The Operation of the Insolvency System in the U.K.: Some Implications for Entrepreneurialism

Bryan Gladstone
Jennifer Lane Lee

ABSTRACT. An inquiry of entrepreneurs in economic theory is followed by an overview of the insolvency system in the UK. The impact of the insolvency system upon entrepreneurs in the UK is then discussed. It is concluded that while there have been ostensible attempts at reforming insolvency law, these efforts have primarily benefitted large firms. Moreover, it is maintained that the current operation of insolvency law remains principally geared toward the protection of creditors. As a consequence, small entrepreneurial firms have little or no alternative to liquidation, irrespective of the best interests of the company or its creditors. The entrepreneurial founders of these failed firms are then faced with potential disqualification and long-term, if not permanent, financial obstacle to continued entrepreneurship. It is proposed that the severity of the regime discourages the re-entry of entrepreneurs into the market thereby depriving the UK economy of an experienced and potentially vital force for innovation.

I. Introduction

Micro-economic policies of the British government during the 1980s focused on the creation of new firms and the promotion of a so-called 'Enterprise Culture'. Even though a large number of firms were born during the 1980s, many succumbed to insolvency in the recent recession. Since exit is a natural part of the operation of the market, this does not necessarily imply that the policies were a failure. However, where the exit of these firms is coupled with a legal and financial bias against those individuals who were at the helm, then enterprises of the future may never be born and the mistakes of the past never corrected. As a consequence, the long sought after 'Enterprise Culture' may never be engendered.

The purpose of this paper is to consider the implications for entrepreneurialism of the way the British insolvency system approaches small company failure. We begin by examining the place of entrepreneurs and entrepreneurialism in economic theory and conclude that a qualitative view of the entrepreneur has come to the fore. This leads us to the assumption that social structures, such as the legal system, can have a significant impact upon the decision making of individuals who possess "entrepreneurial qualities".

Next, we present the framework of the insolvency system and discuss briefly how it disposes of the resources of failed enterprises. What is revealed is that insolvency law in the UK operates against the rehabilitation of failed entrepreneurs and that, as a result, an 'Enterprise Culture' is not being fostered.

The paper concludes with a consideration of the issues raised. It highlights issues that should concern policy-makers and excite the interest of researchers. It is remarkable that, at a time when interest in small business development is great, so little is known about how entrepreneurs are treated when things go wrong. The Scottish King, Robert the Bruce, despondent after a series of crushing defeats at the hands of the English, was taught by a spider, "If at first you don't succeed, try, try again." He did just that at Bannockburn and so won a famous victory and commemoration

Final version accepted on October 26, 1993

Bryan Gladstone
Sheffield Business School
113 Arundel Street
Sheffield, S1 2NT
UK

and

Jennifer Lane Lee
Liverpool Business School
98 Mt. Pleasant
Liverpool, L3 5UZ
UK

Small Business Economics 7: 55–66, 1995.

on statues throughout Scotland. Were he a failed small businessman in the United Kingdom today and not a medieval Scottish king, he may never have had the opportunity to venture again into battle.

II. The economic role of the entrepreneur

Of all of the schools of economic thought, most of the credit for the development of the modern perception of the entrepreneur belongs to the Austrian school and, more specifically, to Joseph Schumpeter. Schumpeter began his career by addressing the contentious issue of the origin of profits. He hypothesized that profits were derived, not from the exploitation of labour nor the earnings of capital, but rather they were a "transient anomaly" that resulted from technological or organisational innovations. Such innovations may take the form of the creation of a new product or process, the opening up of a new market, the capture of a new source of supply, or the new organisation of an industry (Chell, 1991). And the profit-making innovations stemmed from the attributes and actions of one individual – the entrepreneur.

Schumpeter (1934) considered the entrepreneur to be "the pivot on which everything turns." He identified the function of the entrepreneur as being "to reform or revolutionise the pattern of production by exploiting an invention or, more generally, an untried technological possibility for producing a new commodity or an old one in a new way, by opening up a new source of supply of materials or a new outlet for products, by reorganizing an industry and so on" (Schumpeter, 1987, p. 132). He suggested that the entrepreneur is dynamic, and actually creates disequilibrium through his constant innovation. In sum, Schumpeter viewed the entrepreneur with a passion that is unique among the Austrian economists and, for that matter, among most economists: for him the entrepreneur is an extra-ordinary individual who through trial and tribulation drives the economy along toward a new, higher state.

The entrepreneur aims for some point beyond the existing equilibrium, thus placing his actions outside the existing system. This disequilibrating effect revolutionizes the economic structure from within and destroys the existing one. Schumpeter called this the process of "Creative Destruction" (Schumpeter, 1987, p. 83). But there are limits to the cycle of death and rebirth, according to Schumpeter. Controversially, he envisions the process of progress as becoming mechanized and thereby ironically obviating the need for the disequilibrating activities of the entrepreneur.

A contemporary member of the Austrian school, Israel Kirzner, also examined in depth the place of the entrepreneur in economic theory though he held somewhat differing views from Schumpeter. To Kirzner, the entrepreneur is a catalyst who is alert to unexplored possibilities of exchange (Kirzner, 1982, p. 273). The different profit opportunities are spotted because of differing individual perceptions and differing levels of creativity. That is, the "entrepreneurial knowledge" was there all along, only the individual's particular ability to harness it differentiates him from others.

