



Corporate insolvency

Introduction

The following offers a summary of insolvency as it applies to corporations and its effects on the company and directors. Insolvency is a complex matter and whilst it may not often feature in examinations, it has broader implications for those who own the company and those who do business with it. It may also have effects for directors who have traded the company into insolvency, and who could possibly face disqualification if they have transgressed the law.

Why does it matter?

Corporate insolvency is a very serious issue and really requires professional advice and guidance before deciding to have the corporation wound up or go into administration because of the implications for the business – both internally such as with employees, and externally with creditors – and for the owners of the business (shareholders). Directors may also be held financially responsible where they have acted in a way to allow the business to go into insolvency, and they may be disqualified from holding office if they have wrongfully attempted to trade their way out of insolvency.

As such, you should have sufficient knowledge of the subject to realize when it is necessary to seek this advice, but whilst unlikely to feature on examination papers, it may come up so it is best practice to be prepared (just in case). Problem questions can be quite complex and essay-type questions require a detailed knowledge of both the **Companies Act 2006** and the **Insolvency Act 1986**. Make sure you have this knowledge before attempting to answer a question on this topic.

The death of a corporation

At some point it is likely that a company will be wound up. As corporations possess a legal personality separate from the owners, and as corporations are an abstraction rather than natural persons, they must be formally wound up to 'die'. Corporations may be wound up when solvent where they have not been traded or the owners do not wish to continue trading and have no wish to sell the business, and so on. However, it is more common for a corporation to be wound up when it cannot pay its debts – it is insolvent.

What is insolvency?

A corporation becomes insolvent where it has insufficient assets to satisfy its debts. When insolvent, the following are the available procedures applicable to corporations:

- liquidation (compulsory liquidation/company voluntary arrangement):
 - creditors' voluntary liquidation,
 - members' voluntary liquidation (the corporation must be solvent);
- administration;
- administrative receivership.

Liquidation or administration – the difference

Liquidation

A company being wound up and being liquidated refer to the company ceasing to exist. Liquidation, where a liquidator is appointed to wind up the company, may take effect either:

- through a petition to a court for the *compulsory* liquidation of the company (under the **Insolvency Act (IA) 1986 s 124A**) conducted by an Official Receiver; or
- through the members seeking the *voluntary* liquidation of the business/creditors' voluntary liquidation.

It is the function of the court to assess the merits of the petition and it has the option to make the order for winding-up, or it may refuse.

The **IA 1986 s 122** identifies the grounds upon which an order for the compulsory liquidation of a company may be made.

Looking for extra marks?

Note that liquidation is not a process to ensure creditors are fully paid. It is merely a process to ensure the company's affairs are correctly handled (collecting and distributing monies, fulfilling the administrative requirements of de-registering at Companies House, and so on).

The winding-up order

Following the court's order for the winding-up of the corporation, the company's liquidation is effective from the date of the petition to the court and, until another liquidator is appointed, the Official Receiver assumes this position. Once the order has been given, notice of the order (and a copy) must be provided to the Registrar, who will then publish this in the *London Gazette*.

The types of liquidation available are:

- members' voluntary liquidation;
- creditors' voluntary liquidation;
- compulsory liquidation.

Members' voluntary liquidation

Members of a company may achieve a voluntary winding-up through the moving of a special resolution to that effect. When passed, the company will appoint a liquidator at a general meeting (this may be an option where the company is still solvent and the members may wish to gain something from the remaining assets of the company). The corporation must have sufficient assets to satisfy its debts in full within 12 months of the winding-up.

Revision tip

Ensure you explain that where it is discovered that the company is unable to satisfy its debts (it is/will become insolvent), it will no longer be a members' voluntary liquidation but rather the company will be placed into a creditors' voluntary liquidation.

