COMPASS
FINANCIAL RECOVERY & INSOLVENCY

Insolvency and

Business Recovery

Procedures

A Brief Guide

Compiled by
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GUIDING YOU TO RECOVERY
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I What is Insolvency?

Insolvency is legally defined as:

> A company is insolvent (unable to pay its debts) if it either does not have enough assets to cover its debts (i.e. the value of assets is less than the amount of its liabilities), or if it is unable to pay its debts as they fall due.
>
> An individual is insolvent if he or she is unable to discharge his or her debts as they fall due.

Once a company or individual has become insolvent, several courses of action are open, sometimes resulting in a return to solvency.

Once insolvency is recognised, the insolvent company or individual must seek to ensure that there is no reduction in assets, or increase in liabilities. In any insolvency procedure, the insolvency practitioner takes control of all of the assets and ensures that all creditors are treated fairly and equally, in proportion to their claims. In addition, in most company insolvency procedures, the insolvency practitioner must report to the Department for Business Innovation & Skills ("BIS") on the conduct of directors.

An insolvent company goes into administration, administrative receivership or liquidation, whereas an individual becomes bankrupt, or enters obtains a debt relief order. Insolvent individuals and companies alike can enter voluntary arrangements. These procedures are further commented on in sections III and IV below.

Whilst insolvency procedures and terminology are similar in England, Wales and Northern Ireland, they differ in Scotland. Please note that the following notes include no reference to the procedures in Scotland.

II What Happens in Insolvency?

The objective of any insolvency procedure is to maximise returns to creditors. The mechanism used to achieve that goal will depend on circumstances and the availability of assets, but in many cases an insolvency practitioner will attempt to rescue the business if this will provide a better return for the creditors.

The process of **corporate insolvency** may be initiated by one of several parties.

- The directors and/or shareholders are able to initiate several forms of insolvency process if they believe the company is (or is about to become) insolvent. They may appoint an administrator or apply for an administration order, or they may liquidate a company by means of a creditors' voluntary liquidation. Alternatively a charge holder (usually a bank) may, on request, appoint an administrator or an administrative receiver. (It is generally not possible to appoint an administrative receiver where the charge was created after 15 September 2003).

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- Creditors may apply for the company to be liquidated via the Court, a compulsory liquidation.

- A debenture holder holding a charge or mortgage over the assets of a company may appoint an administrator or an administrative receiver if it considers that repayment of a loan or its security is threatened and if the borrower has breached the loan covenants. (Again, an administrative receiver cannot generally be appointed where the charge was created after 15 September 2003).

- The Secretary of State for BIS may petition the Court for the winding up (compulsory liquidation) of a company if he believes it is acting against the public interest.

As far as **individuals** are concerned, either the debtor or one of his creditors can begin the insolvency process by presenting a petition for bankruptcy to the Court.

Alternatively, with the assistance of a licensed insolvency practitioner, the debtor may prepare a proposal for an individual voluntary arrangement.

On 6 April 2009 Debt Relief Orders were introduced, designed to be for those for whom bankruptcy or an individual voluntary arrangement is unavailable or perhaps unaffordable.

III Forms of Corporate Insolvency

There are five categories of insolvency procedure for companies:

- Company Voluntary Arrangement

- Administration

- Administrative Receivership

- Creditors' Voluntary Liquidation

- Compulsory Liquidation (winding up by the Court)

Receivers may also be appointed under fixed charges (Fixed charge receiverships) on specific assets owned by a company. These are not technically insolvency appointments as such appointments may be made irrespective of the solvency of the company.

There is also members' voluntary liquidation (MVL), but this only applies to solvent companies and is instituted by the shareholders.

Of the above the first three may be employed as a vehicle for business rescue, whilst either form of liquidation is a terminal process and usually marks the end of the business activities.

Rescue Procedures

When a company reaches the stage where formal insolvency procedures are necessary the primary objective for the directors and the insolvency practitioner is to realise the greatest return for the company's creditors. Depending on the stage at which the company realises it is in trouble, the best return is almost always most likely to be achieved by keeping the company's business operating. This enables two possibilities, either the business can continue to operate and generate cash for the creditors or it can be sold on as a going concern. Companies with businesses that are sold on as going concerns almost always achieve a much higher realisable value than the liquidated value of its assets or its businesses and therefore, provide a greater return to creditors.

