is clearly that funding should be private and ideally provided by the banks which are members of the scheme. The vast majority of existing schemes are privately funded by the banks which are covered by the scheme³⁸ and this means that the costs of providing insurance cover will actually be passed on to the consumer through the mechanism of interest rates and various bank charges.

Other funding matters include whether the funding should be provided ex ante or ex post. This means that in an ex ante scheme the banks will be required to make regular contributions into a fund which will then be available whenever required. The majority of countries with explicit schemes have taken the ex ante approach but amongst the exceptions is the United Kingdom which has only a relatively small fund with banks being expected to provide funding when or if the need arises. The trend appears to be towards ex ante schemes and jurisdictions, such as France and Germany, have moved from an ex post to an ex ante basis in recent years. One of the findings of Garcia is that “funded schemes appear to be more rule-based and offer less discretion for the administrators and less uncertainty for those insured than ex post systems.”³⁹

Another important issue is the target level for the fund. It would be economically inefficient for the banks to be required to make substantial contributions to an ever increasing fund which is out of proportion to the amount of claims which are likely to be made on it. This refers to claims being made during ordinary times and when there is a systemic crisis. It would be unrealistic to expect a country’s deposit insurance fund to attempt to build a fund which could withstand a major systemic banking crisis and should such a crisis exist it may be necessary for ex post funding to be provided as well as some temporary funding from public sources.

How to fund the scheme is another matter where the approaches taken are different. The majority of jurisdictions charge fixed premiums⁴⁰ but another possibility is to charge premiums

³⁶ Garcia *op cit* n 6 at Chapter IV.

³⁷ Discussed above.

³⁸ According to Garcia *op cit* n 6 at 31 only one of the 67 explicit, limited schemes was not privately funded. This is Chile which had at that time a system which was fully funded by the government.

³⁹ Garcia *op cit* n 6 at.32.

⁴⁰ A formula will be used such as a percentage of total deposits.

which are risk adjusted. This is the approach taken in the United States and approximately twenty other countries⁴¹ but it can be problematic in practice. How is the risk level of a bank to be assessed? Various methods are used and if this is to be thought of in terms of insurance coverage rather than simply a form of deposit protection there is some logic in attempting to make premiums risk sensitive. Before risk based premiums can be introduced it would be necessary for the country concerned to be able to accurately calculate such risk factors and this means that for most developing countries such an approach may not yet be feasible and that the best approach in such a situation would be for fixed premiums using a formula which is easily understood and transparent.

JURISDICTIONAL APPROACHES

European Union

All member states of the European Union are required to provide a deposit protection scheme in accordance with the Deposit Guarantee Directive⁴². This Directive sets out minimum standards which must be observed by all member states by each state is entitled to provide a higher degree of protection should it wish to do so. The prime aim is to provide protection for consumers and the Directive sought to provide flexibility by allowing Member States to provide a higher level of protection than provided for in the Directive. It was also thought to be very important to ensure that deposit insurance could not be used to give one Member State a competitive advantage by ensuring that home state cover cannot exceed the cover provided in a host state⁴³. As a result the approaches taken differ significantly throughout the Member States but all must provide the minimum level of cover required by the Directive. The Directive allows, but does not insist upon, the provision of a ten per cent element of co-insurance to apply to the whole of the protected deposit. Accordingly a Member State need only provide 90% cover up to the minimum level of cover which must be provided.

United Kingdom

The first protection for depositors came into effect in 1982 as a result of the introduction of the Banking Act 1979 and prior to that it was simply a case that when a bank was in financial difficulties it would be for the government together with the Bank of England to decide whether or not to provide support by providing financial assistance to protect the distressed bank⁴⁴. At the time of its introduction the provision of deposit protection was clearly viewed as consumer protection measure. As noted above when first introduced the level of protection provided was limited to a maximum of 75% of the first £10,000 held by a depositor at a member bank. The cover was available to both private individuals and companies. The level of cover was raised to 75% of the first £20,000 when the Banking Act 1987 came into force. This still meant that in all cases the depositor would have to suffer at least 25% of the loss. Although the scheme was intended to be primarily a consumer protection measure designed to provide sufficient protection to prevent severe hardship to the most vulnerable depositors⁴⁵ because of the high level of co-insurance which applied to all deposits, regardless of how modest, it could hardly be said to have fulfilled this aim of protecting the most vulnerable. The Deposit Guarantee Directive, which was discussed in the previous section, had the effect of producing welcome change to the level of protection provided in the United Kingdom. The requirement that the minimum degree of protection to be provided was 90% of the first ECU 22,222 ensured that the level of co-insurance was reduced to 10% of the first £20,000 per depositor per bank. This at least represented a significant dilution of the potential effect of the co-insurance requirement.

⁴¹ For example, Argentina, Canada and Sweden.

⁴² Directive 94/19/EC.

⁴³ See Campbell A, and Cartwright P, 'Deposit Insurance: Consumer Protection, Bank Safety and Moral Hazard' [1999] *European Business Law Review* at 97.

⁴⁴ See Campbell and Cartwright *op cit* n 6 at Chapter One.

⁴⁵ See *Banking Supervision* Cmnd. 9695. Ch.3.5.

The level of protection remained at this level until the introduction of the Financial Services Compensation Scheme⁴⁶ as a result of the Financial Services and Markets Act 2000⁴⁷ coming into force. Under the FSCS 100% coverage is provided up to £2,000 and thereafter 90% cover up to £33,000. Finally, the United Kingdom had decided to provide a level of 100% protection but this has been set at an extremely low level. The continuation of the use of co-insurance is discussed in detail later in this article.

United States

In the United States the principal purpose of deposit insurance has always been the reduction of systemic risk rather than the protection of depositors. The Federal Deposit Insurance Corporation⁴⁸ was established by the Banking Act 1933 as part of the action taken to restore financial stability to the banking system. There had been a wave of bank failures and it was felt necessary to introduce deposit insurance in an attempt to stabilise the banking system and to stop runs on banks. Although the primary purpose was to attempt to promote such stability the major by-product was a very high level of consumer protection. From its inception the policy makers in the United States decided against the introduction of co-insurance and instead provided 100% cover up to a particular limit. Initially this was set at \$5,000 but has since been increased to \$100,000. As this limit applies per depositor per insured institution it will generally be the case that individuals who deposit with banks in the United States will be able to enjoy complete protection for their savings. Another factor, which is probably responsible for a high level of awareness of the existence of the scheme and the level of coverage, is the traditionally high level of bank failure in the United States.

Other jurisdictions

According to Garcia by the year 2000 there were formal explicit deposit protection schemes in existence in approximately 72 countries⁴⁹ with 10 of these countries offering full coverage. The others offered limited coverage, some with an element of co-insurance but the majority deciding against the use of co-insurance. In 2000 there appeared to be 20 jurisdictions using co-insurance with 15 of these requiring that a depositor would have to suffer a partial loss regardless of the size of the deposit. Five of the countries provided complete cover up to a specific limit with a co-insurance requirement above that. Since then the United Kingdom has introduced complete coverage with a co-insurance element above that.

Most of the schemes have been introduced in the 1980s and 1990s but since this survey was concluded several more countries have either introduced, or are preparing for the introduction of, explicit, limited deposit insurance schemes. The use of co-insurance is appears to be diminishing and most of the newer deposit insurance schemes do not make use of it. This, of course, is in accordance with the recommendations of international bodies such as the International Monetary Fund⁵⁰.

The most recent proposal for a scheme to be introduced in a European country is in Switzerland. Although it is perceived to be possibly the safest country in which to deposit savings with a bank Switzerland has not been immune from bank failures and there have been banking problems affecting some regional banks in the 1990s. The new scheme will be administered by the banking industry and will provide limited coverage of 30,000 Swiss Francs per depositor per institution. There is no element of co-insurance. Although the ceiling is

⁴⁶ This is not only concerned with bank deposits but only this aspect is being considered here.

⁴⁷ This statute is concerned with all aspects of financial supervision.

⁴⁸ The Federal Deposit Insurance Corporation has a very broad range of responsibilities including regulation of insured banks and as a receiver of failed banks.

⁴⁹ See Garcia *op cit* n 6 at 29.

⁵⁰ See Garcia *op cit* n 6 at 14.

relatively low depositors who ensure that they have no more than 30,000 Swiss Francs in any one institution will be completely protected⁵¹.

Within the European Union at least one Member State, the Netherlands, is currently considering amending its deposit protection scheme.

Some Problem Areas

Despite the changes in the United Kingdom the new framework provided by the Financial Services Compensation Scheme arguably lacks generosity in the level of protection provided when compared with many other jurisdictions. It falls far short of the level suggested by the International Monetary Fund and the introduction of co-insurance at such a low level is a negative feature and appears to be against the prevailing trend. The approach taken in the United Kingdom is to provide protection for depositors rather than to have an effect on systemic crises but as it provides such a small level of cover at 100% it is unlikely to be able to have a significant impact on a banking crisis. When compared, for example, to the level of protection provided in the United States it appears to be a very poor relation. Of course, it must not be forgotten that the scheme in that jurisdiction has as its main objective the prevention and control of systemic crises. By providing a depositor protection scheme with sufficiently generous financial limits that give a level of protection which provides complete protection for the average depositor the United States provides a framework under which there is no need for any depositor to initiate a bank run. Not only is the scheme helping to ensure that healthy banks are not damaged by bank runs the United States scheme does provide a very serious level of consumer protection which greatly exceeds that provided by many jurisdictions which claim that their deposit insurance schemes are primarily a consumer protection measure.

There are matters of concern for many of the jurisdictions which are considering the introduction of a formal, explicit deposit insurance scheme. First, the lack of an adequate regulatory and supervisory infrastructure is a matter of considerable concern in many of these jurisdictions. It has already been seen that the prevailing body of expert opinion is that an effective legal framework for the regulation of banks is a necessary precondition for the introduction of a scheme. That, however, is not enough as effective supervision is also of vital importance. This, especially, in many developing countries may be a problem. It is relatively easy for a developing country to draft the legislative framework⁵² but the provision of effective supervision may be much harder to achieve as this requires both resources and expertise. The current criticisms being levelled at the Bank of England with regard to its supervision of BCCI highlight the difficulties faced by banking supervisors.

A second problem is that it has often been the case that jurisdictions have wanted to introduce such a scheme at a time of crisis, or immediately after a crisis, and this raises a number of issues. The pressures, both political and social, to take action during or immediately after a crisis are significant but that is not an ideal, or indeed, a good time to consider such action. The ideal time to introduce such a scheme is at a time when banks are not failing but, of course, this is when there is little or no pressure on the relevant authorities and other matters are likely to be seen as being of greater importance and more immediate at such a time.

Conclusions

⁵¹ The information on the new Swiss scheme was provided by Dr. Eva Hupkes of the Swiss Federal Banking Commission.

⁵² Especially as it will usually be possible for expert assistance to be made available. This is often provided by international organisations such as the International Monetary Fund, The World Bank, The Asian Development Bank and the European Bank for Reconstruction and Development.

It is reassuring from the viewpoint of consumer protection that the European Union identified the protection of depositors as a subject which all Member States needed to address and that a minimum level of protection should be provided in all Member States. It is regrettable however, from a consumer protection perspective, that the United Kingdom has chosen to provide such a low level of cover, especially in relation to those deposits which are fully protected. That such an amount should be set at only £2,000.00 is unfortunate as even those who have relatively modest savings will bear some of the loss should their bank be unable to repay what is owed. Admittedly in the United Kingdom this does not tend to happen very often but that should be no reason for complacency. The depositors in Barings Bank did not have to rely on the deposit protection scheme but the depositors of BCCI were not so fortunate and even those with very modest savings had to suffer some degree of loss. If it can be argued, and it generally is, that the United Kingdom has a well capitalised, efficient and well regulated banking sector then it also surely follows that the provision of a higher level of fully protected deposits would be unlikely to be a particularly great drain on the deposit insurance fund. When the protection provided by, for example, such countries as the United States, France, Italy and Canada is examined it can be seen that the United Kingdom's scheme is far from generous in its coverage.

Before concluding it is worth referring to Garcia's summary of IMF advice for depositor protection schemes. First, that a properly designed deposit insurance system can achieve both an underpinning of the stability of the banking system of a country while at the same time achieving the goal of limiting the need for public funding. Second, for this to be the case it must be introduced when the banks are reasonably solvent and only where there is adequate regulation and supervision coupled with well-formulated lender of the last resort policy by the central bank (or other government agency).⁵³

With the creation of the Financial Services Authority in the United Kingdom in 1997 and the legislative framework of the Financial Services and Markets Act 2000 it is to be hoped that the FSA, working in conjunction with the Bank of England in accordance with the Memorandum of Understanding, will ensure that the banking sector in the United Kingdom should be well regulated and potential banking problems greatly reduced. This, coupled with the well established lender of last resort policies of the Bank of England, should help to ensure that the scheme in the United Kingdom will rarely be used. This is just as well because of the shortcomings of the Financial Services Compensation Scheme with its low level of complete cover before co-insurance takes effect.

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Wrongful Trading : A Theoretical Perspective

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I Introduction

⁵³ Garcia *op cit* n 6 at 27.

One of the primary roles of a liquidator of an insolvent company is to augment the asset pool that is available for distribution to the creditors of the company, so as to ensure that the creditors, who will not of course obtain full payment for the credit that they have extended, receive as large a return as possible on the debts that are owed to them by the company. One action which liquidators might contemplate initiating is an action against the directors of the company personally on the basis that they engaged in wrongful trading prior to the liquidation of the company. This action would be initiated pursuant to s.214 of the Insolvency Act 1986. Section 214 provides, in effect, that the liquidator of a company that is in insolvent liquidation (effectively the situation where a company's assets are not sufficient to pay its debts at the time of liquidation⁵⁴) may commence proceedings against the company's directors, and these proceedings may ask that the directors be ordered to make such contribution to the company's assets as the court thinks proper.⁵⁵ Directors may only be liable where at some time before the commencement of the winding up of the company, they knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation.⁵⁶ Courts are not to make an order against directors if satisfied that after the directors first knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation, they took every step with a view to minimising the potential loss to the company's creditors as they ought to have taken.⁵⁷ It is worth pointing out that s.214 does not mention "wrongful trading," it is a description that is only provided by way of title to the section. The trading that offends against s.214 is, perhaps, better referred to as "irresponsible."

There has been a reasonable amount of literature discussing the section and its application, from a purely doctrinal perspective.⁵⁸ In this respect the existence of s.214 has been assumed to be normative. This paper endeavours to consider whether this assumption is reasonable. The paper examines, from a theoretical perspective, whether a wrongful trading style provision is justified. Part II of the paper provides some background to the section, including a brief consideration of its aim, rationale and operation. Part III then rehearses and evaluates the arguments, mainly developed in Australia, that have been articulated for the abolition of provisions like s.214. Part IV then investigates some of the reasons given for supporting the provision. The following Part proceeds to consider whether companies and their creditors are able to opt out of the application of s.214, and whether they should be permitted to do so. The final Part offers some conclusions.

II Background

Patently, s.214 can be characterised as a regulation that is intended to control corporate activities. The objective of a regulation is to affect the demeanour of someone so as to

⁵⁴ Section 214(6).

⁵⁵ See s.214(1).

⁵⁶ See s.214(2).

⁵⁷ Section s.214(3).

⁵⁸ For example, F.Oditah, "Wrongful Trading" [1990] L.M.C.L.Q. 205; L. Doyle, "Anomalies in the Wrongful Trading Provisions" (1992) 13 Co. Law. 96; A. Hicks, "Advising on Wrongful Trading : Part 1" (1993) 14 Co. Law 16; A.Hicks, "Advising on Wrongful Trading : Part 2" (1993) 14 Co. Law 55; P.Godfrey and S.Nield, "The wrongful trading provisions – all bark and no bite" (1995) 11 I.L. & P. 139; R.M. Goode, *Principles of Corporate Insolvency Law*, 2nd ed., (Sweet and Maxwell, London, 1997) at 458-477; A.Walters, "Enforcing Wrongful Trading – Substantive Problems and Practical Incentives" in B.A.K. Rider (ed), *The Corporate Dimension* (Jordans, Bristol, 1998); C.Cook, "Wrongful Trading – Is it a Real Threat to Directors or a Paper Tiger" [1999] *Insolv Law* 99; S.Griffin, *Personal Liability and Disqualification of Company Directors* (Hart Publishing, Oxford, 1999) at 57-98; M. Simmons, "Wrongful Trading" (2001) 14 *Insolvency Intelligence* 12; P. Fidler, "Wrongful trading after Continental Assurance" (2001) 17 *IL & P* 212, A. Keay, *McPherson's Law of Company Liquidation* (Sweet and Maxwell, London, 2001) at 621-634.

precipitate a particular outcome.⁵⁹ In this regard, the wrongful trading provision was introduced in order to require directors to take some action to arrest their companies' slide into insolvency; directors were to be forced to engage in more rigorous monitoring of their companies' health. The section was designed to address the situation where directors can see that their company is in difficulty and they do nothing to protect creditors' interests.

