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An Introduction To Insolvency - Part 1

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Introduction

A company (or LLP) will be considered to be insolvent if it is unable to pay its debts. A person can be insolvent, but they will be referred to as bankrupt. This Legal Long will discuss the insolvency of companies in England and Wales only.

When is a company insolvent?

The Insolvency Act 1986 (as amended) (the "Act") governs insolvency laws in England and Wales. Whilst the Act does not define the term "insolvent", it states that a company will be deemed to be insolvent if:

1. the company is unable to pay its debts as they fall due (the cash flow test); or
2. the value of the company's assets is less than the amount of its liabilities, taking into account its contingent and prospective liabilities (the balance sheet test).

Insolvency procedures

There are four main insolvency procedures for companies in England and Wales. These are:

1. Administration
2. Company Voluntary Arrangement
3. Compulsory Liquidation
4. Creditors' Voluntary Liquidation

We provide a summary of each of these procedures below.

1. Administration

A company that is insolvent, or is likely to become insolvent, can enter administration. A company in administration may be rescued or reorganised or its assets realised under the protection of a statutory moratorium. On entering administration, an insolvency practitioner (the administrator) is appointed to control the company's affairs and business.

There are three purposes of administration, as follows:

1. first, to rescue the company so that it can continue as a going concern; or
2. second, if the first objective cannot be met, the administrator must aim to achieve a better result for the company's creditors as a whole than would be likely if the company was put into liquidation; or
3. third, if the administrator thinks that neither the first nor the second objective can be met, to realise the company's property to make a distribution to the company's secured or preferential creditors.

In order for a company to enter administration, the proposed administrator has to confirm that one of the purposes of administration set out above is reasonably likely to be achieved.

An administrator can be appointed by court order or by the out of court route, depending on who is appointing the administrator.
Our next Legal Long in this series will discuss the administration process in greater detail.

2. Company Voluntary Arrangement ("CVA")

Under a CVA, a company in financial difficulties enters into a binding agreement with its creditors. It is a deal between the insolvent company and its creditors whereby they agree to accept a sum less than what they are owed e.g. 75p for £1 owed.

The creditor, together with the insolvency practitioner ("IP"), prepares a proposal for consideration by the creditors and at a meeting, if 75% of creditors (in value) approve it, it will be legally binding on all creditors, whether or not they actually voted for the proposal.

The company's directors stay in control of the company with the support of the IP. If the company does not keep up with the agreed payments, the IP may have to petition for the company's liquidation, at which point creditors will not be bound by the terms of the CVA and can pursue the company for all sums due.

3. Compulsory liquidation

Unlike administration and CVA, where there is a potential chance of survival for a company, compulsory liquidation is the end of the road for a company; it will cease to trade and exist. It is also referred to as "winding up" and is a court procedure i.e. a court order is required for a company to be placed into compulsory liquidation.

To start the process, a creditor or the company itself has to present a winding up petition at court. A creditor can take this step if: (i) the company owes a debt of more than £750 and has failed to pay this debt after formal payment demand for the debt has been made; or (ii) it already has an unpaid County Court Judgment against the company. There will be a court hearing at which the company may choose to oppose the winding up petition (if a creditor has presented the winding up petition). If the winding up petition is granted, a liquidator is appointed to the company by the court. The liquidator's principal role, in addition to investigating the conduct of the company and its directors in the run up to the liquidation, is to collect in the company's assets (if any) and realise them and distribute the proceeds to the company's creditors. At the end of the process, the company is dissolved.

4. Creditors' Voluntary Liquidation

Unlike compulsory liquidation, this is an out of court procedure. If the company is insolvent and the directors have taken the decision to cease trading, this option is quicker and less costly than compulsory liquidation. The company calls a meeting of its creditors who are then invited to vote to put the company into liquidation and approve the appointment of the liquidator. The liquidator will give creditors an indication of how much they are likely to receive e.g. 20p for every £1 owed.

As with compulsory liquidation, the liquidator collects in the company's assets (if any), realises them and then distributes the proceeds of the sale of the assets to the company's creditors in satisfaction of their debts. As with compulsory liquidation, the liquidator has to investigate the company's affairs in the run up to the liquidation. At the end of the process, the company is dissolved.

Other procedures

It is worth highlighting three other procedures which are not insolvency procedures but which are often discussed in terms of enforcement and winding up of companies:

1. Administrative receivership – historically, an administrative receiver was appointed by a secured creditor who had a floating charge over the whole or substantially the whole of a company's assets. The company did not have to be insolvent. The administrative receiver's role was to run the company, with a view to selling the company as a going concern or to sell its assets, and use the profits to repay the indebtedness owed to the secured creditor. Under the Enterprise Act 2002, which came into effect on 15 September 2003, the procedure was effectively abolished as a remedy for creditors holding a floating charge created after this date (with some limited exceptions, such as in relation to qualifying capital market arrangements and urban regeneration projects). Instead, holders of a qualifying floating charge are entitled to put the company into administration, as set out above. Any creditor holding a floating charge created before 15 September 2003 can still appoint an administrative receiver to enforce its security.

2. Fixed charge receiverships – a receiver may also be appointed by the holder of a fixed charge (e.g. a bank) over assets owned by a company. The receiver collects in and realises the company's assets which are subject to

the fixed charge and uses the proceeds to repay the debt owed to the holder of the fixed charge. A receiver can be appointed to a company's assets irrespective of the solvency of the company.

3. Members' Voluntary Liquidation - this only applies to solvent companies and is initiated by the shareholders of the company when a company has come to the end of its useful life and no longer has a purpose. This may be due to a restructuring of the company's assets or as part of a group re-organisation; or the shareholders may simply wish to retire or leave the company and therefore need to realise their interests. Companies involved in this procedure are able to pay all their creditors and are not insolvent, which is evidenced by the directors swearing a declaration of solvency at the beginning of the process. The company's assets are collected in and realised by the liquidator, creditors are paid in full and the final step is for the company to be dissolved.

In our next Legal Long in this series, we shall be looking at the administration procedure in more detail.

If you would like to discuss this further, please contact Claire Cummings at Claire.Cummings@cummingslaw.com or on 020 7585 1406.

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