

## 2.4

# Legal Issues for Failing Companies and Corporate Rescue

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Inevitably there will be a variety of matters requiring attention at the end of a company's existence. These can broadly be divided into three categories:

- Can the financial position be turned around?
- What are the formal insolvency procedures available?
- What are the director's personal liabilities or other actions arising from the failure?

### **Turnaround**

The most important step for the management of any business to take when they are experiencing difficulties is to identify, and if possible quantify, the extent of their problem. Signs of financial difficulty are very plain, but are often overlooked by management: falling profits, falling asset values, excessive borrowing and even boardroom tension. However, there is one phenomenon that makes a corporate rescue plan a priority for management: cash, or more particularly, the lack of

it. Without steady cash flow, a company is unable to pay its staff or creditors, to meet the interest obligations on its borrowings, or to provide working capital for any corporate activity. Difficulties with cash flow are the surest sign of difficulties ahead.

There are no specific legal issues exclusively associated with a company turnaround. The objective is to make the best of a difficult position, but the directors must be aware of the potential for personal liability if the turnaround is unsuccessful. The various turnaround strategies that can be adopted include:

### ***Negotiating with existing lenders***

This may entail trying to renegotiate the terms of existing debt financing, as well as attempting to obtain further finance. Although the principal lender is likely to be reluctant to commit any new money to the business, it may agree to co-operate with the restructuring of the existing financing and afford the business some breathing space. The possibilities include rescheduling capital repayments under the loans, so that only interest is paid in the short term; extending the period of repayment, thereby reducing the size of the monthly commitment; or converting some of the debt into equity.

### ***Raising new equity***

This can be done either by way of a rights issue, or by placing shares with a new or existing shareholder such as a financial institution. If this option is proposed, the directors must not mislead the potential investors as to the company's financial position (see Directors' Personal Position).

### ***Disposal of assets***

Often, the only realistic prospect of raising much needed cash is to sell assets. The disposals have to be quick and this usually comes at a cost (ie the price which the assets will attract). Alternatively, the only buyer may be someone connected with the company. The directors will have to ensure that any such sale does not give rise to a claim against them personally.

### ***Introducing new management***

It may be appropriate to consider replacing part of the management of the business. This can give a new perspective to the handling of the

existing crisis and/or can indicate to lenders or investors that the business is prepared to adopt a radical programme to deal with the problem. In addition, if a suitably experienced replacement is engaged they can bring to the business essential skills to deal with the existing difficulty. However, the company must handle such a change carefully and try to avoid any further claims against the business (eg for unfair or wrongful dismissal).

### ***Informal agreement with creditors***

The company may also try and reach some informal agreement with its creditors that they will provide the company with time to make payment (often from the anticipated proceeds from a particular contract). The dangers here are that such agreements are not binding on the creditors and can be ignored by the creditor if he loses patience. Similarly, if any one creditor does not agree, that individual can undo all the hard work in persuading the majority to agree. If that individual creditor is then 'paid off', the company may have inadvertently entered into a preference (see Directors' Personal Position).

In general, a combination of these strategies will be tried by the management of a company in crisis, with varying degrees of success. If none of these strategies are suitable or have not had the effect of turning around the company's fortunes, it will be necessary for the management to consider a formal insolvency procedure.

## **Insolvency procedures**

### ***Definition of insolvency***

Perhaps surprisingly, there is no strict definition of 'insolvency' within the Insolvency Act 1986 (IA). However, Section 123(1) IA 1986 gives a definition of an 'inability to pay debts'. A company is said to be unable to pay its debts if:

- (a) a creditor serves a demand (see below) and the company neglects to pay the sum or to secure or compound for it to the reasonable satisfaction of the creditor; or
- (b) execution or other process issued on a judgement is returned unsatisfied in whole or in part; or

- (c) it is proved to the satisfaction of the court that the company is unable to pay its debts as they fall due (known as the 'cash flow' test).

A company is also deemed unable to pay its debts (Section 123(2) IA) if it is proved to the court that the value of the company's assets is less than the amount of its liabilities (known as the 'balance sheet' test). It should be noted that being deemed unable to pay debts by reason of failure of the balance sheet test is a rebuttable presumption – a subsidiary company with a negative balance sheet, supported by parent company loans, may well be able to pay its trade creditors without difficulty.

### ***Statutory demand***

A statutory demand is a written demand (in the prescribed form) served by a creditor on a debtor. Before winding-up proceedings are issued against a company, the creditor should either serve a statutory demand or have first issued execution on a judgement that has been returned unsatisfied in whole or in part. The demand sets out the sums claimed as outstanding and puts the debtor on notice that after 21 days from service, the creditor will be able to treat the debtor as unable to pay his debts and, as such, will be able to issue winding-up proceedings against it. The debtor company has 21 days from the service of the statutory demand to comply. Receipt of a statutory demand should signal to the directors the onset of insolvency (in the unlikely event that they were not previously aware of difficulty).

