The *Paramount* Case: consequences for the insolvency profession

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This paper deals with the background to and consequences of the House of Lords' judgment in *Paramount Airways Ltd* (and consolidated cases) delivered on 16 March 1995, concerning the adoption of employment contracts by administrators and administrative receivers. The House of Lords confirmed that an employee's contract of employment is adopted if his employment is continued for more than 14 days after the appointment of an administrator or administrative receiver. Whilst the *Insolvency Act 1994* restricts the consequences of the *Paramount* judgement in relation to future administrations and administrative receiverships, the Act is only effective from 15 March 1994. The result is that insolvency practitioners remain potentially liable for huge employment liabilities in respect of administrations and administrative receiverships between 29 December 1986 (the commencement date for the provisions of the Insolvency Act 1986) and 15 March 1994.

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Abbreviations

IA 1986	The Insolvency Act 1986
IA 1994	The Insolvency Act 1994
Paramount	Paramount Airways Ltd 1987
SPI	Society of Practitioners of Insolvency
CVA	Company Voluntary Arrangements

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I. Introduction and Definitions

The *Insolvency Act 1986* [the IA 1986] and the rules made under it provide the principal statutory regime governing insolvent companies. Under the IA 1986, an **administrator** may be appointed by the court to manage the affairs, business and property of a company in financial difficulties. The purpose of an administration order is to impose a moratorium on proceedings against the insolvent company usually either to enable the company to survive, possibly through the approval of a voluntary arrangement or the sanctioning of a compromise or arrangement with its creditors, or to achieve a more advantageous realisation of the company's assets than would be effected in a liquidation. Administration under the IA 1986 is therefore viewed as part of the corporate 'rescue culture'.

Administration should be distinguished from administrative receivership which although also viewed as part of the rescue culture is a separate insolvency procedure provided for under the IA 1986. An **administrative receiver** is a receiver or manager of the whole (or substantially the whole) of a company's property appointed by or on behalf of holders of debentures secured by a charge which was created as a floating charge. This is usually a bank which takes the debenture as security for its financial exposure to the company. If the company defaults in its financial obligations to the bank, then the floating charge is said to crystallise and the bank will appoint an administrative receiver. The administrative receiver's primary task will be to take control of the company's affairs with a view to utilising the assets subject to the charge to pay back the company's indebtedness to the bank.

Both administrators and administrative receivers will be insolvency practitioners and often qualified accountants. Although their roles are rather different both may well continue the company's business for a period of time. In order to carry on the business of an ailing company for any length of time, it will normally be necessary to retain at least some of its employees.

Administrative receivers are often colloquially referred to as receivers. They should be distinguished from **receivers** in Scotland whose role is broadly similar to that of administrative receivers in England and Wales.

The three cases of *Paramount Airways Ltd*[1], *Leyland DAF Ltd* and *Ferranti International plc*[2] raised questions as to the rights of employees whose employment had been adopted (or continued) by an administrator or an administrative receiver in these circumstances. Before looking in detail at the impact of these three cases on the insolvency profession, it is helpful to review how the problem of the employment obligations of such office holders arose.

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1 *Paramount Airways (No.3) CA, 22 February 1994 (1994/2 All ER 513); HL 16 March 1995*

2 *Re Ferranti International plc and Re Leyland DAF Ltd CA ([1994] BCC 658) and HL, 16 March 1995*

II. Creation of the problem

A. Pre *Paramount Airways Ltd* - case history traced

The decision of the Court of Appeal in *Nicoll v Cutts [1985]*[3] exposed the vulnerability of employees whose contracts of employment continued during receivership.

Previously, it had been the practice of administrative receivers to pay employees for services rendered during the receivership. In this case an employee's contract of employment had not been terminated and the receiver had not paid him, even though he had, to a limited extent, used the employee's services. However, the employee's claims that the receiver was personally liable, or that he should be paid as an expense of the receivership, were rejected by the Court of Appeal.

The Court of Appeal held in this case that a receiver who retained employees after his appointment had not adopted their contracts of employment, and was therefore not personally liable for paying their salaries.

