



SUMMATIVE (FORMAL) ASSESSMENT: MODULE 3B
THE INSOLVENCY SYSTEM OF THE UNITED KINGDOM
(ENGLAND AND WALES)

This is the **summative (formal) assessment** for **Module 3B** of this course and is compulsory for all candidates who **selected this module as one of their compulsory modules from Module 3**. Please read instruction 6.1 on the next page very carefully.

If you selected this module as **one of your elective modules**, please read instruction 6.2 on the next page very carefully.

The mark awarded for this assessment will determine your final mark for Module 3B. In order to pass this module, you need to obtain a mark of 50% or more for this assessment.

INSTRUCTIONS FOR COMPLETION AND SUBMISSION OF ASSESSMENT

Please read the following instructions very carefully before submitting / uploading your assessment on the Foundation Certificate web pages.

1. You must use this document for the answering of the assessment for this module. The answers to each question must be completed using this document with the answers populated under each question.
2. All assessments must be submitted electronically in MS Word format, using a standard A4 size page and a 11-point Arial font. This document has been set up with these parameters – **please do not change the document settings in any way. DO NOT** submit your assessment in PDF format as it will be returned to you unmarked.
3. No limit has been set for the length of your answers to the questions. However, please be guided by the mark allocation for each question. More often than not, one fact / statement will earn one mark (unless it is obvious from the question that this is not the case).
4. You must save this document using the following format: **[studentID.assessment3B]**. An example would be something along the following lines: 20222-514.assessment3B. **Please also include the filename as a footer to each page of the assessment** (this has been pre-populated for you, merely replace the words "studentID" with the student number allocated to you). Do not include your name or any other identifying words in your file name. **Assessments that do not comply with this instruction will be returned to candidates unmarked.**
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- 6.1 If you selected Module 3B as one of your **compulsory modules** (see the e-mail that was sent to you when your place on the course was confirmed), the final time and date for the submission of this assessment is **23:00 (11 pm) GMT on 1 March 2022**. The assessment submission portal will close at 23:00 (11 pm) GMT on 1 March 2022. No submissions can be made after the portal has closed and no further uploading of documents will be allowed, no matter the circumstances.
- 6.2 If you selected Module 3B as one of your **elective modules** (see the e-mail that was sent to you when your place on the course was confirmed), you have a **choice** as to when you may submit this assessment. You may either submit the assessment by **23:00 (11 pm) GMT on 1 March 2022** or by **23:00 (11 pm) BST (GMT +1) on 31 July 2022**. If you elect to submit by 1 March 2022, you **may not** submit the assessment again by 31 July 2022 (for example, in order to achieve a higher mark).
7. Prior to being populated with your answers, this assessment consists of **7 pages**.

ANSWER ALL THE QUESTIONS

QUESTION 1 (multiple-choice questions) [10 marks in total]

Questions 1.1. – 1.10. are multiple-choice questions designed to assess your ability to think critically about the subject. Please read each question carefully before reading the answer options. Be aware that some questions may seem to have more than one right answer, but you are to look for the one that makes the most sense and is the most correct. When you have a clear idea of the question, find your answer and **mark your selection on the answer sheet by highlighting the relevant paragraph in yellow**. Select only **ONE** answer. Candidates who select more than one answer will receive no mark for that specific question.

Question 1.1

Please select the **most correct ending** to the following statement:

The Administration (Restrictions on Disposal etc to Connected Persons) Regulations 2021 restrict pre-pack sales which constitute a substantial disposal of the company's property to connected parties where the disposal occurs:

- (a) within 10 weeks of the commencement of the administration.
- (b) **within 8 weeks of the commencement of the administration.**
- (c) within 4 weeks of the commencement of the administration.
- (d) on the day the company enters administration.

Question 1.2

What is the **maximum length** of a Moratorium under Part 1A of the Insolvency Act 1986 to which creditors can consent without any application to the court?

- (a) 40 business days.
- (b) One year and 20 business days.
- (c) One year and 40 business days.
- (d) **One year.**

Question 1.3

Which of the following **is not** a requirement for a company that wishes to enter into a Restructuring Plan under Part 26A of the Companies Act 2006?