While some jurisdictions, notably the United States and Canada, do not have a similar provision to s.214, others, such as Ireland,⁶⁰ Australia⁶¹ and New Zealand,⁶² do. Others, which do not have a provision that can be regarded as similar to s.214 in terms of the way that it is drafted, do have a provision which is designed to achieve similar aims.⁶³ Provisions akin to wrongful trading might be more numerous in Europe in the not too distant future. A high level group of experts on company law have recommended to the European Union that it introduce a framework rule proscribing wrongful trading.⁶⁴

Section 214 was introduced because the existing fraudulent trading provision had failed in curbing directors running up losses when their companies were in deep financial difficulty.⁶⁵ Regulating directors through the use of s.214 was an attempt to stop directors from externalising the cost of their companies' debts and placing all of the risks of further trading on the creditors. For, if a company is heading for insolvent liquidation, the creditors of the company are effectively the ones who have a residual claim over the company's assets⁶⁶ and so the directors should be taking actions to minimise the losses of the creditors. The provision covering wrongful trading requires the directors' allegiance to shift from the shareholders (assuming shareholder primacy⁶⁷) to the directors.

It is generally accepted that directors can be expected, when their companies are in difficulty, to embrace actions which involve more risk,⁶⁸ because the shareholders, given the concept of limited liability, have little to lose where their company is in financial distress. If the risk-taking pays off then the shareholders will see their wealth maximised, but if it does not then they have lost nothing more; it is the creditors who will bear the cost. Many would argue that

⁵⁹ K. Yeung, "Private Enforcement of Competition Law" in C. McCrudden (ed), *Regulation and Deregulation* (Oxford, Clarendon Press, 1999) at 40

⁶⁰ Companies Act 1990, s.138 (reckless trading).

⁶¹ Corporations Act 2001, s.588G-Y (insolvent trading).

⁶² Companies Act 1993, ss.135-136 (reckless trading).

⁶³ For instance, France (Book II of the Commercial Code 2000 requiring a déclaration de cessation des paiements (directors must make a declaration of insolvency when their company is unable to pay their debts). See Paul Omar, "The European Initiative on Wrongful Trading" [2003] *Insol L* 239 at 245.

⁶⁴ *Report of the High Level Group of Company Law Experts on a Modern Regulatory Framework for Company Law in Europe*, 126, and available at :

http://europa.eu.int/comm/internal_market/en/company/companymodern/consult/report_en.pdf

⁶⁵ Insolvency Law Review Committee, *Insolvency Law and Practice* (generally referred to as "the Cork Report") Cmnd 858, HMSO, 1982, at paras 1776-1778

⁶⁶ Steven Schwarcz in "Rethinking a Corporation's Obligations to Creditors" (1996) 17 *Cardozo Law Review* 647 at 668.

⁶⁷ This is the prevailing approach in Anglo-American corporate governance, namely that the directors primary duty is to the shareholders of their companies. For a discussion, see J. Armour, S. Deakin, and S.Konzelmann, "Shareholder Primacy and the Trajectory of UK Corporate Governance" ESRC Centre for Business Research, University of Cambridge, Working Paper No. 266 (2003).

⁶⁸ Barry E Adler, "A Re-Examination of Near-Bankruptcy Investment Incentives" (1995) 62 *University of Chicago Law Review* 575, 590-598; Royce de R Barondes, "Fiduciary Duties of Officers and Directors of Distressed Corporations" (1998) 7 *George Mason Law Review* 45 at 46, 49; Katherine H Daigle and Michael T Maloney, "Residual Claims in Bankruptcy: An Agency Theory Explanation" (1994) 37 *Journal of Law and Economics* 157. See Company Law Review Steering Group, *Modern Company Law for a Competitive Economy: Final Report* Vol 1 (DTI, London, 2001), para 3.15.

corporate regulations are introduced because of market failure,⁶⁹ and s.214 might be seen as a response to the fact that market forces have failed to discipline directors and, thereby, prevent creditors losing out.

When the wrongful trading provision was first introduced by the Insolvency Act 1986 there was a great deal of optimism. For instance, one commentator said that it was “unquestionably one of the most important developments in company law this century.”⁷⁰ Another stated that s.214 was a “welcome additional weapon in the fight against abuse of the privilege of limited liability by directors of trading companies.”⁷¹ But this initial enthusiasm has waned considerably and there have been several negative assessments of the provision over the past 10 years, including a concern that few proceedings have been initiated.⁷² This appears to have empirical support from a survey of disqualified directors conducted by Andrew Hicks.⁷³ Of those disqualified on the ground of unfitness, Hicks found that the most common basis for this was trading while insolvent, yet no proceedings were brought under s.214 against these directors.⁷⁴

There are a number of problems that have dogged s.214, including the difficulty experienced by liquidators in getting funds to run proceedings and determining from what date wrongful trading commenced, and the meaning of elements of the section, such as : what constitutes a director taking “every step” so as to minimise potential loss to company creditors?⁷⁵ We can put these aside as we now consider the theoretical justification for s.214.

III Opposition to Regulation

While there has been little in the way of theoretical examination of the wrongful trading provision in the UK,⁷⁶ there have been some significant commentaries in Australia, discussing the Australian equivalent, ss.558G-Y of what is now the Corporations Act 2001. Most have been opposed to the existence of the provision. The opponents of the provision have generally sought to adopt a law and economics approach to their studies. The main opponents of any provision like s.214 have been Justin Mannolini,⁷⁷ Professor Dale Oesterle⁷⁸ (providing some

⁶⁹ For example, Professor Ian Ramsay in “Models of Corporate Regulation : the Mandatory/Enabling Debate” in C.Rickett and R. Grantham, *Corporate Personality in the 20th Century* (Hart Publishing, Oxford, 1998) at 219.

⁷⁰ D.Prentice, “Creditor’s Interests and Director’s Duties” (1990) 10 OJLS 265 at 277.

⁷¹ F.Oditah, “Wrongful Trading” [1990] L.M.C.L.Q. 205 at 222.

⁷² For instance, see P.Godfrey and S.Nield, “The wrongful trading provisions – all bark and no bite” (1995) 11 I.L. & P. 139; Walters, “Enforcing Wrongful Trading – Substantive Problems and Practical Incentives” in B.A.K. Rider (ed), *The Corporate Dimension* (Jordans, Bristol, 1998); C.Cook, “Wrongful Trading – Is it a Real Threat to Directors or a Paper Tiger” [1999] *Insolv Law* 99

⁷³ *Disqualification of Directors : No Hiding Place for the Unfit* (Chartered Association of Certified Accountants, Research Report No.59, London, 1998).

⁷⁴ D. Arsalidou, “The impact of section 214(4) of the Insolvency Act 1986 on directors’ duties” (2000) 21 *Co Law* 19 at 20

⁷⁵ See s.214(3).

⁷⁶ A notable exception, in relation to aspects of the provision, is Rizwaan J. Mokal, “An Agency Cost Analysis of the Wrongful Trading Provisions : Redistribution, Perverse Incentives and the Creditors’ Bargain” (2000) 59 *CLJ* 335.

⁷⁷ “Creditors’ Interest in the Corporate Contract : A Case for the Reform of our Insolvent Trading Provisions” (1996) 6 *Australian Journal of Corporate Law* 14.

⁷⁸ “Corporate Directors’ Personal Liability for ‘Insolvent Trading in Australia, ‘Reckless Trading’ in New Zealand and ‘Wrongful Trading’ in England : A Recipe for Timid Directors, Hamstrung Controlling Shareholders and Skittish Lenders” in I M Ramsay (ed), *Company Directors’ Liability for Insolvent Trading* (Melbourne, Centre for Corporate Law and Securities Regulation and CCH Australia, 2000).

American views of the provisions) and Dr David Morrison.⁷⁹ While some of the points made by these commentators are section specific, other points are equally applicable to any form of wrongful trading type provision. In fact Oesterle offers his discussion as commentary on all wrongful trading type regulations, and specifically those extant in Australia, the UK and New Zealand. It is helpful to discuss the objections voiced by the opponents, thematically. The following discussion does not purport to be exhaustive as many of the issues raised have been discussed already in other places in relation to directors' duties to take into account creditors' interests.⁸⁰

A. Discouraging People from Becoming Directors

The first argument that is mounted by Oesterle is that executives are less likely to take up positions on boards because of the existence of wrongful trading regulation.⁸¹ This is not a new argument, for it has been asserted in other contexts when addressing the potential liability of directors. Professor Ron Daniels, for instance, states that the "liability chill will deter talented individuals from accepting a nomination for board service."⁸²

First, it has been established in some studies,⁸³ that directors are frequently not aware of their responsibilities when entering office and this state of affairs, sadly, continues for many when they are in post. This causes one to ask why directors would resign or not accept a post because they are worried about possible liability under s.214, when many are not aware of the possibility of personal liability under this provision.

⁷⁹ "The Australian Insolvent Trading Prohibition – Why Does It Exist?" (2002) 11 *International Insolvency Review* 153 at 161 and "The Economic Necessity for the Australian Insolvent Trading Prohibition" (2003) 12 *International Insolvency Review* 171.

⁸⁰ For instance, see L.S. Sealy, "Director's Wider Responsibilities – Problems Conceptual Practical and Procedural" (1987) 13 *Mon ULR* 164; Ross Grantham, "The Judicial Extension of Directors' Duties to Creditors" [1991] *JBL* 1; David A. Wishart, "Models and Theories of Directors' Duties to Creditors" (1991) 14 *New Zealand Universities Law Review* 323; Mark Byrne, "An Economic Analysis of Directors' Duties in Favour of Creditors" (1994) 4 *Australian Journal of Corporate Law* 275; Anne E. Conway Stilson, "Reexamining the Fiduciary Paradigm at Corporate Insolvency and Dissolution : Defining Directors' Duties to Creditors" (1995) 20 *Delaware Journal of Corporate Law* 1; Steven Schwarcz in "Rethinking a Corporation's Obligations to Creditors" (1996) 17 *Cardozo Law Review* 647; Mark E. Van der Weide, "Against Fiduciary Duties to Corporate Stakeholders" (1996) 21 *Delaware Journal of Corporate Law* 27; Rutheford B. Campbell Jr, "Corporate Fiduciary Principles for the Post-Contractarian Era" (1996) 23 *Florida State University Law Review* 561; Andrew Keay, "Directors' Duties to Creditors : Contractarian Concerns Relating to Efficiency and Over-Protection of Creditors" (2003) 66 *MLR* 665; Jonathan Lipson, "Directors' Duties to Creditors : Volition, Cognition, Exit and the Financially Distressed Corporation" (2003) 50 *University of California at Los Angeles Law Review* 1189.

⁸¹ Above n25 at 29.

⁸² Ronald J. Daniels, "Must Boards Go Overboard? An Economic Analysis of the Effects of Burgeoning Statutory Liability on the Role of Directors in Corporate Governance" in Jacob S. Ziegel (ed), *Current Developments in International and Comparative Corporate Insolvency Law*, (Oxford, Clarendon Press, 1994) at 569. Also, see L. S. Sealy, "Director's Wider Responsibilities – Problems Conceptual Practical and Procedural" (1987) 13 *Mon ULR* 164 at 186; Stephen R. McDonnell, "Geyer v Ingersoll Publications Co : Insolvency Shifts Directors' Burden From Shareholders to Creditors" (1994) 19 *Delaware Journal of Corporate Law* 177 at 209; Christopher C Nicholls, "Liability of Corporate Officers and Directors to Third Parties" (2001) 35 *Canadian Business Law Journal* 1 at 5.

⁸³ For instance, see the government's White Paper, *Modernising Company Law*, Vol 1, CM5553-1, TSO, July 2002, at para 3.2; Roman Tomasic and Stephen Bottomley, "Corporate Governance and the Impact of Legal Obligations on Decision Making in Corporate Australia" (1991) 1 *Australian Journal of Corporate Law* 55 at 83.

There has been some anecdotal evidence to the effect that people are now more wary about becoming directors,⁸⁴ but other evidence has been to the contrary, such as the following view : “[T]he truth is that there is no shortage of candidates for the board...It seems that people still want to belong to the club [FTSE 100 companies] that continues to exist at the top of British business.”⁸⁵ Those arguing that persons are being dissuaded from becoming members of boards seem to focus more on the liability of directors for breach of duty of care and skill rather than any mention of wrongful trading. Also, there does not appear to be any empirical study that has established that people are more wary of accepting directorial posts because of concerns over wrongful trading, and in any event there is no indication that directors or prospective directors are more concerned about wrongful trading liability, when compared with other heads of liability. Clearly, while there might have been more publicity concerning directorial liability in recent times, the imposition of responsibilities on directors is far from new. Allied to this is the fact that there is no suggestion in any study that there has been a shortage of persons willing to be appointed as directors. As Professor Harry Glassbeek points out:

“[S]ome well informed people, with a great deal of worldly experience, whose reputation (as well as personal fortunes) ought to mean something to them, seem to be falling over themselves to sit on supposedly perilous boards of directors.”⁸⁶

Admittedly, in *Re Continental Assurance Co of London plc*⁸⁷ Park J recognised that if non-executive directors were liable in the kind of case before him (a wrongful trading case), many well-advised persons would refrain from taking up the office of director, but the fact of the matter is that the directors were not held to be liable, and as I explain later in the paper, only the most irresponsible of directors have been found liable for wrongful trading.

It must not be forgotten that there are drawbacks with entering most professions, and liability attaches to many professionals. For example, there have been a significant number of actions taken against auditors over the past decade.⁸⁸ Despite this there is no lack of talented individuals who are desirous of entering the accounting profession, and even to act as auditors.⁸⁹ Furthermore, there are all sorts of reasons why competent people do not enter a specific profession, even if they have the academic and personal qualities needed; it is too complex an issue involving personal choices to maintain that people are not entering a particular vocation because of one issue. In any event, are we to determine what should be the appropriate legal position in a given area based on whether a particular post is attractive or not? If that was the case, and because many police services in the UK are experiencing difficulties in recruiting officers, we might consider legalising a number of activities so that we can make the job of police officers less demanding and more attractive.

It is probable that the resignations of directors are due to several issues. It is more likely that directors resign because they are worried by a whole raft of burdens placed upon them by a

⁸⁴ Frances Gibb, “Directors chilled by the fear of financial liability,” *The Times*, September 23, 2003.

⁸⁵ Patience Wheatcroft, “Let some others join the club,” *The Times*, October 15, 2003.

⁸⁶ *Ibid.*

⁸⁷ [2001] BPIR 733.

⁸⁸ In relatively recent days there has been a well-publicised investigation in the United States into the work of the auditors of Enron when it entered bankruptcy.

⁸⁹ It must be acknowledged that the auditing profession, most notably the big international accounting firms (known as “the Big Four”), has lobbied for a cap to be placed on the liability of auditors, due to concerns over the size of damages’ awards against auditors.

number of pieces of legislation and court decisions,⁹⁰ rather than fear over wrongful trading. The fact of the matter is that in most common law countries, legislatures and courts alike have got tougher with directors over the past 15 years, and it is not possible, short of a detailed empirical study, to ascertain if there is a single occurrence that causes directors to resign or deters qualified people from accepting posts as directors. Intuitively I would want to say that it is a combination of factors, with any one factor probably not making the difference for directors.

Assuming that directors do feel more vulnerable, it is probable that they might be able to safeguard their position by obtaining director and officer (D&O) insurance. Section 310 of the Companies Act permits companies to purchase insurance for their officers against liability, *inter alia*, for breach of duty. Such insurance appears to be available to companies, and, compared with the situation in the United States, it has been available at a reasonable cost, especially if purchased by the company itself.⁹¹ The taking out of such insurance increased during the 1990s,⁹² but this increase might not be sustained given the fact that in the past year or so there have been significant price rises in premiums in the UK,⁹³ although it has been argued that policies in the UK were under-priced for many years and the increases in the UK are by way of market correction.⁹⁴

B. Directors Will Become More Risk-Averse

The argument has been made that, even if people want to, and do, become, directors they will be effectively hamstrung in what they do. Oesterle has asserted that directors will be more cautious in taking risks; they will be more concerned about protecting their own positions, and this will lead to directors failing to maximise wealth for the benefit of shareholders as well as they could if they were freed from the fear of wrongful trading.⁹⁵ This is not necessarily so. Provided that directors are engaged in appropriate monitoring and reacting properly to the results of that monitoring there is no reason for the directors to be overly risk-averse, unless and until those matters identified in s.214 come into play, that is when the directors know or ought to conclude that there is no reasonable prospect that the company would avoid going into insolvent liquidation. From that point it is expected that the directors would be more risk-averse. What Oesterle overlooks is that directors, particularly in private companies, are required by some creditors to guarantee personally the debts of their companies. If the possibility of liability for wrongful trading makes directors more risk averse, then surely so must the giving of guarantees, for it is more likely that the directors will be called upon to pay the creditors under the guarantees than be liable by way of a court order under s.214. Yet Oesterle does not call for the abolition of guarantees. Rather, he states that the solution to dealing with companies that have problematical financial histories is to require a standard form personal guarantee and that this solution to the risk problem is elegant.⁹⁶

The degree of risk permitted on the part of the directors of companies should always depend on the actual level of financial difficulty. The degree of financial instability and the degree of risk

⁹⁰ This is indicated in David Leibowitz, "Cover charge," *The Lawyer*, November 10, 2003, p25.

