The Legal Framework of Corporate Rescue Procedure: A Brief Overview

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Abstract:

This paper is designed to throw an insight into the legal framework of corporate rescue procedure of the companies in the case of insolvency which are generally governed by insolvency laws. It analyzes the present status and application of insolvency law of our country in the context of companies, by comparing the same with the law of England & Wales. The paper contains major provisions of the present law relating to corporate rescue procedures in English jurisdiction including landmark judgments given in that context. By this comparison, the paper aims to provide the reader with the instigation of thought for making possible improvements in our present law by way of implementing rescue procedures for companies which are in financial difficulties.

1. Introduction

In the realm of corporate law, it is not uncommon to find companies which are in financial distress. The primary reasons for these events, although not exhaustive, may include over-expansion, inadequate marketing, poor management, excessive interest rates, loss of market share, or even fraudulent activities.[1] Whenever a company is facing serious financial difficulties, it has a number of options which are primarily designed to protect interests of the creditors and those of the company itself as well. As an outline, the insolvency procedures include provisions which are aimed to rescue the company, and in the circumstances it is not appropriate, to dissolve the company.

The question 'what is insolvency?' cannot be answered by giving a single, definitive answer. There may be found a number of tests, some of which are incorporated in legislative provisions or followed in case laws. Due to different natures of these tests, it remains true that a company can be found insolvent according to one test, but not on others.[2] 'Insolvency' of a company can be defined based on two principal tests; firstly, where it is unable to pay its debts ('cash flow', or 'commercial' insolvency), secondly, where its liabilities exceed its assets ('balance sheet', or 'absolute' insolvency)[3]. Under the first test, a company's failure to pay an undisputed debt may indicate the cash flow insolvency. This notion appears to be true with the respect of a company's policy of late payment of bills. In *Taylor's Industrial Flooring Ltd v M &*

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[1] Parry R. *Corporate Rescue* (Sweet & Maxwell, 1st edition, 2008) p. 1

[2] Totty P & Moss G *Insolvency* (Sweet & Maxwell, 2010, Release 64, volume 1) at A1-02

[3] Goode R *Principles of Corporate Insolvency Law* (Sweet & Maxwell, 3rd edition, 2005) p.86-87

H Plant Hire Ltd[4], Staughton LJ expressed the view that the delay in paying debts by a company after it falls due may be a sufficient ground for the creditors to file an insolvency petition[5]. As a starting point, the court will necessarily look into whether the company is in fact, paying its debts or not. Although in relation to UK legislation of insolvency, the cash flow theory has much more broader application.

Under the second test, the issue would be to determine whether the company's liability exceeded its assets. This requires the valuation of both the liabilities and assets. In valuating liability, contingent and prospective liabilities must be taken into account. In *Re Dollar Land Holdings Plc*[6], prospective liability is stated to include an obligation to repay a loan and an undisputed claim for unliquidated damages for more than a nominal amount. It is a binding liability which is not yet matured. On the other hand, contingent liability is considered to be dependent on an event to occur, which essentially triggers the enforceability of the repayment[7]. The Insolvency Act 1986[8] does not indicate how the contingent liabilities are to be valued for the purpose of balance sheet insolvency. However, in *Re A Company (No 006794 of 1983)*[9], it was held that in assessing liability of the company, the contingent liabilities are regarded as to whether, and if so when, they become present liabilities. One instance would be where the liabilities are admitted in a winding-up petition.

Valuation of assets of a company involves the valuation of assets both on the basis of the company's business being sold as a going concern and on the basis of the assets being broken up and sold separately. The Insolvency Act 1986 does not specify the exact basis but the valuation on the former basis usually produce higher figure.[10]

2. Categories of Insolvency Procedures: Corporate Rescue

As stated above, a company in difficult position is faced with basically two types of procedures. First, where the company dissolves and ceased to carry on business, or on other terms, non-rescue procedures; second, where the company continues to trade despite the apparent distress under specific arrangements to pay off the debts, also known as rescue procedures.