- (a) The company has encountered, or is likely to encounter, financial difficulties that are affecting, or will or may affect, its ability to carry on business as a going concern.
- (b) A compromise or arrangement is proposed between the company and its creditors, or any class of them, or its members, or any class of them.

Commented [WPA1]: 36/50 = 72% - despite some oversights a generally strong performance.

Commented [WPA2]: 6/10

(c) The purpose of the compromise or arrangement is to eliminate, reduce or prevent, or mitigate the effect of, any of the said financial difficulties.

(d) The company is, or is likely to become, unable to pay their debts, as defined under section 123 of the Insolvency Act 1986.

Question 1.4

In cases where the Administration (Restrictions on Disposal etc. to Connected Persons) Regulations 2021 apply and an independent report from an Evaluator is obtained, the independent report must be obtained by whom?

(a) The administrator.

(b) Any secured creditor with the benefit of a qualifying floating charge.

(c) The purchaser.

(d) The company's auditor.

Question 1.5

Which one of the following **is not** a debtor-in-possession procedure?

(a) Administration.

(b) Restructuring Plan.

(c) Scheme of Arrangement.

(d) Company Voluntary Arrangement.

Commented [WPA3]: A is correct

Question 1.6

A liquidator may pay dividends to small value creditors based upon the information contained within the company's statement of affairs or accounting records. In such circumstances, a creditor is deemed to have proved for the purposes of determination and payment of a dividend where the debt is **no greater than how much**?

(a) £500

(b) £750

(c) £1,000

(d) £2,000

Question 1.7

Which one of the following **is not**, in itself, a separate ground for disqualification of a director under the Company Directors Disqualification Act 1986?

(a) Wrongful trading.

(b) Breach of fiduciary duty.

Commented [WPA4]: B is correct

- (c) Being found guilty of an indictable offence in Great Britain.
- (d) Being found guilty of an indictable offence overseas.

Question 1.8

The administrator is under a general duty to provide a statement for creditors' consideration setting out proposals for achieving the purpose of administration. He or she must obtain a creditors' decision on whether or not to approve the proposals **within how many weeks** of the date the company entered administration?

- (a) 6
- (b) 8
- (c) 10**
- (d) 12

Question 1.9

Which of the following statements is **incorrect**?

- (a) An insolvency officeholder from an EU Member State will be automatically recognised by the courts in the UK whether the officeholder was appointed before or after Brexit.
- (b) An insolvency officeholder from an EU Member State is automatically recognised by the courts in the UK if appointed before Brexit.
- (c) An insolvency officeholder from an EU Member State appointed after Brexit may apply to a UK court for recognition under the Cross Border Insolvency Regulations.
- (d) An insolvency officeholder from an EU Member State cannot apply to a UK court for recognition under section 426 of the Insolvency Act 1986.**

Commented [WPA5]: A is correct

Question 1.10

Under section 216 of the Insolvency Act 1986, a director of a company which has been wound up insolvent may not, unless an exception applies, be a director of a company that is known by a prohibited name **for what period of time**?

- (a) 6 months.
- (b) 12 months.**
- (c) 2 years.
- (d) 5 years.

Commented [WPA6]: D is correct

QUESTION 2 (direct questions) [10 marks]

Commented [WPA7]: 8/10

Question 2.1 [maximum 5 marks]

Commented [WPA8]: 3/5 – the answer to i) is not quite complete but nearly there – the answers to ii) and iii) are incorrect – Sec of State/ OR and administrator

Who may bring an action under: (i) section 423 of the Insolvency Act 1986; (ii) section 6 of the Company Directors Disqualification Act 1986; and (iii) section 246ZB of the Insolvency Act 1986?

- (i) The Official Receiver;
The liquidator;
The administrator;
Any victim such as a creditor, regardless, if such victim is bound by a CVA or not, may with leave of the court, bring such an action;
Where the victim is bound by the CVA, the supervisor of the CVA.
- (ii) The insolvency practitioner.
- (iii) A liquidator.

Question 2.2 [maximum 5 marks]

Commented [WPA9]: 5/5

List the **five (5)** qualifying decision procedures by which creditors may make decisions in the context of an insolvent company.

1. Correspondence;
2. Electronic voting;
3. Virtual meeting;
4. Physical meeting;
5. Any other procedure which enables creditors who are able to participate in the decision making process, to participate equally.