This seemed an alarming situation for employees and Parliament reacted by introducing new provisions into the *Insolvency Bill* which was then before it [now the IA 1986]. The remedy was to confer special rights on employees whose contracts of employment were 'adopted' by receivers or administrators. Sections 19 (5), 44 (2) and 57 (5) of the new *IA 1986* sought, in part, to counter the mischief caused by the *Nicoll v Cutts* case. Under section 19 (5) of the IA 1986, an administrator has only 14 days from the date of his appointment to decide whether to adopt contracts of employment. Specifically, section 19[4] states:

> **19.** — (I) The administator of a company may at any time be removed from office by order of the court and may, in the prescribed circumstances, resign his office by giving notice of his resignation to the court.
>
> (2) The administrator shall vacate office if—
>
> *(a)* he ceases to be qualified to act as an insolvency practitioner in relation to the company, or
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> *(b)* the administration order is discharged.
>
> (3) Where at any time a person ceases to be administrator, the next two subsections apply.

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[3] *Nicoll v Cutts, 1985, 1BCLC 322*

[4] Section 19 of the *Insolvency Act 1986* before its amendment by the *Insolvency Act 1994* which took effect in relation to appointments from 15 March 1994.

(4) His remuneration and any expenses properly incurred by him shall be charged on and paid out of any property of the company which is in his custody or under his control at that time in priority to any security to which section 15(1) then applies.

(5) Any sum payable in respect of debts or liabilities incurred, while he was administrator, under contracts entered into or contracts of employment adopted by him or a predecessor of his in the carrying out of his or the predecessor's functions shall be charged on and paid out of any such property as is mentioned in subsection (4) in priority to any charge arising under that subsection.

For this purpose, the administrator is not to be taken to have adopted a contract of employment by reason of anything done or omitted to be done, within 14 days after his appointment.

In short, in an administration, liabilities incurred whilst the administrator is in office under contracts of employment 'adopted' by him, are charged upon the company's assets when he vacates office. This charge will rank in priority to any payment to any other type of creditor (including preferential and secured creditors) and in priority to the administrator's remuneration and other expenses.

A similar provision on the adoption of employment contracts exists in section 44 (2) of the IA 1986 with regard to administrative receivers. Section 44[5] states:

44.— (I) The administrative receiver of a company—

(a) is deemed to be the company's agent, unless and until the company goes into liquidation;

(b) is personally liable on any contract entered into by him in the carrying out of his functions (except in so far as the contract otherwise provides) and on any contract of employment adopted by him in the carrying out of those functions; and

(c) is entitled in respect of that liability to an indemnity out of the assets of the company.

(2) For the purposes of subsection (1)*(b)* the administrative receiver is not to be taken to have adopted a contract of employment by reason of anything done or omitted to be done within 14 days after his appointment.

(3) This section does not limit any right to indemnity which the administrative receiver would have apart from it, nor limit his liability on contracts entered into or adopted without authority, nor confer any right to indemnity in respect of that liability.

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[5] Section 44 of the *Insolvency Act 1986* before its amendment by the *Insolvency Act 1994* which took effect in relation to appointments from 15 March 1994.

In effect, under section 44, administrative receivers are personally liable on contracts of employment 'adopted' by them, although they are entitled to an indemnity out of the company's assets in respect of such liabilities.

Although sections 19 (5) and 44 (2) of the *IA 1986* apply only to England and Wales, section 57(5) *IA 1986* contains a virtually identical provision in relation to the adoption of employment contracts by receivers in Scotland. Section 57[6] states:

> **57.**— (1) A receiver is deemed to be the agent of the company in relation to such property of the company as is attached by the floating charge by virtue of which he was appointed.
>
> (2) A receiver (including a receiver whose powers are subsequently suspended under section 56) is personally liable on any contract entered into by him in the performance of his functions except in, so far as the contract otherwise provides, and on any contract of employment adopted by him in the carrying out of those functions.
>
> (3) A receiver who is personally liable by virtue of subsection (2) is entitled to be indemnified out of the property in respect of which he was appointed.
>
> (4) Any contract entered into by or on behalf of the company prior to the appointment of a receiver continues in force (subject to its terms) notwithstanding that appointment, but the receiver does not by virtue only of his appointment incur any personal liability on any such contract.
>
> (5) For the purposes of subsection (2), a receiver is not to be taken to have adopted a contract of employment by reason of anything done or omitted to be done within 14 days after his appointment.
>
> (6) This section does not limit any right to indemnity which the receiver would have apart from it, nor limit his liability on contracts entered into or adopted without authority, nor confer any right to indemnity in respect of that liability.
>
> (7) Any contract entered into by a receiver in the performance of his functions continues in force (subject to its terms) although the powers of the receiver are subsequently suspended under section 56.