Company Voluntary Arrangement (CVA)

A company voluntary arrangement is a procedure which enables a company to put a proposal to its creditors, whereby they agree to accept a certain sum of money in settlement of the debts due to them. The procedure is extremely flexible and the form which the voluntary arrangement takes will depend on the terms of the proposal agreed by the creditors. For example, a CVA may involve delayed or reduced payments of debt, capital restructuring or an orderly disposal of assets.

The proposed arrangement requires the approval of at least 75% in value of the creditors who vote, and once approved is legally binding on the company and all its creditors, whether or not they voted in favour of it. There is limited involvement by the Court, and the scheme is under the control of an insolvency practitioner acting as Supervisor.

Administration

Administration is a procedure available to a company that is, or is likely to become, insolvent. It places the company under the control of any insolvency practitioner and the protection of the Court with the following objectives.

- Rescuing the company as a going concern
- Achieving a better result for the creditors as a whole than would be likely if the company were wound up without first being in administration.
- Realising property in order to make a distribution to secured or preferential creditors.

While a company is in administration creditors are prevented from taking any actions against it except with the permission of the Court.

An administrator may be appointed:

- By an order of the Court, on application by the company, its directors, one or more creditors, or, if it is in liquidation, its liquidator
- Without a Court order, by direct appointment by the company, its directors or a creditor who holds security of a type which qualifies him to make an appointment.

A secured creditor who is qualified to make an appointment may also intervene where the company has made an application to the Court. This means that in practice the secured creditor's choice of administrator will prevail.

An administrator's powers are very broad. They include powers to carry on the company's business and realise its assets. The administrator displaces the company's board of directors from its management function and has the power to remove or appoint directors. The administrator must prepare proposals for approval by the creditors setting out how he intends to achieve the purpose of administration.

There is a one year time limit within which the administration must be concluded, but this period can be extended with the agreement of the creditors or permission of the Court if more time is needed to achieve the purpose of administration. The administration may also come to an end if the administrator thinks the purpose of administration has been achieved or cannot be achieved.

On conclusion of an administration:

- The company may be returned to the control of its directors and management
- The company may go into liquidation
- The company may be dissolved (if there are no funds for distribution to unsecured creditors)
- If a company voluntary arrangement has been agreed during the administration, the arrangement may continue according to its terms. (It is therefore possible for a voluntary arrangement to run concurrently with an administration).

Administrative Receivership (often abbreviated to "Receivership")

Administrative receivers are normally appointed by a bank or other lending institution which has as security for a loan (under a floating charge) the whole or substantially the whole, of a company's property. The ability to appoint normally arises when the company is in default or in breach of the terms of its borrowing.

The charge is contained in a document known as a debenture, which will frequently also include fixed charges on certain assets and the lender is referred to as the debenture holder.

The administrative receiver has similar powers to the administrator described above. He can continue to operate the business, and often does, whilst trying to sell it as a going concern.

An administrative receiver has no authority to deal with the claims of unsecured creditors (e.g. trade creditors). Therefore if funds become available for distribution to unsecured creditors they must be dealt with by a separately appointed liquidator.

It is no longer possible to appoint an administrative receiver under a debenture created after 15 September 2003. Instead, creditors with floating charge security can appoint an administrator.

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Liquidations

A liquidation may be solvent or insolvent. (As mentioned above a solvent liquidation is known as a members' voluntary liquidation (MVL), in which the liquidator is appointed by the shareholders and the company's assets are sufficient to settle all its liabilities, including statutory interest, within twelve months.)

An insolvent liquidation will be either a creditors' voluntary liquidation (CVL), which is begun by resolution of the shareholders, or a compulsory liquidation, which is instituted by petition to the Court.

Liquidation may occur following a receivership or administration' or the company's directors or shareholders may recommend that the company be put directly into liquidation via either a CVL or MVL.

