

# MACFARLANES

## CORPORATE

---

### BRIEFING

#### COMPANIES IN FINANCIAL DIFFICULTY

##### PRACTICAL ISSUES FOR DIRECTORS

###### Introduction

A company, or group of companies, may find itself facing financial difficulty for many reasons. Poor trading, the loss (perhaps through insolvency) of an important customer (or supplier), excessive cost of borrowings not covered by earnings, litigation, loss of investor support. In some cases the writing may have been on the wall for some time. In others, it might be a sudden catastrophic event or change of circumstances which is the cause.

There may be a temptation to struggle on in the hope (or unrealistic belief) that things will turn round until, faced with a cash crunch - an inability to meet the month end payroll, the freezing of the overdraft - there is no further room for prevarication.

Leaving things to the last moment is of little benefit to the company's shareholders, its creditors or employees. Changes in the law, particularly the Insolvency Act 1986 (the *1986 Act*), have been designed to encourage directors to seek help and advice earlier, and at a time when more options may be open for saving the business.

This paper covers the legal issues involved, including the different kinds of insolvency procedure available and the implications for directors of acting improperly, or failing to act at all.

##### DUTIES OF DIRECTORS

###### Being informed

First and foremost, it is the responsibility of the board of directors of a company facing financial difficulty to ensure that they have accurate, comprehensive, regularly updated financial and trading information to enable the proper monitoring of the company's situation and to form the basis on which informed decisions may be taken.

If the company's own systems cannot reliably provide this information, urgent external support from an accountancy firm will be required.

The information should, in particular, enable the directors to determine whether the company can (and can expect to continue to) satisfy two tests, namely:

- ◆ the cash flow test - that the company can pay its debts as they fall due
- ◆ the balance sheet test - that the company's gross assets (valued at their current saleable, not book, value) exceed its gross liabilities taking into account its contingent and prospective liabilities (for example, future rent, performance of prepaid contracts and potential liabilities under guarantees or warranties).

If the company is unable to satisfy one or other test, it is 'unable to pay its debts' for the purposes of the 1986 Act. This has a number of implications: it is at risk of being put into liquidation by creditors; it will be in breach of any contract (including lending covenants) which use the Insolvency Act tests as an event of default; transactions which it enters into may subsequently be set aside (if it goes into liquidation or administration); and the directors risk incurring personal liability for the company's debts if it eventually goes into liquidation. In practice, if it fails the first test, a trading company is unlikely to be able to carry on for long irrespective of its net asset position. Reliable cash flow forecasts are vital.

###### Staying informed

Monitoring of the financial situation needs to be undertaken on a regular basis until it is decided that specific action is required, or that the company's problems are clearly over.

###### Advice

Independent external professional advice from corporate recovery specialists should be sought without delay if the board is concerned that insolvency is a real possibility - not least for the personal protection of the directors.

###### The key issue

The board's particular concern should be to satisfy itself that, if the company continues to trade, there is at least a reasonable prospect of it avoiding insolvent liquidation i.e. that it can survive as a going concern and pay all its creditors. If at any stage the point is reached when the board cannot reasonably conclude, after a careful analysis of the facts and after proper advice, that there is a 'reasonable prospect' of this, the board's duty is to take every step with a view to minimising the potential loss to creditors. Failure to do so could lead to the directors being found liable for wrongful trading, and personally liable for the company's debts (see further below).

If the company has negative net assets (i.e. it fails the balance sheet test), but the board considers that it has a reasonable prospect of avoiding insolvent liquidation and can expect to pay creditors as they arise from its cash flow or from new capital, it may continue to trade, but the prospect of avoiding liquidation must be kept under constant review.

### **Record keeping**

On each occasion when the solvency of the company is discussed by the board, copies of the information and advice before the meeting and minutes of the proceedings should be kept by the directors and their advisers since this will be evidence, if needed later, that the board considered the correct issues, was properly advised and acted appropriately. The minutes of each meeting of the directors should be reasonably detailed, describing the reasons, and the facts upon which they are based, for continuing to trade.

### **Groups of companies**

The distinction between companies within a group, based on their separate legal personality, is often blurred where the group is solvent and managed effectively as a single unit. Elaborate structures may be set up for administrative or tax planning reasons and transactions between group members may take place on terms which would not be offered to external third parties. Specific group members may employ the group work force, or own its buildings, and make these available on cost cover terms to other members of the group. Payment between group members may well not be settled regularly in cash, but give rise to inter company debts and credits.

Arrangements which are practical and defensible within a solvent group may cease to be so when companies within the group become insolvent. The directors of each company must act in relation to each company without regard to their duties as directors of other group companies. This may of course give rise to particular difficulties where duties owed to different companies within a group conflict, and in those circumstances it may become necessary for directors to relinquish multiple directorships.

In practice, the solvency of one company in a group may depend on the solvency of another, either because the assets of the first substantially comprise shares in or debts owed by the second, or the first has guaranteed the debts of the second (which is commonly the case where group borrowing arrangements are in place). In these circumstances the strategic interests of all companies within the group may be the same. Nonetheless, the directors of each company must have primary regard to the effect which actions taken, or permitted, by that individual

company may have on the creditors of that company, rather than the creditors of other companies within the group or the overall solvency of the group as a whole.

### **Who is a 'Director'?**

Anyone duly appointed as a director in accordance with the company's articles of association is clearly a director (whether or not his details have been registered at Companies House).

For the purposes of the 1986 Act, anyone 'occupying the position of director' is treated as if he were a director, even if not formally appointed. So anyone involved in management decision making of the kind conventionally dealt with at board level might be held to be a director for these purposes.

It is possible that someone held out as a director (perhaps with the word 'director' in his job title or on his business card) though not formally appointed might be regarded as a director, but probably not if there is a functioning board at which key management decisions are taken, and in which the individual concerned is not entitled to participate.