The Kirznerian entrepreneur acts as a middleman who affects the exchange of unexplored opportunities (Kirzner, 1982, p. 273). He may hold no resources of his own, and may not even be an investor in the exchange. So the entrepreneur has the possibility of obtaining a pure profit from an exchange by convincing capitalists that the surplus left over after the exchange is large enough to make everyone better off. Importantly, critical to the success of such a venture is the entrepreneur's ability to persuade lenders of his competence and trustworthiness.

Marc Casson (1982), while not a member of the Austrian school, has contributed much to more recent explanations of the role of the entrepreneur and is at the vanguard of the development of so-called psychological economics. A follower of Frank Knight, Casson believes that entrepreneurs receive a return, not for adapting to change, but rather for bearing uncertainty. He proposed a definition of the entrepreneur as "someone who specializes in the taking of judgemental decisions about the coordination of scarce resources" (Casson, 1982, p. 23). Since judgement is central to Casson's vision of the entrepreneur, the qualities and abilities of the individual are crucial to his ability to make the correct decisions and thus reap the economic rewards.

In conclusion, the entrepreneur in economic theory is generally considered to be a unique individual. A qualitative view of the entrepreneur has continued to grow in popularity with economists and psycho-social theorists. These qualities may be innate, or they may be developed, but clearly they do not emerge in a vacuum. Whether distinguished by innovative capacity, creativity or good judgement, the entrepreneur nevertheless is vital to the workings of the modern market. How society views these qualities, and the individual that possesses them, is pertinent and how the economic and legal system harnesses or alternatively obstructs them are crucial to their deployment.

III. Entrepreneurs and the experience of failure

Theorists disagree as to whether the qualities that make an individual an entrepreneur are innate or can be developed through training and experience. Whatever the conclusion, an entrepreneur, born or educated, will benefit from experience. Furthermore, it is a truism that some of the most beneficial experience is experience garnered through failure. But in the UK, neither policy nor practice has as yet accounted for this "experience factor".

In theory, successful entrepreneurs will temporarily reap profits that attract new competition whilst unsuccessful entrepreneurs will leave the market. The best get in first and reap the highest rewards, followers trail in behind, and through their competition "reform and revolutionize the pattern of production" (Schumpeter, 1987, p. 132). Unsuccessful entrepreneurs somehow melt away; ". . . and there [are] fewer firms in the industry" (Koutsoyannis, 1979, p. 161). But is this "melting away" the same as failure? Or is it part and parcel of the cycle of creative destruction proposed by Schumpeter? The implication of standard theory, that factors of production have somehow been reallocated, provides no answer.

Even the few commentators who take a closer interest in the implications of the process of company failure do not consider how the imperfections in the system may impact on entrepreneurs. For instance, Scott and Ritchie (1984) suggest that entrepreneurial failure provides a learning experience which improves the entrepreneur's ability. Such commentary tells us nothing about what actually happens to the unsuccessful entrepreneur upon the failure of the venture. Binks and Vale (1990), in their otherwise excellent *Entrepreneurship and Economic Change*, offer a full recipe book of policies to encourage entrepreneurship, but have virtually nothing to say about failure itself except that it is "a costly and inefficient process . . ."(Binks and Vale, 1990, p. 132). Their emphasis is on improving entrepreneurialism through the training of entrepreneurs and business advisors so as to avoid failure. They merely agree with Scott and Ritchie that it is traditional to learn entrepreneurial skills from one's mistakes.

Undeniably, professional advisors, such as enterprise agencies and consultants, might help to prevent the failure of the business and thus avoid recourse to the tangle of the legal system (See, Keeble *et al.*, 1993). But they seldom act to advise entrepreneurs on how to re-enter the market after they have failed. This perhaps stems from nature of the small firm creation strategy espoused by many policy-makers which encourages business start-up, but does not focus specifically on the individuals who are the principal actors in this process. David Storey and his colleagues have suggested that the government's small firm creation policies should be abandoned in preference to a strategy that encourages existing firms to grow (Storey *et al.*, 1987). They emphasize furthermore, that policy-makers must also be concerned with those viable firms which face financial difficulties that they cannot resolve on their own. Storey's recommendations do not, however, address the difficulties of the small business from the perspective of the individuals who have faced them and lost.

In summary, the prevalence of support infrastructure for business start-ups is being challenged and policy-makers, researchers and consultants are beginning to address the needs of existing firms. However, there is still little or no concomitant recognition of, or accompanying policy, to rehabilitate entrepreneurs forced out of entrepreneurialism, even though they are a vital part of the competitive cycle. The impact of failure on the individual entrepreneur has been of minimal interest to most theorists, perhaps because their concern focuses primarily on the qualities of entrepreneurialism rather than the individual employing them (Dalton, 1974, pp. 41–51). Carsrud (1990), in an advisory discussion of public agency support for small business people, goes so far as to describe the fundamental defining characteristic of the entrepreneurial personality as, "that which causes the entrepreneur to keep on picking him or herself up after setbacks . . ." Carsrud perhaps unintentionally gives the impression that this "characteristic" is an inherent trait. Unfortunately, there is no evidence that entrepreneurialism is so plentiful that society can ignore the possibility that the consequences of failure may have a profoundly limiting effect on the supply of entrepreneurial talent.