⁹¹ Vanessa Finch, "Personal Accountability and Corporate Control : The Role of Directors' and Officers' Liability Insurance" (1994) 57 *MLR* 880, especially at 890 and 902. According to Finch, insurance for directors has not been placed under the same stress as insurance for auditors (at 905).

⁹² *Ibid* at 900.

⁹³ "Directors face liability dilemma," *Corporate Finance*, May 2003, 1, 1.

⁹⁴ "Directors face liability dilemma," *Corporate Finance*, May 2003, 1, 1; Neil Hodge, "UK companies say D & O rate increases don't reflect risks" (2003) 37 *Business Insurance* 4.

⁹⁵ Above n25 at 30.

⁹⁶ *Ibid* at 33.

are interrelated⁹⁷ and the latter must be determined by the former. Hence, the more obvious it is that the creditors' interests are at risk, the less risk to which the directors should expose the company.⁹⁸ As mentioned earlier, if the company is financially embarrassed the shareholders and directors might have nothing to lose by embracing a high risk strategy;⁹⁹ the taking of substantial risks could be highly profitable and might rescue the company from the financial mire. But if the gamble fails the creditors will lose out.

Yet undoubtedly the point at which a director is subject to s.214 is not always precise. A director can re-assess strategy when he or she knows that there is no reasonable prospect that the company would avoid going into insolvent liquidation, but concern that a court, at a later date, might hold that a director ought have concluded that insolvent liquidation was a reasonable prospect might lead to over-caution. This is an issue which is taken out of the hands of the director. Having accepted this point, there appears to be no evidence that since the introduction of s.214 there has been a reduction in the amount of risk-taking that occurs in British markets.

C. The Courts Lack Experience and Ability

Oesterle is one among several commentators¹⁰⁰ that are sceptical when it comes to the suitability of the courts to assess the conduct of directors.¹⁰¹ According to Oesterle : "The forum for a decision... is stacked against the director."¹⁰² The learned commentator goes onto say that judges lack business experience and "clever lawyers and paid experts will ably add to the confusion."¹⁰³ This overlooks the fact that directors are able to hire clever lawyers to argue their case and to pay experts to substantiate their argument that they have acted properly. With directors we are not talking about naïve, vulnerable persons in society. But leaving that point aside, what about the argument that the courts are not the appropriate forum for considering whether directors have acted properly?

Oesterle argues that the sympathy of the judges will be with the trade creditors who have suffered losses and the judge will be against the directors who oversaw the company's demise.¹⁰⁴ The suggestion appears to be made, certainly by Oesterle, that the courts will hold directors liable as a matter of course. The claim is outlandish and, in any event, it simply does not accord with the only empirical evidence that we have in the UK, namely the reported decisions. There have not been many wrongful trading cases that have been reported since 1986, but in those that have been, directors have done pretty well. Courts, when reviewing what occurred to a company, often some years before the hearing of the action, have demonstrated a good deal of understanding of the positions in which directors found themselves at the relevant time. It is submitted that the judges have carefully analysed the situation

⁹⁷ See *Kinsela v Russell Kinsela Pty Ltd* (1986) 4 ACLC 215 at 223; *Equiticorp Finance Ltd (in liq) v BNZ* (1993) 11 ACLC 952 at 1017.

⁹⁸ *Ibid.* Also, see the view of Ramesh Rao, David Sokolow & Derek White, "Fiduciary Duty a la Lyonnais : An Economic Perspective on Corporate Governance in a Financially-Distressed Firm" (1996) 22 *The Journal of Corporation Law* 53 at 65.

⁹⁹ Ironically, directors might in such circumstances, absent any duty to take creditors' interests into account, not be liable in taking such action, even though the action is close to reckless because the shareholders would not complain.

¹⁰⁰ For example, Professor Brian Cheffins in *Company Law : Theory, Structure and Operation* (Oxford, Clarendon Press, 1997), at 543; D.Wishart, "Models and Theories of Directors' Duties to Creditors" (1991) 14 NZULR 323 at 340-341.

¹⁰¹ Above n25 at 38.

¹⁰² *Ibid.* A view apparently accepted by G. Varallo and J. Finkelstein, "Fiduciary Obligations of Directors of the Financially Troubled Company" (1992) 48 *Business Lawyer* 239.

¹⁰³ *Ibid.*

¹⁰⁴ *Ibid.* This is a view also held by Henry Butler and Larry Ribstein in "Opting Out of Fiduciary Duties : A Response to the Anti-Contractarians" (1990) 65 *Washington Law Review* 1 at 56.

confronting directors, and have generally come down on the side of the directors. For instance, in *Re Continental Assurance Co of London plc*¹⁰⁵ Park J in a mammoth judgment considered what directors had done during the period in which they were alleged to have breached s.214. His Lordship was satisfied that the directors had available to them sufficient financial information, even though the systems employed were a little antiquated and record-keeping systems were not particularly good.¹⁰⁶ Surely if a judge was disposed to find for the creditors he could have at least attacked the directors for not having a better financial system in place. But his Lordship did not. Even where the courts have found against a director they have manifested a degree of generosity. For example, in *Re Purpoint Ltd*¹⁰⁷ Vinelott J said that he had some doubts as to whether a reasonable director would have permitted the company to have commenced trading at all because of critical factors such as a lack of a capital base and the only assets that the company had were purchased from borrowings or acquired on hire purchase. Yet his Lordship did not hold that the respondent director ought to have concluded that the company was doomed from the outset.¹⁰⁸ The conclusion that can be drawn from the case law is, as indicated above, that the judges have carefully assessed detailed and quite complex testimony, and the judgments demonstrate an appreciation of many of the business issues encountered by directors. The judgments in *Re Sherborne Associates Ltd*,¹⁰⁹ and *Re Continental Assurance Co of London plc*¹¹⁰ are examples. The judgment of Park J is meticulous in detail and generous in result. The judges generally appear to realise that directors have to make tough decisions in often difficult circumstances. Furthermore, in *Re Brian D Pierson (Contractors) Ltd*¹¹¹ the judge recognised that what had to be taken into account in a wrongful trading case was the standard of the reasonable businessperson and that this sort of person would be “less temperamentally cautious than lawyers and accountants.”¹¹² The court was taking into account the position of a director and there was clear acceptance that the business approach of a director will involve some risk.

The favourite allegation that is asserted in relation to the courts is that they will base their decision on hindsight, and that will convict the director who always could have done more.¹¹³ With respect, the courts appear to have been vigilant concerning this possibility. In the wrongful trading case of *Re Sherborne Associates Ltd*,¹¹⁴ the judge expressed the view that it is dangerous to assume that “what has in fact happened was always bound to happen and was apparent.”¹¹⁵ The fact of the matter is that English courts have refused to second-guess directors in their commercial dealings.¹¹⁶

But is it the case that liquidators are threatening to issue, or even initiating, proceedings pursuant to s.214 and this has caused directors to feel forced to offer payments to avert or settle such proceedings because of the concern that the courts will find against them? Even Cheffins, who is sceptical of the courts’ suitability to deal with wrongful trading cases, thinks not,

¹⁰⁵ [2001] BPIR 733.

¹⁰⁶ Ibid at 771.

¹⁰⁷ [1991] BCLC 491; [1991] BCC 121.

¹⁰⁸ Ibid at 498; 127.

¹⁰⁹ [1995] BCC 40.

¹¹⁰ [2001] BPIR 733.

¹¹¹ [2001] 1 BCLC 275.

¹¹² Ibid at 305.

¹¹³ For example, above n24 at 38.; B. Cheffins in *Company Law : Theory, Structure and Operation* (Oxford, Clarendon Press, 1997 at 543.

¹¹⁴ [1995] BCC 40.

¹¹⁵ Ibid at 54 per Judge Jack QC. Lewison J in *Secretary of State for Trade and Industry v Goldberg* ([2004] 1 BCLC 597 at 613) made the same point in relation to an assessment of a director’s conduct when hearing an application under the Company Directors’ Disqualification Act 1986.

¹¹⁶ Law Commission, *Company Directors : Regulating Conflicts of Interests and Formulating a Statement of Duties* (Law Commission Consultation Paper No 153, 1998), at para 15.30.

because s.214 does not provide a significant weapon in the liquidator's arsenal.¹¹⁷ This is supported by more recent commentary.¹¹⁸ One practitioner has stated that : “[I]t is difficult to see where the directors have conscientiously set about discharging their duties, given serious consideration to the matter and come to rational conclusions”¹¹⁹ that the directors will be held liable.

The above statements quoted from judgments together with the approach taken by the courts does not suggest that judges fail to evaluate adequately the situation in which directors find themselves, and making decisions in favour of creditors because they feel sorry for creditors. Some indication of the fairness shown to directors is further to be found in the fact that the courts have refused to permit a liquidator to amend the date that he or she has pleaded as being the date from which wrongful trading commenced.¹²⁰ The liquidator is saddled with the date that he or she has nominated at the outset of the hearing of the proceedings.

The cases suggest that judges will only find directors liable where the latter have plainly acted irresponsibly, a point made by the judge in *Re Sherborne Associates Ltd.*¹²¹ Subsequently, Park J in *Re Continental Assurance Co of London plc*¹²² made a similar point when he said that typically the cases where directors have been found liable have involved directors who have :

“[C]losed their eyes to the reality of the company's position, and carried on trading long after it should have been obvious to them that the company was insolvent and that there was no way out for it. In those cases the directors had been irresponsible, and had not made any genuine attempt to grapple with the company's real position.”¹²³

In sum, while judges will, it is acknowledged, often have to wrestle with difficult questions flowing from differing views of what constitutes right action in the circumstances in which companies operated,¹²⁴ they are able to make a fair assessment of the actions of directors and are now able and better equipped to take practical and commercial decisions.¹²⁵ Judges have sought to achieve a balance between the protection of bona fide creditors, on the one hand, and ensuring that directors (on behalf of their companies) are not totally discouraged from taking appropriate business risks, on the other hand. The very paucity of cases where liquidators have succeeded contradicts totally the assertion that judges are going to be set against directors.

The one allegation that might be made against the process is that courts might not be apprised of all the necessary information for making a decision, due to time and cost. However, this is something that could be levelled at many areas of the law, such as actions brought pursuant to s.459 of the Companies Act 1985. Also, directors do have the opportunity in trials to lay before the court the evidence that would support a contention that they are not liable for wrongful trading.

D. Creditors Should Protect Themselves

¹¹⁷ Cheffins, *Company Law* at 545.

¹¹⁸ P.Fidler, “Wrongful trading after Continental Assurance” (2001) 17 IL & P 212; Spence, “Personal Liability for Wrongful Trading” (2004) 17 *Insolvency Intelligence* 11.

¹¹⁹ Fidler *ibid* at 215.

¹²⁰ *Re Sherborne Associates Ltd* [1995] BCC 40; *Re Continental Assurance Co of London plc* [2001] BPIR 733.

¹²¹ [1995] BCC 40 at 56.

¹²² [2001] BPIR 733.

¹²³ *Ibid* at 769.

¹²⁴ William T. Allen, “Ambiguity in Corporation Law” (1997) 22 *Delaware Journal of Corporate Law* 894, 899.

¹²⁵ A point accepted as far back as 1982 by the Cork Committee (para 1800).

The point that is often made in relation to many aspects of corporate law, particularly by contractarian scholars, is that creditors do not need the benefit of regulation, for they are able to take care of themselves by means of “an entire armoury of techniques.”¹²⁶ Oesterle brands wrongful trading as supporting paternalism, because it is based, wrongly in his view, on the idea that creditors warrant some form of protection.¹²⁷ Morrison asserts that besides contract-related protections, creditors can avail themselves of insurance.¹²⁸ Trade credit insurance can certainly be purchased so as to protect creditors against the risk of non-payment. But this is not a frequent occurrence, for in 2001 it was asserted by the Association of British Insurers that only five per cent of UK trade was credit insured.¹²⁹ This could be due to the fact that either creditors do not wish to insure, but rather to take the risk of non-payment, or insurers might be reluctant to give cover. Many smaller creditors, who, ironically, are the ones who are in the greatest need of insurance, extend credit in situations where they would not have the opportunity of obtaining insurance. Even if they did have, the cost of credit insurance is rising¹³⁰ and the cost element that they would have to build into their price for granting credit would, more often than not, price them out of the market. The creditors who might be able to get insurance, the more substantial creditors such as financial institutions, would usually prefer to self-insure.

Much is made by Mannolini that creditors can protect themselves by having a contract with the company that safeguards them, but undoubtedly *ex ante* contracts have their limitations in this regard.¹³¹ One of the main drawbacks with this strategy is that it is impossible to draft a contract that deals effectively with all of the issues that the parties might want to address and which covers every possible contingency.¹³² Contracts often are only as good as the foresight of the parties and their advisers. As Professor Dale Tauke has said:

“The ability of contracting parties to enter into complete contingent claims contracts in the face of complex and uncertain contingencies is limited by the bounded rationality of the parties – the limits of the human mind in comprehending and solving complex problems.”¹³³

Another problem is that entering into formal and widely-drawn contracts can be costly,¹³⁴ which, increases the transaction costs of extending credit.

¹²⁶ D. Goddard, “Corporate Personality – Limited Recourse and its Limits” in C. Rickett and R. Grantham, *Corporate Personality in the 20th Century* (Hart Publishing, Oxford, 1998) at 22.

¹²⁷ Above n25 at 41.

¹²⁸ “The Australian Insolvent Trading Prohibition – Why Does It Exist?” (2002) 11 *International Insolvency Review* 153 at 170.

¹²⁹ Martin Posner, “Credit Insurance : An Overview” *Credit Management*, April 2001, 18 at 19.

¹³⁰ Mel Mandell, “Money’s costing more” (2002) 15(4) *Troy* 58 at 58.

¹³¹ Michael J. Whincop, “Painting the Corporate Cathedral : The Protection of Entitlements in Corporate Law” (1999) 19 *OJLS* 19, 30-31. For further discussion about the limitations of using contracts for protection, see A. Keay, “Directors’ Duties to Creditors : Contractarian Concerns Relating to Efficiency and Over-Protection of Creditors” (2003) 66 *MLR* 665 at 690-692.

¹³² See the comments of Christopher A. Riley in “Contracting Out of Company Law : Section 459 of the Companies Act 1985 and the Role of the Courts” (1992) 55 *MLR* 782 at 786 in this regard.

¹³³ Dale B. Tauke, “Should Bondholders Have More Fun? A Reexamination of the Debate Over Corporate Bondholder’s Rights” [1989] *Columbia Business Law Review* 1 at 15, n28.

¹³⁴ R. Coase, “The Nature of the Firm” (1937) 4 *Economica* 386, 391-392; Larry E. Butler and Henry N. Ribstein, “Opting Out of Fiduciary Duties : A Response to the Anti-Contractarians” (1990) 65 *Washington Law Review* 1 at 28; David M. W. Harvey, “Bondholders’ Rights and the Case for a Fiduciary Duty” (1991) 65 *St John’s Law Review* 1023 at 1037; Michael J. Whincop, “Painting the Corporate Cathedral : The Protection of Entitlements in Corporate Law” (1999) 19 *OJLS* 19 at 28.

Finally, if a creditor is able to negotiate the inclusion in a contract of favourable terms, then this is only of any use, for the most part, if the creditor is willing to monitor the affairs of the company. The necessary monitoring can be time-consuming and costly, and even then it might not be sufficient to keep the creditor well-informed.¹³⁵ Again, monitoring will increase transaction costs.¹³⁶

Mannolini,¹³⁷ in a trenchant attack on the Australian equivalent of s.214, argues that creditors can protect themselves through three avenues. First, creditors can include in the credit contract, if they choose, a raft of debt covenants, providing, for instance, that the company will not take on any superior or equal ranking debt.¹³⁸ A second defensive measure identified by Mannolini is the taking of personal guarantees from directors.¹³⁹ Finally, a creditor is entitled to require the creation in its favour of a charge to enable it to have some security over the debtor company's property.¹⁴⁰ If a creditor is able to negotiate successfully to have, for instance, restrictive covenants inserted in a contract, the taking of guarantees or security, then it is advisable that the creditor monitors the affairs of the company and, possibly, the directors. The necessary monitoring can be time-consuming and costly, and even then it might not be sufficient to keep the creditor well-informed.¹⁴¹ Many creditors will not have the resources to carry out necessary monitoring, and if they do they might not have the sophistication to assess any details that are obtained from the company.¹⁴²

Mannolini asserts that the contractual process is sufficient to ensure that creditors are adequately compensated.¹⁴³ He states that creditors are able to insist on a higher interest rate if they are dealing with a company that might fall into financial difficulty and the risk of repayment is not guaranteed.¹⁴⁴ If, so the argument goes, a creditor negotiates a contract and then a later stage is able to recover any outstanding debt from the directors, it is "on a *risk adjusted basis*...effectively overcompensated."¹⁴⁵

But, when a contract is entered into, the parties decide on price depending on what they know at the time. A problem for parties to contracts, particularly some creditors, is the existence of informational asymmetries. Yet, one of the things that the parties are aware of at the time of the making of the contract is the existence of the wrongful trading provisions. Just as the existence of security can affect the allocation of risk, so can the effect of the wrongful trading provisions. As Dr Michael Whincop has stated: "If parties can price-protect in the absence of the rules, they are capable of price-protecting when they are present."¹⁴⁶ Further to this, it is

¹³⁵ See the comments of Professor Cheffins in his book, *Company Law : Theory, Structure and Operation* (Oxford, Clarendon Press, 1997), 524.