### ***Liquidations (winding-up)***

A company may be wound up voluntarily or compulsorily. Usually, a company is only wound up if it is insolvent. When a company is wound up, a Liquidator is appointed to take control of the company's assets. The Liquidator's role is to maximise the realisation from the company's assets and to distribute the realisations to the creditors. In the unlikely event that there is a surplus after payment of costs and the creditors in full (together with statutory interest), he will make a return of any balance to the shareholders.

The effect of liquidation is to terminate a director's duties and powers to the company and its creditors. The Insolvency Act imposes

various additional duties on the director to provide information, documentation and general assistance to the 'office holder' (ie in a liquidation, the Liquidator) in the exercise of the office holder's duties.

### ***Company Voluntary Arrangement (CVA)***

An insolvent company can make an 'arrangement' with its creditors to avoid liquidation. The company will make a proposal to an insolvency practitioner (the nominee) who reports to the court and summons a meeting of creditors. If 75 per cent in value of the creditors agree, the arrangement is binding on all those creditors who had notice of the meeting and were entitled to vote. At the meeting, a Supervisor is appointed to oversee the arrangement (usually the nominee, although creditors may appoint an alternative insolvency practitioner). The return on a CVA is likely to be better than in cases of winding-up and allows the debtor company to keep trading in most cases. It is important for the proposals to be realistic and achievable by the company in adverse conditions. There is no purpose in promising creditors the earth, only for the arrangement to fail after three or four years.

### ***Administration***

Introduced under IA 1986, the purpose of an Administration Order is to rescue a weak or insolvent company by allowing it to continue trading or to provide it an opportunity to realise its assets more advantageously than could be achieved by a winding-up. An Administration Order may be obtained by the company, all the directors, or even the creditors making an application to court and demonstrating that one of the statutory purposes for which an Administration Order may be granted can be achieved. If an Administration Order is made, a moratorium is put into place during which time the company cannot be wound up nor can any creditor (including a landlord) take steps to enforce any security or repossess goods. The moratorium allows the Administrator time to effect the necessary arrangements to either allow the company to dispose of its business and/or assets, or to continue trading under a CVA. Following the making of the Administration Order, the Administrator must, within three months, put proposals to the creditors of the company as to how he proposes to deal with the business during the period for which the

Administration Order is in force. These must be approved by the creditors in a meeting organised by the Administrator. If an Administrator sells the whole or most of the assets of the company, liquidation usually follows. It should be noted that Administration Orders are not granted whimsically or as a matter of course and must be for the purpose of:

- (i) the survival of the company, and the whole or any part of its undertaking, as a going concern; or
- (ii) the approval of a voluntary arrangement; or
- (iii) a more advantageous realisation of the company's assets than would be effected on a winding-up.

### **Administrative Receivership**

This is not a procedure (not to be confused with an Administration Order) created by statute but has its roots in common law. It is based on a contractual relationship between a company and the holder of any debenture (containing a specific type of charge known as a 'floating' charge) over the company's assets. On appointment, the Administrative Receiver takes control of all the company's assets and, depending on the circumstances, may run the company as a going concern and/or attempt to sell its business and assets. The Receiver's primary function is to make sufficient realisations to enable a payment in whole or in part to be made to his appointer, the debenture holder. Usually, the debenture holder is a bank or other financial institution. Under the Government White Paper *A Second Chance*, it is proposed that Administrative Receiverships will cease to be a major insolvency procedure.

### **LPA Receivership**

A Receiver may alternatively be appointed by the holder of a fixed charge (normally a mortgage) over specific property belonging to either an individual or a company. This is distinct from the appointment of an Administrative Receiver as detailed above, where he is appointed over all of the assets of the company in receivership. The person appointed under that fixed charge is correctly known as an 'ordinary receiver'. Since an Ordinary Receiver is appointed under the provisions of the Law of Property Act 1925 (LPA), he/she is often commonly known as an LPA Receiver. The LPA Receiver's powers are very limited by comparison to the powers of an Administrative Receiver.

## **Directors' personal position and other possible actions**

Directors are faced with difficult issues in deciding the most appropriate course of action to take. Taking appropriate professional advice is a prudent first step.

Generally speaking, a director's duties at common law and under the Companies Acts are to act in the best interests of the company, the shareholders and the creditors (in that order) and generally to act with reasonable care and skill. However, when a business is facing financial difficulties, the emphasis changes and they must act in the best interests of the creditors first. The Insolvency Act 1986 exposes directors to potential liabilities if they fail to take every step to minimise creditors' losses.