Failure is a component of the competitive cycle that should not be ignored, as Hoppitt (1987) pointed out in *Risk and Failure in English Business 1700–1800.* "Risk taking," said Hoppitt, "is part and parcel of enterprise and, as Schumpeter saw, those risks can only be properly appreciated if the unsuccessful are studied alongside the successful" (Hoppitt, 1987, p. 16). Hoppitt found that, in the Eighteenth Century, rising levels and rates of bankruptcy were caused because more businessmen were taking risks and correspondingly because their decisions were also becoming more risky: ". . . the mass of imitators did their imitating job so well and in such numbers that not only was growth realised, but instability worsened and rates of bankruptcy increased" (Hoppitt, 1987, p. 177).

The willingness of new entrepreneurs to enter the market does not disprove the existence of a substantial opportunity cost to society from the withdrawal of others. In fact, there is considerable anecdotal evidence to the contrary. For example, Sochiro Honda, the Japanese auto magnate, actually attributes his phenomenal success to repeated failures and the introspection which ensued (Gilder, 1986). Obviously, some entrepreneurs will be discouraged by the failure of their company and some will not. It is self-evident, however, that the experience itself does have an impact on the morale of entrepreneurs. Moreover, the current process into which the failed entrepreneur falls may impact on more than the individual's psyche; it may ultimately affect their actual ability to re-enter the market, even where their desire to do so remains strong.

Whether a business fails, or in our terms is liquidated, is not an issue which can or should be resolved by either policy-makers or lawyers. Nor is the question of whether the entrepreneurial founder of a failed firm should foster another business. Rather, each issue is solely a question for the market. The market, being the best processor of information available, will provide the closest answers as to whether the costs of supporting a particular troubled firm or ambitious entrepreneur are outweighed by the potential future benefits. Unfortunately, the way in which the legal system responds to potential failure seriously impedes the scope for a market-based assessment.

IV. Small company failure and the legal system

A small company is assumed to be an independent business of less than 50 employees and a turnover of no more than £2 million, managed in a personalised way by its owners or part-owners, and possessing a small market share (Bolton Committee Report, 1971). The small entrepreneurial company, in this context, is a small company, driven by an entrepreneur who is (or has been) operating as a force for transition within its particular industry.

In simplest terms, small companies fail when they are struck off the Register at Companies House or will be removed (Storey, 1987). While we lack a consistent formal definition of company failure, it is usually taken to be when a firm stops trading under its present ownership through its inability to meet the demand of its creditors. Variations of this definition have been used in most inquiries into business failure (London Business School, 1987, p. 7). Company failure may involve:

(a) the liquidation of assets and loss of all associated jobs or
(b) the sale of all or part of the firm as a going concern.

In either case, the proceeds are used to meet the demands of creditors.

Creditors are paid according to the strength of their claims against the firm. Most senior are secured creditors, who secure against fixed assets such as land or buildings, and the debenture holders who hold floating charges against the whole of the debtor's asset base. Behind secured creditors in the queue are the preferred creditors. These include the government, those with claims arising from the insolvency proceedings (most notably the insolvency practitioners acting as receivers or liquidators) and redundant employees. In the event of a company failure senior creditors are paid first followed by junior creditors and, ultimately, owners.

Prior to 1986, insolvency law was specifically structured in favour of creditors and geared toward pursuing fraudulent debtors. No procedure existed whereby the insolvent debtor could voluntarily liquidate his affairs and no alternative process was viable for the small trader. In 1976, the government established a committee under the chairmanship of Sir Kenneth Cork to reappraise the entire insolvency system. The Cork Committee (1980) advised that the time had come for a new law governing insolvency and criticised the predilection for "retributive and punitive justice toward the debtor."

It recommended that the balance of the system be tilted away from punishment and toward rehabilitation, but cautioned that "high standards of commercial morality" must be guarded so as to retain the public confidence. Today, UK insolvency law is based on the Insolvency Act of 1986 (and corresponding Insolvency Rules), and the Companies Act of 1985. While an ostensible effort has been made to rehabilitate the debtor and to facilitate the recovery of the insolvent business, in practice the primary objective of the law remains the protection of creditors (Gladstone, 1993, p. 20).

The aims and objectives of the current law can be inferred from the powers granted to creditors or to the Official Receiver acting on behalf of the creditors:

(a) To remove directors from management. It is a long-standing principle of UK law that those in power when a company fails should have no significant continuing management role (Goode, 1990, p. 6);

(b) To suspend individual actions by creditors. This is central to an orderly insolvency processing, but in the UK there are special cases in all forms of insolvency wherein certain classes of claimant's individual rights are not affected. For instance, an unsecured creditor can put a company which is already in administrative receivership into liquidation over the objections of other creditors (Sealy and Milman, 1988, p. 373);

(c) To ensure an orderly and fair ranking of creditors and a distribution of assets which reflects that ranking. This is important in the specific case of a company liquidation when a large number and variety of creditors are present;

(d) To prevent or void transactions which are unfair to creditors. This involves legal constraints on directors and insolvency practitioners. Should a director allow trade when he/she knows the company is insolvent or should a practitioner diminish the value of a company in his/her care through trade, they can be pursued for damages by creditors and the former can be disqualified (Griffiths and Williams, 1986, pp. 5–14);

(e) To investigate the causes of company failure and to punish culpable management by directors and officers. It is a basic principle of the law that those unfit to manage should be punished for losses caused to creditors and employees (Goode, 1990, p. 8);

(f) To facilitate the recovery of companies. Insolvency practitioners are charged to seek the best possible outcome for creditors. This may mean that a company in receivership or administration can trade out of insolvency (Cork Gully (A), p. 2).