At present, The Companies Act 1994 governs the dissolution of companies by way of winding up in Bangladesh. Essentially, there are three modes of winding up procedure.[11] The modes of winding up are: winding up by court, voluntary winding up and winding up under the supervision of court. However, the non-rescue

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[4] [1990] BCLC 216
[5] [1990] BCC 44, at 51
[6] [1994] 1 BCLC 404
[7] *Winter v IRC* [1961] 3 All ER 855
[8] It is the primary legislation that deals with the corporate insolvency in England and Wales.
[9] [1986] BCLC 261
[10] Boyle A. and Birds J. *Boyle & Birds' Company Law* (Jordan Publishing, 7th edition, 2009) p.815
[11] The Companies Act 1994, section 234

procedure which is available in other jurisdictions including England and Wales has not been featured in any of the statutes concerning corporate managements in Bangladesh.

In England & Wales, the Insolvency Act 1986 introduced two new procedures, both of them falls into the category of rescue procedure: the company voluntary arrangement and the company administration order.

Rescue procedure essentially involves going beyond the normal managerial aspects of a company at the instance of corporate trouble.[12] It includes both the processes which are well within the formal legal framework governed by legislature and also the processes which are rather informal in nature. If compared, the initial benefit that a company may receive out of an informal rescue process both from management and shareholders point of view is that the publicity of the corporate distress will be less than that of the formal process. It is suggested that the company in corporate distress would have a better chance to survive if it can avoid adverse publicity.[13] In contrast, formal processes of rescue involve more investigation and insight of the company affairs, and essentially, change in the control of the management of the company.[14] In certain cases, it is more attractive than the informal process to the creditors.[15] Therefore, it can be considered that both processes have advantages and disadvantages. In this work, only the formal processes of rescue are considered with relevant analysis.

2.1 Company Voluntary Arrangement

As an outline, the company voluntary arrangement ('CVA') is intended to provide the company with a simpler method of rescue achieved by a binding agreement with the creditors.[16] The essential feature of a CVA is that the creditors enter into an agreement with the company allowing it an extra time to pay its debts. As a general consideration, there is no technical requirement within any statutory provision that the company in question needs to be insolvent or unable to pay its debt before it can enter into a CVA. However, the success of CVA underlies in the fact that the creditors anticipate better payment of debt from the company than that of while not entering into the agreement.[17] The procedure initially was introduced in Insolvency Act 1985 ss. 20-26, and was later consolidated in the Act as Part I[18]. CVA enables the company's directors to remain in control of it under the supervision of an insolvency practitioner. With the amendment of Part I of the Act by the Insolvency Act 2000,

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[12] Vanessa F *Corporate Insolvency Law* (Cambridge University Press, 2009, 2nd edition) p. 243
[13] Brown, *Corporate Rescue* pp 11-13
[14] Insolvency Act 1986 ss. 234-7
[15] Vanessa F *Corporate Insolvency Law*(Cambridge University Press, 2009, 2nd edition) p. 253
[16] *Gore-Browne on Companies*, (Jordan Publishing, 2004, 45th edition) at 49 [1]
[17] Weisgard G. Griffiths M & Doyle L. *Company Voluntary Arrangements and Administrations*, (Jordan Publishing, 2010, 2nd edition) p. 3
[18] Parry R. *Corporate Rescue* (Sweet & Maxwell, 2008, 1st edition) p.131. see: fn 1

there are now two types of CVA procedures. Firstly, CVAs *without* moratorium which are governed by Part I of Insolvency Act 1986 as amended by Insolvency Act 2000; secondly, CVAs *with* moratorium which are governed by Insolvency Act 2000[19].