QUESTION 3 (essay-type questions) [15 marks in total]

Commented [WPA10]: 9/15

Question 3.1 [maximum 6 marks]

Commented [WPA11]: 0/6 although much of the answer is accurate, it does not address the question which required an explanation of ss 233, 233A and 233B.

Can an administrator who wishes to continue to operate the business of the company in administration require suppliers of goods and services to continue to supply those goods and services during the administration?

The administration of a limited company can only take place if there exists one of three possible outcomes of the administration. These are laid out in paragraph 3 of Schedule B1 of the Act:

1. Paragraph 3(1)(a) - To consider rescuing the company;
2. Paragraph 3(1)(b) - To achieve a better result for the company;
3. Paragraph 3(1)(c) - To realize property so as to make a distribution to secured creditors.

The general powers of an Administrator are laid out in section 59 – 64 read with Schedule 1 of the Act. These powers are wide and far reaching as they allow the Administrator of a company to “do anything necessary or expedient for the management of the affairs, business and property of the company.”¹

¹ Section 59(1) of the Act.

With these powers, the Administrator must pursue a single objective as outlined in para 3 above based on an objective consideration of all material factors.

In terms of section 66, the administrator of a company may make a payment to a creditor "otherwise than in accordance with paragraph 65 or paragraph 13 of Schedule 1 if he thinks it likely to assist achievement of the purpose of administration."²

Administration protects an insolvent but otherwise viable company from looming creditors. As the main purpose of administration is to rescue a company, the Administrator must assess whether rescue as enumerated in para 3 (1)(a) above is viable.

This will entail a consideration of the value of the assets of the company, the cash-flows, and whether the business can return to profitability.

Despite serious cashflow problems, certain factors may influence the decision to continue trading, so as to rescue the company, including if there are large amounts of money to collect in or substantial realizable assets.

This could pose a challenge unless the company reduces its credit or negotiates a cash on delivery arrangement to reduce the risk to creditors.

Where the realization of property is the only realistic option available in terms of paragraph 3(1)(c), subsection (4)³ applies, and the administrator must perform his functions in the interests of the company's creditors as a whole.

The Administrator in acting under paragraph 3(1)(c) must not bring more harm upon the creditors or place them in a position worse off than they would be in had the Administrator applied his/her mind to rescuing the company or achieving a better result.

The caveat here is the thread of the *pari passu* principle must be kept in mind by the Administrator who, in seeking to realize assets to repay a secured creditor, must not act in favour of that creditor, to the detriment of others.

This point was dealt with in the judgment of *Davey v Money* [2018] EWHC 766 (Ch) in regard to the working relationship as between the Administrator and a secured creditor.

The Court in Davey's case found that the Administrator who becomes the puppet of the secured creditor, or who is misled by the said creditor will cause the creditor to be liable for breaches by the administrator.

At the end of the day, the Administrator must be sure that rescue of the company is a viable option through continued trading; or if not a viable option, then to achieve a better result for creditors.

Question 3.2 [maximum 9 marks]

Explain the order of priority of payments in a liquidation and explain the nature of the rights enjoyed by each class of creditor or expense.

Liquidation payments may be categorized into expenses and payments to creditors. Expenses must be paid first before any payments to creditors are made.

² Section 66 of the Act.

³ Paragraph 3(4) reads, The administrator may perform his functions with the objective specified in sub-paragraph (1)(c) only if-- (a) he thinks that it is not reasonably practicable to achieve either of the objectives specified in sub-paragraph (1)(a) and (b), and (b) he does not unnecessarily harm the interests of the creditors of the company as a whole.

Creditors are then paid in order of priority: Ordinary preferential creditors are paid before secondary preferential creditors.

Thereafter floating charge holders are paid, subject to any "prescribed part" that may be applicable. Applicability will depend on the discretion of the liquidator taking into account the overall benefits which are awarded which may be disproportionate.

Last in statutory preference to be paid are the unsecured creditors, usually tradesmen and artisans.

Expenses:

The payment of expenses, paid in order of priority, is enshrined in section 155 of the Insolvency Act, 1986 read with rules 6.42 and 7.108.

The first expense that is paid is the costs involved in preserving, realizing or getting any property, including the cost of legal proceedings associated therewith.

The second expense payment is toward the cost of any security provided by the liquidator.