Creditors' voluntary liquidation

Where a company is insolvent and is unable to continue to trade, the company may choose voluntarily to enter liquidation. The company identifies the financial plight to creditors, and it must cease trading (paying creditors, ordering/receiving goods, and so on following the passing of the resolution). The creditors will appoint the liquidator who must be supplied with relevant information (details of creditors, contracts, employment details, and so on) and assisted by the directors in the creditors' meeting.

Compulsory liquidation

The compulsory winding-up of a company will generally be the result of such a petition to the court by a creditor, but may also occur following a petition by the company or a member. The Official Receiver will usually become the liquidator.

Corporations may be wound up when they are still solvent; however, many are wound up when they are insolvent and therefore are unable to pay creditors. Whilst liquidation

Liquidation or administration – the difference

involves bringing a corporation to an end (its death), administration is a procedure where an insolvency practitioner is appointed, under the control of the court, to take control of the business. The administrator is appointed by one of the following:

- an order of the court;
- the corporation/directors (without a court order); or
- a secured creditor (without a court order).

Simply because a creditor petitions the court for a winding-up of the company does not mean that it will be granted. The court has discretion in this area, particularly where it may be in the best interests of others not to bring the company to an end.

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Re ABC Coupler & Engineering Co Ltd [1961] 1 All ER 354 (Ch)

A creditor of the company petitioned for its winding-up to ensure it recovered money owed, but other creditors opposed the petition. The court held that it would apply its discretion and the application was refused.

Why administration?

Administration is generally chosen instead of liquidation where the intention is for the corporation to be ‘saved’ from its current insolvent position and continued as a going concern. The administrator must be qualified to act as an insolvency practitioner.

It may also be used where it is envisaged that such a procedure would achieve a better result for creditors than would be achieved if the business was wound up. Finally, it may be used as a mechanism to realize property and assets to distribute to the secured and preferential creditors. During administration (which is to be completed within one year – although extensions to this time frame are available), creditors are not able to take action against the business unless having been given permission from the court.

The powers of the administrator are contained in the **IA 1986** (as amended) and in exercising these he/she is acting as the company’s agent.

A court will make an order for administration when satisfied that the company is unable, or is likely to become unable, to pay its debts and the order will be likely to achieve the aims as established in the **IA 1986 Sch B1 para 3**.

When an administration order is made, the corporation is restricted from going into liquidation and being wound up, save for the provisions identified in **Sch B1 para 42**.

Administrative receivership

This is usually a measure taken by a lender which has security over (a substantial part of) the assets of the corporation (in the form of a floating charge). Where the corporation is in breach/default following a demand for payment, the lender may appoint the administrative receiver until such time as the security is realized/owed money is repaid. The administrative

receiver has the authority to dispose of the assets to which the floating charge relates, and having provided for the costs in realizing these assets, and the preferential creditors being paid, the monies will be distributed to the charge-holders.

Corporate voluntary arrangement

Similar to the system which helps individuals in financial difficulties, the Corporate Voluntary Arrangement (CVA) is a procedure which allows a corporation to approach its creditors with a proposal to accept a (lower) sum of money in settlement of its debts to them. The corporation identifies the terms, but these are subject to negotiation by the creditors and a minimum of 75 per cent (of the value) of the creditors to agree. A supervisor is appointed who distributes the money to the creditors.

Looking for extra marks?

Importantly, identify that a CVA covers the debts that are subject to the arrangement – future debts must still be paid according to the contractual agreement between the parties.

The consequences for the directors upon insolvency

Depending on which procedure was used, the liquidator, administrator, administrative receiver, or Official Receiver has an obligation to submit a report to the Secretary of State for the Department for Business, Innovation and Skills (DBIS) on the conduct of the directors who held office in the previous three years of the corporation's life. Based on the report, the Secretary of State has the option, where deemed appropriate, to seek disqualification of the director.

Examples of actions that may lead the Secretary of State to seek a disqualification order include:

- a failure to maintain proper accounting records;
- a failure to make returns to Companies House;
- a failure to submit tax returns; and
- continuing to trade when the company was insolvent (to the detriment of creditors).