¹³⁶ Richard A. Posner, "The Rights of Affiliated Corporations" (1976) 43 *University of Chicago Law Review* 499 at 508.

¹³⁷ "Creditors' Interest in the Corporate Contract : A Case for the Reform of our Insolvent Trading Provisions" (1996) 6 *Australian Journal of Corporate Law* 14.

¹³⁸ *Ibid* at 23.

¹³⁹ *Ibid* at 23-24.

¹⁴⁰ *Ibid* at 24.

¹⁴¹ See the comments of Professor Cheffins in *Company Law* at 523-524.

¹⁴² *Ibid* at 523.

¹⁴³ Above n84 at 30.

¹⁴⁴ *Ibid* at 31.

¹⁴⁵ *Ibid*.

¹⁴⁶ Michael J Whincop, "The Economic and Strategic Structure of Insolvent Trading" in I M Ramsay (ed), *Company Directors' Liability for Insolvent Trading* (Melbourne, Centre for Corporate Law and Securities Regulation and CCH Australia, 2000) at 58.

extremely difficult, if not impossible, to determine, in any given case, whether a creditor has been over-compensated, an assertion made by Mannolini in relation to creditors obtaining benefits from a wrongful trading order. A number of factors have to be taken into account in determining over-compensation, namely: a model for pricing debt; information concerning the way in which interest rates are set in equilibrium; what information did the company have access to at the time of the credit being extended; and knowledge of way that creditors trade off a provision for protection in the contract and price protection.¹⁴⁷

Returning to the issue of information asymmetry for a moment, it is possible to say that directors have an incentive to encourage creditors to undervalue the risk that they are undertaking (so that the price of the credit will be lower), and so they may not disclose certain information. The existence of something like wrongful trading redresses the balance in some way so that creditors might get some benefit where directors have failed to make disclosure. Of course, wrongful trading will apply equally to all directors, whether they have acted openly or not.

E Premature Advent of Insolvency Regimes

It has been argued that the existence of a s.214 type provision is likely to cause directors, concerned about their personal liability, to take their companies into administration or liquidation prematurely.¹⁴⁸ There is no evidence that directors are embracing liquidation or administration more often because of fear of s.214. The numbers of administrations have been very low over the years and the only large increase in liquidation numbers since 1986 was during the years in the early 1990s following the harsh recession of the late 1980s. Clearly, there were reasons other than fear of wrongful trading for the increase in numbers. This is borne out by the fact that after the effects of the recession died out, the liquidation numbers decreased.

The only empirical evidence that seems to point to the fact that directors might be more risk-averse when their companies are struggling financially comes from the United States and relates to large listed companies.¹⁴⁹ This evidence is of little relevance to many companies, and particularly those that are closely-held. The directors of closely-held companies are usually also the major shareholders and often they are, naturally, so closely linked to the company's business that they will seek to take every risk possible to save their company. With many closely-held firms, shareholder-managers are sentimentally attached to their firms and have often sunk their life savings into them as well as a lot of effort, and they are prepared to attempt any action that might turnaround the company's fortunes.¹⁵⁰ In *Re Produce Marketing Consortium Ltd*,¹⁵¹ Knox J pointed to the fact that one of the two directors of the company was unable to see the realities of the company's trading position.¹⁵² A survey of English case law

¹⁴⁷ Ibid.

¹⁴⁸ Above n25 at 30. Also, see Victor C. S. Yeo and Joyce Lee Suet Lin, "Insolvent trading – a comparative and economic approach" (1999) 10 *Australian Journal of Corporate Law* 216 at 231-232; Stephen R. McDonnell, "Geyer v Ingersoll Publications Co : Insolvency Shifts Directors' Burden From Shareholders to Creditors" (1994) 19 *Delaware Journal of Corporate Law* 177 at 207.

¹⁴⁹ Lynn M. LoPucki and William C. Whitford, "Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies" (1993) 141 *University of Pennsylvania Law Review* 669.

¹⁵⁰ Rizwaan J. Mokhal, "An Agency Cost Analysis of the Wrongful Trading Provisions : Redistribution, Perverse Incentives and the Creditors' Bargain" (2000) 59 *CLJ* 335 at 353-354.

¹⁵¹ (1989) 5 *BCC* 569.

¹⁵² Ibid at 598.

suggests that it is the directors of closely-held companies that are generally subjected to legal proceedings, and in the decisions that have gone against directors, closely-held companies have been involved.¹⁵³ This is supported by a recent empirical study undertaken in Australia in relation to that country's insolvent trading provisions.¹⁵⁴ The study found that in 91% of the cases brought against company directors, directors of private companies were involved. The study was only able to identify the number of shareholders in 16 of the 103 companies involved in the cases that were studied, and it found that the average number of shareholders in those companies was 1.81. There is evidence, certainly with respect to small companies that directors fail to embrace an insolvency procedure early enough.¹⁵⁵ If companies initiated some insolvency procedure earlier perhaps there might be more corporate rescue and less wrongful trading.

In suggesting that wrongful trading precipitates the acceptance, prematurely, of insolvency regimes, the opponents of wrongful trading are assuming that the advent of an insolvency regime is tantamount to the end of the company's life. While this might be the case with liquidation, this is certainly not the case with administration. This is especially so since the introduction of the corporate insolvency provisions in the Enterprise Act 2002. These provisions are designed by the Government to encourage the rescue of companies through the process of administration, which has been made more accessible. Directors can now appoint an administrator extra-judicially and this will, inter alia, reduce time and costs.¹⁵⁶ This action could have two benefits, namely enabling directors to protect themselves and ensuring that their company's position will be assessed by a licensed insolvency practitioner in the shelter of a moratorium. The administrator's assessment might lead to a proposal for the company's rescue from its financial mire, thereby producing an optimal outcome for all stakeholders. In one reported case, *Re Chancery plc*¹⁵⁷ the directors appear to have petitioned for an administration order so as to avoid wrongful trading occurring. In Australia it appears that the equivalent procedure to administration (voluntary administration) may have been used by directors to avoid engaging in insolvent trading.¹⁵⁸

F. Directors are Unfairly Penalised

Mannolini has asserted that wrongful trading provisions can lead to directors being held liable for actions or inactions short of fraud or deliberate wrongdoing, such as a mere error of judgment.¹⁵⁹ Yet, Mannolini is ready to deny creditors any rights in relation to possible errors of judgment which they make, such as not assessing the commercial risks properly in extending credit to companies. There does not appear to be any reason why creditors should bear the burden of their errors, but directors are to be excused.¹⁶⁰ This is an element of Mannolini's

¹⁵³ For instance, *Re Produce Marketing Consortium Ltd* (1989) 5 BCC 569; *Re DKG Contractors Ltd* [1990] BCC 903; *Re Purpoint Ltd* [1991] BCLC 491; [1991] BCC 121; *Re Brian D Pierson (Contractors) Ltd* [2001] 1 BCLC 275.

¹⁵⁴ P. James, I.M. Ramsay and P.Siva, "Insolvent Trading – An Empirical Study" (Research Report, Centre for Corporate Law and Securities Regulation, University of Melbourne, 2004) available at <<http://cclsr.law.unimelb.edu.au/research-papers/monograph%20series/Insolvent%20Trading%20final.pdf>>

¹⁵⁵ Above n97 at 353-354.

¹⁵⁶ Insolvency Act 1986, Schedule B1, para 22(2).

¹⁵⁷ [1991] BCC 171 at 172.

¹⁵⁸ A. Herzberg, "Why are there so Few Insolvent Trading Cases?" (1998) 6 *Insolvency Law Journal* 177.

¹⁵⁹ Above n24 at 32.

¹⁶⁰ It is to be noted that it has been held that directors are not able to be excused under s.727 of the Companies Act because relief is not compatible with s.214 (*Re Produce Marketing Consortium Ltd*

broader argument that placing liability on directors is unfair. While he accepts that some creditors will not be sufficiently sophisticated to assess the risks pertaining to the extension of credit to some companies, he is not ready to accept that loss should fall on directors. His rationale for this view appears to be that directors of small closely-held companies have, from a historical perspective, been the subject of most recovery actions initiated by creditors and liquidators.¹⁶¹ This probably comes as news to lawyers acting on behalf of creditors and liquidators. To be sure, where guarantees have been given by directors this might be the case. But even then, why should directors be the objects of generosity and excused from liability? Mannolini's answer is that they are entrepreneurs involved in risk-taking that acts as the "motor for the entrepreneurial economy."¹⁶² He asks rhetorically: "Why should the law constrain entrepreneurs to adopt conservative trading strategies when rational creditors and shareholders may well prefer risky strategies?" With respect, what Mannolini fails to tell us is why directors should be seen in this light and not creditors. Is it not the case that creditors are also entrepreneurs in the business of risk-taking?¹⁶³ Loss might fall on one group of entrepreneurs. Which one will it be? The fact of the matter is that when a company collapses creditors will always lose out, but directors will not unless wrongful trading actions are initiated and are successful.

While creditors will lose out if a company collapses, Morrison argues that directors also lose out in the sense that their reputation will be tarnished to the extent that they might find it hard to obtain work again.¹⁶⁴ The implication from the commentator's point is that the imposition of wrongful trading liability is just a further unreasonable injury that directors suffer as a consequence of their company's collapse.

It is questionable whether loss of reputation is an issue for those directors who are involved in closely-held companies. It is more likely that directors of these kinds of companies will start up afresh with another company that they control (unless they have been disqualified). Will their reputation with creditors, however, be tarnished so that if they do move to another company, or establish their own new company, they have difficulty in getting credit? It is not likely that potential creditors will be aware, save in the smallest of fields, of what the director has done in the past, for as we have already considered, creditors often lack information on which to base their decision to extend credit. Certainly some creditors are likely to give credit in ignorance. Other creditors might, in spite of what a director has done previously, extend credit because of the tough competition that exists in the market.

It is likely, as indicated earlier, that wrongful trading is more relevant to directors of closely-held companies for their monetary and human capital is tied up in these companies. In this regard, Cheffins points out that if a closely-held company collapses then the directors will have lost what they invested in the company, as well as possibly having to pay out on personal guarantees.¹⁶⁵

(1989) 5 BCC 569; *Re Brian D Pierson (Contractors) Ltd* [2001] 1 BCLC 275). It is respectfully submitted that this is not necessarily the case. Both s 214 and s 727 involve subjective and objective tests, and so there should be no bar to the application of s 727 to s 214.

¹⁶¹ Above n24 at 32.

¹⁶² Ibid.

¹⁶³ Michael Whincop, "Taking the Corporate Contract More Seriously: The Economic Cases Against, and a Transaction Cost Rationale for, the Insolvent Trading Provisions" (1996) 5 *Griffith Law Review* 1 at 13. This is a point that Cheffins also makes in *Company Law* at 523.

¹⁶⁴ "The Australian Insolvent Trading Prohibition – Why Does It Exist?" (2002) 11 *International Insolvency Review* 153 at 160.

¹⁶⁵ *Company Law* at 523.

Returning to the issue of reputation, if we assume that Morrison is correct in relation to medium - large companies and reputations of directors will suffer if their company collapses, it might be argued that the wrongful trading provision can be influential in directors ensuring that creditors' losses are minimised. As Professor Ron Daniels has stated:

“[I]n light of their imminent re-entry into the job market, managers may reason that the best strategy to adopt in a distress situation is one of honesty and integrity. Rather than using wrongdoing as a way of gambling the company back to success, the managers may decide to avoid unscrupulously any hint of wrongdoing out of a concern for inflicting irrevocable damage to their reputational capital in the managerial market.”¹⁶⁶

In any event, assuming Morrison to be correct, we might then ask whether a director's loss of reputation constitutes any reason for not making a director liable to creditors who have lost out? The diminution in the level of the director's reputation does not compensate the creditors, who, while they might find some solace in the fact that the director has difficulty operating again, will be more concerned to recover some money.

Although a wrongful trading provision might lead to a director being held liable, it must be remembered that its existence is not so heavy a burden for directors as the imposition of a personal guarantee. Under most standard guarantees, the liability of directors is not limited and liability is automatic in relation to the company's liabilities to the creditor. In contrast, liability under s.214 only ensues if a court is satisfied that the directors knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation, and the directors are unable to convince the court that they took every step with a view to minimising the potential loss to the company's creditors as they ought to have taken.

The changes made to the administration regime procedure by the Enterprise Act potentially lighten the burden of directors. Until the corporate insolvency provisions in the Enterprise Act became operative on 15 September 2003, if directors wished to place their company into administration, arguably one of the safest responses to concerns over the possibility of wrongful trading, they had to obtain a court order. Besides being costly, it took a significant amount of time to obtain such an order. Now directors are able to place their company into administration¹⁶⁷ by simply giving notice to the holders of floating charges over the whole, or substantially the whole, of their company's property of an intention to appoint an administrator,¹⁶⁸ as well as filing a copy of the notice of intention to appoint with the court.¹⁶⁹ It has been asserted that the easy access to voluntary administration in Australia, an extra-judicial form of insolvency process akin to administration in the UK, has reduced the number of insolvent trading actions.¹⁷⁰

¹⁶⁶ R. Daniels, “Must Boards Go Overboard?” (1994-5) 24 *Can Bus L J* 229 at 241 and referred to in Mokal, above n97 at 352.

¹⁶⁷ Insolvency Act 1986, Para 22 of Schedule B1.

¹⁶⁸ Insolvency Act 1986, Para 26 of Schedule B1.

¹⁶⁹ Insolvency Act 1986, Para 27 of Schedule B1.

¹⁷⁰ A. Herzberg, “Why are There so Few Insolvent Trading Cases?” (1998) 6 *Insolvency Law Journal* 177.

G. Increase in Transaction Costs

Although not specifically articulated by those attacking the wrongful trading provision, although implicit in a number of points made, it might be argued that in order to keep from falling foul of s.214, directors have to engage in more monitoring so as to risk-minimise, and that, as a necessary concomitant, there is an increase in the company's costs, producing less efficient use of company resources. It appears that courts will take into account, when assessing the actions of directors, the costs that are associated with undertaking inquiries and realise that company funds cannot be used for every check possible and that directors must act quickly in some situations. As discussed above, the courts have tended to view the position that confronts directors pragmatically in coming to decisions concerning the conduct of directors. Whincop has suggested that all that courts will require is that an adequate process of monitoring exists so that the directors will be informed, and that the directors take into account the information produced. Also, while the costs involved might be substantial, it is likely that the process implemented should be effected in order for the directors to fulfil management responsibilities, in general terms, and to enable them to be able to provide the required external reporting.¹⁷¹ Hence, the marginal cost involved in taking steps to ensure that wrongful trading does not occur appears to be low.¹⁷²

It could be pointed out that undertaking monitoring is an integral element of the normal duties of directors,¹⁷³ and that the action that directors take to monitor their companies' position also has potential for benefiting the company as a whole in that inefficiencies and problems in general could be identified. In effect the monitoring is just practising good corporate governance.

Finally, it has been indicated in a significant amount of the recent law and economics literature in relation to companies that it is doubtful whether regulations pertinent to the terms of contracts, has any allocative efficiency costs at all.¹⁷⁴

IV Support for Regulation

A. General

Generally speaking there has been little support for regulation articulated in the literature. Two contractarians, Dr Michael Whincop, in relation to the Australian insolvent trading provision, and Dr Rizwaan Mokal in relation to the British wrongful trading provision, have voiced support for regulation. This is interesting as contractarians, certainly those embracing a law and economics approach to corporate law, are usually portrayed as being totally opposed to the provisions. Having said that, there are other contractarians who have not addressed wrongful trading type provisions, such as Professor Lucian Bebchuk, who favour some mandatory provisions,¹⁷⁵ and who might support something akin to s.214.

¹⁷¹ "Taking the Corporate Contract More Seriously : The Economic Cases Against, and a Transaction Cost Rationale for, the Insolvent Trading Provisions" (1996) 5 *Griffith Law Review* 1 at 26.

¹⁷² A view to which Whincop subscribes : *ibid.*

¹⁷³ See the comments in *Re Barings plc (No 5)* [1999] 1 BCLC 433 at 489.

¹⁷⁴ Above n92 at 45 and citing B. Black, "Is Corporate Law Trivial? : A Political and Economic Analysis" (1990) 84 *Northwestern University Law Review* 542; Henry Butler and Larry Ribstein, "Opting Out of Fiduciary Duties : A Response to the Anti-Contractarians" (1990) 65 *Washington Law Review* 1; F. Easterbrook and D. Fischel, *The Economic Structure of Corporate Law* (1991).