It is clear that in the case of administrations and administrative receiverships in England and receiverships in Scotland, the *IA 1986* provides a 14 day 'grace' period, from the date of appointment, during which the office holder is not to be taken to have adopted a contract of employment. The concept of 'adopting' was not defined by the Act.

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[6] Section 57 of the *Insolvency Act 1986* before its amendment by the *Insolvency Act 1994* which took effect in relation to appointments from 15 March 1944.

Members of the insolvency profession were concerned about the ambiguity of sections 19, 44 and 57 but appear to have been reassured by Mr Justice Harman's ruling in the case of *Re: Specialised Mouldings Ltd 1987*[7].

It became the practice of both administrators and administrative receivers to side-step neatly sections 19 and 44 of the IA 1986 by relying on the High Court decision in *Specialised Mouldings*. In this case, the Court approved a form of letter to be sent to employees by receivers declaring that they were **not** adopting contracts of employment or assuming any personal liability by virtue of allowing those contracts to continue. This meant that the administrator or administrative receiver was still liable to pay for the services of the employees, which would be treated as an expense of the administration in priority to all other claims. However, he did not have to pay any other contractual entitlements, such as pay in lieu of notice and contractual redundancy pay, arising out of the termination of the employment as an administration expense.

For the five years following the decision in *Specialised Mouldings Ltd*, administrators and administrative receivers thought they knew where they stood. But then came the first of the *Paramount Airways* decisions.

B. The ruling in Paramount Airways Ltd

1. The High Court decision

The subject of the adoption of employment contracts returned to the High Court in *Re Paramount Airways Ltd*[8], this time in the context of an administration. Very briefly, the facts were that seven days after being appointed administrators of Paramount Airways Ltd, a charter airline, the administrators sent a letter to all employees in which they said they would continue to pay their salaries but did not and would not assume personal liability in respect of contracts of employment (ie a 'Specialised Mouldings' form of letter). The staff were kept on by the administrators for some months in the hope that it might be possible to sell the airline as a going concern. Eventually it became clear that no buyer would be found and dismissal letters were sent out. Two pilots claimed salary in lieu of notice and holiday pay and eventually made an application to the High Court on the grounds that the administrators were acting in a way which was unfairly prejudicial to the interests of the company's creditors including its employees. The administrators sought the directions of the court.

The High Court accepted that it was possible for administrators to contract out of the provisions of the IA 1986 on adoption of contracts of employment by use of a letter, but held that the particular letter which the administrators had used in this case was ineffective for the purpose. The administrators appealed to the Court of Appeal.

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7 *Re: Specialised Mouldings Ltd [unreported 13 February 1987 ChD]*

8 *Re Paramount Airways Ltd (No.3), 1991 4 All ER 267*

2. The Court of Appeal decision

The Court of Appeal[9] rejected altogether the concept of avoiding adoption by letter. It held that if administrators continue after an initial 14 day period of grace to employ staff and pay them substantially in accordance with their pre-administration contracts, they would be held, by implication, to have adopted those contracts of employment. If administrators wanted to use existing staff to carry on the business of a company in administration, they had either to adopt the existing contracts or negotiate entirely new contracts which were not a sham.

Administrators or administrative receivers had to consider the possibility of dismissing the entire workforce within the 14-day 'grace period' or else face not only meeting employment liabilities arising after their appointment but also certain additional employment entitlements. The immediate prospect seemed to be the widespread closure of insolvent businesses by administrators and administrative receivers which might otherwise have been preserved as going concerns. The alternative of negotiating new contracts with individual employees would not be a viable option in most cases because of time and cost constraints. Parliament sought to avert this by enacting emergency legislation in the form of the *Insolvency Act 1994* [the IA 1994].