The important inference to draw from this list is that insolvency's primary victims in law are creditors and that, whilst company directors may not be criminally culpable, they are at least guilty in failing in their duties to creditors. Only the last named objective deals with recovery and it is not a strongly emphasized power so much as a highlighted possibility. In many ways, for an insolvency practitioner to attempt to trade a company out of insolvency might be seen as contradicting his/her responsibility to avoid diminution of company asset value. To carry on in business is to risk just that.

Equally, the capacity of creditors to get a company wound up in some instances, even though other creditors have agreed to let it go into administrative receivership, is significant. It is the strongest possible deterrent to attempts by insolvency practitioners to seek a solution that enables the debtor to trade its way out of insolvency. Benzie points out how, far from ordering and regulating debtor-creditor conflict, the process may become "a race by creditors leading to company insolvency and the personal bankruptcy of debtors" (Benzie, 1986, p. 24).

It is understandable why this situation should come about. When a system is geared towards the regulation of creditor claims the crucial factor becomes the establishment of a queue that competing creditors must accept. Seniority of debt is the most significant factor in such a system.

Thus, UK insolvency law does not bring as much opportunity to avoid the negative effects of insolvency as might be desirable. It is difficult to reconcile the sixth objective, facilitating the recovery of companies, with the other five. Goode's view is that the purpose of insolvency law is primarily to regulate the pursuit of claims so as to prevent the "free for all . . . of individual claims by different creditors . . . ." and replace it with a mechanism that allows for the collection and realisation of assets and their equitable distribution amongst individual claimants (Goode, 1990, p. 2). As long as it is possible for individual creditors to pursue debts against the possible best interests of other creditors, it is going to be difficult for creditors in general to agree to less drastic solutions than the winding up of debtor firms.

V. The insolvency procedures and small firms

The insolvency procedure can take anyone of several forms spelled out in the Insolvency [IA, 1986] and Companies Acts [CA, 1985]. These include: voluntary arrangements, administration, administrative receivership and liquidation. Liquidations can either be compulsory or voluntary.

Administration has been described as the UK equivalent of the American Chapter 11 provision. It is instituted through an application to the Court for an administrative order installing an insolvency practitioner as company administrator. Once an administrator is appointed, the appointment of a receiver or the enforcement of security claims against company assets is not allowed. Administration orders may be granted when one or more of the following outcomes is likely to be achieved (County NatWest WoodMac, 1991, p. 31):

(a) The survival of all or part of the company;
(b) The approval by creditors of a voluntary arrangement to restructure the company;
(c) The sanctioning of a compromise or other revised arrangement between creditors and the company (such as a CA s. 425 voluntary arrangement);
(d) A more advantageous realisation of the assets of a company than a winding up.

Administration is rarely put in place because it requires the agreement of creditors holding floating charges (debenture holders) against the company. Such creditors, usually banks, are loathe to agree unless the company is very large because the implementation of an administration order is costly and complex. Moreover, many smaller firms are further discouraged from using the administration procedure because of the way the Insolvency Rules operate. Insolvency Rule 2.2 requires an in-depth, independent report on the company's affairs. Complying with this rule is difficult and expensive and beyond the financial capacity of most troubled firms. Consequently, in most cases creditors ignore the administration procedure and apply for a receiver or liquidator to be brought in (Cork Gully (B), p. 7).

Company voluntary arrangements (CVA) are work-outs agreed with creditors without recourse to the formal insolvency system (CA, 1985, s. 425). This procedure is usually recommended where the company has suffered short-term problems that can be remedied. Because of the costs, the expanded time scales, the varying positions of debtors and creditors, and the inability to obtain a protective interim order, this technique has rarely been used by companies (Insolvency Bulletin, 1992, p. 7; Economist, 1992). Under a CVA, the company is completely exposed until the Court sanctions the scheme, so a creditor can call in the receiver over the heads of other creditors whenever it thinks its interests are prejudiced. Also, the CVA offers no protection to the company director from prosecution for wrongful trading should the company continue trading while the company is insolvent.

All this leaves the insolvent company in a very precarious position and as a result, the procedure is at present only used at the end of an administration order when an insolvent firm is well on the road to recovery (Jack, 1993).

Administrative receivership occurs when a creditor (usually a bank) is unwilling to continue supporting a company and asks the board of directors to invite it to appoint insolvency practitioners to act as administrative receivers. In most cases a bank has decided to collect on its floating charge and 'pulled the plug'. The normal outcome is the sale of the business as a going concern or piecemeal with the proceeds put towards the liquidation of the outstanding debts. Creditors get paid in full in order of seniority until the money runs out. With the exception of the marginal creditor, they recover all or nothing.

Administrative receivership is less expensive than administration since it avoids court involvement, but it allows for no restructuring of debt. Moreover, as noted above, an unsecured creditor can force a company that is in administration into receivership or full liquidation, even over the objection of other creditors (Sealy and Milman, 1988). It also means the end of involvement in the company for its directors. However, in this respect, it is less onerous than liquidation as there is little likelihood of them being investigated and declared unfit to act as directors.