¹⁷⁵ "The Debate on Contractual Freedom in Corporate Law" (1989) 89 *Harv L R* 1395.

It is likely that those scholars advocating a progressive or communitarian approach to corporate law¹⁷⁶ would take the view that there should be regulation to proscribe wrongful trading. The progressive school as far as corporate law is concerned is centred in the United States and none of its adherents have addressed wrongful trading style provisions, as there are no counterpart provisions in the United States, so some of the following discussion is based on what has been advocated in general progressive literature.

It has been argued in the progressive literature,¹⁷⁷ *inter alia*, that companies are public institutions with public obligations and it is necessary to have mandatory rules to control what they and their managers do.¹⁷⁸ The company is perceived not as a nexus of contracts, as it is viewed by most contractarians, but as “a community of interdependence, mutual trust and reciprocal benefit.”¹⁷⁹ Progressive scholars have rejected the idea that all of the parties who are involved in companies are able to protect themselves, and even if self-protection measures were feasible, disparities in bargaining power would prevent creditors from obtaining effective protection. These disparities lead to bargaining outcomes that are substantially unfair. As a consequence, progressives have argued for mandatory rules in order to provide adequate protection.¹⁸⁰ Now let us turn to some of the specific arguments that might support a wrongful trading provision.

B. Problems with Protective Measures

Earlier we noted that it has been argued that creditors are able to take whatever precautions are needed in order to protect their interests given the risk involved.¹⁸¹ Often banks¹⁸² and other substantial institutions are in view when this is stated. Banks are able to demand guarantees from directors and can take the time, and go to the expense, of having a substantial contract drafted to protect their interests. Also, they have the necessary experience in their own organisation to advise on how to structure a particular transaction, something that is not available to most smaller creditors. A significant number of creditors are not sophisticated or powerful enough to demand terms that will compensate for risk. A study by Professors Gilson and Vetsuypens¹⁸³ discovered that while banks were able to have covenants that influence

¹⁷⁶ The progressive school literature is voluminous and too extensive to cite in full. Examples of the scholarship can be seen in the monograph, Lawrence E. Mitchell (ed), *Progressive Corporate Law* (Boulder, Colorado, Westview Press, 1995) and the following works: William W. Bratton Jr, in “The ‘Nexus of Contracts Corporation’: A Critical Appraisal” (1989) 74 *Cornell L Rev* 407; Lawrence Mitchell, “The Fairness Rights of Bondholders” (1990) 65 *New York University Law Review* 1165; David Millon, “Theories of the Corporation” [1990] *Duke LJ* 201; Lyman Johnson, “The Delaware Judiciary and the Meaning of Corporate Life and Corporate Law” (1990) 68 *Texas Law Review* 865; Lawrence E. Mitchell (ed), *Progressive Corporate Law* (1995). For critiques of progressive scholarship, see, for example, Michael E DeBow and Dwight R Lee, “Shareholders, Nonshareholders and Corporate Law: Communitarianism and Resource Allocation” (1993) 18 *Delaware Journal of Corporate Law* 393

¹⁷⁷ Of course, just as with schools of thought, like the law and economics school, not all progressives adhere to the same view on all matters.

¹⁷⁸ For example, see Douglas M Branson, “The Death of Contractarianism and the Vindication of Structure and Authority in Corporate Governance and Corporate Law” in Lawrence E. Mitchell (ed), *Progressive Corporate Law* (1995) at 93.

¹⁷⁹ David Millon, “Communitarianism in Corporate Law: Foundations and Law Reform Strategies” in Lawrence E. Mitchell (ed), *Progressive Corporate Law* (1995), at 10.

¹⁸⁰ *Ibid* at 4.

¹⁸¹ See text relating to notes 72-93. Also, see Christopher C. Nicholls, “Liability of Corporate Officers and Directors to Third Parties” (2001) 35 *Canadian Business Law Review* 1 at 23.

¹⁸² For instance, see Laura Lin, “Shift of Fiduciary Duty Upon Corporate Insolvency: Proper Scope of Directors’ Duty to Creditors” (1993) 46 *Vanderbilt Law Review* 1485 at 1502.

¹⁸³ “Credit Control in Financially Distressed Firms: Empirical Evidence” (1994) *Washington University Law Quarterly* 1005 at 1010, 1011.

corporate actions included in contracts, this was not the case with trade creditors.¹⁸⁴ Many of such creditors have little power and effectively are not engaged in bargaining – they have to extend credit or perish.¹⁸⁵

While diversification of risk would be the most prudent option for trade creditors, thereby ensuring that any default would not impact so heavily on their financial position, this is not always viable, particularly for those involved in some industries, such as construction. Further, many creditors extend credit to players in only one industry. When collapses occur, especially in times of recession, one often finds that a number of companies in the same industry will fail,¹⁸⁶ so creditors might discover that diversifying is not effective.

Another option for creditors is to investigate potential debtors by obtaining information, such as financial data and details of past credit history, in order to ascertain the probability of default and to determine on what terms, if any, credit should be extended.¹⁸⁷ Yet this rarely occurs as far as many trade creditors are concerned, even those that could be regarded as the more sophisticated,¹⁸⁸ because like a number of the measures canvassed above, there is insufficient time, and creditors do not have the necessary staff to undertake this action, or cannot afford to employ professionals to act on their behalf.

There are multifarious reasons for the fact that a substantial portion of creditors fail to take measures that will provide adequate protection. These are : ignorance of the ramifications of dealing with a company; concern that a competitor might be able to provide the supplies or the funds if a decision to supply or lend is not made speedily, and, consequently, there is a lack of time in which either to undertake checks or to enter into negotiations on terms; taking action is costly; and the nature of risk changes over time. It is also clear that some creditors do not have the opportunity, given the circumstances in which they are extending credit, to avail themselves of protective measures, because goods or services have to be provided within a short space of time or else the business is lost to a competitor.

In addition, while creditors might take measures to protect themselves, these will not, in all likelihood, stop some directors from acting improperly or irresponsibly. For instance, the payment by the company of creditors who are not connected with the company usually cannot be recovered as a preference by an administrator or liquidator for a variety of reasons.¹⁸⁹ As it is not possible either to predict the future or, for many creditors, to undertake monitoring of the

¹⁸⁴ A US study undertaken by Elliehusen and Wolken found in 1993 that trade creditors made up 20 per cent of all non-bank, non-farm small businesses' liabilities, as well as that 80 per cent of all companies used trade credit, thus trade credit represents a significant part of corporate liabilities ("An Empirical Investigation into Motives for Demand for Trade Credit" Federal Reserve Board Study, 1993, and referred to in Neelam Jain, "Monitoring costs and trade credit" (2001) 41 *The Quarterly Review of Economics and Finance* 89 at 90 and Christina V Atanasova and Nicholas Wilson, "Borrowing Constraints and the Demand for Trade Credit : Evidence from UK Panel data" July 2001, Leeds University Business School).

¹⁸⁵ See the comments of Professor Lawrence E. Mitchell in 'Trust. Contract. Process.' in Lawrence E. Mitchell (ed), *Progressive Corporate Law* (1995) at 187.

¹⁸⁶ An example is the building industry in Australia in the early 1990s when many construction companies entered liquidation following the savage recession of the late 1980s and early 1990s. Another example is the dot com companies in the late 1990s.

¹⁸⁷ Cheffins, *Company Law*, at 74.

¹⁸⁸ John Hudson, 'The case against secured Lending' (1995) 15 *International Review of Law and Economics* 47 at 56.

¹⁸⁹ See *Re M C Bacon Ltd* [1990] BCLC 324; Andrew Keay, 'Preferences in Liquidation Law : A Time for a Change' (1998) 2 *CfILR* 198.

affairs of companies, allowing creditors to make provision *ex ante*, it is appropriate for there to be some kind of *ex post* adjustment,¹⁹⁰ through the agency of s.214.

C. Absence of Bargaining Power

It might be argued, and would be argued by progressive scholars, that even if self-protection measures were feasible, disparities in bargaining power would prevent creditors from obtaining effective protection. These disparities lead to bargaining outcomes that are substantially unfair.¹⁹¹ Many trade creditors¹⁹² are almost “involuntary” creditors as they have little choice whether or not to deal with, and extend credit, to companies. Trade creditors often lack the necessary bargaining power to obtain contractual concessions from companies because the market is competitive and a company will probably have little difficulty, in most lines of business, in finding another trading partner who will not demand concessions. Also, because trade creditors are not extending the same amounts of credit as banks, and as the gains made by most trade creditors are relatively low, taking action to ascertain information about the company is regarded as inefficient and they are not so likely to negotiate explicit terms of credit. Of course, default is likely to have a greater impact on trade creditors compared with financiers.¹⁹³ Perhaps this answers the criticisms of some who say that too much responsibility has been placed on directors to be aware of the position of their companies and not enough has been placed on creditors to appraise risk and protect themselves;¹⁹⁴ simply many creditors are not lackadaisical, but are just unable to ascertain the necessary information that might assist their lending decisions. Wrongful trading provides compensation for the absence of true bargaining between the company and the creditors. Under progressive arguments the provision makes life fairer for creditors.

D. Commercial Morality

According to the Insolvency Law Review Committee, in its 1982 report, *Insolvency Law and Practice* (commonly known as “the Cork Report”),¹⁹⁵ “it is a basic objective of the law to support the maintenance of commercial morality,”¹⁹⁶ and, according to the courts, to ensure high standards are maintained. Most would acknowledge that commercial morality must be fostered. The difficulty, of course, is finding agreement as to what commercial morality entails, and how far the courts and legislation should go about fostering it. While many would deny company law carrying out a public function, it would appear that some parts of company law have more than a private law impact.¹⁹⁷ Cheffins has noted that there is a public interest element connected with the regulation of directors and what they do.¹⁹⁸ Traditionally, the doctrine of limited liability, which shifts the risk of failure from the shareholders to the

¹⁹⁰ F. Easterbrook, “Two Agency-Cost Explanation of Dividends” (1984) 74 *Am Econ Rev* 650 at 655.

¹⁹¹ Above n126 at 9.

¹⁹² For a discussion of trade creditors and the difficulties they face, see A. Keay, “A Theoretical Analysis of the Director’s Duty to Consider Creditor Interests : The Progressive School’s Approach” forthcoming in *Journal of Corporate Law Studies*, (2004) Vol 4, Issue 2 (October 2004).

¹⁹³ Richard A. Posner, “The Rights of Affiliated Corporations” (1976) 43 *University of Chicago Law Review* 499 at 505.

¹⁹⁴ Mark Byrne, “An Economic Analysis of Directors’ Duties in Favour of Creditors” (1994) 4 *Australian Journal of Corporate Law* 275 at 281.

¹⁹⁵ Cmnd 858, HMSO, (1982).

¹⁹⁶ *Ibid* at para 191.

¹⁹⁷ For instance, David Sugarman, “Is company law founded on contract or public regulation? The Law Commission’s paper on company directors” (1999) 20 *Co Law* 162 at 178.

¹⁹⁸ Above n134 at 548.

creditors,¹⁹⁹ has been viewed with great suspicion and has affected confidence in the marketplace and amongst the public in general. Section 214, along with other rules, reduces the impact of the shift of the risk of failure.

Arguably, s.214 is one of those parts of company law to which Cheffins' comment in the previous paragraph refers. It is one of the elements of company law that indicates that, "private law as well as public law has an important standard-setting role."²⁰⁰ Robert Walker J stated in *Re Oasis Merchandising Services Ltd*²⁰¹ that an action under s.214 was not simply ordinary civil litigation, for it has a potential public aspect to it.²⁰² More specifically, one can, as the law does, link s.214 with director disqualification. If there is a declaration under s.214, the courts may disqualify the respondent director(s) pursuant to s.10 of the Company Directors' Disqualification Act 1986; disqualification is a consequence of conduct amounting to a breach of commercial morality.²⁰³ Section 214 obviously can be regarded as potentially performing a public function, and a private person, the liquidator, indirectly carries it out.²⁰⁴

An option that is available to Parliament and which signals to the community that the prohibition of wrongful trading is in the public interest, is to grant the Secretary of State for Trade and Industry the power to bring s.214 proceedings in certain cases. This is an approach that has been implemented in Australia in relation to its insolvent trading legislation,²⁰⁵ and has been regarded as relatively successful.²⁰⁶

E. Distributional Fairness

Some may argue, particularly those who are part of the progressive school, that there must be distributional fairness, namely ensuring that the end effect of wealth distribution is fair. It might be argued that it would only be fair that the directors do not directly or indirectly transfer wealth from creditors to shareholders, either by the shifting of funds or causing an increase in risk when the company is heading for insolvent liquidation, so as not to lessen the amount paid to creditors from company funds. To make sure that this does not occur, the law can threaten to impose some form of *ex post* liability on directors so as to redress unfairness. What do we mean by fairness in this context? I have discussed elsewhere²⁰⁷ that in the context of company-creditor transactions, fairness requires an outcome that would be obtained where there is a bargain between unrelated parties with approximately equal bargaining power,²⁰⁸ namely where

¹⁹⁹ R.A. Posner, *Economic Analysis of Law*, (4th ed., 1992) at 394.

²⁰⁰ Above n144 at 181.

²⁰¹ [1995] BCC 911.

²⁰² Ibid at 918.

²⁰³ See *Re Dawson Print Group Ltd* (1987) 3 BCC 322 at 326.

²⁰⁴ For a discussion of the use of private enforcement of public law like provisions, see above n6.

²⁰⁵ The Australian regulator of companies, the Australian Securities and Investments Commission is entitled to bring insolvent trading proceedings against directors.

²⁰⁶ For example, see two papers by B. Collier, "ASIC and Insolvency – Current Activities and Future Directions in Enforcement and Policy" a paper delivered to the Insolvency Practitioners' Association of Australia Conference, 28 May 2003 and available at: [http://www.asic.gov.au/asic/pdf/lib.nsf/LookupByFileName/IPAA_280503.pdf/\\$file/IPAA_280503.pdf](http://www.asic.gov.au/asic/pdf/lib.nsf/LookupByFileName/IPAA_280503.pdf/$file/IPAA_280503.pdf) and "The View From ASIC : A Perspective on Current Activities and Enforcement Powers" a paper delivered to the Practical Insolvency and Practice Management Conference, 15 March 2004 and available at : [http://www.asic.gov.au/asic/pdf/lib.nsf/LookupByFileName/PIPM_speech_140304.pdf/\\$file/PIPM_speech_140304.pdf](http://www.asic.gov.au/asic/pdf/lib.nsf/LookupByFileName/PIPM_speech_140304.pdf/$file/PIPM_speech_140304.pdf)

²⁰⁷ See, "A Theoretical Analysis of the Director's Duty to Consider Creditor Interests : The Progressive School's Approach" forthcoming in *Journal of Corporate Law Studies*, (2004) Vol 4, Issue 2 (October 2004).

²⁰⁸ See, Alison Grey Anderson, "Conflicts of Interest : Efficiency, Fairness and Corporate Structure" (1978) 25 UCLA L Rev 738, 746.

there is fair dealing and a fair price.²⁰⁹ Such a view is consistent with the general idea that fairness, throughout our legal system, involves balance and proportionality as far as the parties to transactions or proceedings are concerned,²¹⁰ and provides support for those who are vulnerable and the meeting of people's reasonable and legitimate expectations. We have already considered the fact that creditors are often the victims of an abuse of bargaining power. The idea of reasonable and legitimate expectations has its roots in contract law²¹¹ and in this context it requires consideration of what the parties would have wanted where there are gaps in a contractual relationship,²¹² namely : what the parties actually anticipated the contract would require in the situation that has in fact occurred.²¹³ Such a consideration allows taking into account such matters as the nature of the company's business and its future, and the kind and position of the creditor providing credit. Some, especially those from the progressive school, would, in assessing reasonable and legitimate expectations, submit that this assessment should include taking into account community values, such as fairness and decency.²¹⁴

As discussed elsewhere,²¹⁵ it might be said that it is reasonable and legitimate for creditors to expect certain things of directors, such as ensuring that the entering into of fresh company liabilities is minimised, when there is no reasonable prospect of insolvent liquidation being avoided. If these expectations are not met then creditors can reasonably expect that directors would be held responsible, and make some contribution to the loss sustained by creditors.

F. Deterrent and Positive Effect

The existence of a wrongful trading regulation might well have both a deterrent and positive effect on the directors in various ways. First, the deterrent effect. Most obviously, the existence of a prohibition against wrongful trading might cause directors to be more prudent when there are financial problems for the company as they must consider that at some later time, if their company enters insolvent liquidation, they might be held to have been in a position where they ought to have concluded that their company could not avoid insolvent liquidation. Directors might be dissuaded from embracing risky courses of action in an attempt to turnaround their companies. Mokal argues that the provision could have a broader deterrent effect, namely that as the provision applies throughout the life of a company and the provision is designed "to encourage managers do all they reasonably ought to, to minimise that loss [to creditors] in the first place,"²¹⁶ it can apply to healthy companies as well.²¹⁷ Second, it might deter directors from passively acquiescing to risky actions proposed by other directors, particularly the executives. While it is probably safe to say that there are a substantial number of directors who are not aware of the wrongful trading prohibition, just like many directors are not aware of the

²⁰⁹ Lawrence Mitchell, "Fairness and Trust in Corporate Law" (1993) 43 *Duke L J* 425, 446.