### **Shadow Directors**

A 'shadow director' is a person 'in accordance with whose directions or instructions the directors of the company are accustomed to act (but so that a person is not deemed a shadow director by reason only that the directors act on advice given by him in a professional capacity)'. Many provisions of the 1986 Act apply to shadow directors just as they do to 'real' directors. The purpose is to ensure that the same sanctions are available against a figure who, without himself being on the board, effectively tells the board, and hence the company, what to do.

To be a shadow director, a person must effectively give directions to the whole Board, not merely to individual directors. Someone, such as an investor, who appoints a single nominated member of the Board would not thereby be treated as a shadow director, even if the nominated director acted in accordance with the investor's wishes. It would be different if the Board as a whole acted as the investor directed.

It has been suggested that a bank could be treated as a shadow director if it were effectively to dictate how the company should be run: for example, to insist on the sale of particular assets, or dictate which creditors should be paid, and when. In practice (partly for this reason) banks tend to be careful how they present conditions for extending further credit or controlling overdraft levels and there is no recorded case of a bank actually having been found liable as a shadow director.

Lawyers and accountants giving legal and accounting advice come within the 'professional capacity' exception, provided they merely advise and leave the commercial decisions to the board. 'Company doctors' and similar business recovery professionals may be in a more ambiguous position.

## PERSONAL LIABILITY

### Wrongful trading

A director, or shadow director, may be held personally liable for a company's debts if he allows the company to continue trading at any time when he knows or ought to conclude that there is no reasonable prospect that the company will avoid insolvent liquidation. This is *wrongful trading* under Section 214 of the 1986 Act.

An action for wrongful trading can only be brought by the liquidator of a company which has gone into insolvent liquidation, whether voluntary or compulsory (see further below). A company goes into insolvent liquidation if, when it goes into liquidation, its assets are insufficient to pay its debts and other liabilities and the expenses of the liquidation i.e. the creditors will not all be paid in full.

#### *Standards expected*

In deciding whether a director has been guilty of wrongful trading, the standard to be applied by the Court is that of a 'reasonably diligent person' having

- ◆ the general knowledge, skill and experience which may reasonably be expected of a person entrusted with carrying out the same functions as are carried out by that director in relation to the company and
- ◆ the general knowledge, skill and experience which that director actually has.

A director will therefore be judged both objectively (he must show the skill etc. which the reasonable director holding his position would be expected to have, regardless of his own ability) and subjectively (the more experienced director must show a higher standard of competence). Further, a director will be judged in relation to the functions which 'have been entrusted to him' even though, in fact, he failed to carry them out.

### *Individual responsibility*

Each director will be judged individually according to these tests. Higher standards may apply to some than to others on the same board. The sales director might not be expected to be as familiar with the details of the company's day to day cash movements as the finance director, but every director shares a responsibility for ensuring that the company is capable of surviving financially, and this responsibility cannot simply be left to one or two individuals on the basis that it is their job, not the job of others. At the very least, there is an obligation to ensure that proper financial management is being exercised by someone with appropriate expertise.

### *Action*

The Court will not find a director liable if it is satisfied that, once he knew or ought to have concluded that there was no reasonable prospect of the company avoiding insolvent liquidation, he took every step which he ought to have taken to minimise the potential loss to the company's creditors.

The steps to be taken are those which a director with the objective (reasonable) and subjective (actual) levels of knowledge, skill and experience which that director has, or is expected to have, ought to take if he knew that there was no reasonable prospect of avoiding insolvent liquidation.

In many cases those steps will involve the adoption of one of the insolvency procedures mentioned below. In almost all cases it will require the directors to ensure that no further credit is incurred (i.e. that no new creditors are created, and existing creditors, such as the overdraft, are not increased) and that assets (including cash) which would otherwise be available on a liquidation are retained. This may make continued trading more or less impossible, with the exception of selling existing stock for at least the price (net of costs) which a liquidator would achieve.

In appropriate circumstances it might be possible to continue trading on a 'ring fenced' basis. That is to say, on a basis which leaves untouched those assets and liabilities which exist at the date when the directors form the view that liquidation will not be avoided. Any further trading must be funded either out of non-recourse funding (either share capital or subordinated loans which will not compete with existing creditors in the event of liquidation) or from income generated entirely from trading from that point forward (and not using existing stock). This might be desirable if the directors believe that keeping the company going will enable them to sell the business as a going concern and at a higher price than a liquidator would achieve, and it might be justified in a group of companies where a formal

insolvency anywhere in the group could cause the entire group to collapse. Ring fencing existing assets and liabilities ensures that existing creditors will not be put in a worse position by continued trading than if the company were put into liquidation immediately - the same assets will be available to meet the same liabilities in either case. But it will be important to ensure that any new creditors will be repaid in full (to avoid them being in worse position than if the company had instead gone into liquidation immediately) and that existing creditors are not otherwise prejudiced (for example, that they will not continue to incur internal costs, perhaps purchasing additional raw material intended for future supplies to the company which they are unlikely to be able to use when the company does ultimately cease trading, and which they would have avoided if they had known liquidation was imminent).

Any decision on the right action to take should be considered and not precipitate. The motive for continuing or ceasing to trade must be to protect the creditors as far as possible.

#### *Resignation*

Resigning will not exempt a director from liability for wrongful trading up to the time of resignation. It might even exacerbate the risk of a finding of wrongful trading since it is unlikely to fulfil the obligation to take 'every step with a view to minimising the potential loss to the company's creditors'. There are circumstances where it might be the only option e.g. for a director on a divided board who, having done his best to put forward his case for action, is overruled by the majority. It is also possible that conflicts of interest, for example in the context of a proposed refinancing, might make it difficult for an individual director representing particular interests to remain on the board.

