

TITLE:

**THE POST-1986 UK INSOLVENCY SYSTEM: A
STUDY OF MODE OF RESOLUTION AND OF
COMPANY OUTCOME.**

NAME: ABDUL KARIM KARGBO

PhD THESIS

**CASS BUSINESS SCHOOL, CITY UNIVERSITY,
LONDON**

MAY 2009.

CONTENTS

LIST OF TABLES	vi
LIST OF FIGURES	ix
ACKNOWLEDGEMENTS	x
ABSTRACT	xi
CHAPTER 1: INTRODUCTION	1
1.0 Background and Motivation	1
2.0 Why Conduct the Study in the UK	2
2.1 Differences between Debtor- and Creditor-Oriented Codes	3
2.2 Types of Research on the UK Creditor-Oriented Code	4
3.0 Why the Chosen Period is Important	4
4.0 Limitations of the Study	6
5.0 Structure and Contribution of the Thesis	7
CHAPTER 2: THE UNITED KINGDOM INSOLVENCY CODE	13
2.1 Introduction	13
2.2 Types of Charges in the UK Insolvency Code	13
2.2.1 Fixed Charge	14
2.2.2 Floating Charge	14

2.3 Priority Ladder in the UK Insolvency Code	16
2.4 The Insolvency Process – The UK Code: Pre-1986	19
2.4.1 Scheme of Arrangement	19
2.4.2 Receivership	20
2.4.3 Liquidation	21
2.4.3.1 Members’ Voluntary Liquidation	21
2.4.3.2 Creditors’ Voluntary Liquidation	22
2.4.3.3 Compulsory Liquidation	23
2.5 The Insolvency Process –The UK Code: Post Insolvency Act 1986	23
2.5.1 Administrative Receivership	24
2.5.1.1 Administrative Receiver’s Appointment and Procedures	25
2.5.1.2 Powers of the Administrative Receiver	27
2.5.2 Administration Procedure	29
2.5.2.1 Administrator’s Appointment and Procedure	30
2.5.2.2 Powers and Duties of the Administrator	34
2.5.3 Company Voluntary Arrangement (CVA)	35
2.6 The Insolvency Process – The UK Code: The Enterprise Act 2002	37
2.7 Conclusion	39
CHAPTER 3: LITERATURE REVIEW AND HYPOTHESES SETTING	41
3.1 Introduction	41
3.2 Review of Literature on ‘Determinants of the Resolution Form Between Administration and Administrative Receivership in the UK’	42
3.2.1 Bankruptcy Costs	43

3.2.2 Information Asymmetry	47
3.2.3 Intangibles	49
3.2.4 Ability to Raise Funds	52
3.2.5 The Economic Cycle	55
3.2.6 Creditors' Complexity	57
3.2.7 Conclusion	62
3.3 Review of Literature on 'The Characteristics of Firms Entering Administration in the UK and the Difference Between Those Reorganising Compared with those Liquidating'.	62
3.3.1 Financial Distress	63
3.3.2 Size	66
3.3.3 Liquidity and Solvency	68
3.3.4 Ability to Raise Funds	71
3.3.5 Profitability and Earnings Prospects	74
3.3.6 Economic Cycle	76
3.3.7 Time in Administration	77
3.3.8 Management Stability/Efficient Management Retention Hypothesis	78
3.3.9 Relationship Banking in Administration	81
3.3.10 Conclusion	83
3.4: Review of Literature on 'The Subsequent Performance of UK Firms Reorganised in Administration'	84
3.4.1 Liquidity and Leverage	85
3.4.2 Operating Performance/Profitability	88
3.4.3 Restructuring/Downsizing	90
3.4.4: Conclusion	92

CHAPTER 4: DATA AND METHODOLOGY	94
4.1 Introduction	94
4.2 Data, Sample Source, and Period	94
4.2.1 Determinants of the Resolution Form between Administration and Administrative Receivership in the UK	94
4.2.2 The Characteristics of Firms Entering Administration in the UK and the Difference Between Those Reorganising Compared with those Liquidating	99
4.2.3 The Subsequent Performance of UK Firms Reorganised in Administration	100
4.3 Overview of the Data	102
4.4 Methodology	104
4.4.1. Linear Probability Model	105
4.4.2 Multiple Discriminant Analysis (MDA)	106
4.4.3 Probit Model	108
4.4.4 Logistic Model	110
4.5 Variables Used in the Chapter on ‘Determinants of the Resolution Form Between Administration and Administrative Receivership in the UK’	113
4.6 Variables Used in the Chapter on ‘The Characteristics of Firms Entering Administration in the UK and the Difference Between Those Reorganising Compared with those Liquidating’	117
4.7: Variables Used in the Chapter on ‘The Subsequent Performance of UK Firms Reorganised in Administration’	120
CHAPTER 5: DETERMINANTS OF THE RESOLUTION FORM BETWEEN ADMINISTRATION AND ADMINISTRATIVE RECEIVERSHIP IN THE UK	123
5.1 Introduction	123
5.2 Motivation and Summary of Hypotheses and Results	124
5.3 Results	127
5.3.1 Univariate Statistics	128