2.1.1 CVA without moratorium

All CVAs are based upon a proposal to the company and its creditors for a composition in satisfaction of its debts or for a scheme of arrangement of its affairs.[20] A CVA where no moratorium is incorporated does not provide the company an authorized period of delay in repaying its debt, and the creditors are not barred from enforcing their rights even during the negotiation. According to the Act, a person must be provided for to act as a trustee or otherwise to supervise its implementation in the proposal, who is referred to as the 'nominee'.[21] It is important to note that although the section refers the nominee to act as a trustee or otherwise, he neither acquire any power to deal in the name of the company nor becomes the officer of the company by virtue of the provision. Any power he gets must come from the terms of voluntary arrangement itself.[22] It is the duty of the nominee to summon meetings of the creditors and shareholders to determine the approval of the proposed voluntary arrangement[23] and to provide accurate and sufficient information to enable creditors to consider the merit of the proposal. Failure to provide this information may be treated as material irregularity enabling the court to revoke approval of the arrangement.[24]

Where the designated nominee is someone other than the existing administrator or liquidator of a company, before summoning the meeting with the creditors and the shareholders, he must make report to the court stating whether, in his opinion, the proposed arrangement has a reasonable prospect of being approved by the creditors and implemented.[25] This statutory requirement may have an effect on the popularity of the CVA. It is observed that the insolvency practitioners tend to prefer and accordingly advise the liquidation than the CVA, on the basis of the uncertainty of the effect of such report.[26] The nominee will usually work closely with the proposers of the arrangements in making this report but there are statutory obligations on the proposers to provide him with necessary information. The role of the court at this stage is merely administrative. It neither vets the proposal nor approves the

[19] The Act inserted a new Schedule A1 into the Insolvency Act 1986
[20] *Gore-Browne on Companies*, (Jordan Publishing, 2004, 45th edition) at 51 [1]
[21] S. 1(2) Insolvency Act 1986
[22] Sealy L. & Milman D, *Annotated Guide to the Insolvency Legislation*, (Sweet & Maxwell, 11th edition, Volume 1, 2008/09) p. 24
[23] S. 4(1) of Insolvency Act 1986
[24] Revoked under s. 6(4), *Re Trident Fashions* [2004] 2 BCLC 35
[25] S. 2(2) of IA 1986; Sch. A1 Para 6(2) of Insolvency Act 1986
[26] Weisgard G. Griffiths M & Doyle L. *Company Voluntary Arrangements and Administrations*, (Jordan Publishing, 2nd edition, 2010) p. 9

nominee's report. A report is not required where an administrator or existing liquidator designates himself as nominee.

Once a CVA is approved by the requisite majority, it is binding on all the creditors and the nominee becomes the supervisor[27] and is responsible for carrying out the functions conferred on him by the arrangement.

2.1.2 CVA with moratorium

Whenever a company aims for CVA with a moratorium, the primary responsibility lies with its directors to apply for it to the nominee. As amended by Insolvency Act 2000, the directors must produce sufficient evidence that the company is likely to have sufficient funds during the moratorium to enable it to carry on business and the CVA has reasonable prospect of success.[28] It has been aimed towards those companies particularly which satisfy two or more requirements for being a 'small' company.[29] Further eligibility requirements for CVA with moratorium are listed in paragraph 4(1) of Schedule A1 of the Insolvency Act 1986. Under this provision, a company is not eligible for a CVA with moratorium if it has a subsisting insolvency procedure. There are also anti-abuse provisions to prevent a company from having the benefit of a number of unsuccessful moratoria in rapid succession.[30]

The procedure is similar with that of CVA without moratorium. The difference is that the company would have a substantial breathing space to carry on its business with the interim indemnity from being sued by the creditors. The moratorium gives the company substantial protection by restricting creditors and others from bringing actions against it.[31] However, the reformed provision governing the area[32] imposes several restrictions on the way the affairs of the company being conducted. During the period of moratorium, no application for administration may be made,[33] and no winding up petition may be presented or any resolution passed with the same effect,[34] except for the petition being filed by the Secretary of the State on the ground of public interest.[35] Most importantly, no other proceedings and no execution or other legal process may be commenced or continued against the company during the moratorium period,[36] which is intended to provide the company with a proper opportunity to attempt a recovery from the situation of corporate distress.