However, the IA 1994 applies **only** to administrators and administrative receivers in England and Wales (and receivers in Scotland) and only to situations where the 14-day grace period had not expired before the Act came into force on 15 March 1994. This Act restricts the liability of administrators and administrative receivers to that of paying wages and contributions to occupational pension schemes arising **after** their appointment and in respect of employment contracts which they adopt.

With administrators and administrative receivers appointed between 29 December 1986 (the commencement date for the provisions of the IA 1986) and 15 March 1994 (the date from which the provisions of the 1994 Act became effective) still potentially liable for contractual employment claims, the insolvency profession had little option but to pursue an appeal to the House of Lords.

At the same time, in order to remove uncertainty concerning administrative receiverships, applications for directions were made to the High Court by the administrative receivers of Leyland DAF Ltd and Ferranti International plc[10]. The High Court ruled that there was no reason why receivers could not exclude personal liability resulting from adoption, but nothing less than a contract would achieve that result.

The decision highlighted a major difference in the wording of the adoption provisions in the IA 1986 [sections 19 and 44]. Those concerned with administration referred to liabilities incurred while the administrator was **in office**, whereas the provisions dealing with administrative receivership imposed personal liability 'on any contract of employment adopted'. If administrative receivers adopted contracts of employment, they became **personally liable** for all liabilities 'on' contracts, whether incurred before, during or after receivership.

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9 *Re Paramount Airways Ltd ,CA 22 February 1994 (1994/2 All ER 513)*

10 *Re Leyland DAF Ltd; Re Ferranti International plc 1994 [BCC 658]*

The administrative receivers of Leyland DAF Ltd and Ferranti International plc were allowed to by-pass the Court of Appeal and their appeals were heard by the House of Lords at the same time as the appeal of the administrators of *Paramount Airways Ltd*. Clearly, insolvency practitioners hoped that the House of Lords would overturn the Court of Appeal's decision in *Paramount*.

3. The House of Lords decision

The House of Lords handed down their judgment in the *Paramount*, *Leyland DAF* and *Ferranti* [11] appeals on 16 March 1995. Essentially, the House of Lords dismissed all three appeals and held as follows:

(a) An employee's contract of employment is 'adopted' if he is continued in employment for more than 14 days (ie. the statutory period of grace) after the appointment of the administrator or administrative receiver.

(b) It is not possible for an administrator or administrative receiver to avoid 'adoption' or alter its consequences unilaterally by informing employees that he is not adopting their contracts, or only doing so on terms.

(c) In the case of both administrations and administrative receiverships, the consequence of adoption of contracts of employment is to give priority only to liabilities incurred by the administrator or administrative receiver during his tenure of office. This will exclude liability for holiday pay accrued prior to his appointment but will include liability for pay in lieu of notice.

In summary, 'adoption' in sections 19 (5) & 44 (2) of the IA 1986 connotes some conduct by the administrator or administrative receiver which amounts to an election to treat the continued contract of employment with the company as giving rise to a separate liability in the administration or receivership. It is not possible to contract out of adoption, nor is it possible for an administrator to cherry pick between the different liabilities under the contract. Accordingly, once the contract has been adopted, it is the whole contract which has been adopted.

Lord Browne-Wilkinson delivered the leading judgment, with which all the other Lordships concurred. He acknowledged that administrators and administrative receivers were operating within a 'rescue culture' ethos and that the result of the Court of Appeal decision was to make it extremely hazardous for administrators or administrative receivers to keep on the employees necessary to enable the company's business to continue:

"....this 'rescue culture' which seeks to preserve viable businesses was and is fundamental to much of the Act of 1986. Its significance in the present case is that, given the importance attached to [administrative] receivers and administrators being able to continue to run a business, it is unlikely that Parliament would have intended to produce a regime as to

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[11] *Powdrill and Atkinson v Watson and another; Talbot and another v Cadge and another; Talbot and another v Grundy and another, House of Lords, 16 March 1995 (as yet unreported but see The Times 23 March 1995).*

employees' rights which renders any attempt at such rescue either extremely hazardous or impossible"[12].