5.3.2 Multivariate Analysis	133
5.4 Conclusion	139
CHAPTER 6 THE CHARACTERISTICS OF FIRMS ENTERING ADMINISTRATION IN THE UK AND THE DIFFERENCE BETWEEN THOSE REORGANISING COMPARED WITH THOSE LIQUIDATING	142
6.1 Introduction	142
6.2 Motivation and Summary of Hypotheses	143
6.3 Results	148
6.3.1 Univariate Statistics	147
6.3.2 Multivariate Analysis	150
6.4 Conclusion	155
CHAPTER 7: THE SUBSEQUENT PERFORMANCE OF UK FIRMS REORGANISED IN ADMINISTRATION	160
7.1 Introduction	160
7.2 Motivation, Expectations and Summary of Findings	161
7.3 Results	168
7.3.1A Liquidity	167
7.3.1B Leverage	169
7.3.2 Operating Performance	171
7.3.3 Labour and Asset restructuring	173
7.4 Conclusion	175
CHAPTER 8: CONCLUSION	178
8.1 Overview of Thesis	178

8.2 Strength of the Thesis and its Contribution	180
8.3 Weaknesses of the Thesis	182
8.4 Future Research	184
REFERENCES	188
LIST OF TABLES	
TABLES OF CHAPTER 1	201
1.1 Number of Companies in Administration and Administrative Receivership in the UK from 1990 to 2002	201
TABLES OF CHAPTER 2	202
2.1 Definition of Absolute Priority Rule (APR)	202
TABLES OF CHAPTER 3	203
3.1 Summary of Studies on Bankruptcy Costs	203
3.2 Summary of Prior Studies in the Reorganisation versus Liquidation Literature with Size a Significant Variable	205
3.3 Summary of Prior Studies in the Reorganisation versus Liquidation Literature with Size not Significant	206
3.4 Effect of Free Assets on the Reorganisation of Firms	206
3.5 Definitions of Financial Distress	207
3.6 Summary of Studies on the Effect of Liquidity Risk, Solvency Risk, and Debt Covenant Violation on Reorganisation.	208
TABLES OF CHAPTER 5	210

5.1 Administration and Receivership Filings	210
5.2 Definition of Variables	211
5.3A Descriptive Statistics and Univariate Tests	212
5.3B Descriptive Statistics and Univariate Tests	213
5.4A Correlation Matrix	214
5.4B Correlation Matrix	214
5.5A Logistic Models on Determinants of the Resolution Form Between Administration and Administrative Receivership	215
5.5B Logistic Models on Determinants of the Resolution Form Between Administration and Administrative Receivership	216
TABLES OF CHAPTER 6	217
6.1A Time Series of Companies that Reorganise and Liquidate in Administration: Sample 1	217
6.1B Time Series of Companies that Reorganise and Liquidate in Administration: Sample 2	218
6.1C Time Series of Companies that Reorganise and Liquidate in Administration: Sample 3	219
6.2 Definition of Variables	220
6.3A Descriptive Statistics and Univariate Tests: Sample 1	221
6.3B Descriptive Statistics and Univariate Tests: Sample 2	222
6.3C Descriptive Statistics and Univariate Tests: Sample 3	223
6.4A Correlation Matrix: Sample 1	224
6.4B Correlation Matrix: Sample 2	224
6.4C Correlation Matrix: Sample 3	225
6.5A Logistic Models: Sample 1	226
6.5B Logistic Models: Sample 2	227

6.5C Logistic Models: Sample 3	228
TABLES OF CHAPTER 7	229
7.1 Number of Reorganised Companies in Administration by Year	229
7.2 Definition of Variables	230
7.3 Descriptive Statistics for Differences in Means and Medians:	
7.3A Two Years Before to the Appointment of the Administrator	231
7.3B One Year Before to the Appointment of the Administrator	231
7.3C Year of the Appointment of the Administrator	232
7.3D One Year after the Appointment of the Administrator	232
7.3E Two Years after the Appointment of the Administrator	233
7.3F Three Year after the Appointment of the Administrator	233
7.4 Mean and Median Peer-Adjusted Ratios Two Years Before to Three Years After:	
7.4A Current ratio (CR)	234
7.4B Liquid ratio (LIQ)	234
7.4C Total liabilities to total assets ratio (TLTA)	235
7.4D Operating profits before interest tax, depreciation and amortisation to total asset ratio (EBITDATA)	235
7.4E Operating profits before interest and tax to total asset ratio (EBITTA)	236
7.4F Logarithm of total assets (LNTOTA)	236

LIST OF FIGURES

FIGURES OF CHAPTER 1	237
1.1 Graphs of Number of Companies in Administration from 1990 to 2002	237
1.2 Graphs of Number of Companies in Receivership from 1990 to 2002	237
1.3 The Path Through Insolvency Proceedings as Studied in Thesis.	238
FIGURES OF CHAPTER 4	239
4.1 Floating Charge Proportion in Administration and Administrative Receivership from 1996 to 2001	239
4.2 Fixed Charge Proportion in Administration and Administrative Receivership from 1996 to 2001	240
Appendix	241

ACKNOWLEDGEMENTS

First of all, I would like to thank The Almighty God for giving me the ability, health, and strength to cope with the demands of the PhD programme.