²¹⁰ See, *ibid* at 425.

²¹¹ Nien-He Hsieh, "Moral Desert, Fairness and Legitimate expectations in the Market" (2000) 8 *Journal of Political Philosophy* 91 at 103. In *R v IRC* ([1990] 1 WLR 1545 at 1569) Bingham LJ said that "The doctrine of legitimate expectations is rooted in fairness."

²¹² William Bratton, "The Interpretation of Contracts Governing Corporate Debt Relationships" (1984) 5 *Cardozo Law Review* 371 at 381-382.

²¹³ Lawrence Mitchell, "The Fairness Rights of Bondholders" (1990) 65 *New York University Law Review* 1165 at 1225.

²¹⁴ Catherine Mitchell, "Leading a Life of its Own? The Roles of Reasonable Expectation in Contract Law" (2003) 23 *OJLS* 639 at 642.

²¹⁵ See, A. Keay, "A Theoretical Analysis of the Director's Duty to Consider Creditor Interests : The Progressive School's Approach" forthcoming in *Journal of Corporate Law Studies*, (2004) Vol 4, Issue 2 (October 2004).

²¹⁶ Above n23 at 363.

²¹⁷ *Ibid* at 368.

duties that they owe to their companies,²¹⁸ this does not mean that the provision cannot act as a deterrent to those who are aware of it.

While there is significant doubt that the present wrongful trading provision has succeeded in deterring irresponsible trading,²¹⁹ a provision like s.214 which can attach substantial civil liability to a director, is capable of having a strong deterrent effect.²²⁰

As far as the positive effect goes, there are two points worth noting. First, directors, in light of the wrongful trading provision, might be more diligent in their monitoring of the activities of executive directors, as well as the health of the company. Second, it might be argued that the wrongful trading provision acts in such a way as to encourage directors to carry out their activities competently because if they do not, and the company enters insolvent liquidation, there is always the possibility that a liquidator will bring wrongful trading proceedings against them.²²¹ Of course, other proceedings, such as for breach of the duty of care and skill, could also be initiated.

G. Achieving a Balance

While the privilege of limited liability is well-known and clearly enshrined in our law, there are occasions when this must in some way be the subject of interference. The law has to achieve a balance between the protection of bona fide creditors, on the one hand, and ensuring that directors (on behalf of their companies) are not totally discouraged from taking appropriate business risks, on the other hand.²²²

Judge Richard Posner asserts that specific doctrines of corporate law should not alter the balance of advantage between debtor and creditor,²²³ yet, arguably, limited liability has altered the balance and, consequently, in some cases there is the need for a counterweight. Limited liability is still, in some ways, a privilege, notwithstanding the demise of the concession theory,²²⁴ and it must not be forgotten that it can work to the disadvantage of creditors.²²⁵ It is, along with separate legal personality, “easily manipulated and often is.”²²⁶ As Cooke J of the New Zealand Court of Appeal stated in *Nicholson v Permakraft (NZ) Ltd*²²⁷:

“It [limited liability] is a privilege healthy as tending to the expansion of opportunities and commerce, but it is open to abuse. Irresponsible structural engineering – involving the creating, dissolving and transforming of incorporated companies to the prejudice of creditors – is a mischief to which the courts should be alive.”²²⁸

²¹⁸ R. Tomasic and S. Bottomley, “Corporate Governance and the Impact of Legal Obligations on Decision Making in Corporate Australia” (1991) 1 *Australian Journal of Corporate Law* 55 at 83.

²¹⁹ For instance, see Schulte. But see Mokal’s comment : above n23 at 362.

²²⁰ Above n6 at 41.

²²¹ Above n20 at 20

²²² Steven Schwarcz in “Rethinking a Corporation’s Obligations to Creditors” (1996) 17 *Cardozo Law Review* 647 at 673

²²³ ‘The Rights of Affiliated Corporations’ (1976) 43 *University of Chicago Law Review* 499 at 505. The remit of the Company Law Review Steering Group when it was established in 1998, was to identify ways in which creation of wealth could occur but at the same as protecting the interests of, such as creditors : *Company Law for a Competitive Economy*, Chapter 5.

²²⁴ Some still hold to the theory, but clearly the vast number of scholars do not accept it.

²²⁵ See Sarah Worthington, “Shares and shareholders : property, power and entitlement” (2001) 22 *Co Law* 258 at 263 (Part 1).

²²⁶ H. J. Glasbeek, “More Direct Director Responsibility : Much Ado About...What?” [1985] *Canadian Business Law Journal* 416 at 422

²²⁷ (1985) 3 *ACLC* 453.

²²⁸ *Ibid* at 459.

The Cork Committee articulated similar thoughts,²²⁹ when proposing a wrongful trading provision (although its recommendation was subjected to significant change by the government of the day), stating that downright irresponsibility is discouraged and those able to avail themselves of protection under the limited liability concept, should be made personally liable when they abuse the concept.²³⁰

Few people are arguing for the abolition of limited liability, but placing a responsibility on directors in times of a company's financial strife, would, at least, provide more of a balance between relevant interests.

V Opting out

In recent years there has been some reasonably hot debate in corporate law circles as to whether companies should be regulated by mandatory laws, or whether laws should be default laws²³¹ permitting companies and others to modify, or opt out of the application of, those laws.²³² This debate centres around the issue of contractual freedom, with many contractarians calling for fewer, and some no, mandatory rules.²³³ Compared with many corporate law statutes in the United States, such as the one applying in the state of Delaware, there is little provision in UK law for opting out.²³⁴ The argument is often put that imposing mandatory laws increase transaction costs, and hence there is a diminution of efficiency, whereas default rules can "operate to reduce the transaction costs which would otherwise be incurred in continually negotiating new contracts."²³⁵ Others argue that a mix of mandatory and optional rules provides for better commercial environment.²³⁶

Can s.214 be seen as a default rule from which parties can opt out? It would appear that as it stands at the moment, it is not also possible to opt out of s.214. First, s.310 of the Companies Act makes void any provision in a contract exempting an officer from liability in respect, inter alia, of a breach of duty. It would seem that wrongful trading is a form of breach of duty by a director. Second, s.214 is a provision²³⁷ that gives a power to the liquidator in his or her capacity as liquidator, and not a power to creditors to take action, so creditors cannot agree to

²²⁹ As did Henry LJ in *Re Grayan Building Services Ltd (in liq)* [1995] Ch 241 at 255.

²³⁰ Para 1805.

²³¹ Sometimes referred as "enabling rules" (Ramsay, above n13 at 221; I. Ayres and R. Gertner, "Filling Gaps in Incomplete Contracts : An Economic Theory of Default Rules" (1989) 99 *Yale L J* 87 at 91) or "gap-filling" (Ayres and Gertner, *ibid*).

²³² See the discussion in Ramsay, above n14; J. Coffee, "The Mandatory/Enabling Balance in Corporate Law : An Essay on the Judicial role" (1989) 89 *Columbia Law Review* 1618 and "No Exit? : Opting Out, the Contractual Theory of the Corporation and the Special Case of Remedies" (1988) 53 *Brooklyn Law Review* 919; L. Bebchuk, ("The Debate on Contractual Freedom in Corporate Law" (1989) 89 *Harv L R* 1395; J. Gordon, "The Mandatory structure of Corporate Law" (1989) 89 *Columbia Law Review* 1549.

²³³ Although some contractarians such as Professor Lucian Bebchuk ("The Debate on Contractual Freedom in Corporate Law" (1989) 89 *Harv L R* 1395) and Dr Michael Whincop ("Taking the Corporate Contract More Seriously : The Economic Cases Against, and a Transaction Cost Rationale for, the Insolvent Trading Provisions" (1996) 5 *Griffith Law Review* 1) have supported the existence of a number of mandatory rules.

²³⁴ Unlike American companies, which can move to another State, if they do not like the company laws in their original home, and yet stay in the same country, British companies cannot.

²³⁵ Above n16 at 221.

²³⁶ Gordon above n179 at 1554.

²³⁷ A provision that is not trivial, given the definition of B. Black, "Is Corporate Law Trivial? : A Political and Economic Analysis" (1990) 84 *Northwestern University Law Review* 542. See the recent decision in *Exeter City AFC Ltd v Football Conference Ltd* ([2004] BCC 498) where it was held that the right of a member to petition pursuant to s.459 of the Companies Act 1985 could not be removed by contract.

have the provision made inapplicable. Courts are probably more likely to uphold an opt out arrangement when it relates to a common law rule, rather than one found in a statute.²³⁸ So accepting the fact that opting out of s.214 is not possible, we can ask the normative question of whether opting out should be permitted?

If opt out were allowed, then creditors might expect some benefit in a contract with the company for giving up any rights under wrongful trading, and if this occurred then the company would lose out from the transaction. The potential beneficiaries would be the directors at the expense of the company. The only benefit for companies might be that their directors will be less risk averse when their company is in some financial difficulty, in that if the directors see a potentially lucrative, but risky, project they might be inclined to pursue it, knowing that they cannot be held liable for wrongful trading.

The practical problem that arises from an opt out provision is that if directors, in the course of negotiations with creditors, seek to favour opt out, it might be seen as a signal to the creditors to be wary, and to consider whether the directors have a hidden agenda. Creditors might not be willing to trust directors. However, if the creditors were to be granted some benefit in exchange for permitting opt out, then they might see it as worthwhile.

Perhaps the biggest hurdle for any opting out is the fact that the unanimous consent of all unsecured creditors would have to be obtained, because all are entitled to share in the proceeds from a wrongful trading action initiated by a liquidator. The transaction costs of obtaining such consent would be high,²³⁹ even if it was practically possible. Whincop identifies two major problems. First, if unanimous consent is required, and the creditors know this, there is the possibility of individual creditors refusing to consent in order to secure some sort of benefit. Second, it would not be easy to identify all of the creditors who need to agree to an opt out.²⁴⁰ As contracts are made a company could agree with each creditor for an opt out, but the company might not be aware of some creditors, such as tort creditors, who, not being consensual creditors, have no opportunity to negotiate with the company. A third problem is that the larger the number of creditors, the more difficult it is to come to an arrangement.

The only possible way that one could have an opt out regime is if creditors were able to bring proceedings personally and at present they cannot do so. Naturally, if creditors could do so, they could then decide to surrender their right to litigate. For creditors to be given the right to bring proceedings, in the first place, one has to deal with the argument that that would be tantamount to queue jumping and would offend against the principle of *pari passu*. Of course, there is always the argument that *pari passu* has little bearing on the outcome of liquidated estates today.²⁴¹ Another point is that s.214, according to Mokal, serves the collectivisation goal of insolvency, and permitting opt out would inhibit that. Also, s.214 would have to be amended so that courts are not empowered to order that directors make a contribution to the assets of the company, but are required to pay compensation to the creditor taking proceedings. One assumes that this would consist of the debt owed and any interest accrued. There are a number of points that favour creditor action over action taken on behalf of all creditors leading to equal sharing. First, not all creditors are equal. There are creditors like banks and other institutional creditors who are able to take adequate protective measures. Some creditors are able to build into the price for extending credit the possibility of loss. Second, not all creditors warrant protection from a wrongful trading provision. Some creditors have extended credit when they were fully aware that the company had a good chance of ending up in liquidation.²⁴² Should they be entitled to compensation? However, the problem with discriminating between

²³⁸ Coffee, “The Mandatory/Enabling Balance” above n179 at 1631.

²³⁹ Above n93 at 66.

²⁴⁰ Ibid.

²⁴¹ See R. Mokal, “Priority as Pathology: The *Pari Passu* Myth’ [2001] CLJ 581

²⁴² The Cork Report adverted to this : para 1797.

creditors is that it is likely to increase costs. One of the primary advantages of collective action is that it “reduces strategic, increases the pool of available assets and generates administrative efficiencies.”²⁴³

It might be argued that there should be no opt out as that would attenuate the public function of s.214. That is, if wrongful trading is seen as a trigger for the disqualification of directors, then it should not be possible for the creditors, acting in self-interest, to permit the directors to “escape” the provision. A way around this problem, and mentioned earlier, might be to grant the Secretary of State for Trade and Industry the power to bring s.214 proceedings in certain cases. But if that were implemented directors might be rather hesitant about entering into an opt out arrangement, on the basis that while it might reduce the chance of litigation, it would not rule it out totally. Furthermore, if any monetary award were made as a result of an application brought by the Secretary of State, to whom would the money be paid, after the payment of liquidation expenses, given the fact that the creditors opted out of wrongful trading?

VI Conclusion

This paper has explored the theoretical arguments that have been mounted against the imposition of any wrongful trading type liability on directors as well as considering the counter-arguments, and the points that might support such a liability. The arguments against wrongful trading can be summarised as follows : wrongful trading is unfair to directors, produces inefficiencies and potentially over-compensates creditors who could ably protect themselves without the need for regulation. Set against these are the arguments for the regulation which essentially involve producing a fair balance between the interests and rights of directors on the one hand and creditors, on the other, deterring irresponsible trading when companies are in financial straits and protecting creditors in certain circumstances. It has been submitted in this paper that while there are some aspects of the arguments that are opposed to wrongful trading have merit, overall they are not as compelling as those that support the continued existence of such a provision.

The paper considered whether the wrongful trading provision could be the subject of an opt out arrangement and concluded that it could not be. It was indicated that it would be difficult to permit opt out in relation to this provision as the right to take legal proceedings is given to the liquidator and not the creditors. If creditors were granted the right to bring proceedings for wrongful trading then opt out is a possibility, although fraught with practical problems.

To be sure, arguments in favour of a proscription against wrongful trading should not be seen to be an argument in support of s.214 as it is drafted at the moment. The present provision is sadly lacking. If there is to be a prohibition against wrongful trading, then the shortcomings that exist with s.214 must be remedied. Certainly, if we are to have a provision, then it must be as clear as possible so that directors know their responsibilities and liquidators can know when such proceedings might be worth bringing, given the fact that liquidators are risk-averse. Section 214 as it presently stands does not, arguably, “fill the bill.” Clearly, if there is to be regulation, then it must be good regulation. At the moment the provision is frustrating, and Parliament needs to re-visit the way that the provision is drafted. At present the provision is difficult to defend, but, as considered in this paper, the concept has merit.

²⁴³ J. Dabner, “Trading Whilst Insolvent – A Case for Individual Creditor Rights Against Directors” (1994) 17 *University of New South Wales Law Journal* 546 at 569 and referring to T. Jackson, “Bankruptcy, Non-Bankruptcy Entitlements and Creditors’ Bargain” (1982) 91 *Yale L J* 857 at 860-868.

Liquidations in Light of the Enterprise Act Reforms

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I INTRODUCTION

Liquidation for companies has been with us for a long time, and ever since the Winding up Act of 1844,²⁴⁴ a statute entitled “An Act for facilitating the winding up the affairs of Joint Stock Companies unable to meet their pecuniary engagements” was passed. The statute was intended to provide creditors with a simple means of obtaining payment of their debts out of company property, and also, by substituting an orderly system under which all members would be required to contribute a proportionate part of the funds necessary to satisfy the liabilities of the company, to reduce the chaos resulting from executions against individual members.²⁴⁵ Subsequently, the concept of limited liability was introduced²⁴⁶ and this meant that shareholders would not be liable for company debts, only being required to pay up what they owed on their shares. Liquidation, which provides a collective procedure, has always been a procedure that prepares companies for their dissolution. Hence, it is always, rightly, associated with killing off companies.

But in recent times there has been concern that companies have been killed off through liquidation too readily. In the Insolvency Act 1986 the Government, following the recommendations of the Cork Report, showed a desire to promote corporate rescue, which is “a major intervention necessary to avert the eventual failure of the company”²⁴⁷ or “the revival of companies on the brink of economic collapse and the salvage of economically viable units to restore production capacity, employment and the continued rewarding of capital and investment.”²⁴⁸ The Insolvency Act 1986 introduced the regimes of administration and company voluntary arrangement to enable companies to escape from their financial malaise. As we know these regimes did not work all that well for a number of reasons, and they have not been popular. Although, of course some might say that administrations in particular have worked well for some football clubs. Of course, rescue did not have to involve the use of one or both of these regimes, and many companies entered into informal arrangements with their creditors that led to their ultimate survival. The overlap of the various procedures was common as companies often exited administrations through liquidation, and administrations were used to provide a breathing space for companies whilst a proposal for a company voluntary arrangement (“CVA”) was being put to creditors (this may have occurred less often with small companies after the moratorium procedure was introduced on 1 January 2003 via the Insolvency Act 2000)

So while we had some rescue going on, the Government was not happy with the amount that was going on. To cut a long story short, the Government included in its Enterprise Act of 2002

²⁴⁴ 7 & 8 Vict. c. 111.