#### *Liability*

If a director is found liable, the amount he may be obliged by the Court to pay is likely to be based on the amount by which the company's losses increased after the time when he ought to have taken steps to minimise those losses, but failed to do so. But the Court has a wide discretion. Any payment will go to the liquidation funds for the benefit of creditors generally. It will not be payable only, for example, to those creditors directly prejudiced by the wrongful trading, such as creditors who extended credit only after the time when the wrongful trading began (nor, it seems, will it be caught by any mortgage created by the company).

At the same time as making an order imposing personal liability, the Court may disqualify a director from acting as a director for up to 15 years (see below).

#### **Fraudulent Trading**

If, in the course of the winding up of a company, it is established that the business has been carried on with intent to defraud creditors, the directors may be found guilty of *fraudulent trading* (under Section 213 of the 1986 Act). As with wrongful trading, the Court may order the directors personally to make a payment to the liquidation fund, and may also disqualify them from acting as directors. Fraudulent trading requires some element of dishonesty on the part of the directors, but this may be inferred where for example it should have been clear that the company was incurring debts which would never be repaid, or where the directors make deliberately misleading statements about their intentions or take active steps to avoid paying particular debts. Fraudulent trading may also result in criminal proceedings for which directors found guilty may be fined or even sent to prison.

#### **Misfeasance or breach of duty**

Under Section 212 of the 1986 Act, if a company has gone into liquidation, the liquidator (or a creditor or shareholder) may apply to the Court for an order compelling the directors to account for any money or assets which they may have 'misapplied' or to pay compensation in respect of any misfeasance or breach of duty.

The Companies Act 2006 gave statutory effect to a number of common law duties. Section 172(1) requires a director to exercise his duties in a way that he considers, in good faith, would be the most likely to promote the success of the company of the benefit of its members as a whole. Section 172(2) states that, in exercising those duties, directors must have regard to (among other matters) the following six factors:

1. the likely consequences of the decision in the long-term;
2. the interests of the company's employees;
3. the need to foster the company's business relationships with suppliers, customers and others;
4. the impact of the company's operations on the community and the environment;
5. the desirability of the company maintaining a reputation for high standards of business conduct;
6. the need to act fairly as between members of the company.

However, if the company's financial condition deteriorates to the point where it may be unable to pay its creditors, it becomes the creditors rather than the shareholders who have an interest in what is done with the remaining assets. Those assets (on liquidation) will be applied towards meeting the claims of creditors, and there may be nothing left for shareholders. In those circumstances, the directors' duty to act in the best interests of the company means in the best interests of the creditors (section 172(3) Companies Act 2006). Breach of that duty exposes the directors to the risk of a claim under Section 212. Directors must therefore have regard to the interests of creditors in their management of the company where there is a risk of liquidation.

Liability may be imposed for breach of other duties, such as statutory duties. This could include causing the company to enter into transactions at an undervalue or preferences (see below).

#### **DISQUALIFICATION OF DIRECTORS**

Under Section 6 of the Company Directors Disqualification Act 1986, the Secretary of State for Business, Enterprise and Regulatory Reform may apply to the Court for a disqualification order to be made against any director of a company which has gone into liquidation, administration or receivership and whose conduct makes him 'unfit to be concerned in the management of a company'.

A disqualification order is an order prohibiting a person from being a director or otherwise involved in the management of a company in any way for as long as the order remains in force (which may be up to fifteen years). It is a criminal offence to act in breach of such an order, and a person doing so is also automatically personally liable for the debts of the company involved.

The Court will have particular regard to the following when deciding whether to disqualify a director

- ◆ misfeasance or breach of fiduciary (trust) or other duty by the director in relation to the company (for example, acting in his personal interest at the expense of the company)
- ◆ misapplication of property of the company
- ◆ the extent of the director's responsibility for the company entering into any transactions at an undervalue with the object of putting assets out of reach of creditors (see below)

- ◆ the extent of the director's responsibility for failure by the company to comply with provisions of the Companies Acts concerning maintenance and retention of accounting records and statutory books
- ◆ the extent of the director's responsibility for failure by the directors to comply with their duty to prepare annual accounts
- ◆ where the company has become insolvent, the extent of the director's responsibility for the causes of the insolvency, or for failure by the company to supply goods or services which have been paid for (in whole or in part), or for the company entering into transactions at an undervalue or giving preferences, and any failure to co-operate with the liquidator or other office holder (see further below).

Insolvency office holders have a duty to report directors to the Secretary of State if they consider that grounds exist for applying for a disqualification order.

As noted above, the Court may make a disqualification order against a director whom it has found liable for wrongful (or fraudulent) trading even if no application has been made by the Secretary of State.

Under the Insolvency Act 2000, the Secretary of State may, as an alternative to seeking a disqualification order, ask directors to enter into binding undertakings imposing restrictions similar to those available under an order. This is regarded as a quicker, cheaper (and perhaps less public) alternative to Court proceedings, but the restriction upon an individual's ability to make a living through the medium of a limited liability company is the same.

It is possible for a director against whom a disqualification order has been made (or who has given an undertaking) to apply to the Court for permission to act as a director in particular circumstances notwithstanding his disqualification. Typically consent will only be given where the Court is satisfied both that the director's involvement in the management of a specific company is desirable, and that safeguards are in place to protect creditors (for example, that he will not have sole discretion in relation to financial matters and the company's management will include other suitably qualified directors capable of exercising financial control).