I would also like to express my profound gratitude and respect to my supervisors, Professor David B. Citron and Dr. Maria Carapeto, for their advice, encouragement, and most of all support throughout my studies at Cass Business School, City University. They kindly assisted me in every way possible to get to this point.

I also want to thank the Commonwealth Scholarship Commission for their financial and other assistance granted to me in the United Kingdom. It would not have been financially possible without their support.

I would like to thank Professor Meziane Lasfer for his help during the initial stage of my work.

Finally, I would like to say thanks to my father, Mr. Sharka M. Kargbo for his support, in every which way, over the years, and to my brother, Lamin Kargbo, for his assistance during desperate times. And to all those who have directly or indirectly contributed to this work, I want to say thanks.

ABSTRACT

This thesis empirically investigates the United Kingdom (UK) insolvency code by focusing on the formal procedures available to distressed firms in the UK. The UK insolvency code is characterised as a creditor-oriented system that enforces a binding agreement between the company and the creditors with a view to maximising payouts to the creditors. However, the government has introduced two major legislative changes – the Insolvency Act 1986 and the Enterprise Act 2002 – to move the UK insolvency code away from its creditor-orientation and towards a system that will increase the chances of distressed, but viable, firms in the UK to reorganise.

The introduction of the Insolvency Act 1986 paved the way for distressed companies in the UK to enter into a formal procedure (administration) specifically introduced as a means of encouraging a culture of reorganisation for distressed firms in the UK. This thesis investigates the functioning of the UK code, by focusing on the two main formal procedures available to distressed firms (administration and administrative receivership) after the introduction of the 1986 Act. The introduction of the Enterprise Act 2002 resulted to the abolition of the administrative receivership procedure while maintaining the administration procedure as the key formal rescue procedure in the UK insolvency code. Hence, conducting research in the UK formal insolvency procedure is important as it provides empirical evidence on the administration procedure, which is now the main rescue vehicle under the Enterprise Act 2002. The thesis focuses on the post-1986 regime in the UK. It consists of 8 chapters including 3 empirical chapters.

Chapter 5 examines a large sample of UK firms that initiated administration or administrative receivership procedures between 1996 and 2001. The aim is to investigate the choice of the resolution form between administration and administrative receivership. The main research question is to investigate whether the newly introduced administration procedure catered for firms with a different set of financial and other characteristics to those that entered administrative receivership. The findings show that there are some distinguishing characteristics between firms entering administration and those entering administrative receivership, implying that administrative receivership was not necessarily the most appropriate insolvency procedure for all distressed firms.

Chapter 6 examines a sample of UK firms that entered administration between 1996 and 2001. The aim of this chapter is to investigate the differences between firms that reorganised in administration versus those that liquidate. The key issue here is whether administration procedure can differentiate between firms potentially likely to survive and those likely to fail. The findings show that there are significant differences between firms that reorganise and those that fail in administration, suggesting that the administration procedure is able to discriminate between viable and non-viable firms.

Chapter 7 examines the subsequent performance of UK firms that reorganised in administration between 1996 and 2001 relative to a matched sample firms from the same industry and of relatively the same size. The aim was to assess the subsequent performance of companies that reorganise in administration using several key ratios, covering the period from two years prior to failure until three years afterwards. The results show significant improvements in the financial performance of reorganised firms, relative to a matched sample firms, during the period after entering administration.

In summary, these results show the importance of introducing the administration procedure in the Insolvency Act 1986. Prior to this date, there was the possibility that some of those firms that reorganised in administration post-1986 might have been liquidated as there was no formal procedure aiming to reorganise distressed firms at that time. The findings clearly show the potential of the administration procedure in attracting distressed firms capable of reorganising. That procedure has now become the foundation upon which the UK insolvency code is built as indicated by the Enterprise Act 2002. However, having said that, the 1986 system also opened the way for severely distressed companies that should have been liquidated speedily in administrative receivership to attempt reorganisation in administration, thus wasting those firms' already severely depleted resources further. In my opinion, the Enterprise Act 2002 should safeguard against this by putting in place procedures to prevent economically distressed companies from attempting to reorganise in administration.