²⁴⁵ Andrew Keay, *McPherson’s Law of Company Liquidation* (London, Sweet and Maxwell, 2001) at 17.

²⁴⁶ Limited Liability Act 1855.

²⁴⁷ A. Belcher, *Corporate Rescue*, (London, Sweet and Maxwell, 1997), at 8.

²⁴⁸ P.Omar, “Thoughts on the Purpose of Corporate Rescue” [1997] 4 JIBL 127.

provisions which made it easier for companies to enter administration, with the hope that this would lead to more companies being rescued when in a financial mire. I will not rehearse most of what the Enterprise Act did in relation to corporate insolvency as I will assume that you are reasonably conversant with it. What I do wish to consider is how, if at all the provisions in the Enterprise Act (“the Act”) have changed the landscape of corporate insolvency as far as liquidation is concerned. The Government did hope for an increase in the number of administrations and a proportionate reduction in the number of liquidations. The figures for the first two quarters of 2004 indicate that the number of administrations has increased and the number of liquidations has decreased overall. In the first quarter there were 331 administrations, with 392 administrations in the second quarter,²⁴⁹ which, if those figures continue, will produce close to double the number of administrations that have been entered into in the best of the previous years. The number of creditors’ voluntary liquidations for this quarter is the lowest since the second quarter of 1998.²⁵⁰ There was a slight increase in creditors’ voluntary liquidations in the second quarter (1.1%), but this represented a 17% reduction for the same period in 2003 (i.e. prior to the coming into operation of the Enterprise Act provisions). Without further data we cannot draw too many conclusions from this, particularly given the fact that the number of compulsory liquidations was down. Also, some of those companies that entered into administration during the first quarter of 2004 would have still been subject to that regime when the figures were documented, but undoubtedly some will end up eventually in a creditors’ voluntary liquidation. I have heard it suggested by experienced legal practitioners, without having time to elaborate on the point, that the Act will lead to the function of liquidation being usurped by administrations, with the result that liquidation might be used infrequently or die out. Is that the case? Is liquidation going to die out? This paper explores that issue. In doing so, it draws some comparisons with the experience in Australia of an administration regime that has been popular and been working for some 11 years.

II THE ENTERPRISE ACT AND ADMINISTRATION

We know from the Act that the Government sees administration as the way to foster corporate rescue. To facilitate the increased use of administration as an insolvency regime, the Act permits the appointment of administrators extra-judicially as well as by court order. The company, its directors and its creditors may still petition for an administration order (Schedule B1, para 12(1)²⁵¹). But, it is now possible for a company or its directors to appoint an administrator without the need to apply for a court order (para 22). Importantly the holder of a qualifying floating charge is also permitted to appoint outside of court (para 14). A qualifying charge for these purposes involves a floating charge which either on its own or together with other securities relates to the whole, or substantially, the whole of the company’s undertaking. In addition, the instrument creating the charge must either:

- state that para 14 applies to the floating charge or otherwise purports to give the debenture holder the power to appoint an administrator; or
- purports to give the debenture holder the power to appoint an administrative receiver (para 14(3)).

Requiring a court order for administration was probably the main reason why administration never really became popular. The procedure was costly and time-consuming. Australia has permitted administration to be initiated out of court ever since administration was introduced as

²⁴⁹ See < <http://www.dtistats.net/sd/insolv/table3.htm> >

²⁵⁰ See < <http://www.dtistats.net/sd/insolv/table1.htm> >

²⁵¹ All references to paragraphs in this paper are to paragraphs in Schedule B1 of the Insolvency Act 1986 unless the contrary is indicated.

an insolvency regime in 1993. The Harmer Committee,²⁵² the Australian equivalent of the Cork Committee, reported in 1988 and recommended the introduction of a regime akin to administration.²⁵³ But rather than following the UK system, it was decided to have no court involvement in the appointment process; courts were only to be involved where there were disputes or administrators needed to obtain directions. The procedure started well in Australia and became and remains very popular, such that the number of administrations outstrips court liquidations and creditors' voluntary liquidations,²⁵⁴ and in fact many of the creditors' voluntary liquidations in Australia result from administrations where no rescue is possible, and the administrations were converted into creditors' voluntary liquidations. The administration process has recently been scrutinised by the Australian Parliament's Joint Committee on Corporations and Financial Services, in a report on the country's corporate insolvency laws, the Committee's conclusion is that the administration process is useful and valuable process for companies that are facing collapse,²⁵⁵ and should be retained as a central feature of Australian corporate insolvency law.²⁵⁶

So, given the experience in Australia, which has a similar commercial environment to the UK, as well as reasonably similar corporate and insolvency processes and ethos, it is likely that administration will, eventually, become popular, especially if the banks can be convinced of the benefits of the procedure. In Australia the support of the banks was critical. It is interesting to note that the support of the banks was obtained despite the fact that the use of administrative receivership was not, unlike in the UK, proscribed after the new legislation became operative. Receivers are still appointed in Australia, but their employment is much reduced compared with 11 years ago. The banks are often content to permit the appointment of an administrator by the company, provided that a practitioner to their liking has been appointed, and they refrain from trumping the appointment.

Assuming that administration will "take off" in the new insolvency dispensation in which we now live, we need to consider what effects it will bring, and, for the purposes of this paper, we consider the effects in relation to liquidation.

III SOLVENT COMPANIES

Before moving on to consideration of the main focus of the paper – insolvent companies – I would like to say a few words about solvent companies, which are, of course, able to be placed into liquidation prior to their dissolution.

It seems to me that where companies are solvent there will be no change as we will continue to see liquidation (members' voluntary liquidations) employed. If a company is not insolvent or likely to become insolvent, the administration process cannot be embraced, because it is necessary before an administration order is given, according to paragraph 11 of Schedule B1 of the Insolvency Act, that the petitioner seeking an order establishes that the company is insolvent or likely to become so, as well as satisfying the court that the order is likely to achieve the purpose of administration. If the company or its directors appoint an administrator extra-judicially, then a declaration must be filed at court, with the notice of intention to appoint an administrator, that states that the company is, or likely, to become insolvent (para 27(2)).

²⁵² Australian Law Reform Commission, *General Insolvency Inquiry*, Report No 45, Canberra, 1988.

²⁵³ Known as "voluntary administration." The regime is provided now by Part 5.3A of the Corporations Act 2001. It was originally introduced by the Corporate Law Reform Act 1992.

²⁵⁴ In 2003 there were 2,235 compulsory windings up, 1,268 creditors' voluntary liquidations, and 2,699 administrations (<http://www.aph.gov.au/senate/committee/corporations_ctte/ail/report/ail.pdf> at p 73).

²⁵⁵ *Corporate Insolvency Laws : A Stocktake* (30 June 2004) and accessible at <http://www.aph.gov.au/senate/committee/corporations_ctte/ail/report/ail.pdf> at para 5.3.

²⁵⁶ Ibid at para 5.41.

The only case where administration can be initiated without it being asserted that the company is insolvent or likely to become so is where the holder of a qualifying floating charge appoints an administrator.

So, except in this last case, the situation in England and Wales is unlike the situation in the United States where the Bankruptcy Reform Act 1978 allows companies to shelter in Chapter 11 bankruptcy (a form of insolvency regime that has some similarities to administration (and many differences) and is the primary vehicle in the US for the rescue of companies) even when they are not insolvent. US companies have, on occasions, used the Chapter 11 process where they are not insolvent in order to achieve a number of goals, such as to protect the company from substantive litigation or to avoid the impact of labour agreements.

Also, a company that is solvent might still be wound up by court order, where a petitioner succeeds in establishing that it is just and equitable, under s.122(1)(g) of the Insolvency Act,²⁵⁷ that the company be wound up.²⁵⁸

One would not expect to see any changes to the situation as far as solvent companies are concerned as the Act was directed at insolvent companies, the types of companies that concerns us today, and it is to those companies that we now turn.

IV INSOLVENT COMPANIES

It is when we come to insolvent companies that the effect of the Act's provisions on liquidation are more important.

A Compulsory Liquidations

1. Miscellaneous Petitioners

Clearly, there will be some of those who are entitled to petition for the winding up of a company who will continue to seek liquidations, whatever the advantages of administration, as they are unable to seek an administration, even by order. The prime example is the Secretary of State for Trade and Industry who has the power to present what is known as a public interest petition under s.124A.²⁵⁹ Where there is a public interest concern over the activities of a company, only a liquidation can occur; administration is not an option. Proceedings under s.124A are brought to bring to light the activities of companies which are having, or potentially have, a prejudicial affect on the public. Insolvency, while not infrequently alleged in public interest petitions, is not a prerequisite to the initiation of proceedings; there will be occasions where it is in the public interest that a solvent, even profitable, company be wound up.²⁶⁰ For the sake of completeness, we should note that petitions for the winding up of companies on the public interest ground can be presented when a company is in administration (para 82(1)).

2. Creditors

Most winding-up petitions are presented by creditors. While creditors, who are not the holders of qualifying charges, are not permitted, under the changes brought about by the Act, to appoint administrators, they are allowed, as they have been since the advent of the Insolvency Act

²⁵⁷ References to sections in this paper are to sections in the Insolvency Act 1986 unless the contrary is indicated.

²⁵⁸ For a discussion of this ground for winding up, see Andrew Keay, *McPherson's Law of Company Liquidation* (London, Sweet and Maxwell, 2001) at 190-207.

²⁵⁹ See, Andrew Keay, "Public Interest Petitions" (1999) 20 *Company Lawyer* 296; Vanessa Finch, "Public interest liquidation : PIL or Placebo?" [2002] *Insolvency Lawyer* 157.

²⁶⁰ *Re a Company No. 007923 of 1994* [1995] BCC 634 at 637.

1986, to petition for an administration order. The need to obtain a court order has always been seen as an obstacle to the employment of administrations, but creditors would have to go through a similar procedure for a winding-up order any way, so creditors might not be discouraged from seeking an administration order, because issues such as cost and time also apply to the winding-up process.

Creditors have always been entitled to apply for an administration order (the old s.9), yet they rarely did so. Why is this the case? Probably for a number of reasons. The most likely primary reason is the likely cost of preparing a Rule 2.2 report and engaging lawyers to make the application. Furthermore, the received wisdom has been that, if the company is defaulting the strong option to take is to petition for winding up. Obtaining an administration order may be seen as easier than getting a winding-up order in some respects as the courts recognise that liquidation is the beginning of the end of the company, and might be stricter in terms of proof. Yet, having said that, to obtain an administration order it is still necessary for a petitioner to prove that he or she is a creditor of the company, which is often a problem that creditors in winding-up proceedings have encountered. This is because companies may either dispute the debt which founds the winding-up petition, or argue that they have a cross-claim or set-off in relation to the debt.²⁶¹ A company might take the same approach where a creditor presents a petition seeking an administration order.²⁶² If the company were successful in this regard then the petitioner would not have the necessary *locus standi* to prosecute the petition for an administration order.²⁶³

A second problem that can exist equally with petitions for administration orders and winding-up orders is establishing that the company is unable to pay its debts. However, with petitions for administration orders, it is acceptable if the court is satisfied that the company is likely to become unable to pay its debts (para 11). But, even if it is in fact easier to enter into administration compared with liquidation, that fact will not, on its own, foster more administrations at the expense of court liquidations. Are there other benefits for creditors? There may be. First, an administration would probably, in many cases, allow for a more orderly and profitable disposition of the company's assets and, possibly, its business, in that prospective buyers will not see the disposition as a fire sale. More funds could be raised and that would increase creditors' dividends. Second, administration would probably allow more time for the completion of potentially beneficial contracts entered into by the company. Third, since the decision in *Buchler v Talbot*,²⁶⁴ a decision of the House of Lords when hearing an appeal in the Leyland Daf litigation, liquidation expenses are not able to be paid out of assets of the company that are subject to a floating charge. Yet, administration expenses could be paid out of assets subject to a charge (paras 70, 99(3)). So, it might be better for the unsecured creditors if the company entered administration rather than liquidation, as there might be more funds available for the unsecured creditors ultimately.²⁶⁵ Coupled with this the creditors may take comfort in the new onerous duties imposed upon the administrator to perform his or her functions as quickly and efficiently as is reasonably possible (paragraph 4); to exercise his or her powers in the interests of the creditors as a whole (paragraph 3(2)); and to perform his or her functions within the parameters of a controlling statute (paragraph 3(3) and 3(4) of Schedule B1).

²⁶¹ See, Andrew Keay, "Disputing Debts Relied On By Petitioning Creditors Seeking Winding Up Orders" (2001) 22 *Company Lawyer* 40.

²⁶² For example, see *Re Simoco Digital UK Ltd* [2004] EWHC 209 (Ch) where the company disputed the debt alleged to be owed by the petitioning creditor for an administration order.

²⁶³ See *Mann v Goldstein* [1968] 1 WLR 1091.

²⁶⁴ [2004] UKHL 9; [2004] 2 WLR 582.

²⁶⁵ Query whether floating chargeholders might be inclined to prefer to petition for liquidation.

This is unlikely as the floating charge holder would have the benefit of his or her security and ultimately the option to appoint his or her own choice of practitioner (para 36(1)). It is submitted that the financial imbalance would have to be quite stark for the qualifying chargeholder to adopt the mentality of seeking liquidation.

It is interesting to note in this context that in a recent decision, *Re Logitext.uk Ltd* (Unreported, 28 July 2004), a creditor did petition for an administration order, and successfully so, when perhaps one might have expected an application for a winding-up order. The petition was for administration rather than liquidation because if administration was ordered, funding was to be made available in order to recover assets for creditors.

Perhaps where a company cannot dispute a creditor's claim, and the creditor would prefer not to incur the costs of obtaining a winding-up order, the creditor might be able to persuade the directors to place the company into administration. The benefit for the directors could be that creditors might be less hostile and less aggressive in questioning the management of the company if they took this action. Certainly, the costs would be less and there would be less erosion of the funds available to be paid to creditors.

In sum, at the present moment, while there might be some advantages to unsecured creditors if administration rather than liquidation was used, it seems unlikely that many of the general body of creditors will petition for administration as opposed to liquidation. However, the creditors that have traditionally accounted for the majority of petitions have now lost their status as preferential creditors: the Inland Revenue and Customs and Excise. What remains to be seen is whether they are going to police the financial position of companies as rigorously as they have until now and petition more or less as a result of their new status as non-preferential creditors. The dangling carrot of sharing in the prescribed part may persuade these creditors to opt for administration where the objective in paragraph 3(1) is likely to be achieved and to refrain from doing so where it is not likely to be achieved. Are we going to witness the dawning of a new age of selective insolvency processes dependent upon the position of each company?

3. From Administration to Compulsory Liquidation

It should be noted that the old administration procedure did not provide an exit route via creditors' voluntary liquidation where an administration order was discharged by the court. But the new process does, so that might lead to a reduction of compulsory liquidations on that basis, although the courts always took some persuasion as to why compulsory liquidation was being chosen over the less expensive and more convenient voluntary liquidation.²⁶⁶ However, there will be cases where a company has been in administration and there are insufficient funds to pay a private liquidator and so the company will go into compulsory liquidation where the official receiver will wind up the company, at the taxpayer's expense.²⁶⁷

B. Creditors' Voluntary Liquidations

It is in relation to creditors' voluntary liquidations ("CVLs") that we could possibly see the greatest effect on liquidations. While, as indicated in the last section of the paper, the exit route for administration can now be by way of a CVL, and, in many cases, will be, and this will increase the number of CVLs, this increase might be offset by a reduction, for other reasons. It seems that there are several attractions for the directors of a company, when their company is insolvent, to embrace administration when they once would have had the company enter a CVL. Of course, even if directors do this, then, as indicated above, the company might end up

²⁶⁶ See G. Lightman & G. Moss, *The Law of Receivers and Administrators of Companies*, 3rd (Sweet and Maxwell, London) at para 23-084.

²⁶⁷ *Insolvency and the Enterprise Act 2002* edited by Stephen Davies QC (Bristol, Jordans, 2003) at 184.

in a CVL eventually, and, if the Australian experience is any guide, a good portion of CVLs in the future might arise following administrations.²⁶⁸

First, directors of a company that do not have a viable business might seek to enter administration as an alternative exit route to liquidation because it might constitute a way of reducing the chances of the company's creditors being able to consider the reasons for the demise of the company and questioning those who managed the company.²⁶⁹

Second, and following on from the previous point, investigations during the course of administration might not be as rigorous as they are in liquidations. While the Australian courts have indicated that they will not tolerate inadequate investigations by administrators,²⁷⁰ they will not expect an administrator to carry out as exhaustive investigations as a liquidator, because, *inter alia*, of the time constraints prevailing in an administration.²⁷¹ Will the approach be the same in our courts? The time constraints in the UK are not as demanding as they are in Australia, but having said that, how often will the scope of the investigations undertaken by administrators be the subject of judicial scrutiny? The answer probably is : not often.