### CRIMINAL LIABILITY

The 1986 Act sets out a number of provisions under which past or present officers (including directors) may be prosecuted and, if found guilty, fined or sent to prison. Examples of conduct which may result in criminal prosecution are:

- ◆ concealing or fraudulently 'removing' property belonging to the company worth £500 or more
- ◆ concealing, destroying, mutilating or falsifying books or records relating to the company (or being privy to anything of the kind being carried out by a third party)
- ◆ pawning, pledging or disposing of property obtained by the company on credit (except in the ordinary course of the company's business)
- ◆ failing to disclose, or hand over, to the liquidator property or records belonging to the company

### LIABILITY FOR RE-USE OF COMPANY NAMES

If a company goes into insolvent liquidation (whether voluntary or compulsory), it is an offence for a person who was a director within 12 months of commencement of the liquidation to act (at any time in the next five years) as a director or otherwise to be involved in the formation or management of a company, or other business, using a name similar to a name used by the company within 12 months before the liquidation (unless permission is given by the Court and subject to certain other specific exceptions).

A person who acts in breach of the prohibition against re-use of a prohibited name may be prosecuted and fined or sent to prison. He may also be held personally liable for debts incurred by the new company whilst trading under the prohibited name.

### SERIOUS LOSS OF CAPITAL BY PUBLIC COMPANIES

Where the net assets of a 'public company' fall to half, or less, of the amount of the company's called up share capital, the directors of the company must, within four weeks of learning of that fact, call an extraordinary general meeting of the company (to be held within eight weeks) at which to consider whether any, and if so what, measures should be taken to deal with the situation: Section 656 of the Companies Act 2006. This applies to any company whose name ends in 'plc' or 'public limited company' - not merely to publicly quoted companies. If a meeting is not held within the time limits, the directors responsible for failing to call a meeting may be fined.

'Net assets' for these purposes are the aggregate of a company's assets less the aggregate of its liabilities (including provisions for contingent and future liabilities and losses). A company's 'called-up share capital' is the amount paid up on its issued share capital, or called but not yet paid, and any further amount payable on a specified future date (whether under the articles, the terms of allotment or any other arrangements for payment for the shares). It is not clear whether a premium paid (or payable) to the company should be included. It would be safer to assume that it should not.

### INSOLVENCY PROCEDURES

#### Liquidation (or Winding up)

Liquidation or winding up (the terms are broadly synonymous) is the process by which a company's operations as a going concern are terminated. The powers of its directors to manage its affairs are superseded by those of the liquidator who is appointed to carry out the winding up. The company's assets are realised (liquidated) by the liquidator and the proceeds used to satisfy its debts and liabilities (as far as possible). Any surplus assets are distributed to the shareholders.

The liquidation of a company may be either:

- ◆ compulsory, when the liquidation results from the Court making an order at the request (petition) of a creditor, shareholder or the company itself (or its directors) that the company should be wound up. In these circumstances the Official Receiver (a Government official) is appointed liquidator in the first instance, with power for the creditors to appoint a replacement if they wish. Often, the precursor to a petition for winding up is the service on the company of a statutory demand. This is a formal demand for payment, within 21 days, of an outstanding debt, failing which the creditor may issue a petition without further notice; or
- ◆ voluntary, when it is initiated by a resolution of the shareholders that the company should be wound up.

A voluntary winding up will be a *creditors' voluntary liquidation* if the directors do not, or cannot, make a statutory declaration that the company will be able to pay its debts including contingent and prospective debts and the costs of the winding up within the following twelve months.

If the directors are able to make a declaration to that effect, the liquidation will be a solvent, *members' voluntary liquidation*, under which all the creditors will be paid in full, and the creditors will take no part in it beyond receiving payment of what they are owed.

A liquidation which commences as a members' voluntary liquidation may be converted to a creditors' voluntary liquidation if it appears that the creditors will not, after all, be paid in full. Either type of voluntary winding up may be converted into a compulsory winding up by the Court making an order to that effect.

#### **Provisional liquidation**

Where a winding up petition has been issued, the Court may appoint a provisional liquidator to manage the company pending the making of the winding up order itself. The Court has wide discretion over the powers which it may give to a provisional liquidator, but the intention is usually to ensure the preservation of the status quo until liquidation proper commences.

#### **Administration**

The administration procedure was first introduced by the Insolvency Act 1985, which was quickly replaced by the Insolvency Act 1986. It has been significantly amended by the Enterprise Act 2002.

A company may be put into administration in one of two ways: either by Court order or by the filing of notice at Court by the company itself or a creditor holding appropriate security.

In either case, the effect is the same. The company is placed under the control of a licensed insolvency practitioner - the administrator - who has a statutory duty to seek one of the following objectives:

- ◆ the rescue of the company as a going concern, failing which
- ◆ a better result for the creditors as a whole than would be likely if the company were to go into liquidation, failing which
- ◆ the realisation of property to enable a distribution to be made to secured (or preferential) creditors.

To assist him in achieving one of these objectives the administrator has wide statutory powers to manage the company, sponsor a company voluntary arrangement (see below) and, if necessary, sell its business and assets.

While the administration continues, the company is protected from action which might otherwise be taken by creditors. This extends to preventing secured creditors from exercising their security, landlords from repossessing leasehold premises, suppliers from recovering stock delivered on retention of title terms and finance lessors from recovering assets, quite apart from debt recovery by creditors generally (through litigation or winding up proceedings).

The administrator is obliged to draw up proposals to be put to the creditors for approval at a meeting held within (usually) eight weeks of his appointment. Depending on what (and whether) proposals are adopted, the administration order may, in due course, be lifted and the company will either return to the control of its management (if, for example, a voluntary arrangement or scheme of arrangement has been adopted) or go into liquidation (if, for example, its business has been sold or an attempt to adopt a voluntary arrangement or scheme has been unsuccessful).

Historically it was only possible to appoint an administrator by application to Court for an order to that effect. This remains an option, and the application may be made by the company itself, its directors or any creditor, supported by a statement in support from the proposed administrator and an affidavit verifying the company's financial position and other relevant information.