He acknowledged the impracticality for either an administrator or an administrative receiver being able to assess in the first 14 days of the insolvency the relative merits of either closing down or continuing the business. He also noted that the fact that Parliament moved so quickly to correct the decision in Paramount by introducing the IA 1994 shows that the construction put on the Act of 1986 by the Court of Appeal operates in a manner contrary to public interest. Nevertheless, albeit reluctantly, the House of Lords affirmed the decision reached by the Court of Appeal.

C. *The Insolvency Act 1994*

As outlined above, in March 1994 Parliament enacted emergency legislation to limit the consequences of The Court of Appeal's decision in *Paramount Airways Ltd*. On 18 March 1994 the Government put forward the *Insolvency (No.2) Bill* which became the *Insolvency Act 1994* on 24 March 1994. The Act is retrospective in its effect to 15 March 19 94 - the day after Mr Heseltine's statement to the House of the Government's intention to take action[13]. As a result of this Act administrators and administrative receivers are able to adopt contracts of employment with the effect that only wages, salaries and pension contributions payable from the time of adoption will qualify as expenses of the procedure. Any other liabilities arising from the contracts of employment will be treated as unsecured claims against the company. The 1994 Act did not, however, relieve the insolvency profession of the spectre of *Paramount*.

Since the House of Lords' judgment, officers of the Society of Practitioners of Insolvency (SPI) have made written representations and had two meetings with Mr Jonathan Evans, then the Minister for Corporate Affairs, to try to persuade him of the need for giving retrospective effect to the *1994 Insolvency Act*. The SPI have also carried out an exercise, at the Minister's request, to attempt to quantify the likely magnitude of potential claims and to identify to whose account they would fall. In addition, SPI have made representations on the professional indemnity insurance consequences of *Paramount*.

Despite the arguments put forward by the SPI and other interested parties, the Minister decided in May 1995 not to make the 1994 Act retrospective. He has also declined to mitigate the problem by some alternative means such as placing a restriction or cap on claims or by excluding directors on the grounds that they were stewards of the companies which failed.

In a letter to the SPI, Mr Evans said:

"I have now given careful consideration to all the arguments which have been urged on us and I am writing to inform you that we [the Government] have decided that it would not be appropriate for the Government to bring forward legislation to give retrospective effect to the provisions of the 1994 Insolvency Act. We do not believe it would be right to legislate to take away from employees rights which the courts have determined they always had under the

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[12] *Ibid*

[13] HC Deb 14 March 1994 c615-620

1986 legislation. Such rights cannot, in our view, accurately be described as a 'windfall' for employees"[14].

In response, Mr Colin Bird of the SPI has informed his members that "the Minister's decision will cause immense difficulties in relation to cases affected by the Lords' judgment. A number of legal questions have been identified to which, at present, we do not know the answers. The profession finds itself, therefore, to an almost unprecedented extent, in unchartered waters"[15].

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[14] 'Government rules out legislation to reverse Paramount Judgment', DTI Press Release, 26 April 1995.

[15] Letter by Colin Bird, President of the Society of Practitioners of Insolvency, to Members, dated 25 May 1995.

III. Implications of the House of Lords ruling for the insolvency profession

A. Insolvency practitioners' liabilities

The House of Lords' judgment has different consequences for administrations and administrative receiverships. An administrator is only liable under section 19 (5) for liabilities incurred during the administration. This will include the liability to pay wages accruing during the contractual period of notice, pension contributions in respect of the notice period or damages for failure to give proper contractual notice. The liability of administrators is limited to the assets at their disposal.

Conversely, administrative receivers are **personally liable** to employees for liabilities incurred during the receivership in relation to the employees' contracts of employment.

Many insolvency practitioners and lawyers have criticised the House of Lords' interpretation of sections 19 (5) and 44 (2) of the IA 1986 as seriously undermining the rescue culture the Act was designed to encourage. It is argued that it was open to the Lords to hold that a **positive** step is required to adopt a contract and had they done this, the anomalies thrown up would then have been avoided.