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[27] S. 7(2) of Insolvency Act 1986
[28] S. 1A of the Insolvency Act, 1986
[29] Insolvency Act 1986, Sch. A1 Paras 2(1) and 3
[30] Boyle A J and Birds J *Boyle & Birds' Company Law* (Jordan Publishing, 7th edition, 2009) p.823
[31] Parry R. *Corporate Rescue* (Sweet & Maxwell, 1st edition, 2008) p. 139
[32] Sch. A1 of Insolvency Act 1986
[33] Ibid, Para. 12(1)(d)
[34] Ibid, Para. 12(1)(e)
[35] Ibid Para. 12(5)(a) and S. 124A of IA 1986; the provision also states three more exceptions. see: Sch. A1, Para 12(5), IA 1986
[36] Ibid Para 12(1)(h)

2.2 Administration

2.2.1 General

Administration is intended to be short-term remedy in order to tide the company over a period until either the business run by the company can be sold or the assets can be more advantageously realized.[37] Under this rescue scheme, an administrator is appointed to overtake the functions of the directors. Although the procedure was first introduced in part II of the Act, it has been amended by the Enterprise Act 2002 and now is governed by Sch. B1 of the Act supplemented by Insolvency Rules 1986 (the 'Rule')[38].

Following the recommendations in the *Insolvency Law and Practice*[39] report by the Cork Committee, the new administration procedure was introduced in the Act. It has been one of the most important recommendations of the committee, as to provide with a possible and effective alternative to insolvent winding up in order to reducing the economic and social damage resulting from avoidable insolvencies.[40]

However, due to a number of provisions in the enacted legislation, the administration procedure faced lack of effectiveness. As explored in '*The Nature and Functions of a Rescue Culture*'[41] by Hunter, the administration procedure was failing to meet the actual purpose which was designed to contribute in the corporate insolvency. Firstly, the procedure was heavily dependent upon court application, and therefore was costly, burdensome and slow.[42] Secondly, a floating charge holder had an effective veto on the appointment of an administrator. According to *a Review of Company Rescue and Business Reconstruction Mechanism, Report by the Review Group*[43] the operation of Part II of the Insolvency Act 1986 was hindered due to the open ended nature of the administration process. The provision did not contain any time limit thereby had created much uncertainty. Furthermore, there was a presence of gaps in the statutory moratorium. After the presentation of a petition for the appointment of an administrator and during the currency of an administration order there was an embargo on enforcement of security rights and other claims against the company.[44]

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[37] Hoffmann J in Re Arrows Ltd (no.3) [1992] BCLC 555
[38] In the present work, all the term Rule refers to the Insolvency Rules 1986 , unless contrary is stated
[39] Cmnd 8558 (1982)
[40] Davis-White M. & Frisby S. *Kerr and Hunter on Receivers and Administrators*, (Sweet & Maxwell, 2010, 19th edition) p. 291
[41] [1999] JBL 491
[42] *Gore-Browne on Companies*, (Jordan Publishing, 2004, 45th edition, volume 2) at 52 [1]
[43] May 2000
[44] Re Lomax Leisure Ltd [2000] BCC 352

The result was the implementation of the Enterprise Act 2002, to bring forward a significant change in the procedure of administration[45]. A government White Paper *Productivity and Enterprise: Insolvency – A Second Chance*[46] was published in July 2001.

In this whitepaper, administration was promoted as the best means by which all interest groups of a company could participate in determining the fate of a company in financial difficulty, thereby enhancing the company's chances of survival.

2.2.2 Administration after reform: present position

The new provisions are being applied on the administrations commenced on or after 15 September 2003. The administrations before that are still governed by the old rule. According to the new provisions of the Act, an administrator can be appointed by the court; by a qualified floating charge holder out of court, or by the company itself upon giving prior notice to a qualified floating charge holder.[47] Because of the relevance of the present work, nothing further on the appointment procedure of the administrator is discussed.