After this, payments are made to the person responsible for drafting the statement of affairs of the company, or any accounts.

The liquidator must thereafter pay all disbursements incurred during the winding-up of the company which expenses include those incurred by the creditor's committee.

Following the payment of the above expenses, the liquidator will then pay the remuneration owed to anyone employed by the liquidator to perform any service for the company.

It is only after these payments have been made that the liquidator is entitled to be remunerated.

Where assets were sold off in the course of liquidation, the amount of corporation tax on chargeable gains which accrued will, after the liquidator has been remunerated, be paid off.

If there are any other expenses materially associated with the liquidator's functions and which do not fit into the enumerated categories above, then those will be paid last in line.

Payments to creditors

Preferential Claims

Preferential Creditors, as defined in sections 386, 387 and Schedule 6: section 175(1) of the Act, are paid in first preference to all creditors, but only after the expenses as listed above have been paid.

Preferential claims, or debts are split into ordinary preferential claims, and secondary preferential claims. Ordinary preferential claims rank in priority over secondary preferential claims. In the event that the company assets are insufficient to pay all the preferential creditors, then those creditors will be paid in equal proportion since these debts rank equally amongst themselves.

Ordinary Preferential Claims

Ordinary preferential debts are listed in schedule 6 of the Act:-

1. Where employees have contributed from their own earnings to an occupational pension scheme, the preferential debt is an amount is calculated for the four (4) months prior to the commencement of the winding-up.
2. The employer who has contributed to the employee's pension scheme as alluded to in (1) above will count as a preferential debt under schedule 6, but in this case the amount is calculated for a period of twelve (12) months before the relevant date.
3. Remuneration calculated for a period of four months prior to the commencement of the winding-up, in whole or in part, owed to an employee up to a maximum value of £400
4. Holiday remuneration of an employee during employment and which has accrued prior to the winding-up is a preferential debt, but a distinction is drawn between this accrued remuneration and remuneration payable in respect of a period of holiday or sick leave which is instead regarded as wages.
5. Where a creditor has advanced monies to the employer in order to pay wages or holiday remuneration, those monies become a preferential debt and places the creditor in the shoes of the employee.
6. Where the *European Coal and Steel Community Treaty* is applicable, notably *art. 49* and *art. 50*, levies on the production of coal and steel are preferential debts.
7. Where the *Reserve Forces (Safeguard of Employment) Act 1985* is applicable, the amount which is ordered to be paid including any default by the employer in the discharge of the employer's obligations under the Act. These claims are rare.
8. Where a financial institution holds deposits of monies of the company, and then becomes insolvent, the the Financial Services Compensation Scheme will pay out a value of the eligible deposit which does not exceed the compensation that is ordinarily payable under the Scheme to the relevant person owed such monies.

Secondary Preferential Claims – Section 386 of the Insolvency Act 1986

Secondary claims, or debts are paid out after the ordinary preferential debts have been settled. The following qualify as secondary debts.

1. The Scheme will also pay out a value of monies to persons in respect of an eligible deposit as exceeds any compensation that would accrue under the Scheme in para (9) above.
2. The Scheme will also pay out eligible deposits to persons when those deposits were made through a non-UK branch of the credit institution if the branch is recognized as a UK branch through authorization by a competent authority of the UK.
3. PAYE tax deductions, national insurance deductions, VAT payments and Construction Industry Scheme deductions, as well as student loan repayments are secondary debts.

As can be seen from the above, limited employee claims and some taxation liabilities are regarded as preferential claims. In addition, government tax owed to the Crown is once again since the reintroduction of the Finance Act 2020, a preferential claim.

Floating Charge Holder

Floating charge holders are paid after preferential creditors have been paid, in the order in which the floating charge was incurred i.e. the oldest debt is paid first.

Under section 176A of the Insolvency Act, the liquidator is obligated to act in terms of a floating charge incurred on or after 15th September 2003.

This means keeping aside a “prescribed part” of the company’s net property for the payment of unsecured creditors.

Net property is the amount remaining after liquidation expenses and preferential debts have been paid so as to pay floating charge holders.

If there is an excess in value of the net property after the unsecured creditors have been paid, then the remaining monies revert for payment to the floating charge holders, in order of priority of the date the debt incurred.