Since the relevant sections of the Enterprise Act came into force (in September 2003) it is also possible for an administrator to be appointed, either by the directors or by a creditor (a *qualifying floating chargeholder*) holding security which would previously have entitled him to appoint an administrative receiver (see below), simply by filing notice in Court (subject to certain safeguards).

A qualifying floating chargeholder may appoint an administrator by notice accompanied by a statutory declaration to the effect that the charge is enforceable and the appointment complies with the statutory requirements. It must be supported by a statement from the intended administrator consenting to his appointment and confirming his opinion that the purpose of administration is reasonably likely to be achieved.

An appointment by the directors is effected in a similar manner, but they must first file notice of their intention to make the appointment. This must be supported by a statutory declaration confirming that the company is insolvent, but not in liquidation or subject to a winding up or administration petition. The notice must be served on any qualifying floating chargeholder, and the directors may only proceed with the appointment if the chargeholder consents or fails to make an appointment himself within five business days. There are other restrictions where the company has been subject to a previous administration, moratorium or voluntary arrangement in the preceding 12 months.

Administration was originally conceived as a way to allow a company temporary breathing space during which to effect a compromise with creditors. In practice it has most often been used as a precursor to a business sale, followed by liquidation. The scope for a company to continue to trade whilst a sale is negotiated is more flexible than in liquidation, and a sale on better terms may be secured. Now that the relevant parts of the Enterprise Act 2002 have come into force, including the new streamlined out of Court procedure, the emphasis may shift slightly towards 'rescuing' the company through the adoption of some form of restructuring - or at least, that is the intention.

Administration is not available, or only in a modified form, for certain types of company, or companies involved in certain businesses, such as insurance and certain utilities.

### **Moratorium**

A procedure offering small companies protection similar to administration, but more quickly and cheaply, was introduced by the Insolvency Act 2000. In circumstances where it is appropriate to put forward proposals for the adoption of a voluntary arrangement among creditors (see below), the directors of an eligible company will first be able to file for a moratorium.

In order to obtain a moratorium, the directors must file certain documents in Court, including the terms of the proposed voluntary arrangement and a statement of support from an insolvency practitioner who, if the voluntary arrangement is adopted, will be appointed as its supervisor. Among other things he must confirm that, in his opinion, the arrangement stands a reasonable chance of being adopted and implemented and that the company is likely to have sufficient funds to enable it to continue trading (to the extent it intends to) pending the adoption of the arrangement. The moratorium comes into force once application has been filed and continues for an initial period of 28 days (which may be extended) to give time for the arrangement to be voted on by creditors. No Court order is required.

Whilst the moratorium is in force creditors are prevented from taking action against the company in much the same way as during an administration. Conversely, the company is limited in its freedom to dispose of assets or incur additional credit. The intention is that the status quo should be maintained until the creditors have had an opportunity to decide whether to approve the arrangement or not.

A moratorium may only be applied for by a company which meets at least two of the criteria for qualification as a 'small' company. These are (currently): turnover less than £5.6m, gross assets less than £2.8m and fewer than 50 employees. The financial limits are assessed by reference to the company's most recent statutory accounts. A holding company whose own assets and turnover qualifies it as small will be disqualified if the assets and turnover of its subsidiaries exceeds the limits. Certain categories of company are ineligible for the moratorium procedure, such as insurance companies and others involved in financial services and markets.

### **Receivership, including Administrative Receivership**

A creditor (typically a bank or other lender) with security in the form of a mortgage or charge over the company's assets may, if the terms of the mortgage allow, appoint a receiver with wide powers to enforce the security by selling the assets caught by the mortgage and using the proceeds to repay the creditor's debt.

A receiver appointed in respect of the whole, or substantially the whole, of a company's property by the holder of a charge created before 15 September 2003 comprising (at least in part) a 'floating' charge (i.e. a charge over non fixed assets, such as stock) is called an *administrative receiver*. Although an administrative receiver is primarily concerned with ensuring repayment of any sums owed to the creditor which appointed him, he has in addition certain statutory duties designed to give some level of protection to other creditors, particularly in relation to the provision of information to creditors and the protection of preferential unsecured creditors (primarily employees, up to statutory limits).

The power to appoint an administrative receiver is not available to the holder of a charge created after 15 September 2003 (following the coming into force of the Enterprise Act). Such a chargeholder may nonetheless be able to appoint an administrator (see above) or, possibly, an LPA receiver (see below). Charges created before that date are unaffected, so administrative receivership will continue to be relevant for some years to come.

A receiver may also be appointed by the Court on the petition of a creditor, usually in relation to specific, income generating assets such as rental property (a *Court receiver*), or by a secured creditor over a specific asset (such as a building) under a combination of the Law of Property Act and the mortgage (an *LPA receiver*), but appointments of such receivers remains rare (in the context of trading companies), notwithstanding the limitations nowadays on charge holders' abilities to

appoint administrative receivers. An LPA receiver (unlike an administrative receiver) may be ousted on the appointment of administrator, making them a much less effective debt recovery tool.

### **Company Voluntary Arrangement**

A company voluntary arrangement (CVA) under Part I of the 1986 Act is a proposal put forward by the directors (or an administrator or liquidator) for a reorganisation of the company's debts under the supervision of a licensed insolvency practitioner (the *supervisor*). Typically a CVA provides for existing creditors to accept partial payment of their debts out of a fund set up using existing assets of the company, topped up from the proceeds of future trading over a limited period. The fund is administered by the supervisor, who is also responsible for settling the amount of creditors' qualifying claims.

Outside an administration or liquidation, the directors, invariably with the assistance of the proposed supervisor (at this stage called the *nominee*), draw up the terms of the proposed CVA. This is then submitted to the Court with a statement of support from the nominee, and proposed dates for holding meetings of the shareholders and creditors at which to vote on it. Unless the Court for some reason directs otherwise, the nominee will convene the meetings (for between 14 and 28 days after the Court filing) and send notice to all known shareholders and creditors.