The final option for insolvent companies is straight-forward *liquidation*. Liquidation can be either voluntary, where shareholders appoint a liquidator and ask creditors to approve their action, or it can be compulsory, where a creditor, owed at least £750, applies to the Court for referral to the Official Receiver. The Official Receiver in a compulsory liquidation can either appoint a liquidator or can act in that capacity himself where there are insufficient funds available.

Liquidation is a last resort action. There is little chance that any but the most senior creditors will receive recompense. The Official Receiver or appointed liquidator is there to dispose of assets as quickly as possible. Liquidations always involve an investigation into the conduct of the directors and can lead to their disqualification from holding any management role for from two to fifteen years (Cork Gully Directors (B), p. 2).

Department of Trade and Industry statistics, covering all sizes of insolvent companies, reveal a marked variation between the frequency with which different routes are followed. Liquidations and receiverships are by far the most frequent with the work-out options of administration and voluntary arrangement followed by only a handful of all insolvent firms. The statistics clearly demonstrate that the insolvency systems bias toward the creditor continues.

Thus, in spite of the recommendations of the Cork Report calling for an end to the predilection for "retributive and punitive justice toward the debtor," the current procedures are overwhelmingly geared towards the protection of creditors' interests. As such there is nothing in UK insolvency law that actually assists the directors of insolvent companies or the owners of unlimited firms in surviving insolvency crises. Of all insolvent companies between 1989 and 1992, only 672 English or Welsh companies entered into administration and only 300 agreed to voluntary arrangements (DTI).

These statistics do not account for size, but due to the complexities and expense of the administration and voluntary arrangement procedures, it is safe to assume that few if any insolvent small companies escaped liquidation. Recent research seems to confirm this assumption. A survey by Deloitte, Haskins and Sells with Business in the Community in 1989 found that a primary problem in supporting small businesses was the reticence of private sector fund providers to contemplate changes in their approach that carried increased risk to credit safety (Deloitte *et al.*, 1989, p. 9). This was confirmed in a later study by Cousins Stephens Associates (1991, pp. 71–72). As Table I shows, only about 1% of insolvencies are tackled through administration or CVA. In other words, the owners and directors of 99% of insolvent firms lose them.

Cork Gully bluntly warns prospective clients that it is usually too expensive to take small businesses into administration or voluntary arrangements leading to rescue (Cork Gully (B), p. 12):

> The basic structures of the legislation are there, but the means to implement them are lacking in many cases.

There has been some evidence of efforts by small businesses and their advisors to persuade creditors to become more amenable to informal voluntary arrangements (Curran and Blackburn,

TABLE I
Insolvency proceedings in England and Wales

	1989	1990	1991	1992
Company Insolvencies				
Compulsory liquidations	4,020	5,997	8,368	9,732
Creditors' voluntary liquidations	6,436	9,074	13,459	14,692
Total insolvent liquidations	10,456	15,051	21,827	24,424
Other insolvency proceedings				
Administrative receiverships	1,706	4,318	7,515	n/a
Administrations	135	211	206	120
Voluntary arrangements	43	58	137	76
Total other proceedings	1,884	4,587	7,858	n/a

Source: DTI
Note: Members' voluntary liquidations are not included because they are not associated with insolvency.

1992, pp. 25–28; Goldstein, 1993; Aston Business School, 1991, pp. 68–71; Wren, 1987, p. 109). In essence, this amounts to little more than recognition that creditors are more likely to be sympathetic to escape packages when they have enough information to make an informed assessment of risk (Coopers & Lybrand, 1992). Given the overwhelming statistical evidence, it appears to be a faint hope.

Insolvency Bulletin quotes a number of insolvency practitioners who claim that CVAs will become more common with them. But, as noted above, CVAs can take years to set up and complete; it is difficult to ensure continuing credit for the firm; and once creditors are advised that a CVA is being sought, their claims may flood in before the CVA can be set up (Insolvency Bulletin, 1992, p. 7). Moreover, a CVA will cost the average small company £25,000–30,000, which is between a third and a half of the cost of an average receivership (Krasner, 1992, p. 9). Such a sum is still too great a cost for most small companies to carry. In a survey of roughly 60% of the insolvency practice offices in the United Kingdom, Krasner found reports of only 26 completed CVAs in 1991 and 18–38 in the first 11 months of 1992.[1]

Gladstone (1993), in another survey of insolvency practitioners found that neither CVAs nor administrations were considered viable options. The only exception was where there was a single main creditor, strong business prospects and little likelihood of realising a significant sum from debtor assets. Only relatively asset-rich insolvent small firms can contemplate surviving a further call on presumably depleted finances required to complete a CVA.

Mark Goldstein, an insolvency practitioner who specializes in CVAs, is more optimistic about the role of CVAs. Instead, he thinks that CVAs might be "the best of any" of the variety of global rescue and reorganisation procedures (Goldstein, 1993). He says that the procedure, correctly formulated, provides the company with the opportunity to work its way out of trouble, thereby saving jobs and preserving assets while repaying creditors. He asserts that the supposed drawbacks of the procedure have, in his experience, proved surmountable.

But in spite of his enthusiasm for the procedure, Goldstein nevertheless concedes that Britain does not have a "rescue culture" – the absence of which prevents practitioners and secured lenders from grasping the value of the CVA. He concludes, "we are still thinking first about burial rights for struggling companies, rather than acting as paramedics who can save them" (Goldstein, 1993).