The “prescribed part” of a company’s net property is staggered:

Where the company’s net property is £10 000 or less, the “prescribed part” is 50% of the net property, unless the liquidator is of the opinion that payment to the unsecured creditors would be disproportionate to the benefits, in which case the “prescribed part” will not apply.

Where the company’s net property exceeds £10 000, the “prescribed part” is 50% of the first £10 000, in value. Thereafter an additional 20% of the excess value subject to a maximum of £800 000 may form part of the “prescribed part.”

It is important to note that floating charge holders who are not paid in full and therefore have an unsecured balance owing to them cannot participate in this distribution.

Unsecured Creditors

Ranking last in order of payment from the insolvent company, the unsecured creditors are then paid a dividend of whatever – if anything – is left to distribute.

Unsecured creditors rank last in statutory preference because they do not have any security over the debts incurred by the company toward them.

QUESTION 4 (fact-based application-type question) [15 marks in total]

Commented [WPA13]: 13/15

Prior to going into compulsory liquidation on 23rd December 2021, under pressure from its bank, Stercus Bank plc, and in order to prevent it from demanding repayment of the company’s loans, Corfee Zero Limited (“the Company”), granted a debenture in favour of Stercus Bank plc in February 2021. The debenture contained a floating charge over the whole of the Company’s undertaking.

The winding up order followed a creditor’s winding up petition issued on 14th October 2021.

In July 2021, as the Company continued to suffer cash flow problems, the directors approved the sale of 5 coffee roasting machines to Ann Young (a director) for £10,000 in cash. The machines had been bought for £25,000 a year before.

A month before the winding up order was made, Ann Young received an email from Beans and Leaves Ltd, one of the Company's key suppliers. The supplier demanded immediate payment of all sums owing to it and informed the Company that further supplies would only be made on a cash on delivery basis. As the continued supply of coffee beans was seen as essential by the Company, the board authorised a payment of £8,000 to cover existing liabilities and agreed to further payments, on a cash on delivery basis, for further supplies which amounted to further payment of £3,000 up to the date of the winding up order.

The liquidator has asked for advice whether any action may be taken in respect of the floating charge in favour of Stercus Bank plc and the two subsequent transactions.

Using the facts above, answer the questions that follow.

Identify the relevant issues and statutory provisions and consider whether the liquidator may take any action in relation to:

Question 4.1 [maximum 5 marks]

Commented [WPA14]: 5/5

The floating charge in favour of Stercus Bank plc;

Note: Unless otherwise stipulated, references to the Act are references to the *Insolvency Act, 1986*.

Issue:

Whether the debenture granted in favour of Stercus Bank which contained a floating charge over the Company's whole undertaking is vulnerable to attack and can be avoided?

Law:

Section 245 of the Act applies to the circumstances in which the avoidance of floating charges occurs when the company is in liquidation.

The purpose of this section is to guard against opportunistic unsecured creditors who obtain the security of a floating charge before the company goes into liquidation.

There are two hurdles to overcome when determining invalidity under section 245:

a) The first test is the "relevant time" test.

Subject to subsection (4), in terms of section 245(3) the time at which a floating charge is created by a company is determined by two aspects:-

- Where the floating charge is created in favour of a person is connected to the company: The relevant time is within a two-year period prior to insolvency.⁴
- Where the floating charge is created in favour of a person is not connected to the company: The time period is twelve months before the company went into insolvency.⁵

⁴ Section 245(3)(a) of the Insolvency Act, 1986.

⁵ Section 245(3)(b) of the Act.

Where the person is not connected, the relevant time of twelve months must also be analyzed with reference to section 245(4) of the Act. This subsection holds that at the time of the creation of the floating charge in favour of the person not connected to the company, the company must have been unable⁶ to pay its debts within the meaning of section 123 of the Act or became⁷ unable to pay its debts as a result of the transaction under which the charge is created.

b) The second test involves “new consideration”⁸ of security.

A floating charge will only be valid in respect of monies provided to the company at the same time or after the charge was created.⁹ Therefore, if new, or fresh consideration was provided for the security, the floating charge will survive invalidity.

