Corporate Insolvency - What does it mean?

The word 'insolvency' carries many frightening connotations for business owners. However, being insolvent does not necessarily mean that your company must close up shop for good. Here, we discuss how to determine whether your company is insolvent, along with some of the main insolvency options that might save your company.

How do I know if my company is insolvent?

According to the Insolvency Act 1986, a company is insolvent if it is "unable to pay its debts". There are two tests that will show if this is the case: the cash flow test and the balance sheet test.

The cash flow test states that a company is unable to pay its debts if the following conditions are met:

• The company has proven to the court that it cannot pay its debts when they fall due.

• A creditor serves the company a written demand for a debt exceeding £750 and does not receive full or partial payment within three weeks of serving the demand.

• The company has not carried out a court-ordered execution, payment or process in favour of a creditor.

With the balance sheet test, a company is deemed insolvent if it proves to the court that its liabilities exceed the value of its assets.

Insolvency processes:

Company voluntary arrangements

This non-terminal procedure allows an over-indebted company to voluntarily restructure its business based on its creditors' recommendations of how to deal with its debts.

The company shareholders and creditors must first vote on the company directors' proposal for a company voluntary arrangement (CVA). Once approved, the CVA usually becomes effective at the end of a 28-day challenge period. An insolvency practitioner is then nominated and approved to become the 'supervisor' responsible for calling all CVA meetings. If the CVA is successful, the arrangement will terminate upon completion. If it fails, the supervisor will take the necessary steps to put the company into administration.

Administration

Administration is intended to rescue companies that are struggling financially. Firstly, the company either files for an administration order from the court, or the company is placed into administration out of court, by having certain prescribed documents filed with and stamped by the court. This is typically done by the company's directors.

An interim moratorium then comes into effect until an administrator is appointed for an initial one-year period with the goals of rescuing the company, achieving a better return for creditors, and realising property to be distributed to secured or preferential creditors. The administrator is an officer of the court who takes full control of the company's assets and affairs, with the power to carry on the company's business.

Administrative receivership

In this rarely used process, a holder of a floating charge over all or a substantial portion of a company's assets (usually a bank) appoints an administrative receiver. The administrative receiver then acts as the company's agent in the interests of its appointer, determining the most effective course of action to recover the debts owed to the appointer. That being said, the receiver must act in good faith, without unduly prejudicing the interests of the company or its creditors, and owes a duty of care to any other security holders.

Liquidation

Liquidation is a terminal insolvency process that ultimately dissolves the company. The first type of liquidation is compulsory liquidation, which is usually court-ordered following the submission of a petition by a creditor on several grounds.

The second type of liquidation is voluntary liquidation, which covers members' voluntary liquidation and creditors' voluntary liquidation, both of which are triggered by a shareholders' resolution. If the directors swear a statutory declaration of solvency, the liquidation is deemed members' voluntary liquidation; this declaration must be sworn at least five weeks prior to the shareholders' meeting to resolve to liquidate the company. If, however, the directors do not swear this declaration, the company's creditors must meet within 14 days of the shareholders' resolution, and nominate a liquidator.

In both scenarios, the directors' powers cease, and the liquidator acts as the company's agent, to the benefit of the company and its creditors. The liquidator's primary purpose in compulsory and voluntary liquidation is the beneficial realisation of the company's assets and the distribution of proceeds.

Additional options

Insolvent companies may also pursue a scheme of arrangement, or dissolution. The latter may be done voluntarily after liquidation or administration. Dissolution effectively ends the company's corporate existence, so no one can act on its behalf; nor can it commence any legal proceedings.

Pitfalls to avoid

The fact that a company is a separate legal entity from the persons running it can sometimes give the false sense of security that the directors and shareholders are not responsible if things go wrong. On the contrary, although there is a 'corporate veil' that works to separate legal liabilities, if a struggling business is left to languish in pursuit of other opportunities, the consequences can have a severe and long term impact. It is therefore very important to make sure the correct and most suitable procedure is followed when winding down an insolvent business.

If a company is simply left to become insolvent and then dissolved without having complied with the correct procedures, there is a risk that the company's assets will become 'bona vacantia' (essentially, ownerless), losing the value of those assets for the company's initial owners and requiring a complicated and expensive legal process to correct the situation.

Getting the right advice

If your business is facing insolvency, it is crucial to consult with an experienced, qualified solicitor on how best to salvage the business or the value of its assets.

For more information, or for expert advice on business or personal legal issues, call us on +44 (0)20 3475 6751 or via email at info@carterbond.co.uk