Alternatively, a Court can make a Winding-up Order for a compulsory liquidation on the application of a creditor or of the company itself.

In an MVL the liquidator is appointed by shareholders. In a CVL the appointment is made by the shareholders, subject to confirmation or replacement at the creditors' meeting by the creditors. In a compulsory liquidation the Official Receiver will initially be appointed liquidator, but creditors can them nominate another insolvency practitioner.

There are a number of possible reasons for making a Winding-up Order. The most common is because the company is insolvent.

Insolvency can be established by failure to comply with a statutory demand requiring payment within 21 days, or by execution against the company's goods which remains unsatisfied.

A Winding-up Petition may also be presented by the Secretary of State for BIS on the grounds of public interest.

A CVL is a liquidation begun by resolution of the shareholders, but is under the effective control of the creditors, who can appoint a liquidator of their choice at the meeting of creditors that must be held. Recent changes in legislation have placed a greater onus of responsibility on the directors of a company. The CVL is now the most common way for directors to take action at an early stage, in order to minimise the risk of personal liability for wrongful trading. Furthermore, unlike a compulsory liquidation, a CVL does not bring the directors' conduct under the scrutiny of the Official Receiver, although the liquidator is required to report to the Department for BIS on the conduct of the directors.

It is also possible for a liquidation to proceed as a CVL without the need for a creditors' meeting, where it follows immediately on the conclusion of an administration and there are funds available for the unsecured creditors. The liquidator will be the administrator, or other person previously approved by the creditors.

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IV Forms of Personal Insolvency

There are several types of insolvency procedure available to individuals in England, Wales and Northern Ireland, depending upon their circumstances.

- Bankruptcy
- Individual Voluntary Arrangement
- Debt Relief Order

Bankruptcy

Bankruptcy is the administration of the affairs of an insolvent individual by a trustee in the interests of his creditors generally. The trustee's function is to realise the assets and distribute them among the creditors in a prescribed order of priority.

Bankruptcy proceedings commence with the making of a Bankruptcy Order by the Court. Immediately on making the Order the Official Receiver becomes receiver and manager of the bankrupt's estate, pending the appointment of a trustee. Where there are significant assets, an insolvency practitioner will usually be appointed to act as trustee, either by a meeting of creditors or by the Secretary of State for BIS.

An application for a Bankruptcy Order may be made by any creditor owed more than £750 or by the individual himself. Subject to certain exemptions, once the Order is made, control of the bankrupt's assets pass to the Official Receiver and then to the trustee. The bankrupt loses any right to his property apart from any equipment needed by him for use in his business, and basic domestic equipment such as clothes, bedding and furniture, and certain pension rights.

There are special rules regarding the bankrupt's home. Generally speaking, if the bankrupt has equity in a house, it will need to be realised. The law though discourages a trustee from taking steps to force a sale through the Court during the first twelve months of the bankruptcy where the bankrupt is married or has young children living with him. Rules introduced in April 2004 give the trustee three years from the date of the Bankruptcy Order to sell the house or otherwise deal with the bankrupt's interest in it. If he does not do so within that time, the property will revert to the bankrupt. Also if the value of the equity is less than £1,000 the trustee will not be able to sell it at all.

There are certain restrictions of bankruptcy which usually last until the bankrupt is discharged (although his assets remain with the trustee).

If the bankrupt has an income above his needs and those of his dependants, he may be required to make contributions of this "surplus" to his creditors for up to three years. Until his discharge, the trustee may also claim any property acquired by the bankrupt after the Bankruptcy Order, such as assets left to him in a Will.

During the bankruptcy the bankrupt is subject to certain restrictions. These include being unable to obtain credit of more than £500 from anyone without telling that person that he is an undischarged bankrupt. The bankrupt must not carry out business under a name different from that under which he was declared bankrupt without disclosing the fact that he is an undischarged bankrupt, and he may not act as a company director without the Court's consent.