Liquidation is far easier in terms of time and is a more remunerative route for a secured creditor that any other option. Cressy (1992) has considered the dilemma facing banks in their efforts either to reschedule the debt of a defaulting debtor or to recover what they can through liquidation (Cressy, 1992, pp. 6–8). He hypothesizes that the profit-maximising strategy for the bank is to liquidate those firms with the highest asset values and lowest bankruptcy costs, "*since they are more valuable dead than alive.*" It is therefore the firms that are best suited to develop and implement a work-out plan that are the most likely to be liquidated.

Furthermore, Underdown (1992) highlights the difficulties involved in achieving adequate levels of cooperation between the different parties who must collaborate to avoid receivership or liquidation, stressing the often large social and cultural gap between lenders and accountants on the one hand and small business people on the other. He suggests that professional class lenders and accountants find it difficult to identify with the liquidity problems of often working-class craftsman-entrepreneurs. Even if they wish to do so, they may find that the entrepreneurs find the same difficulty in opening up about business problems to them, because the socio-cultural gap is so wide from their perspective (Gill, 1988, pp. 43–51). The insolvency practitioners surveyed by Gladstone believed that many SME failures could be avoided if insolvency practitioners were brought in at an earlier stage, but that entrepreneurs did not understand that practitioners could help them to avoid insolvency (Gladstone, 1993, pp. 105–106).

Thus, for a host of reasons, the insolvent small business would appear to be poorly served by the UK insolvency regime. It is not in a strong position in law to influence its creditors in pursuit of long-term survival. There is evidence of growing awareness of the inadequacy of UK insolvency law as a framework to encourage outcomes that involve the survival of the firm, but there is little sign of change. Investigators such as Underdown are finding clear signs of the lack of communication between small firms and creditors, and the popular press reports regularly on the issue (Stein, 1993). The creditor bias in insolvency law would appear to build on that lack of communication to the detriment of survival chances of insolvent small businesses.

VI. The long-term consequences of insolvency for owners of small companies

In addition to facing the loss of their company, company owners and directors also face the potential loss of their ability to own or manage future companies. The Insolvency Act of 1985 introduced provisions that increased the likelihood that directors of insolvent companies would be disqualified (IA, s.212 *et seq.*). According to a NatWest Guide to the Act, the new provisions

> reflected the urgency of the need to strengthen substantially the effectiveness of control over the activities of directors. It was widely believed that too many unscrupulous or incompetent persons were hiding behind the facade of limited liability companies to escape the consequences of their own actions or inactions.

Under the Companies Act 1985 provisions had already been introduced that disqualified an individual from acting as the director of a firm for certain named offenses or if two companies with which he was associated had gone insolvent within a five year period (CA, s. 295 *et seq.*). Likewise, the Director's Disqualification Act (1986) mandated that practitioners report on the conduct of every director of an insolvent company to the DTI. The subsequent Insolvency Act overlaps these laws and furthers the likelihood of directors facing disqualification. In addition to disqualification, the liquidators of a firm can apply to the Court to have the director made personally liable for some or all of the companies debts (IA, s. 214).

We have shown that UK insolvency law does not encourage the survival of insolvent firms and that it is particularly harsh on small companies. The possible consequence is that experienced entrepreneurs in Britain are discouraged from re-entering the market. Furthermore, it is also possible that the known defects and consequences of insolvency law could deter the initial entry of an innovative or creative individual into the small firm sector. Unfortunately, due to a paucity of statistical evidence differentiating insolvency procedure outcomes according to size, this assertion will require some effort to prove. However, we believe, as do numerous other authors, that there is a direct correlation between company size and likelihood of a favourable outcome for firms entering the insolvency system (McQueen, 1992; Cork Gully (B), 1991; Gladstone, 1993; Hobson, 1990).

Some statistical evidence for this assertion is provided by the Society for Practitioners of Insolvency. In an annual survey of their members, they found that the percentage of jobs saved through the insolvency system increased as the size of the company increased. For companies with under 100 employees, less than 30% of jobs were saved whereas for companies over 100, over 62% of jobs were saved. A dramatic 93% of jobs were saved in companies with over 400 employees. Put another way, the smaller the firm, the less likely that any jobs will be salvaged from it. We maintain that this is because the small firm that enters the insolvency system is typically liquidated.

As we have noted, liquidation carries long-term consequences for the owners of the defunct firms. In addition to facing the stigma of bankruptcy and potential disqualification, one of the most obvious deterrents to the re-entry of a entrepreneur is the lack of available credit. If the entrepreneur is made personally bankrupt, then his ability to obtain credit can be affected for up to eight years (McQueen, 1993). And, according to Berry and Hill (1989), ". . . these days, once bankruptcy occurs, it is virtually certain that a sale of the matrimonial home will take place if no other arrangements are made with the trustee" (Berry and Hill, 1989, p. 19). Since the home is often a main ingredient in obtaining finance for small entrepreneurial firms, the loss of it through bankruptcy might preclude any future projects of the entrepreneur (Black *et al.*, 1993). Thus the stigmatization implicit in the operation of the system serves to stifle, or even prohibit, the competitive provision of finance by the market.

