

AVOIDING CORPORATE INSOLVENCY?

In the last couple of years Insolvency Law has changed to provide company owners and directors (and a Company's creditors) with more options to avoid insolvent liquidation. Liquidation usually involves the company ceasing business, often with a loss of goodwill built up by the owners, perhaps over many years, and can occur where parts of the business are still profitable.

A company will be insolvent if it is "unable to pay its debts" (by reference to one or more of the following):

- The company is unable to pay its debts as they fall due;
- The value of the company's assets is less than its liabilities, (including contingent and prospective liabilities);
- The company has not paid a debt exceeding £750 after being served with a written demand (known as a "statutory demand").
- A court judgment is unsatisfied.

Directors should try and determine whether a company is insolvent or not as early as possible, for many reasons. For example, if a company is insolvent when it enters into a transaction, the transaction may be set aside. Directors also owe many financial duties once a company is insolvent, breach of which could result in personal liability or criminal prosecution.

If a company is insolvent, liquidation (also known as winding up), either voluntary or by court order, is likely to follow, unless the directors and/or creditors take swift action to try and rescue the company.

There are now three main statutory rescue options available to companies that may be insolvent:

1. Voluntary arrangements ("CVAs")
2. Administration
3. Schemes of arrangement under section 425 of the Companies Act 1985 (1985 Act) ("section 425 schemes").

CORPORATE VOLUNTARY ARRANGEMENTS

A CVA is an agreement between a company, its shareholders and its creditors, which involves delayed or reduced debt payments or a capital restructuring. The directors must make a detailed written proposal to the company and its creditors. The arrangement must be implemented under the supervision of a qualified insolvency practitioner (called a "*nominee*").

The *nominee* must, within the set period, submit a report to the court, recommends if meetings of the shareholders and creditors should be summoned to consider the CVA proposal. Those making the proposals must give the *nominee* a statement of the

company's affairs. The proposal usually leaves the directors in control of the company with its debts being re-scheduled

The CVA proposal will be approved if more than 75% in value of the creditors present and voting at the relevant meeting approve it. A simple majority of the shareholders must also approve the CVA. The rights of a secured creditor (e.g. a bank with a mortgage or debenture), to enforce its security cannot be changed without its consent, nor can any changes of the rights of so called "preferential creditors" (like employees) be made without their consent. A CVA binds who had notice of the meeting and now, those who did not have notice but would have been entitled to attend.

If all meetings vote in favour of the CVA, the *nominee* (or an alternative insolvency practitioner) is redesignated as the "*supervisor*". If the *supervisor* considers that the CVA should be abandoned, an administration order or an order that the company be liquidated will follow. If the CVA proceeds and is successful the *supervisor* must report on its implementation. A successful CVA would typically result in the company being relieved of most of its pre-CVA debts and having been able to trade uninterrupted throughout the CVA process.

A major drawback of CVA's, until recently, was that, while the directors were writing the proposals and finding a *nominee*, creditor action could tip the company into liquidation.

Now an optional 28 day *moratorium* is available for small companies (defined as companies turning over less than £5.6 million and with less than 50 employees). The directors may apply to the court while the proposals for the CVA are being considered. During the *moratorium* the directors remain in control with the support of the *nominee* under the proposed CVA. The effect of a CVA *moratorium* is to prevent creditors from taking enforcement action without the court's permission e.g.

- A landlord repossessing business premises;
- A secured creditor enforcing security over the company's property e.g. by appointing a receiver or repossessing goods.

The introduction of the *moratorium* will boost the chances of getting a CVA off the ground, resulting in CVA numbers increasing.

ADMINISTRATION

Purpose of Administration

This form of business recovery was revised considerably in 2003 with a view to ensuring the prime objective first, to rescue the company as a going concern. If this cannot be achieved the administration should secondly, result in a better return for the company's creditors as a whole than if the company were liquidated.

Only if neither of those objectives are possible, should administration be implemented to realise property to make a distribution to the secured or preferential creditors, but without harming the interests of the creditors as a whole.

Over time administration will largely replace receivership because, unless a bank debenture was signed before 15th September 2003, bankers cannot appoint an administrative receiver; formerly the preferred route for a bank to try and recoup its loans.

Unlike “old” administration under the 1986 Insolvency Act (which confusingly will still be around for a while) new administration can be started quickly both out of court and if necessary by court order.

Out of court.

Appointment of an *administrator* can be by a person like a bank who holds a mortgage or debenture that includes a “qualifying” floating charge (QFCH)

Directors or the Company can also appoint an *administrator* but must give notice of their intention to do so to any QFCH. The bank will have five business days to appoint its own *administrator*. An interim *moratorium* on creditor action (including any action to enforce security) comes into effect when notice is given by the company. If the bank does not object, the director’s choice of *administrator* will be appointed.

The directors or the company cannot however use the out-of-court route if there is an existing winding up petition. If a creditor has already issued a petition, the company will need to apply to the court because, if the court does make an administration order, it will dismiss any outstanding winding up petitions.

Court appointment

The court route can be used by the company or its directors, or any creditor. The court must be satisfied that the company is, or is likely to become, unable to pay its debts and that administration is reasonably likely to achieve its purpose. QFCH’s can intervene if any other person makes the application and can request that a person specified by the QFCH is appointed.