To be adopted, a CVA must be *approved* by a simple majority (over 50%) of the votes cast by shareholders and 75% of the votes cast by unsecured creditors at their respective meetings, and not objected to by more than 50% of the votes of creditors who are not connected with the company. Creditors have one vote for every £1 of debt owed to them. Objecting creditors have rights to challenge the CVA within 28 days of its adoption if they consider it unfairly prejudices their interests. This will result in a Court hearing to decide the issue.

### **Scheme of Arrangement under Section 895 of the Companies Act 2006**

An alternative to a CVA is a scheme of arrangement under Section 895 of the Companies Act 2006 (a *scheme of arrangement*). This may apply not only as between the company and its creditors or any class of them, but also as between the company and the shareholders or any class of them.

The company (or any creditor, shareholder, the administrator or liquidator) may apply to the Court for an order convening a meeting of the creditors or members affected by the proposed scheme.

For the scheme to be adopted it must be approved by 75% of the votes cast by each of the different classes of creditors or members and be approved by the Court. A member or creditor affected by the scheme may appear at the Court hearing at which approval is sought and may persuade the Court not to confirm the scheme. If Court approval is given, the scheme becomes binding on all shareholders and creditors.

There are obvious similarities between a CVA and a scheme of arrangement. Which is the more appropriate in given circumstances will generally depend on the company's creditor profile. The availability of a moratorium (see above) may be a factor in favour of CVAs for small companies - certainly its intention is to overcome the difficulty with CVAs (and shared by schemes) that, having informed creditors that the company is by definition in serious difficulty, there is (in the absence of a moratorium, or administration) nothing to prevent those creditors with self help remedies (such as the recovery of retention of title stock) from exercising their rights before the arrangement has been adopted.

## **PREPARATION FOR THE ONSET OF AN INSOLVENCY PROCEDURE**

### **The Board's responsibility**

The Board cannot rely on the creditors to choose the right time to appoint a liquidator, administrator or administrative receiver - even if, for example, the bank has appointed reporting accountants to review the position with a view to the possible enforcement of its security. The bank may, for its own reasons, prefer to delay an appointment and want the company to continue to trade in the meantime.

The directors must remember that, until a liquidator, administrator or receiver has actually been appointed, they remain responsible for the management of the company and obliged to act in the best interests of all creditors, particularly those who are unsecured. They are otherwise at risk of liability for wrongful trading or misfeasance (above).

Conversely a creditor may pre-empt matters by, for example, issuing a winding-up petition at a time when the Board is working to put together a refinancing or scheme of some kind.

Whether an insolvency procedure is planned, or may need to be invoked as a defensive measure, some advance planning is likely to be desirable.

### **Preparation for liquidation**

If the directors decide to recommend voluntary liquidation, they must convene a meeting of shareholders at which to consider a winding up resolution. They must also convene a meeting of the company's creditors to be held within 14 days after the shareholders meeting. In practice the two meetings are usually held on the same day.

If the resolution is to be passed with the support of a qualifying floating chargeholder (to avoid the need to give five business days' advance notice), its written consent will be required.

Before convening meetings it will usually be desirable to line up a suitably qualified insolvency practitioner who will be prepared to accept appointment if the resolution is passed. Although the creditors, at their meeting, have power to substitute their own nominee for the liquidator appointed by the shareholders, this rarely happens in practice. The proposed liquidator and his staff will generally take over the mechanics of convening both the shareholder and creditor meetings, including placing advertisements in accordance with the statutory requirements.

The directors must also prepare a statement of affairs (showing the company's assets and liabilities) to be presented at the creditors' meeting and must appoint one of their number to act as chairman of that meeting. The proposed liquidator will help with preparing the statement.

### **Preparation for administration**

Documentation is required for the appointment of an administrator (whether by notice or on application to the Court). If the appointment is to be made with the support of a qualifying floating chargeholder (to avoid the need to give five business days' advance notice), its written consent will be required. A statement of support must be obtained from the proposed administrator, who will need to be satisfied that the purpose of the administration is likely to be achieved. Even if administration is not the immediate intention, the Board may wish to consider having the necessary documentation prepared, so that application may be made at short notice if necessary to provide protection against unilateral creditor action.

### **Preparation for appointment of administrative receiver**

Although it will for be the bank or other holder of a fixed and floating charge to make the decision to appoint an administrative receiver, the clearing banks generally prefer to be 'invited' to make an appointment rather than act unilaterally. In part this is for the sake of speed and in part a response to political pressure from the Government, and peer pressure within the banking community, to encourage rescue rather than

receivership (which is regarded in some quarters as a process whereby secured creditors protect themselves at the expense of other 'stakeholders' - hence its abolition). In any event, it may be desirable on all sides for the intended receiver to be introduced to the business in advance of formal appointment in order to minimise the hiatus following the handover of management of the business from the Board to the receiver's team. In some circumstances it might be desirable for the company's business to be prepared for on-sale immediately following appointment (sometimes referred to as a "pre-packaged" receivership), particularly where the customer base or work force is mobile and might be lost as soon as the receivership is announced.

### **Group companies**

It has been mentioned above that the position of the individual companies within a group (and their respective creditors) must be viewed separately when insolvency beckons. It is quite possible that different procedures may be appropriate to different companies within the same ownership group. A receiver (where applicable) might be appointed over certain companies and administrators over others, whilst others may stay out of formal insolvency altogether.

An exercise should be undertaken to establish, company by company, what security has given, the extent of cross-guarantees and the level of inter-company indebtedness so that each company's solvency and ability to continue to operate after a collapse elsewhere in the group can be determined.