B. The size of claims

There are conflicting reports both on the number and cost of potential employment claims against administrators and administrative receivers. For example, it has been estimated in one publication that the leading accountancy firms could each face legal claims totalling around £50 million[16]. In contrast, SPI is reported to have told Corporate Affairs Minister, Jonathan Evans, that total claims resulting from the judgment could total as much as £500 million, with claims from 1,000 high earning directors alone possibly reaching £130 million.[17] SPI is also reported to have estimated that the current national exposure of accountancy firms is £2bn.[18]

It has also been estimated that between 1987 and 1994, there were more than 27,000 administrative receiverships and more than 1,000 administrations[19]. It is said that some idea of the problem may be gauged from the maximum amount of the claims made by the Ferranti employees, which has been quantified at around £3.9 million, with claims for payments in lieu of notice and under severance agreements amounting to more than £2 million alone[20].

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16 'Insolvency firms face £50m hit', *Accountancy Age, 6 April 1995*

17 Ibid

18 Legal Times, 21 March 1995

19 *'Accountancy Age'*, 30 March 1995.

20 Ibid

The Times reported recently[21] that John Gunn, former Chairman of British & Commonwealth has received from the company's administrators, Ernst & Young, an estimated £600,000 in the light of the Paramount ruling as a consequence of the continuation of his contract of employment. British & Commonwealth collapsed in 1990. *The Times* also reported that John Buchanan, a former manager of insurance group Sale Tilney which crashed in December 1992 has made an employment claim for £800,000[22].

The Mail On Sunday reported[23] that three former directors of Olympia & York, developer of Canary Wharf, are making claims for £1 million in total. It also reported that claims have been made by former directors of both Coloroll and Lowndes Queensway against the officeholders of the companies concerned and that such claims are currently being assessed.

It is likely that the repercussions of such claims would go far beyond the insolvency practitioners concerned and their professional insurers. They could also affect the banks which had been instrumental in their appointment, and which may be morally or legally liable to indemnify them for any losses.

C. Legal problems

Insolvency practitioners are now dealing with claims from employees dismissed during administrations and receiverships where the contracts of employment were adopted before 15 March 1994 (when the IA 1994 came into effect).

The SPI has identified a number of legal questions arising from the *Paramount* ruling which remain difficult to resolve[24]. The problems may be broadly divided into two types: those relating to the claims themselves, and those concerning access to funds with which to meet them.

1. Problems relating to claims

- **Is there a duty to seek out claims and is the position different in administrations and receiverships?**

Administrations

The SPI states that the consensus view is that an administrator **in office** does have a duty to seek out claims. This is because an administrator is an officer of the court and is therefore bound by the rule in *ex parte James* to act honestly and fairly towards creditors. In the case of an administrator who has obtained his release or **vacated office** the position is less clear, but the SPI point out that a possible view is that although an administrator who vacates office

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21 "John Gunn to receive £600,000 pay off", *The Times, 1 September 1995.*

22 Ibid

23 "MCC Claim abandoned", *Mail on Sunday, 10 September 1995*

24 'Paramount - the problems', Technical Bulletin by the Society of Practitioners of Insolvency, Issue No. 23, May 1995.

without having sought out claims may be liable for breach of statutory duty, he does not have a continuing duty to seek out claims after he has been released from office.

Receiverships

The SPI have stated that since an administrative receiver is not an officer of the court, the view could be taken that he is not subject to the rule in *ex parte James*. This said, the SPI would still advise administrative receivers to adopt a cautious approach in those cases where they are still holding funds out of which to meet receivership expenses. The view has been expressed that where an administrative receiver has vacated office he does not have a duty to seek out claims.

- **What is the effect of the release of administrators and the vacation of office of receivers?**

Administrations

Section 20 of the IA 1986 provides an administrator with a release from liability when he has completed the administration of the company. However, that release does not affect possible claims under Section 212 of the IA 1986 which relate to misfeasance and breach of duty by the administrator.

In the case of *Paramount*, the House of Lords stressed that in delivering their judgment they were simply stating the legal position that had always applied. It seems unlikely, therefore, that administrators will be able to avoid a charge of breach of duty merely on the basis that they were unaware of the correct meaning of provisions 19 and 44 of the IA 1986.

Receiverships

There is no concept of the release of a receiver on his vacation of office. Moreover, there is no suggestion in section 37 or 44 of *IA 1986* that the liability of the receiver applies only as long as he is in office.

