Practice questions for chapter 24 – Corporate rescue, insolvency and dissolution

Essay question

To what extent has UK company law adopted a rescue culture?

Introduction

- This question involves a discussion of the extent to which UK company law aids struggling companies. This will involve a discussion of the pre-1985 position whereby the law did not seek to aid companies experiencing financial difficulties, and the pro-rescue procedures introduced by the Insolvency Act 19895 and which are now found in the Insolvency Act 1986.

Pre-1985 position

- Prior to the enactment of the Insolvency Act 1985, UK company law did little to aid ailing companies and companies that struggled with financial difficulties were 'left to die.' Point out the severe consequences that can result from the liquidation of a company, including the company's employees will lose their jobs, other businesses that supplied the company may be forced into liquidation and creditors of the company will likely go unpaid. If the company is a large multinational, its liquidation may even adversely affect the national economy in which the company is based.
- Given these significant adverse effects, it soon came to be realized that there should be mechanisms in place to aid struggling companies, so that such companies could be brought back to profitability. However, the law needs to strike a delicate balance between aiding struggling companies and protecting the creditors of such companies. Should a rescue attempt fail and the assets of the company be depleted further, the creditors will receive even less than if the rescue attempt had not been made.
- The 1982 Cork Report favoured the UK adopting a 'rescue culture' whereby mechanisms are put in place to aid struggling companies and this recommendation was implemented by the Insolvency Act 1985, which was soon replaced by the Insolvency Act 1986. The result was the introduction of two notable rescue procedures, namely administration and company voluntary arrangements.

Administration

- Administration was introduced by the Insolvency Act 1986 and is a clear example of the law's desire to foster a rescue culture and aid ailing companies. In recent years, the value of the administration procedure has been in evidence. In January 2009, the UK entered recession and a number of prominent high-street companies (e.g. Woolworths, Zavvi, USC, MFI) experienced severe financial difficulties and went into administration in an effort to avoid liquidation. In adverse economic times, the value of the administration procedure is greater than ever.
- The pro-rescue nature of the administration process is evident from the hierarchy of objectives that an administrator is appointed to achieve. The primary purpose of the administrator is to rescue the company as a going concern and this is indeed the principal purpose of the administration process. The administrator must exercise his functions with this objective solely in mind, unless he believes that rescue is not a reasonably practicable objective. In such a case, the administrator's function shifts to achieving the best possible result for the company's creditors. This hierarchy of objectives demonstrates that, as regards the balancing act discussed above, the administration process favours

the rescue of the company as opposed to the protection of creditors, although of course the rescue of the company will also aid the creditors in the long-term.

- The pro-rescue nature of the administration process is further evidenced by the statutory moratorium. If the creditors of companies in administration cold enforce their security, the pro-rescue nature of administration would be frustrated. Therefore, no creditor can, unless he obtains permission from the court or the administrator, enforce his security, take steps to repossess goods in the company's possession, or initiate any legal proceedings against the company or the property of the company.
- Given the choice between immediate liquidation and placing a company in administration, there are several notable advantages in using the administration procedure. First, and most obviously, it may allow a company to trade its way back into profitability. Second, administration is likely to be less expensive than liquidation. Third, upon liquidation, the company's assets are usually sold off for whatever price the liquidator can obtain, whereas assets sold by an administrator are likely to fetch a high price. Fourth, the company's creditors may have better prospects of being paid than if the company were liquidated, and the employees (or some of them) may be able to retain their jobs.

Company voluntary arrangements

- Another important, but underused, rescue mechanism is the company voluntary arrangement (CVA). A CVA basically allows a company to enter into a binding agreement or arrangement with its creditors. The agreement will be approved by the creditors and once approved, it will bind everyone who was entitled to vote at, or would have been entitled to vote had they had notice of, the creditors' meeting.[1]
- The pro-rescue nature of the CVA is evidenced in that, if the company is in the process of being wound up when the CVA is approved, then the court can stay the winding-up and give such directions as it thinks appropriate for facilitating the implementation of the CVA.[2]
- We saw above that one of the principal benefits of the administration procedure was the statutory moratorium. Initially, the effectiveness of CVAs was adversely affected by creditors who could derail the CVA by appointing a receiver or by petitioning the court for a winding up order. Accordingly, a new form of CVA was introduced that provides the company with a moratorium similar to that which exists under the administration procedure.
- Whilst a CVA is a useful rescue procedure, there is little doubt that administration is a more effective procedure. However, for directors who wish to retain office, a CVA might be a more appropriate procedure.

