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INSOLVENCY INVESTIGATIONS

Overview

The Official Receiver has an obligation in a compulsory liquidation to investigate if the company has failed, and if so, to investigate the causes of the failure. He must also investigate the dealings and affairs of the company generally. He must make an application to Court on the outcome of the investigations, if he sees fit.

The liquidator has no specific duty to carry out an investigation in a voluntary liquidation. However, he must carry out such investigations as are necessary to determine the assets and liabilities of the company, to review the decisions and actions of the directors, to determine whether transactions may be set aside and to identify any rights of legal action which the company or liquidator may have against them or against third parties.

A liquidator is obliged to take appropriate steps to investigate what assets are available to the company in a winding up. This will include inviting creditors to bring matters to his attention, enquiring of officers and management, verifying the statement of affairs against audited, filed and management accounts, reviewing books, accounts and papers and identifying possible legal action.

If there are grounds for further investigation or action, he should discuss the matter with the liquidation committee. Funding issues should be discussed with them. If the liquidator comes across evidence that the company or an officer has been guilty of an offence, the matter should be reported to the authorities.

In the case of an insolvent liquidation, the liquidator must report to the Secretary of State on the conduct of past and present directors, where it appears that their conduct is such as to make them unfit to be concerned in the management of a company.

Disqualifying Directors

An Official Receiver, Liquidator, Administrator and Administrative Receivers are required to report on directors' conduct. They are obliged to make a return within six months of the start of the relevant process. They are required to file a D1 report for directors whose conduct has been unfit and a D2 report for directors whose conduct is deemed to be fit. They must cover all directors and shadow directors in office, within three years before the commencement of the process.

The Secretary of State must make an application for disqualification within two years. The Courts can make a disqualification order where a director has been director of a firm which became insolvent and his conduct as director makes him unfit to be concerned in the management of a company. The minimum period for disqualification is three years, with a maximum of fifteen.

Under a disqualification order, a person may not act as a director or be otherwise involved, directly or indirectly in the promotion, formation and management of a company, without the leave of Court. Anybody acting in contravention of a disqualification order is guilty of an offence and is jointly and severally liable for the company's debts.

SIP4 gives guidance to Insolvency Practitioners in relation to disqualification orders. If an insolvency practitioner has not found any unfit conduct within six months or his information is insufficient, he should make an interim return. If relevant conduct is found at a later date, a further report can be made. The reports must be made within one year and the applications must be made to Courts within two years. If Liquidators cannot make any specific investigation into directors' conduct, they can act on the basis of what comes to light in the ordinary course of investigation.

Criteria for disqualification

An isolated technical failure should not be looked at. Rather, the director's overall conduct is to be assessed. The following types of misconduct are relevant to assessing the overall position:-

- loans to directors to purchase shares of the company;
- personal benefits obtained;
- criminal convictions;
- breach of duty;
- misapplication of funds;
- voidable transactions;
- prejudicing of creditors such as by dishonoured cheques, delaying tactics, retention of monies to finance trading, undervalue transactions, preferences;
- overstating assets in accounts, misconduct in factoring, responsibility for insolvency, responsibility for non delivery of goods, responsibility for preference.

A disqualification undertaking may be given by an individual that he will not act as director for a specified time. The minimum and maximum times are the disqualification periods. An undertaking may be accepted in lieu of an application for disqualification order.

Review and Set Aside of Past Transactions

Liquidators (and other insolvency officers such as administrators) are entitled to look at transactions which have dissipated the company's assets. The purpose is to take back assets which have been wrongfully removed from the company so that they are available for payment to the creditors generally.

Liquidators have powers to apply to set aside voidable transactions undertaken by the company within certain time periods before liquidation. Action can be taken against directors and others to recover the funds for the benefit of the liquidation. There are a number of distinct grounds upon which liquidators can seek to undo transactions and recover money.

Where company assets have been given away by a gift or for less than full value when the company was insolvent or about to become insolvent or became insolvent as a result, then under certain circumstances, the transaction can be set aside. The liquidator or administrator can apply to Court to have the transaction set aside. If the

transaction was entered into in good faith with reasonable grounds for believing it would benefit the company, this may be a defence.

An unlawful preference is a transaction with a creditor, a surety or guarantor by which the company puts the creditor or guarantor in a better position then they would have been in, without the act concerned. The company must be insolvent at the time or as a result of the preference, in order for it to be challenged. It must take place within a certain timeframe before insolvency. The Liquidator/Administrator may apply to the Court to have it restored to the prior position. It is presumed that there is a desire or intention to prefer, if the parties are connected.

An extortionate credit transaction is one which, having regard to the risks and rewards, is grossly out of line with ordinary principles of fair dealing. The provision of credit must take place in the relevant time and liquidator and administrator must apply to Court to have the Agreement varied or set aside.

Transactions that are at undervalue can be set aside within 2 years. Unlawful preferences with unconnected parties can be set aside within 6 months and in the case of connected parties, 2 years. Extortionate transactions can be set aside within 3 years. A connected party is a director or an associate of any such person. Associates include most relations, business associates, trustees, and companies connected with such individuals.

A floating charge granted over a company's assets within 12 months of insolvency is invalid, except to the extent that new value is given. A floating charge within the relevant time period is invalid. The Liquidator/ Administrator must make an application to show the floating charge is invalid and that the assets purported to be covered by it can be taken free of it.

Fraudulent and Wrongful Trading

Fraudulent trading is where directors or other controllers of the company knowingly carry on business with the intent of defrauding creditors. Persons who knowingly are party to fraudulent trading, can be made liable to contribute to the company’s assets

as the Court decides i.e. can be made personally liable for the company's debts. Fraudulent trading is also a criminal offence.

Wrongful trading is where a director of an insolvent company knows that a company is not able to pay debts and does not take steps to minimise losses to creditors. This is a civil claim. The Court can order that a director contributes to the company's assets as it thinks fit. Wrongful trading is easier to prove than fraudulent trading. It need only be show that the directors should have known that the company was insolvent.

A director may have breached his duty to the company. He may have misapplied company funds. Legal action can be brought against a director, past directors or other parties. The Court will require the Defendant to reimburse monies as it sees fit or as appropriate.

A director or a "shadow" director (a director in fact, but not in name) of a company in insolvent liquidation may be prohibited or restricted from being a director of a company within 5 years. Involvement need not only be as director. Prohibition or restriction can apply to anybody involved, directly or indirectly, in the promotion or formation of the company. The person in breach becomes liable for debts incurred during the period in which they are involved with the company.

If the insolvency practitioner transfers the business to a successor company, notice must be given to the Creditors by the successor. The notice must give details of the name and the full circumstances of the acquisition.

This Guide is intended as an overview and broad outline of the matters covered in it. Its purpose is to inform and raise awareness. We are happy to offer specific legal advice on particular circumstances.

This Guide should not be relied on as a substitute for comprehensive legal advice with reference to the particular circumstances.

While we have taken due care in the preparation of this publication, we do not accept legal liability as a result of any reliance placed on anything in this Guide. The reader should rely only on specific legal or taxation advice.

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