Finally, intuition supports the assertion that failed entrepreneurs in the UK are dissuaded from re-entering the market. Galt and Heasell (1991) suggest that

> . . . as well as assessing the expected positive benefit of self employment over wage employment, potential entrepreneurs are also keenly aware of the possibility of failure and . . . risk averse individuals will weigh this heavily in their decision as to whether to enter or not. The consequences of failure, or exit from a market must therefore become a determining factor in the entry decision.

Thus, where an individual is risk averse, or has become risk averse, he may be much less likely to try again in a market in which they have tasted failure. The ramifications of this bias against ruination may be greater still: as stressed above, potential first-time entrepreneurs, observing the predicament of those who have gone before, might choose never to enter the market at all.

Today, a popular view is that entrepreneurs do not simply take risks, rather they take *calculated* risks. Schumpeter and others have maintained that risk taking is a characteristic of business, but not of entrepreneurialism *per se* (Carland *et al.*, 1982; Schumpeter, 1934; Meredith *et al.*, 1982; but see Hull *et al.*, 1980; Brockhaus, 1980). The view of the calculated risk-taker is supported by psychosocial theorists such as McClelland. McClelland (1961) believes that entrepreneurs are motivated by a need to achieve and he has concluded that the high achiever is one who takes calculated risks.

If the entrepreneur is one who makes decisions based on calculated assessments of risk, then the risk posed by failing is surely to be considered. Since entrepreneurs, being individuals, will have varying degrees of risk-aversion, the prospect of failing will be of varying significance to each. It follows, then, that some entrepreneurs, after experiencing the adverse consequences of failing under the UK insolvency system, may choose never to take the risk again.

VII. Conclusions

An efficient market must filter out inefficient entrepreneurialism just as it does the inefficient use of other resources. It is our premise that the UK insolvency regime is rather too severe a selector. It may be that many potentially successful small business entrepreneurs are not hearing the message given by the spider to Robert the Bruce, and thereby never trying their hand in business again.

This issue mandates considerable further research. Above, we declared that we know of no direct statistical evidence which differentiates the outcomes of insolvency proceedings according to the size of the firm. While we believe our conclusions are based on strong intuitive arguments and a wealth of anecdotal evidence, we feel they would benefit enormously from statistical support that examines specifically small firms. Also, we have deduced that since small firms are typically liquidated, and since liquidation always involves an investigation of the director of that firm, it follows that the directors of failed small firms are usually investigated by the DTI and therefore often face potential disqualification. But once again, we lack statistical support to back up this assertion.

In addition to essential empirical research, we hope that this paper will incite further, related research. For instance, there is a need for a close look at second and third time entrepreneurs (in the UK and elsewhere) to determine what distinguishes them from those entrepreneurs who are discouraged after an initial unsuccessful attempt. Such an enquiry will have to overcome significant methodological hurdles since it could potentially touch on academic areas as diverse as psychology, economics, sociology and the law, but would undoubtably be of tremendous value to policy-makers.

There is also a need to examine the CVA procedure as a rescue option for troubled small firms. Can it now be made more readily available to small firms? Or is a complete change in the attitudes of the insolvency professionals and the policy-makers necessary before the law will be made to work for the small company and the entrepreneurs who hope to launch them?

Note

[1] Two respondents aggregated a total of 20 CVAs completed between 1987 and 1992.

References

Aston Business School, 1991, *Constraints on the Growth of Small Firms: A Report of a Survey of Small Firms*, Department of Trade and Industry, London: Her Majesty's Stationery Office.

Benzie, A. G., 1986, 'Changes to Liquidation Procedures', *Insolvency: Companies, Directors and the New Legislation*, Guildford: College of Law Lectures.

Berry, Christopher and Steve Hill, 1989, 'Bankruptcy: Avoiding the Loss of the Matrimonial Home', *The Law Society's Gazette* (12 April), 14–19.

Binks, Martin and Philip Vale, 1990, *Entrepreneurship and Economic Change*, Maidenhead: McGraw-Hill.

Black, Jane, David de Meza and David Jeffreys, 1993, 'House Prices, the Supply of Collateral and the Enterprise Economy', Working Draft, University of Exeter.

Bolton Committee, 1971, *Small Firms: Report of the Committee of Inquiry on Small Firms*, Cmnd 4811, London: Her Majesty's Stationery Office.

Brockhaus, R. H., 1980, 'Risk Taking Propensity of Entrepreneurs', *Academy of Management Journal* **23**(3), 509–520.

Carland, J. W., F. Hoy, W. R. Boulton and J. A. C. Carland, 1984, 'Differentiating Entrepreneurs from Small Business Owners', *Academy of Management Review* **9**(2), 354–359.

Carsrud, Alan, 'Entrepreneurs and Entrepreneurship', taped lecture from the MSc. in *Entrepreneurial Studies by Distance Learning*, Stirling: University of Stirling.

Casson, Mark, 1982, *The Entrepreneur: An Economic Theory*, Oxford: Martin Robertson.

Chell, Elizabeth, Jean Haworth and Sally Brearly, 1991, *The Entrepreneurial Personality*, London: Routledge.

Coopers & Lybrand, 1992, *Solutions for Business*, London: McGraw Hill.

Cork, Sir Kenneth, 1980, *Bankruptcy: Interim Report of the Insolvency Law Review Committee*, London: Her Majesty's Stationery Office.