It may become necessary for directors to resign from the boards of certain group companies in order to avoid irreconcilable conflicts of interest. For the same reason, different companies within the group might require separate legal and other professional advice.

Liquidation severs the group relationship between the company in liquidation and its parent company for tax purposes. The implications of this should be considered and may influence the desirability, or timing, of a voluntary liquidation.

### **Stock Exchange Announcements**

In the case of a listed company (in the UK), there is an obligation under the Listing Rules of the Financial Services Authority to notify the Company Announcements Office of the London Stock Exchange without delay of 'all relevant information' not in the public domain concerning a change (a) in the company's financial condition (b) in the performance of its business or (c) in its expectation as to its performance which (in any case) if made public would be likely to lead to substantial movement in the price of its listed securities.

Obviously a change in the company's financial condition leading it to consider any form of insolvency procedure, or requiring it to enter into negotiations with its lenders, or to call a meeting under Section 656(1)-(3) (see above) is likely, once news gets out, to lead to substantial movements in its share price.

The company need not make an announcement in respect of impending developments, or matters in the course of negotiation, and it may give information on a confidential basis to certain categories of people, including its advisers and those with whom it is negotiating. But if, at any time, confidentiality is, or is likely to be breached, a warning announcement must be made. Once negotiations extend beyond a relatively limited group of creditors, it is unlikely that confidentiality will be maintained. The UK Listing Authority is likely, in that event, to suspend listing of the company's shares.

Similar provisions may apply where the company's shares are listed in other jurisdictions.

## **POSITION OF DIRECTORS AFTER AN INSOLVENCY PROCEDURE HAS COMMENCED**

### **Compulsory Liquidation**

The directors' powers effectively cease on the making of the winding up order (or on the earlier appointment of a provisional liquidator) and their contracts of employment terminate.

### **Voluntary Liquidation**

#### *Members'*

On the appointment of the liquidator, all the powers of the directors cease except to the extent that the liquidator or a meeting of the shareholders agree they should continue.

#### *Creditors'*

On the appointment of the liquidator, all the powers of the directors cease except to the extent that the liquidator or liquidation committee (or creditors) agree they should continue.

### **Administration**

On the appointment of an administrator, the directors' powers do not cease altogether, but they are seriously curtailed. The 1986 Act prohibits the directors from exercising any power which could be exercised in such a way as to interfere with the exercise of the powers of the administrator, except with the administrator's consent. Consent may be general or specific, and administrators generally lay down guidelines for the continuing involvement (if any) of the directors in managing the company's business.

An administrator has the power to remove and appoint directors, if necessary.

In principle the directors remain liable to complete statutory returns (such as the Annual Return) on behalf of the company and to keep records and file statutory accounts. In practice, returns are unlikely to be made unless it is intended that the company will in due course come out of administration as a going concern.

### **Administrative Receivership**

When an administrative receiver is appointed by a secured creditor, the receiver assumes power, in place of the board, to carry on the business and to realise the company's assets. The directors are left with little to manage, but their statutory obligations continue, and they remain entitled to exercise the company's powers to the extent that the administrative receiver does not wish to, and such exercise will not interfere with his dealing with the assets under his control. The directors, for example, may take steps to put the company into liquidation where they think this is advisable. The directors also retain authority to institute, on behalf of the company, proceedings against the administrative receiver and his appointor, if appropriate (for example, to challenge the validity of the appointment).

### **Voluntary Arrangement**

The directors remain in office and retain their powers while the arrangement is being proposed, and after it is adopted. They will, though, be subject to the supervision of the nominee/supervisor to ensure that the arrangement is properly implemented.

### **Co-operation**

In all cases the directors will be expected to co-operate with the liquidator, provisional liquidator, administrator or administrative receiver (the office holder), and may be obliged to answer questions, hand over documents and other property and give the office holder such information concerning the company, its promotion, formation, business, dealings or property as he may reasonably require. Similar provisions apply in relation to anyone else who may have relevant information, including the company's auditors and professional advisers.

This power may even be used to require directors to provide evidence on the basis of which the office holder may decide to bring a claim for wrongful trading or recommend disqualification proceedings (although recent safeguards have been introduced to limit the circumstances in which such evidence may be used).

### **Voidable transactions**

If a company goes into liquidation, its assets (if any) after secured and preferential creditors have been paid will be distributed among its unsecured creditors *pari passu* i.e. in proportion to the amount of the admitted debt owed to each creditor. This is the liquidation 'dividend'. The purpose of liquidation is to achieve equality among unsecured creditors.

The 1986 Act contains a number of provisions designed to prevent steps being taken ahead of liquidation to defeat the *pari passu* principle. In particular, liquidators (and administrators, and in some cases creditors) have powers to seek redress in circumstances where assets have been removed from the company at less than their proper value, or individual creditors have been given preferential treatment. Directors found to have been involved in approving transactions of this kind may incur personal liability or disqualification.

### **Transactions at an undervalue**

The liquidator or administrator of a company which has at a 'relevant time' entered into a transaction with any person at an undervalue may apply to the Court (under Section 238 of the 1986 Act) for an order restoring the position to what it would have been if the company had not entered into the transaction.

'Transaction' is not exhaustively defined in the 1986 Act. It expressly includes a gift, agreement or arrangement, but is sufficiently wide to cover any dealing with the company whether formal or informal.

A transaction is at an undervalue if

- ◆ the company makes a gift or otherwise enters into a transaction on terms that provide for the company to receive no consideration (i.e. payment or other benefit) or
- ◆ the company enters into a transaction for a consideration the value of which, in money or money's worth, is significantly less, in money or money's worth, than the consideration provided by the company.

The transaction must have been entered into at a 'relevant time'. A transaction is made at a relevant time if the company is unable to pay its debts at that time, or becomes unable to pay its debts as a result of the transaction, and if it goes into liquidation or administration within two years after entering into the transaction (or if it enters into the transaction after a petition for administration has been presented against it).

