Chapter 10 – Corporate rescue and insolvency

In March 2010, Emily and Becky incorporated a company (Shoes in the City Ltd) that specialised in selling ladies footwear. Emily and Becky were the company’s only members and each owned 100 £1 shares. Emily and Becky were the company’s only directors.

For the past 18 months, the company has been experiencing financial difficulties. In September 2012, the company’s overdraft with the Black Horse Bank plc had reached its limit of £250,000. In return for increasing the overdraft limit to £300,000, the Black Horse Bank plc demanded security and took a floating charge over all the company’s assets. The business continued to struggle and, in January 2013, Emily and Becky were informed by the company’s auditor that insolvent liquidation was inevitable, although Emily and Becky disagreed and held out hope that the company’s financial prospects would improve. Emily and Becky decided to try and trade their way out of their financial difficulties by having a sale. Unfortunately, the sale failed to increase business and in March 2013, Shoes in the City was wound up. By this time, the company’s overdraft with Black Horse Bank amounted to £290,000.

Barry has been appointed liquidator and has discovered several disturbing facts (i) in August 2012, Emily and Becky caused the company to repay an unsecured loan of £5,000, which Becky had made to the company some months before; (ii) 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 remaining 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 (IA 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 (IA 1986, s 245(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

- 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 (see the IA 1986, s 214). 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 [1997], 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:
  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 (**IA 1986, s 239(4)**). 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 (**IA 1986, s 239(3)**).

- 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.