The appointment of an administrator will displace the board of directors from their existing management functions and the administrator will take control of the property to which he thinks the company is entitled.[48] It may be important to note that the provision corresponds to s.17(1) of the old provision, replacing the words 'to which he thinks the company is entitled' by 'to which the company is or appears to be entitled'. Therefore, the subjective belief of the administration becomes crucial.[49]

The Administrator's main function is to carry out the purpose of the administration,[50] which are: firstly, the administrator will be required to carry on his responsibilities with the primary objective of rescuing the company as a going concern[51]; secondly, as a whole, the administrator's role will be to achieve better result for the creditors than that had the company went into liquidation; and thirdly, if the first two objectives cannot be fulfilled, administrator's purpose will be to realize property in order to make a distribution to one or more secured or preferential creditors, without harming the interest of the creditors as a whole. It is important to note that, like a liquidator, an administrator owes no duty to individual creditors.[52]

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[45] s.248 of the EA 2002 replaced the whole Part II of the IA 1986 with a new Sch. B1 of IA 1986. However, see: s. 249, where old Part II is still applicable in relation to a number of categories.
[46] Department of Trade and Industry (Cm 5234), 2001
[47] Sch. B1, IA 1986, Para. 10, 14(1) and 22(1) respectively
[48] Sch. B1, Para 67, IA 1986
[49] Sealy L. & Milman D. , *Annotated Guide to the Insolvency Legislation*, (Sweet & Maxwell, 11th edition, Volume 1, 2008/09) p. 560
[50] Para 3(1), Sch. B1, IA 1986
[51] Explanatory notes Enterprise Act 2002 Hmso para 648
[52] Kyrris v Oldham [2004] BCC 111

In comparing the new provision with the old, it may be said that one single purpose of rescuing the company was intended by the parliament. For this, the administration is given with three hierarchical objectives, and as a rule of thumb, the approach is to rescue the company as a going concern unless another approach would produce better result for creditors. In short, the emphasis was given in rescuing the company.[53]

It may also be noted here that if the company is rescued as a going concern successfully, it may either be sold to a willing purchaser in return of sufficient capital to repay the debts it owed to the creditors, or the directors would be re-appointed after the administrator's office is ceased. Although the later is a possibility, the primary objective of the process is the former one and in most cases, the company is sold as a going concern to another party either by public auction or by necessary directions of the court.

3. Conclusion: Possibility of Implementation

The present corporate legal framework of our country does not have any rescue procedures aimed at rescuing insolvent companies. As it is evident that the rescue process, although complex, has been intended to achieve specific purposes which are absolutely vital in the context of commerce and corporate sectors, the possibility of introducing similar concepts in our jurisdiction may be considered. The purpose of rescue procedure is simple, to allow the company which is at the threat of insolvency an opportunity to turn around and if possible, become solvent. It is true that the primary target of the creditors of the company is to make profits out of their investments, and in any event, get their money back in full. In this connection, insolvency procedures might not help them too much in achieving this purpose particularly in the case where the company is genuinely insolvent due to wrong decision-making and under no circumstances, it can pay the creditors in full. Thus, the need to have rescue procedures might be justified where the opportunity given to the company is better utilized and the solvency is regained.

The corporate rescue procedures may be introduced as a separate Part in The Companies Act 1994. As an introduction, a simplified version of rescue procedure

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[53] Davis S. (QC), *Insolvency and the Enterprise Act 2002*, (Jordan Publishing, 2003) p.78

may be aimed at whereby the company, whether private or public, will be able to make arrangements with the creditors to allow itself sufficient time and breathing space to improve the insolvency situation. It might be done under the supervision of any nominated corporate expert whereby the nomination may be made either by the creditors or by the court. Also, it may be made obligatory to explore the possibilities of rescue procedure first before any insolvency procedure may be brought against the company. If the corporate rescue becomes impossible, or at least impracticable, then the insolvency procedures may be instigated.

Although the non-rescue procedures in operation would inevitably be favourable to the creditors to get their money back, yet, the recue procedure would be able to attain much attraction for those companies suffering from financial difficulties as an exciting alternative to have themselves to be wound up.