Where an officer/receiver of a company in liquidation has been guilty of fraud in relation to the company, or has breached his/her directors' duties, or committed an offence of knowingly being a party to fraudulent trading, the court may issue an order for a maximum term of up to 15 years (s 4).

Where a director (or shadow director) had been engaged in conduct that led to a company becoming insolvent and it is considered he/she is unfit to act in a management capacity, an order may be made (for not less than two years – s 6).

Payments following liquidation

It is also possible for the articles to establish grounds for the disqualification of a director.

Revision tip

Explain that disqualification of a director may apply to both natural (human) persons as well as corporations that hold directorships.

Payments following liquidation

The following list is the hierarchy of payments made following a corporation's liquidation:

- the liquidator's fee and associated costs;
- preferential creditors (employees/pension contributions, and so on);
- holders of floating charges;
- unsecured creditors;
- the shareholders – they share any remaining money.

Note, in an answer to questions involving the distribution of the corporation's assets following liquidation, that whilst shareholders are entitled to share in the distribution of any leftover money when all the corporation's debts have been satisfied, in reality there is little money left (notably where the company is insolvent). This is the reason why shareholders and unsecured creditors are very vulnerable when a company is in financial difficulty.

! Conclusion

This summary has identified some of the main features of a corporation's insolvency and the ways in which a company may be brought to an end.

Further reading

Elwes, S (2005) *Limitations on Presenting a Petition for the Winding-Up of a Company* (London: Tolley's Insolvency Law and Practice), p 42

Goode, R (2011) *Principles of Corporate Insolvency Law*, 4th edn (London: Sweet & Maxwell)

Mokal, R J (2005) *Corporate Insolvency Law: Theory and Application* (Oxford: Oxford University Press)

Tribe, J (2009) 'Company Voluntary Arrangements and Rescue: A New Hope and a Tudor Orthodoxy', 5 *Journal of Business Law* 454

Useful websites

www.bis.gov.uk/insolvency

The Insolvency Service is a body established to provide a framework and means to deal with financial failure and associated misconduct. It operates on the basis of associated legislative provisions (notably the Companies Acts 1985 and 2006, Insolvency Acts 1986 and 2000, and the Company Directors Disqualification Act 1986) and its website contains a wealth of practical information.

www.fsa.gov.uk

The website of the Financial Services Authority. This is an independent governmental body provided with authority under the Financial Services and Markets Act 2000; it maintains the list of quoted companies, and has rule-making, investigatory, and enforcement powers to protect the public and maintain confidence in the financial system (eg through reducing crime).

www.insolvency-practitioners.org.uk

The Insolvency Practitioners Association is a body whose members work and study in the field of insolvency. It has its own code of ethics and promotes standards for those engaged in insolvency practice. The website provides information regarding new policies and laws, and other subject-specific information relating to conferences, etc.

www.london-gazette.co.uk/insolvency

The *London Gazette* provides a comprehensive and growing range of services for those who require information on corporate insolvency and personal bankruptcy events.

www.theqca.com

This is a not-for-profit organization that represents the interests, particularly, of smaller quoted companies (those outside the FTSE 350).

Exam question

Where a corporation finds itself in financial difficulty, an administrator or liquidator may be appointed.

Tasks

1. Explain how in and in which circumstances these bodies are appointed.
2. Explain the function of each and the significance of their appointment.
3. Evaluate the power they may exercise over the directors and how they may deal with the company's creditors.

Exam question

Outline answer

The answer to this question will probably be largely descriptive and therefore some insight and detail in when each body will be appointed is required for the better grades.

Task 1

A company being wound up and being liquidated essentially refer to the company ceasing to exist. Liquidation may take effect either through a petition to a court for the compulsory liquidation of the company (under the IA 1986 s 124A) or the members may seek the voluntary liquidation of the business.

The liquidator, who must be a qualified insolvency practitioner, is appointed to wind up the company and to dispose of its assets in the best interests of the creditors and formally remove the company's registration at Companies House.