The temptation for directors is to walk away from the company while they still can, in the hope that their potential liability will then cease. Resignation, however, is usually not appropriate – it is not normally considered to be taking every step to minimise creditors' losses. The directors will generally have to stay on board and work on a strategy (whether turnaround or one of the formal procedures described above) that safeguards the creditors' position. Resignation is more likely to be appropriate for the director who is being excluded from the management of the company by the other director(s). He/she may well not have sufficient information to enable him to make informed decisions, but will still be equally potentially exposed to personal liability as the other directors.

The directors must decide whether there is a genuine prospect that the business can survive, or whether it is inevitable that some formal insolvency procedure will follow. It is vital that the business' management obtain early advice from their professional advisers to assist them in making this decision.

The personal liabilities to which the directors may become exposed or the other specific legal actions that may arise in circumstances of financial difficulty include:

### ***Wrongful trading***

Section 214 IA 1986 allows a Liquidator of an insolvent company to apply to the court for an order declaring that any director (whether past or present) who carried on the business at a time when they knew or ought to have concluded that there was no reasonable prospect that

the company would avoid going into insolvent liquidation, is to make a personal contribution to the assets of the company. The court will not make such an order if it is satisfied that after the director 'knew' insolvency was inevitable he/she took every step with a view to minimising the potential loss to the creditors of the company, as he/she ought to have taken. Proving that appropriate professional advice was taken at an early stage will help demonstrate to a court that all such steps were taken.

### ***Fraudulent trading***

Section 213 IA 1986 allows a Liquidator of a company to apply to the court for an order declaring that any person (not just directors) knowingly carried on the business with the intent to defraud the company's creditors or the creditors of any other person, or for any other fraudulent purpose. If the court makes such a declaration, it will then make that person liable to make personal contributions to the assets of the company. Section 458 of the Companies Act (CA) 1986 also makes such activity a criminal offence (although this is not limited to circumstances of insolvency). The insolvency legislation also provides an 'office holder' (usually an insolvency practitioner) with a number of powers to adjust transactions entered into by the company in the period leading up to the insolvency.

### ***Transfers at undervalue***

Section 238 IA 1986 allows the office holder to apply to court to set aside any transaction entered into at an undervalue made during the relevant period. In brief, if the company makes a gift, or other transaction for which it does not receive any payment, or the payment in money or money's worth is significantly less than the consideration provided by the company in either case at any time in the two years (if the transaction is to any person 'connected' to the company, six months if the parties are not 'connected') before the 'onset of insolvency' or in the period between the onset of insolvency and the making of an order in a formal insolvency procedure, the transaction may be set aside.

### ***Preferences***

Section 239 IA 1986 allows the office holder to apply to court to set aside any transaction entered into made during the relevant period

that prefers any person. If the company does anything, or allows anything to be done, as regards one (or more) of its creditors or a surety or guarantor 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 that person would have been in if that transaction had not been entered into, and the company was influenced in doing so by a desire to prefer that person, then that transaction can be set aside. In the case of a preference to a 'connected' person the intention to prefer is presumed.

The relevant time period is again two years before the onset of insolvency (if the transaction is to any person 'connected' to the company) or otherwise during the six months before the onset of insolvency.

The classic example of a preference is the payment of a creditor who has the benefit of a personal guarantee from the directors. The directors prefer that creditor so as to avoid personal liability under the guarantee.

### ***Transaction defrauding creditors***

Section 423 IA 1986 allows any 'victim' (which includes the office holder or individual creditors) of a transaction at undervalue to apply to the court to restore the position to that which would have prevailed if the transaction had not been entered into and to protect the interests of the victims of the transaction. A transaction at an undervalue includes a gift, transaction for no payment, or for payment the value of which in money or money's worth is significantly less than the consideration provided by the company. The applicant must satisfy the court that the purpose of the transaction was to put the asset(s) beyond the reach of the person who is making the claim or otherwise prejudicing the interests of such a person. It should be noted that unlike preferences and transfers at undervalue (as described above), there is no 'relevant time' during which such a transaction must have occurred. Accordingly, the applicant may be someone who was not a creditor of the company at the time that the transaction was made.

### ***Matters affecting public limited companies***

Section 142 CA 1985 (which only applies to public limited companies) requires any public limited company whose net assets fall to half of its

share capital to call a shareholders' meeting to consider what to do. Failure to do so is an offence.

In addition, quoted companies must avoid creating a false market in their securities. Section 47(1) of the Financial Services Act makes it an offence to induce a person to acquire or dispose of investments by intentionally or recklessly making misleading, false or deceptive statements, promises or forecasts, or dishonestly concealing material facts. Section 47(2) makes it an offence to carry out any act or engage in any course of conduct that creates a false or misleading impression about the market in an investment if the intention is to create that impression and so induce someone to buy or sell that investment. There is the obvious temptation for a director to talk up a company in order to sell shares held by him or his family, perhaps so as to avoid the total loss that the director may suspect is on the way.