Cork Gully [A], 1991, *Annual Review 1991*, London: Cork Gully.

Cork Gully [B], 1991, *Insolvency in Brief*, London: Cork Gully.

County NatWest WoodMac, 1991, 'Company Pathology', *Equity Briefing Paper*, CNWM (7), London.

Cousins Stephens Associates, 1991, *Constraints on the Growth of Small Firms: A Report of a Survey of Financial Institutions and Other Organisations*, Department of Trade and Industry, Her Majesty's Stationery Office.

Cressy, Robert C., 1992, 'Small Firm Debt Rescheduling versus Insolvency: The Bank's Decision Problem', *Warwick Business School SME Centre Working Paper Series*, No. 9.

Curran, James and Robert A. Blackburn, 1992, 'Small Firms and Local Economic Networks: Relations Between Small and Large Firms in Two Localities', *Kingston Business School Business Paper Series.*

Dalton, George, 1974, *Capitalism, Communism and the Third World*, London: Penguin.

Deloitte Haskins and Sells, 1989, *Local Authority Support to Growing Business*, London: Deloitte Haskins and Sells.

The Economist, 1992, 'When Firms Go Bust', 1 September, 67–71.

Galt, Vaughan and Steve Heasell, 1991, 'Entrepreneurship and Growth', paper presented at the *21st European Small Business Seminar*, Barcelona.

Gill, John, 1988, 'Providing Effective Help for Infant Businesses in Areas of Unemployment', *International Small Business Journal* **7**(1), 43–51.

Gilder, George, 1986, *The Spirit of Enterprise*, Middlesex: Penguin Books.

Gladstone, Bryan, 1993, *Rescue or Ruination: A Comparison of Approaches to Small Business Insolvency and Bankruptcy between the United States and the United Kingdom*, MSc. in Entrepreneurial Studies, Scottish Enterprise Foundation, University of Stirling.

Goldstein, Mark, 1993, *Treasury Management*, forthcoming.

Goode, R. M., 1990, *Principles of Corporate Insolvency Law*, London: Sweet & Maxwell.

Griffiths, Michael and Stuart Williams, 1986, *The 1986 Insolvency and Companies Legislation*, CAET, London.

Hobson, Rodney, 1990, 'Creditors Recover More with Voluntary Schemes', *The Times* (13 January).

Hoppitt, Julian, 1987, *Risk and Failure in English Business 1700–1800*, Cambridge: Cambridge University Press.

Hull, D. L., J. J. Bosley and G. G. Udell, 1980, 'Renewing the Hunt for the Heffalump: Identifying Potential Entrepreneurs by Personality Characteristics', *Journal of Small Business* **18**(1), 11–18.

Insolvency Bulletin, 1992, 'CVA Who is Doing It?', November, 7.

Jack, Andrew, 1993, 'Insolvency Law Seen as Bayoneting the Wounded', *The Financial Times* (January 21), p. 8, cols. 1–7.

Kirzner, Israel M., 1982, 'The Theory of Entrepreneurship in Economic Growth', in C. A. Ken, D. L. Sexton and K. H. Vesper (eds.), *Encyclopedia of Entrepreneurship*, New Jersey: Prentice-Hall.

Koutsoyannis, A., 1979, *Modern Microeconomics*, 2nd ed., London: MacMillan Education.

Koutsoyannis, A., 1982, *Non-Price Decisions: The Firm in a Modern Context*, London: MacMillan Education.

Krasner, Gerald, 1992, 'Corporate Voluntary Arrangements', *Insolvency Bulletin*, November, 8–10.

London Business School, 1987, *A Study to Determine the Reasons for Failure of Small Businesses in the UK*, London: Stoy Hayward and NatWest Bank.

McClelland, D. C., 1961, *The Achieving Society*, Princeton, New Jersey: Van Nostrand.

McQueen, John, 1992, *Bankruptcy: The Reality and the Law*, Lancaster: The Bankruptcy Association of Great Britain and Ireland.

Ratford, W.F. *et al.*, 1985, *A Guide to the Insolvency Act 1985*, London: Financial Training Publications.

Schumpeter, Joseph, 1934, *The Theory of Economic Development*, Cambridge: Harvard University Press.

Schumpeter, Joseph A., 1987, *Capitalism, Socialism and Democracy*, 6th ed., New York: Harper and Row.

Scott, Michael and John Ritchie, 1984, 'Re-thinking Entrepreneurial Failure', in John Lewis, John Stanworth and Allan Gibb (eds.), *Success and Failure in Small Business*, London: Gower.

Sealy, Michael and David Milman, 1988, *Annotated Guide to the 1986 Insolvency Legislation*, London: CCH Editions.

Stein, R., 1993, 'You Can't Blame It All on Banks', *Today*, 26 February., 34.

Storey, D. J., K. Keasey, R. Watson and P. Wynarczyk, 1987, *The Performance of Small Firms, Profits, Jobs and Failures*, London: Croom Helm.

Underdown, Brian, 1992, *Corporate Insolvency: Aspects of Interaction*, unpublished research proposal, Sheffield University.

Verin, Helene, 1982, *Entrepreneurs, Enterprises, Histoires d'une Idee*, Paris: Presses Universitaires de France.

Wren, Colin, 1987, 'Closure Rates among Assisted and Non-Assisted Establishments', *Regional Studies* **22**(2), 107–119.