In Australia the administrator is required to report to the regulator,²⁷² the Australian Securities and Investments Commission ("ASIC"), any incidents of misconduct with respect to any type of company. But the ASIC has received few reports from administrators,²⁷³ and this is somewhat of a concern. It fuels speculation that some directors are using administrations to avoid examination of their activities. This was suggested in research conducted by the ASIC, where it was found that the aim behind embracing administration in 20% of the companies studied was to achieve liquidation.²⁷⁴ In more recent times, this has continued to be of some concern in Australia, and the evidence given to the Australian Parliament's Joint Committee on Corporations and Financial Services suggests that the voluntary administration procedure is being used as a means to liquidate a company, and to enable directors to avoid subsequent investigations into their conduct.²⁷⁵

There is always the possibility that a practitioner accepts an appointment as an administrator founded on the belief that either the second objective of administration, namely that administration would achieve a better result for company creditors than is likely in liquidation, or the last resort option (property is realised to make a distribution to one or more secured or preferential creditors) is reasonably capable of being achieved. Assets or the business might be sold off to directors or connected parties, and because the proceeds are not sufficient for there to be a pay out to creditors, the administrator might refrain, as he or she is entitled to do so, from holding a creditors' meeting (para 52) (usually required within 10 weeks of the appointment (para 51)). Following this, the practitioner could take the company directly from

²⁶⁸ An Australian study found that in the State of New South Wales from 1993-1997, approximately 50% of all CVLs followed administrations ("A Study of Voluntary Administrations in New South Wales" (ASC Research Paper 98/01, Sydney, 1998).

²⁶⁹ A point also made by Ben Larkin and Alexandra Smith in "Pre-Packaged Business Sales Following the Introduction of the Enterprise Act 2002" (2004) 1 *International Corporate Rescue* 78 at 83.

²⁷⁰ *Re Bartlett Researched Securities Pty Ltd* (1994) 12 ACSR 707 at 710; *Deputy Commissioner of Taxation v Pddam Pty Ltd* (1996) 19 ACSR 498.

²⁷¹ See *Hagenvale Pty Ltd v Depela Pty Ltd* (1995) 17 ACSR 139 at 145.

²⁷² Corporations Act 2001, s.438D.

²⁷³ A Proctor, "Current Developments in the ASC's Enforcement Programs" (1996) 8 *Australian Insolvency Bulletin* 11 at 14. The ASC was the former name of the ASIC.

²⁷⁴ "A Study of Voluntary Administrations in New South Wales" (ASC Research Paper 98/01, Sydney, 1998).

²⁷⁵ See *Corporate Insolvency Laws : A Stocktake* (30 June 2004) and accessible at <http://www.aph.gov.au/senate/committee/corporations_ctte/ail/report/ail.pdf> at para 5.23-5.24.

administration to dissolution under paragraph 84,²⁷⁶ whereby the company is dissolved three months after the administrator has lodged, and had registered, a notice sent to the registrar of companies advising that there can be no distribution to creditors. This latter procedure, mirroring what can be done in relation to some liquidations,²⁷⁷ is designed to reduce costs and time, and, theoretically, is laudable.

Third, and allied to the previous points, the directors might be able to have more input during the administration process, when compared with liquidation. This might enable the directors to secure a transfer of the assets or business to themselves or connected parties, without, perhaps, the same scrutiny as in a liquidation. We must remember that the administrator has the power to remove a director (para 61) and a company officer is not entitled to exercise management power without the approval of the administrator (para 64), so the influence and involvement of directors in relation to the administration is not guaranteed. But in Australia, where the administrator has similar powers to restrict or thwart the influence of directors, the evidence given to the Australian Parliament's Joint Committee on Corporations and Financial Services in its report on the country's corporate insolvency laws indicates that some directors have been able to manipulate the procedure for their own advantage.²⁷⁸

Fourth, the directors can choose their own appointee and creditors cannot override it, unlike in a CVL, without getting a court order of removal under para 88. Applying for removal is time-consuming and costly, and far more difficult than just voting against a liquidator's nomination at a creditors' meeting. Of course, all of this does not apply to the holder of a qualifying charge, who is able to trump any appointment by a company or its directors, by either appointing its own administrator or, if permitted, an administrative receiver (paras 26 and 14).

Fifth, while administrators can employ the adjustment provisions in ss.238-245 of the Act, they cannot commence actions for wrongful trading under s.214. While it might be felt that the thought of wrongful trading may not fill most directors with terror these days, actions are still available and the change to the Insolvency Rules (Insolvency (Amendment) (No2) Rules 2002 (SI 2002/2712) that allows a liquidator to use company assets to fund such actions now might lead to more use of the action (r.4.218(1)(a)(i)). Also, a perusal of the case law demonstrates that where directors have clearly acted irresponsibly, buried their heads in the sand or worse, actions are successful.²⁷⁹ Having said that, it seems that there is always the possibility that an administrator could move a company from administration into a CVL, under paragraph 83, on the basis that there will be a distribution to unsecured creditors. But, it appears that to do this, an administrator must be able to say that there will definitely be a distribution, and not that there is likely to be one. The administrator could not, where there are no funds to be distributed, convert the administration into a liquidation on the ground that if liquidation occurs, he or she would be empowered to initiate a wrongful trading action that *might* produce some funds for distribution.

Sixth, if administration occurs, then there might always be a chance of rescue. Liquidators are able to apply for an administration order (para 38(1)) so as to facilitate a rescue, something that has always been possible, since the advent of the Insolvency Act 1986, but rarely invoked.

²⁷⁶ See Ben Larkin and Alexandra Smith in "Pre-Packaged Business Sales Following the Introduction of the Enterprise Act 2002" (2004) 1 *International Corporate Rescue* 78 at 84.

²⁷⁷ See Insolvency Act, ss.201-204.

²⁷⁸ <http://www.aph.gov.au/senate/committee/corporations_ctte/ail/report/ail.pdf> at para 5.20.

²⁷⁹ A point made by the judge in *Re Sherborne Associates Ltd* ([1995] BCC 40 at 56). For cases where there was clear wrongful trading, see, for instance, *Re DKG Contractors Ltd* [1990] BCC 903; *Re Purpoint Ltd* [1991] BCLC 491; [1991] BCC 121; *Re Brian D Pierson (Contractors) Ltd* [2001] 1 BCLC 275. Also, see the more recent case of *Rubin v Gunner* ([2004] 2 BCLC 110; [2004] EWHC 316 (Ch)) where the respondents were held liable.

Finally, if the company is placed into a CVL, one of the directors must attend and preside at the creditors' meeting that meets after the members have resolved to wind up the company (s.98(1)). This is often an unpleasant experience for the director concerned. If an administration is implemented a creditors' meeting might never be held, or at least it will be held some time after the commencement of administration. Further, it will be the administrator (or his or her nominee) who will preside at the meeting, not a director (r.2.36(1)).

Of course, creditors have rights along the way to do something to stop abuses of the administration process. First, creditors with 10% of the total debt of the company can requisition an initial meeting of creditors (under para 52(2)), as well as further meetings (para 56(1)). Second, creditors might apply to the court claiming that the administrator has either acted so as to unfairly harm their interests or proposes to act in a way that will have that effect (para 74(1)). Third, creditors can requisition a meeting if they have 10% of the total debt, and replace the administrator at a meeting (as can the holder of a qualifying charge who appointed the administrator (para 92),²⁸⁰ if there is no holder of a qualifying charge and the administrator was appointed by the company or the directors (para 97)). Fourth, where the administrator lodges a notice with the registrar of companies advising that there can be no distribution to creditors, and the company should be dissolved without the need for liquidation, dissolution does not occur for three months, creditors have to be informed that the administrator is seeking to dissolve without the need for liquidation and creditors have the opportunity of seeking, in relation to the three month period following the filing of the necessary notice with the registrar of companies, the extension, suspension or disapplying of the period (para 84(5)(b),(7)). But the chances are that creditors will only take action in a fraction of administrations. Most creditors have often determined at the point of liquidation or administration that either their money is lost or they will get a pitiful return at best. Further, creditors, for the most part, will not be actively monitoring the company as they have other things to do, and do not want "to throw good money after bad."

V. GENERAL

For some of the above reasons it might be worthwhile directors deciding to initiate administration if they feel that it is likely that a winding-up petition is to be presented against their company.²⁸¹ Also, such a strategy would mean that the official receiver has no duty to conduct an investigation, and no public examinations can be held, although an administrator could initiate a private examination under s.236.

A possible disadvantage, for the creditors, where administration rather than liquidation is embraced is that the administrator, unlike the liquidator, cannot disclaim company property. So an administrator could be saddled with onerous property that reduces what the creditors receive. In such a case it would always be possible for the administrator to recommend a conversion to a CVL.

Directors might now see administration more favourably as an escape route from possible wrongful trading. It appears that this might have been done in *Re Chancery plc*,²⁸² but because of the time and cost involved in obtaining an administration order, directors might have been discouraged in the past from seeking administration where they were concerned over wrongful trading. In favour of directors taking their companies into administration now is the fact that the administration process can be initiated more cheaply and quickly, and the administrator is still not, as we have considered earlier, able to bring wrongful trading proceedings against the

²⁸⁰ The company or the directors of the company may replace an administrator where the company or the directors appointed the administrator (para 93(1), 94(1)).

²⁸¹ If a winding-up petition has been presented, then the company could not appoint an administrator. A petition would have to be presented for an administration order (see para 25).

²⁸² [1991] BCC 171 at 172.

directors. By way of caution, we must note that there is nothing in the wrongful trading provision, s.214, which tells us what will excuse a director from liability,²⁸³ and so appointing an administrator will not necessarily save a director from liability if the company subsequently enters liquidation and wrongful trading proceedings are commenced by the liquidator.

VI. AN ASSESSMENT

Certainly there appears to be evidence from around the world where corporate rescue procedures with a similar (albeit not the same) approach have been introduced, that these procedures are being used in lieu of liquidation. The use of the process of administration to usurp the role of liquidation in some cases would be consistent with what occurs in the United States, where it seems that Chapter 11 bankruptcy is used frequently to liquidate companies.²⁸⁴ As indicated earlier, the number of administrations in Australia are on par with liquidations and some concern has been manifested that administration is being used as a way of effectively liquidating a company.²⁸⁵

The circumvention of liquidation might be of more concern if it was not for the fact that under the Act administrators are entitled to institute proceedings to have certain transactions, such as transactions at an undervalue²⁸⁶ and preferences²⁸⁷ adjusted. Administrators in Australia do not have the power to employ the Australian equivalent provisions,²⁸⁸ nor are these sorts of action available where a company is being administered under Chapter 11 in the United States.

It will be interesting to see what view the courts take in relation to the new provisions. In Australia, after 11 years of operation the judiciary is very warm to administration. There is no reason to suggest that English courts will take a different approach, although they might be wary about administration acting as a virtual substitute for liquidation. In *Re AMCD (Property Holdings) Ltd* (unreported, 15 June 2004), Lewison J refused to make an administration order on the petition of the directors (the directors could not appoint out of court in this case because there was a winding-up petition pending) because this was a last minute attempt at putting off liquidation and the administrator would essentially be doing what a liquidator could do. Yet, in *Re Logitext.uk Ltd* (unreported, 28 July 2004) Lindsay J made an administration order on the application of a creditor where a company did not appear to have a chance of rescue, but his Lordship did so because he was persuaded that administration might produce a better realisation for the creditors, compared with liquidation, as funding would be made available, if an administration order was made, in order to recover assets for creditors.

Notwithstanding the approach taken in *Re AMCD*, this will not, as indicated earlier, prevent the use of administration instead of CVLs as no order is needed unless a winding-up petition is pending (para 25(a)), and judges might not get the opportunity of considering whether a company should go into administration. Even if judges were to be presented with a petition for an administration order, it might be difficult for a judge to determine whether the aim is to use administration as a substitute for liquidation.

Is it necessarily a bad thing if administration is sought to be used as a substitute for liquidation? The answer is not clear. It is probably “yes” and “no.” The answer is “yes” if, ultimately, the

²⁸³ Concern has been exhibited over what can constitute “every step with a view to minimising the potential loss to the company’s creditors” within s.214(3).

²⁸⁴ Jay Westbrook, “The Control of Wealth in Bankruptcy” (2004) 82 *Texas Law Review* 795 at 800 (n 11).

²⁸⁵ Kim Arnold, “Australia’s Insolvency Inquiries” to be found on the website of the Insolvency Practitioners’ Association of Australia at:

<<http://www.ipaa.com.au/pdfs/INSOL%20March%20Article%20Kim%20Arnold.pdf>>

²⁸⁶ Section 238.

²⁸⁷ Section 239.

²⁸⁸ See Corporations Act 2001, Part 5.7B, Division 2.

creditors get a better deal with greater dividends and a quicker pay-out. The answer is “no” if administrations are used to circumvent some of the investigative processes that are usually undertaken in liquidation, and conduct that is inconsistent with commercial morality is being perpetrated, and not being uncovered.

VII. CONCLUSION

Remember the question that I posed at the outset - are we going to see the virtual death of liquidation, given the new provisions? Well, I would submit that the answer to my question is “no.” I doubt if administrations will be embraced in many more cases by creditors in lieu of compulsory liquidations, as there does not seem, save in a few instances, any advantages accruing to creditors in seeking an administration order rather than a winding-up order. But, it is likely that the number of compulsory liquidations will decrease (as they are already appearing to do) as some companies that would have ultimately been subject to a winding-up order, will be taken into administration by the company before creditors get to the point of presenting petitions for winding up. Also, in my view, we will see fewer CVLs in due course as directors choose administration rather than a CVL as a way of ending the life of their insolvent company. In effect, there will be some cases, when a company is unable to produce any dividend for the unsecured creditors, where administration will be used as a de facto winding up process, with companies going from administration directly to dissolution.

APPENDIX 1

Constitution of the Centre for Business Law and Practice

1. Objectives

The objectives of the Centre are the promotion of research and teaching in all aspects of business law and practice, including but not limited to the interaction between legal rules and business practice. These objectives may, where appropriate, be pursued through links with other constituent parts of Leeds University or departments or centres within other Higher Education Institutions, as well as through links with businesses and professions in Leeds and elsewhere.

2. Membership

2.1 Any member of the academic or research staff of the Department of Law or the Leeds University Business School may be a member of the Centre.

2.2. Other individuals, whether members of the University or not, may be appointed to membership of the Centre by the University Council on the nomination of the Executive Committee.

2.3 Institutions or firms may become associate members of the Centre if they fulfil the conditions established in by-laws made from time to time by the Executive Committee of the Centre.

3. Administration

3.1 The Centre shall be administered by a Director and an Executive Committee.

3.2 The Director shall be appointed by the University Council on the nomination of the Head of the Department of Law after consultation with the members of the Centre. S/he shall hold office normally for a period of three years and shall be eligible for immediate re-appointment.

3.3 The Director shall be responsible to the Executive Committee for the running of the Centre and the representation of its interests. The Director shall have regard to the views and recommendations of the Executive Committee and the Advisory Committee. The Director may be assisted by a Deputy Director or Directors appointed by the Executive Committee normally for a period of three years. Any Deputy Director so appointed shall be a member ex officio of the Executive Committee.

3.4 The Executive Committee shall consist of the Director and any Deputy Director together with the Head of the Department of Law, two representatives of the Leeds University Business School and up to three nominated members of whom not more than two may be members of the teaching staff of the Department of Law. The Executive Committee shall have power to co-opt up to two) additional members. Nominated and co-opted members shall be appointed normally for two years and shall be eligible for immediate re-appointment.

3.5 The Executive Committee shall meet as often as necessary to carry on the work of the Centre, but in any event at least twice a year, the Director acting as convenor. Any

member of the Executive Committee shall have the right to require the holding of a meeting of the Committee.

3.6. Minutes of the meetings of the Executive Committee shall be presented to the following Staff Meeting of the Department of Law.

3.7 There shall be an advisory Committee appointed by the Executive Committee which shall formulate advice and recommendations concerning any aspect of the administration or activities of the Centre. The Advisory Committee shall consist of:

- (a) all members of the Executive Committee;
- (b) up to three members of the teaching staff of the University of Leeds in departments other than Law, being individuals whose activities or interests have relevance to the objectives and work of the Centre;
- (c) up to fifteen persons from outside the University of Leeds with experience in the fields of activity covered by the objectives and work of the Centre.

3.8 The Executive Committee may also nominate up to ten persons to act as Advisers to the Centre. Advisers shall be persons who agree to offer advice on the work of the Centre at the invitation of the Executive Committee

3.9 The Advisory Committee shall meet once a year with the Director acting as convenor. Special Meetings may be held at the request of the Executive Committee.

4. Amendment to the Constitution

This constitution may be amended by the University Council (or any committee acting with authority delegated by the Council) on the recommendation of the Department of Law and the Executive Committee of the Centre.

APPENDIX 2

OFFICERS OF THE CENTRE

Director :	Professor Andrew Key
Deputy Director :	Mr Andy Campbell
Executive Committee:	Dr Jane Frecknall-Hughes (Leeds University Business School)
	Dr Oliver Gerstenberg
	Ms Juliet Jenkins
	Dr Paul Lewis (Leeds University Business School)
	Ms Joan Loughery
	Mr John Snape
	Professor Surya Subedi