The Court will not make an order under this section in respect of a transaction at an undervalue if it is satisfied that the transaction was entered into in good faith and for the purpose of carrying on its business and that at the time there were reasonable grounds for believing that the transaction would benefit the company. This is regarded as a relatively narrow defence with limited application.

If the transaction is entered into with a person 'connected' with the company, the onus is on the connected person to show that the company was not unable to pay its debts (or did not become unable to pay its debts) at the time of the transaction. A connected person for these purposes includes a director (or shadow director) of the company and associates of the company or its directors. An associate is widely defined, and includes relationships based on family ties, partnership, trust and employment. In relation to companies, a company is an associate of another where, broadly, it controls or is controlled by the other, or both are controlled by the same person or group of persons.

Where it finds that there has been a transaction at an undervalue, the Court may make such order as it thinks fit to restore the position. This can include requiring property transferred as part of the transaction, or the proceeds of its sale, to be returned to the company, or payment of the proper price for the transaction. Such an order may even apply to a person who was not party to the original transaction with the company unless the benefit acquired by him was acquired in good faith and for value. A person who is connected with, or is an associate of, the company or the person who entered into the original transaction is presumed not to have received the benefit in good faith unless he can prove otherwise. The onus is on him.

### **Transactions Defrauding Creditors**

The liquidator or administrator of a company or, where the company is not in liquidation or administration, any person prejudiced by a transaction of the type described below, may apply to the Court (under Section 423 of the 1986 Act) for an order restoring the position to what it would have been if the transaction had not been entered into, or otherwise for protecting the interests of anyone prejudiced by it.

The applicant must establish that the company

- ◆ entered into a transaction with another person at an undervalue and
- ◆ did so for the purpose of putting assets beyond the reach of creditors or potential future creditors, or otherwise prejudicing their interests.

There is no express time limit as there is in the case of a transaction at an undervalue. Nor is it necessary to prove that the company was insolvent when it entered into the transaction. A transaction entered into at a time when the directors considered there was a risk of future insolvency and which was designed to protect assets from creditors could be caught.

The Court's powers are similar to those in relation to transactions at an undervalue under Section 238, including power to make orders affecting third parties (although in this case the burden of proof is not reversed in the case of connected persons).

If the Court finds that the (or one of the) purposes of the transaction was to put assets beyond the reach of creditors, that is sufficient for the purposes of Section 423. Despite the statutory title of the remedy, there is no need to prove fraud or dishonesty on the part of the directors.

### Preferences

The administrator or liquidator of a company which has at a 'relevant time' given a preference to any person may apply to the Court (under Section 239 of the 1986 Act) for an order restoring the position to what it would have been if the preference had not been given.

A company gives a preference to a person if

- ♦ that person is one of the company's creditors (or a surety/guarantor for any of the company's debts or other liabilities) and
- ♦ the company does anything or permits anything to be done which has the effect of putting that person into a position which, in the event of the company going into insolvent liquidation, will be better than the position he would have been in if that thing had not been done (such as repaying a debt, waiving a liability or providing security for an existing debt) and

- ♦ the company, in deciding to give the preference, was 'influenced by a desire' to improve the third party's position. Whether a company is influenced by a desire to prefer depends on its motive (as distinct from its intention). If it does something which may in practice improve the position of the creditor in the event of subsequent liquidation, the transaction will not be a preference provided the company's motive - the reason why it acted as it did - was something other than preferring the creditor. For example, a company may find it necessary to pay a supplier which is refusing to provide further goods vital for the continuance of the company's business until paid for previous deliveries: in doing so, the company's motive is to keep the business going, not to improve the supplier's position.

The onus is on the liquidator/administrator to prove the various components of preference - except that, if the alleged preference was given to a connected person (defined as for transactions at an undervalue, above) the connected person must show that the company's motive was something other than preferring him.

A preference is given at a 'relevant time' if entered into within six months before the commencement of liquidation or administration (or within two years if given to a connected person) and at a time when the company is unable to pay its debts.

The Court has the same wide powers as regards the types of order which can be made as for transactions at an undervalue, and the circumstances in which the rights of third parties can be affected are also the same.

### CONTACT DETAILS

If you would like further information or specific advice please contact your usual Macfarlanes contact or:

#### FRANCIS BRIDGEMAN

DD: +44 (0)20 7849 2604  
francis.bridgeman@macfarlanes.com

#### CHRISTOPHER LAWRENCE

DD: +44 (0)20 7849 2968  
christopher.lawrence@macfarlanes.com

#### SIMON BEALE

DD: +44 (0)20 7849 2237  
simon.beale@macfarlanes.com

#### WILLIAM DAVID

DD: +44 (0)20 7849 2321  
william.david@macfarlanes.com

### MACFARLANES LLP 20 CURSITOR STREET LONDON EC4A 1LT

T: +44 (0)20 7831 9222 F: +44 (0)20 7831 9607 DX 138 Chancery Lane [www.macfarlanes.com](http://www.macfarlanes.com)

This note is intended to provide general information about some recent and anticipated developments which may be of interest. It is not intended to be comprehensive nor to provide any specific legal advice and should not be acted or relied upon as doing so. Professional advice appropriate to the specific situation should always be obtained.

Macfarlanes LLP is a limited liability partnership registered in England with number OC334406. Its registered office and principal place of business are at 20 Cursitor Street, London EC4A 1LT. The firm is not authorised under the Financial Services and Markets Act 2000, but is able in certain circumstances to offer a limited range of investment services to clients because it is regulated by the Solicitors Regulation Authority. It can provide these investment services if they are an incidental part of the professional services it has been engaged to provide. © Macfarlanes November 2009