- **What is the effect of the *Limitation Act 1980*?**

According to the findings of the SPI there appears to be a consensus view that the *Limitation Act 1980* will provide a defence in respect of employee claims incurred more than 6 years before the date of the issue of proceedings against the office holder or 12 years in the case of contracts under seal (ie a contract executed as a deed).

In general, the limitation period cannot be extended beyond the relevant 6 or 12 year period. The fact that any potential claimant would have been unaware of his right to sue the office holder until the decision of the House of Lords in *Paramount* is, in the view of the SPI, irrelevant.

However, claims against insolvency practitioners for breach of duty, which would include the breach of any duty to seek out claimants, are not statute barred.

• **What is the position as regards set-off of counter-claims and mitigation?**

An administrator or administrative receiver, faced with a claim from a director who was awarded a long-term employment contract shortly before the collapse of the company, may well decide to lodge a counter-claim alleging breach of fiduciary duty. The effects of such counter claims are complex and will only be capable of being dealt with on a case by case basis.

Employees have an obligation to mitigate their loss and any failure to do so can be taken into account when computing any award for damages to the employee.

• **Will Section 727 of the *Companies Act 1985* provide a defence?**

Section 727 of the *Companies Act 1985* gives the court a discretion in any proccedings against an officer of a company for "negligence, default, breach of duty or breach of trust" to relieve him wholly or partly from liability. The court must be satisfied that the officer has acted honestly and reasonably and that, having regard to all the circumstances of the case, including those connected with his appointment, he ought fairly to be excused.

It was held in the High Court that for the purposes of section 727 an administrator is an officer of the company[25]. However, the Court of Appeal has held that an administrative receiver is not an officer of the company for Section 727 purposes[26].

In any event, section 727 as it exists is not thought to provide any protection to either an administrator or an administrative receiver if sued by a third party. It was held, in the Court of Appeal case of *Customs and Excise Commissioners v Hedon Alpha Ltd [1981]*[27], that such protection only applies to claims brought against the office holder by the company itself, or by a liquidator. There does not appear to be any discretion to grant relief where a claim is brought by a third party such as an employee. However, the SPI have stressed that this does not mean that section 727 cannot be pleaded in any shape or form: the effect of *Paramount* on office holders is so great that it is possible that the courts may look for ways to lessen its effect by softening the approach to section 727[28].

• **What is the impact of company voluntary arrangements?**

There are a number of formal insolvency procedures which are designed to lead to the financial recovery of a company. Arguably the most important of these, is a company voluntary arrangement ('CVA'). A CVA may be defined as an arrangement with the shareholders and creditors of a company for a scheme of arrangement of its affairs which is to be supervised by an insolvency practitioner. There is no restriction on the sort of arrangement which may be proposed. The directors may propose whatever arrangement they

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25 *Re Home Treat Ltd [1991] BCC 165*

26 *Re Johnson & Co. (Builders) Ltd [1955] CH 634*

27 *Customs and Excise Commissioners v Hedon Alpha Ltd [1981] 1QB 818*

28 'Paramount - the problems', Technical Bulletin by the Society of Practitioners of Insolvency, Issue No. 23, May 1995.

consider appropriate in the circumstances and likely to be approved by the shareholders and creditors.

It is unclear what effect the binding of an employee in a CVA following an administration has on any *Paramount* type claim which he may have in relation to the administration. According to the SPI, this is a matter which is likely to be resolved only by litigation.

2. Problems relating to access to funds

• What is the effect of the statutory indemnity and the statutory charges

Sections 37 (in respect of non-administrative receivers)[29] and 44 (in respect of administrative receivers) of the *IA 1986* provide an express right of indemnity out of the assets for liability on employment contracts. An administrator under section 19 (5) of the IA 1986 has a charge over the company's property in his control for debts or liabilities including those arising under employment contracts. The *Paramount* decision does not affect these statutory provisions.

- **Can an office holder recover monies already paid out? Have such monies been paid under a mistake of fact or a mistake of law?**

In connection with *Paramount*, the question which arises is whether funds already paid out have been paid under a mistake of fact (in the mistaken belief that all relevant liabilities had been discharged) or a mistake of law (because the law was believed to be different from that which the House of Lords has now determined). In the case of the former, the money may be recoverable but not in the case of the latter. Again, this is a matter that will need to be decided by the courts.