The liquidator will seek to collect any assets that are owed to the company and then dispose of these to realize any capital. Having realized these assets, the proceeds are then distributed to the creditors, and having settled its debts (where possible), any remaining proceeds are distributed to the company's members.

Some of the following procedural elements should be included:

In proceedings for the compulsory winding up of the company, the IA 1986 s 122(1) specifies as follows:

A company may be wound up by the court if—

...

(f) the company is unable to pay its debts

A company is unable to pay its debts if:

- it cannot pay a debt of over £750 within a period of 21 days of a request for payment (s 123(1)(a));
- failure to make payment after a court judgment (s 123(1)(b), (c), and (d));
- inability to pay debts as they fall due (s 123(1)(e)) – this is not common.

Under the s 124 those entitled to petition to have the company wound up are:

- the company;
- the directors;
- creditor(s);
- a contributory;
- the Secretary of State;
- the Official Receiver.

Instead of liquidation, another approach is appointing an administrator to govern the winding-up of the company. The IA 1986 introduced a mechanism for the appointment of an administrator to manage its affairs. The powers of the administrator are contained in the IA 1986 (as amended) and in exercising these he/she is acting as the company's agent.

The administrator must be qualified to act as an insolvency practitioner.

The administrator is appointed either by the administration order of the court, by the holder of a floating charge, or by the company or its directors.

Task 2

The liquidator sees to the winding-up of a company. A very significant power is provided through IA 1986 s 178 that gives the liquidator the power to disclaim onerous property so as to cease the company from completing unprofitable contracts. The third party would then have to bring an action for breach against the company but he/she would be considered to be an unsecured creditor.

The purpose of the administrator is to perform his/her functions with the objective of rescuing the company as a going concern, achieving a better result for the company's creditors as a whole than would be likely if the company was wound up, or realizing property in order to make a distribution to one or more secured or preferential creditors.

A court will make an order for administration if it is satisfied that the company is unable, or is likely to become unable, to pay its debts and the order will be likely to achieve the aims as established in Sch B1 para. On administration, the company is restricted from going into liquidation and being wound up, save for the provisions identified in Sch B1 para 42.

Holders of floating charges made before 15 September 2003 may appoint a receiver to realize the company's property and obtain owed money. If the charges relate to a majority or all of the company's assets then this appointment will be of an administrative receiver.

Task 3

A liquidator takes over the functioning of the company, relieving the directors of their power.

Where the liquidator believes that a person should make some contribution to the company's assets, he/she may make an application to the court. If, in the course of the winding-up of a company, it appears that a person who was or is an officer of the company; a liquidator, administrator, or administrative receiver of the company; or has been or is concerned in the promotion, formation, or management of the company, and has misapplied or retained money or property of the company, or guilty of any misfeasance or in breach of any other fiduciary duty, the court may, on the application of the Official Receiver, liquidator, or any creditor or contributory, examine the person's conduct. Following this investigation, the court may compel him/her to repay, restore, or account for the money or property or any part of it (including interest at a rate the court thinks fit).

Exam question

Where the company has gone into liquidation, if at some time before the commencement the person knew, or ought reasonably to have known, that there was no reasonable prospect of the company avoiding the liquidation, and that person was a director/shadow director at the time, he/she shall be guilty of wrongful trading if he/she did not take reasonable steps to minimize any potential losses to the creditors.

Out of the funds available to the liquidator, he/she must pay the preferential debts (IA 1986 s 175). The order of distribution is as follows:

- fixed charge-holders;
- fees of the liquidator;
- preferential debts;
- floating charge-holders;
- unsecured debts (*pari passu*);
- return of capital to members in accordance with the articles.

When all sums have been paid out and the final account is ready, a last meeting is held and the Registrar is asked to dissolve the company.

An administrative receiver possesses the authority to dispose of the company assets to which the floating charge relates, and having provided for the costs in realizing these assets, and the preferential creditors being paid, the monies will be distributed to the charge holders.