A QFCH may apply to court, for an administration order, without the need to demonstrate that the company is unable to pay its debts as long as his floating charge has become enforceable. The court can also make an administration order on a QFCH’s application even if the company is already in compulsory liquidation. A truly eleventh hour reprieve.

Administrator’s proposals

Once appointed, the *administrator* must send out a statement of proposals to the registrar of companies, the members and all known creditors. A creditors meeting is called within ten weeks to consider the proposals, unless the company has insufficient property to enable a distribution to be made to the unsecured creditors. At the

meeting, creditors will vote on whether to accept, modify or reject the administrator's proposals.

Secured creditors are only entitled to vote on the proposals where there is a shortfall in the value of the secured assets. The administrator's proposals cannot change the rights of a secured creditor to enforce its security. However, an administration prevents the secured creditor from enforcing its security without the administrator's consent or permission of the court. This can prove a major help to a company with a hostile lender. The *administrator* will need the consent of the secured creditors however, before putting proposals to the unsecured creditors and in most cases there will still be a "special relationship" between secured lenders and administrators.

Administrator's powers and duties

The *administrator* has extensive powers that include "anything necessary for the management of the affairs, business and property of the company". The *administrator* can dispose of floating charge property as if it were not subject to the charge and dispose of other secured assets with the leave of the court.

Unlike a CVA, where directors normally continue to exercise all their powers, in an administration, although directors may remain in office, the *administrator* has power to appoint and remove them and both the company and directors cannot exercise a management power which could interfere with the exercise of the administrator's powers. In effect the *administrator* will run the show.

The Moratorium

Where a company is in administration a *moratorium* restricts creditor enforcement actions without the agreement of the administrator or the court. These restrictions include:

- Repossessing goods in the company's possession under a hire-purchase agreement;
- A landlord may not exercise a right of forfeiture by peaceable re-entry;
- No legal proceedings, execution, distress may be instituted or continued.

Even if the court gives permission for enforcement it may impose conditions on how enforcement is conducted.

Exit routes

Once the administration proposal has been sufficiently achieved, application is made for discharge by filing a notice in the prescribed form with the court and the registrar of companies, and notifying the creditors of the company. The company can then operate as normal, but loses the protection from the moratorium.

If the purpose is not achieved by then, the administrator's appointment will automatically cease to have effect at the end of a 12-month period but can be extended once for a period of up to six months with the agreement of the company's creditors, or any number of times by court order. Likely exit routes from administrations that automatically terminate will be:

- If there is likely to be a distribution to unsecured creditors, the company will be wound up in a creditors' voluntary liquidation.
- If there is to be no distribution to unsecured creditors, the company will be deemed to have dissolved after a period of three months from the registration of the notice.

SCHEME OF ARRANGEMENT

This form of protection arises under the Companies Act and not Insolvency Law.

Under a scheme of arrangement a company may make a compromise with its creditors or shareholders. Unlike a CVA, a scheme requires court sanction. When sanctioned a scheme will bind all members and creditors regardless of whether they had notice. First a court order is required that a meeting of creditors or shareholders be summoned. Before that meeting the company or its administrator sends out a statement setting out the scheme. At the meeting, a majority 75% in value of each of the creditors and shareholder classes must approve the scheme. It is the responsibility of the applicant to decide the definitions of class.

Who makes up a distinct class? To be in the same class creditors or shareholders "*must be confined to those persons whose rights are not so dissimilar to make it impossible for them to consult together with a view to their common interest*" depending on:

- (i) the rights that are to be released or varied under the scheme;
- (ii) the new rights by way of compromise or arrangement.

Following approval by the necessary meetings, application must be made to the court to sanction the scheme. If approved by the court, at a hearing before a judge or registrar of the Companies Court, the order sanctioning the scheme is delivered for registration. The scheme is then binding on all members and/or creditors (or class of members/creditors as relevant) and the company.

Unlike a CVA or administration no *moratorium* applies in a scheme of arrangement unless the company is already subject to one. Schemes of arrangement are more complicated to put into effect than either a CVA or administration but in specific cases can be useful, though they are often too expensive and cumbersome for small companies.

With all forms of creditor protection, the role of a Licensed Insolvency Practitioner is crucial. They are the only persons entitled to act as *nominee*, *supervisor* or *administrator*. It is not merely re-branding that they are now more commonly known

as business recovery professionals. They, together with changes to the Civil Procedure Rules which have made courts more accessible to distressed companies, are the essential conduits by which the aims of modern insolvency law can be achieved. The aim of the developments summarised in this article should afford to many more companies to avoid liquidation, and improve creditor recoveries.

For legal advice on Corporate Insolvency or business law contact Richard Howard on 0800 093 4212

For an insolvency practitioner call:

Helen Phillips on 01753 883315 or visit www.phillipsinsolvency.co.uk

Or Richard Long on 01992 503372 or at info@richardlong.co.uk

To contact a court dealing with corporate insolvency law

Companies Court (general office) on 0207 947 6294

Aylesbury County Court on 01296 393498

or visit www.courtservice.gov.uk