The bankrupt will usually be discharged from bankruptcy automatically after one year, or potentially sooner if the Official Receiver decides to close his file early. Once discharged, the bankrupt is released from his bankruptcy debts, with some exceptions such as Court fines, matrimonial debts and certain student loans. After he has been discharged, the bankrupt does not have any right to take back from the trustee any property that was part of his estate in bankruptcy, and the trustee will remain in office for as long as is necessary to sell the property and distribute the proceeds to the creditors.

The restrictions on a bankrupt may remain if the Official Receiver applies to Court to impose a Bankruptcy Restrictions Order of the bankrupt agrees to sign a Bankruptcy Restrictions Undertaking. These can last for up to 15 years.

Individual Voluntary Arrangement (IVA)

The IVA is a less formal procedure open to insolvent individuals (including those already subject to bankruptcy proceedings). The procedure is flexible and its exact nature varies from case to case, depending on the terms of the proposal. By entering into an IVA with the agreement in excess of 75% by value of the creditors who vote on it at a creditors' meeting, the debtor may be able to order his affairs in a way which benefits his creditors but would not be possible under a bankruptcy; for example by an orderly disposition of assets, introduction of third-party funds, contributions from future earnings or debt rescheduling. The agreement is overseen by a supervisor and is binding on all creditors, whether they voted for it or not.

Except where the debtor is bankrupt when he makes the proposal, only a licensed insolvency practitioner can act as supervisor of an IVA. If the debtor is bankrupt, the Official Receiver can act as supervisor, and a simplified procedure called a 'fast track' can be used, which does not involve a creditors' meeting. It still requires a 75% majority of creditors to approve the proposal.

An IVA cannot affect the rights of secured (e.g. mortgagees) or preferential creditors, except with their express agreement.

The IVA's benefits are its flexibility, its lack of publicity compared with bankruptcy, and the fact that it may be cheaper to administer for the creditors than a bankruptcy and so is likely to increase return to the creditors.

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Debt Relief Order (DRO)

These came into force on 6 April 2009 and can be applied for by an individual who:

- Is unable to pay his/her debts
- Has total unsecured liabilities not exceeding £15,000
- Has total gross assets not exceeding £300 (cars worth less than £1,000 are excluded)
- Has disposable income, after allowing for normal household expenditure, of not exceeding £50 per month
- Is domiciled in England or Wales or has been resident here or has carried on business here for the last three years.

Application is made on line, via an approved intermediary, to the Official Receiver, and if the criteria are met (and a £90 fee paid) the DRO is made (without any reference to Court).

The DRO will generally last for 12 months, during which time the individual cannot:

- Obtain credit exceeding £500 without disclosing the DRO
- Promote, manage or form a company, or be a director, without the permission of the Court
- Carry on business in a name other than that on the DRO
- Obtain more than one DRO in any six year period

The DRO will be registered on the Insolvency Register and the Official Receiver will notify all creditors, but no other notifications will be issued unless the DRO is revoked or extended.

No dividend is paid to creditors, nor may they take any enforcement action against the individual. At the end of the period the individual is free from all the debts scheduled within the DRO.

V Who Gets What?

In an insolvency procedure, control of assets of the debtor business, or individual, rests with the licensed insolvency practitioner, except in voluntary arrangements where control will often remain with the company or the debtor. The insolvency practitioner may in some cases also exercise extensive control over the running of a business.

Once the assets of the individual or company are realised, or as they become available from income streams, they are distributed in a strict order of priority:

- Any individual or organisation holding fixed charge security over a company's assets is paid first, after the costs of realisation.

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- The next group of creditors to receive funds , if there are any remaining, are preferential creditors, which consist mainly of employees' arrears of wages and holiday pay to specified limits

- Third in line are holders of floating charge securities (except for the proportion which may need to be set aside for unsecured creditors)

- Fourth are unsecured creditors (e.g. trade creditors). In insolvency cases this may result in a percentage return by way of dividend or possibly no return at all for this class of creditor.

- Finally, the shareholders, or in the case of a bankrupt, him or herself.

Please note that the contents of the above notes are intended to provide a general overview. They should not be regarded as a substitute for considered advice on specific issues. Accordingly no responsibility can be accepted for the information or for any errors or omissions.

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