Conclusion

- There is little doubt that the passing of the Insolvency Acts 1985 and 1986 has resulted in the law taking a much more pro-rescue approach. In particular, administration is an especially useful rescue procedure and genuinely offers companies an opportunity to take positive steps to avoid liquidation.

Problem question

In March 2012, Emily and Becky incorporated a company (Shoes in the City Ltd) that specialises in selling ladies footwear. Emily and Becky are the company's only shareholders and each owns 100 £1 shares. Emily and Becky are the company's only directors.

[1] Insolvency Act 1986, s 5(2).
[2] Ibid, s 5(3).

For the past 18 months, the company has been experiencing financial difficulties. In September 2015, the company's overdraft with the Black Horse Bank plc has reached its limit of £250,000. In return for increasing the overdraft limit to £300,000, the Black Horse Bank plc demands security and takes a floating charge over the company's assets. The business continues to struggle and, in January 2014, Emily and Becky are informed by the company's auditor that insolvent liquidation is inevitable, although Emily and Becky disagree. Emily and Becky decide to try and trade their way out of their financial difficulties by having a sale. Unfortunately, the sale fails to increase business and in March 2016, Shoes in the City in wound up. By this time, the company's overdraft with Black Horse Bank amounts to £290,000.

Barry has been appointed liquidator and has discovered the following:

- In August 2015, Emily and Becky caused the company to repay an unsecured loan of £5,000, which Becky had made to the company some months before.
- In addition to the money owed to Black Horse Bank, the company owes £10,000 to the Inland Revenue, £30,000 to employees in wages, and £100,000 to unsecured creditors.

Barry estimates that the total assets of Shoes in the City amount to £150,000. Barry's expenses in acting as liquidator amount to £3,000.

Advise Barry.

Introduction

- In this question, you have been asked to advise the liquidator of Shoes in the City Ltd. Accordingly, you will need to state the role of the liquidator. The liquidator's role is to gather in all the assets of the company, to pay off the company's debts and liabilities, and to distribute any remaining assets to persons entitled to them in the correct order.
- Accordingly, you will need to discuss how to best swell the pool of assets and who is entitled to those assets and in what order.

Setting aside the floating charge

- The directors of a company, realizing that liquidation is unavoidable, may attempt to prioritize the position of certain creditors by granting them a floating charge over assets of the company. To prevent this, the Insolvency Act 1986, s 245 invalidates floating charges within the relevant time prior to insolvency. Where the charge is granted to a person who is unconnected with the company (as in our case), the period is twelve months ending on the date of insolvency.[3] Clearly, the floating charge in our problem was created within the relevant period. However, the charge will not be invalidated if the company was able to pay its debts at the time the charge was granted and did not become unable to pay its debts due to the granting of the charge. We cannot state with certainty whether or not this is the case, but given the company's dire financial position, it would not appear to be the case.
- Accordingly, it appears likely that the charge will be invalidated. The company will still owe the money to Black Horse Bank, but the loan will lose its secured status. Accordingly, Black Horse Bank will become an unsecured creditor.

Increasing the assets available for distribution

[3] Ibid, s 245(3).

- Barry's task is to gather up the assets of Shoes in the City Ltd and distribute them to entitled persons in the order stated by the law. One of the principal sources of assets will be the stock and other assets of the company. These can be sold to increase the pool of assets Barry will distribute. However, there are other methods available to Barry to swell the pool of assets and these often involve obtaining a contribution from certain persons who may try to take advantage of the company's vulnerable state by paying off debt early, or selling off assets at a reduced price. In particular, you want to be aware of the rules relating to fraudulent and wrongful trading, transactions at an undervalue, and preferences. Regarding our problem, there is a possibility that both wrongful trading has taken place and that the company has granted Becky a preference.

Wrongful trading

- A liquidator can further swell the assets of the company by obtaining a contribution from any directors who have engaged in wrongful trading. Wrongful trading occurs where three conditions are satisfied, namely:

  1. The company has gone into insolvent liquidation
  2. At some time, before the commencement of the winding up of the company, the person concerned knew, or ought to have concluded, that there was no reasonable prospect that the company would avoid going into insolvent liquidation, and
  3. That person was a director of the company at the time.