• What is the impact of a company voluntary arrangement on rights of recourse

The SPI has indicated that in the recent cases of *Re Leisure Studies Group Ltd [1994]*[30] and *Re A J Bradley-Hole [1995*][31] the courts held that assets subject to a voluntary arrangement were held on trust for the creditors bound by the arrangement, and were not accessible to a subsequently appointed office holder. However, neither case is authority for the proposition that any trust imposed by a voluntary arrangement will take priority over the charge in favour of administrators or receivers created by the Act. In short, it seems that they will be able to indemnify themselves from assets under their control in relation to debts or liabilities incurred while in office.

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[29] A non-administrative receiver includes a receiver/manager of part only of a company's property and a receiver of income appointed under the *Law of Property Act 1925*.

[30] *Re Leisure Studies Group Ltd [1994] 2BCLC 65*

[31] *Re A J Bradley-Hole, unreported, but see SPI Technical Bulletin 22.6, April 1995.*

IV. Current position

For the time being the Government has decided **not** to introduce further legislation to mitigate the effect of the judgment of the House of Lords in the *Paramount Airways*, *Leyland DAF* and *Ferranti* cases.

Of course, the IA 1994, which came into force on 15 March 1994, largely solves the problems of adoption of employment contracts for future administrators and administrative receivers. However, the Act is not retrospective and many administrators and administrative receivers remain potentially liable for claims from employees whose contracts of employment were adopted **before** 15 March 1994.

Claims will come in from two principal sources: senior executives who were employed on high salaries under long-term fixed contracts and from trade unions. Claims from senior executives of the insolvent companies have already prompted a series of highly public legal actions which could continue over the next few years.

It has been argued that the House of Lords' ruling will work very harshly on administrative receivers who have accounted for all the proceeds realised in the receivership to their appointor and who do not have an express indemnity from the appointor. It is not clear what the position of administrators will be if the administration has ended, the administrators have obtained their discharge and release from the court and the assets in the administration have been paid out to creditors.

Of course, even if adoption of employment contracts has occurred, the liabilities of receivers and administrators may be reduced in certain circumstances: for example, because employees have accepted alternative employment (and have thus mitigated their loss) or because claims are statute barred or because counter claims lie against the employees.

Insolvency Practitioners are, therefore, attempting to take steps to restrict the damage. Coopers and Lybrand, for example, are reported as saying that they have adopted a 'one-team' approach', whereby a selected group of individuals will control the *Paramount* aftermath in the UK[32]. Coopers and Lybrand have also said that firms must track the cost of dealing with claims closely. It has estimated that the average claim will require four hours to process[33].

Mr Steve Hill, an insolvency partner at Coopers & Lybrand, who considered the practical implications of Paramount at a conference in April 1995 commented as follows:

"There is great potential for chaos...the insolvency profession must liaise on legal test cases, only take up strong cases and try to avoid cost duplication....The banks don't want hundreds of debates"[34].

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[32] 'The good guys lose, say insolvency firms', *Accountancy Age, 13 April 1995*.

[33] Ibid

[34] Ibid

The issues outlined in this paper highlight some of the complex questions which lie ahead in resolving claims arising from the House of Lords decision in *Paramount*. Unfortunately, there are no clear answers to the various questions identified. The coming year will no doubt be marked by a number of legal test cases.

V. Further Reading

1. *'The Insolvency (No 2) Bill (Bill 76 of 1993/94)'*, Library Research Paper 94/48, 18 March 1994.

2. *'Annotated Guide to the Insolvency Legislation'*, L.S. Sealy and David Milman, 4th edn. CCH Editions Ltd., 1994.

3. *'Corporate Insolvency'*, Shashi Rajani, 2nd edn. Tolley, 1994.

4. 'Corporate Rescues and Insolvencies', James Lingard, 2nd edn. Butterworths, 1989.

5. '*The Law and Practice of Administrative Receivers and Associated Remedies'*, Paul Lange and Hans Hartwig, Sweet & Maxwell, 1989.

Related Research Papers include:

Trade and Industry

94/48	The Insolvency (No 2) Bill [Bill 76 of 1993/94]	18.03.94