- Establishing whether conditions 1 and 3 have been satisfied produces no problems. However, establishing the satisfaction of condition 2 is more complex and in questions involving wrongful trading, it is usually condition 2 that will form the issue that requires discussion. As s 214 uses the phrase 'knew, or ought to have concluded,' condition 2 will be satisfied if the director subjectively knew or objectively ought to have known that there was no reasonable prospect of avoiding insolvent liquidation. This means that if there is a reasonable prospect of avoiding insolvent liquidation, then liability for wrongful trading will not be imposed. In *Secretary for State for Trade and Industry v Taylor*,[4] Chadwick J stated that directors may take the view that a company, though insolvent, should continue to trade out of difficulty and, provided that such views are properly held, no liability will arise.
- Often it will be difficult for you to conclude definitively whether or not condition 2 has been satisfied. However, the fact that the company's auditor has informed them that insolvent liquidation is inevitable would provide proof that Emily and Becky should have concluded that there was no reasonable prospect of avoiding insolvent liquidation.
- Directors found liable for wrongful trading will be required to make a contribution to the assets of the company with this contribution being calculated by reference to the amount that the company's assets were depleted by the director's decision to continue to trade.

Preference

- Where a debtor attempts to avoid the hierarchy of asset distribution that liquidators are bound by, this is known as a preference. Normally, this occurs where a debtor company, knowing that it cannot avoid liquidation, pays certain lower-ranking debts prior to liquidation and in doing so, elevates those debts above debts that rank higher upon liquidation. Specifically, a company provides a person with a preference if two requirements are satisfied:

[4] [1997] 1 WLR 407 (Ch).

1. The person is one of the company's creditors, or a surety or guarantor for any of the company's debts or other liabilities. As Becky is a creditor of the company, this requirement has been met.
2. The company does anything or suffers anything to be done that has the effect of putting that person into a position that, in the event of the company going into insolvent liquidation, will be better than the position in which he would have been had that thing not been done.[5] By paying Becky now, she has been placed in a better position than she would be in had the company become insolvent. The debt owed to Becky has been elevated above debts that would rank higher in the distribution of assets upon liquidation.

- Where a debtor company has granted a preference to a creditor, the liquidator can apply to the court. Should the court hold that a preference has occurred, it can make such order as it thinks fit for restoring the position to that which it would have been had the company not given that preference.[6]
- However, the court will only make such an order if the preference took place at the 'relevant time.' Where the company granted the preference to someone who is connected with the company (as in our case), it must be granted in the two-year period prior to the company entering insolvent liquidation. Clearly, the preference granted to Becky falls within the relevant time.
- Accordingly, Shoes in the City Ltd have granted Becky a preference and Barry would be advised to apply to the court for a restorative order.

Distribution of assets following liquidation

- Once Barry has collected in all the assets and has obtained whatever contributions can be obtained, his task is to distribute these sums to persons entitled to them in the order stipulated by the law. The order will be as follows:

1. First, will be paid Barry's liquidation expenses of £3,000.
2. Second, the preferential debts will be paid. Of the debts owed by Shoes in the City Ltd, only the remuneration owed to the employees will be classed as a preferential debt. However, only remuneration earned in the four months prior to insolvency up to a maximum of £800 per employee will rank as preferential – the remainder of the remuneration owed will rank as unsecured.
3. Third, will be the payment of the unsecured debts. Debts secured by floating charge ranks ahead of unsecured debts (but behind preferential debts), but as discussed above, the floating charge granted by the company will likely be invalidated. Accordingly, the money owed to Black Horse Bank will ranks as an unsecured debt. The £10,000 owed to the Inland Revenue will also rank as unsecured – such debts were once classed as preferential but the Enterprise Act 2002 abolished the preferential status of Crown debts.
4. Fourth, if there are any assets remaining, they will be distributed to the members. However, given that the assets of the company total £150,000 only (not including contributions obtained from the directors for wrongful trading, preferences etc) there is no way that there will be any surplus left to distribute to the members.

- Debts within each category rank equally amongst themselves, meaning that if there are insufficient assets to fully pay all the debts within a category, then the creditors within that category will receive an equal percentage. Consequently, lower-ranking creditors will receive nothing.

[5] Insolvency Act 1986, s 239(4).
[6] Ibid, s 239(3).