New/Fresh consideration can include any one of the following: -

- Money paid,
- Goods or services supplied to a company,
- The discharge of any of a company’s debts,
- Interest payable under an agreement for the payment of money, supply of goods or services or discharge of debts.¹⁰

Application of the Law to the Facts:

The question whether a floating charge is invalid is therefore determined by whether the consideration occurred at the “relevant time” and if so, whether it survives invalidity by “new consideration.”

In *In Re Fairway Magazines* [1992] BCC 924, the Court ruled that consideration by way of payments to directors which ultimately relieved their personal liability could not be validated. Had the payments been made to the Bank instead, the consideration would not be invalid. Whereas the floating charge is invalidated, the underlying debt remains valid.

Stercus Bank lent the company £250,000 in 2015 and then a further £50,000 in February 2021 on condition of a floating charge. Corfee Zero was put into insolvency in October 2021.

Stercus is a creditor unconnected to the company.

The next question is to determine the relevant time period. As Stercus is unconnected to the company, the time period during which the floating charge was created must be viewed within the twelve months prior to the liquidation of Corfee Zero.

⁶ Section 245(4)(a) of the Act.

⁷ Section 123 read with section 245(4)(b) of the Act.

⁸ Under section 245(2), a floating charge on the company's undertaking or property created at a relevant time is invalid except where the new consideration is

(a) the value of so much of the consideration for the creation of the charge as consists of money paid, or goods or services supplied, to the company at the same time as, or after, the creation of the charge,

(b) the value of so much of that consideration as consists of the discharge or reduction, at the same time as, or after the creation of the charge, of any debt of the company...

⁹ <https://www.dcabr.co.uk/articles/invalidation-of-floating-charges>.

¹⁰ <https://www.pinsentmasons.com/out-law/guides/financial-difficulty-and-insolvency-other-considerations>.

Accessed 30th January 2022.

In addition, during the creation of the floating charge, Corfee Zero was unable to pay its debts.

The liquidator may take action against Stercus for the floating charge but it will only apply to the £50,000 and not the old debt of £250,00.

Question 4.2 [maximum 6 marks]

The sale of the coffee roasting machines; and

Issue:

Whether the liquidator can apply for an order under section 238(2) of the Act to void the sale of the coffee machines?

Law:

The sale of the coffee machines to a director of the company, upon approval of the other directors, and at a time at which the company was undergoing financial problems, creates a variety of statutory options available to the liquidator to attack the sale.

In the first place, in terms of section 238(3) of the Act, the transaction may be voided by the Court upon application by the liquidator. The *causa* of the application is found under section 232(2) of the Act. This would be that the transaction occurred at an undervalue.

There are three legal requirements which the liquidator must prove. Those requirements are:-

1. That the company gifted another person an item or items as the case may be; or
2. That the company transacted with a third party on terms in which the company received no consideration; or
3. That the company transacted with a third person for the sale of goods at an undervalue of money, or money's worth.

In addition to demonstrating the existence of one of the requirements under section 238, the liquidator must further prove that the transaction occurred within the "relevant time."

For purposes of section 238, the relevant time is dictated by the provisions of section 240(1). Under section 241(a) the relevant time for a person connected to the company, excluding an employee, is two (2) years.

Under section 241(b) the relevant time for a person not connected to the company is six (6) months.

It is a given that the transaction sought to be attacked under section 238 must also fulfil the foundational clause of section 123 of the Act, i.e. that it occurred at a time when the company was unable to pay its debts or became unable to pay its debts as a consequence of that sale.

Where in cases the sale can be found to have been made to a "connected person" the company is then presumed to have been insolvent at the time or became insolvent subsequent to the transaction.

Upon application by the liquidator, the Court may then grant the application thus restoring the position to what it would be had the transaction not taken place. The Court will refuse to grant

Commented [WPA15]: 5/6 a good answer but the application to the facts was a little limited especially with regard to s 238 which would be the most likely action to be brought

this order where it can be shown that the transaction was entered into in good faith by the company, where the company had reasonable grounds to believe the transaction would be for the betterment of the company.

Secondly, the liquidator may pursue an application for misfeasance under section 212 of the Act *in lieu* of an application under section 238, or (preferably) brought together, albeit in the alternative.

A liquidator who brings this application need only prove that a certain person or persons have "misapplied, retained or become accountable for money or property of the company." These certain persons include directors, past or present of a company, a former liquidator of the company, an administrative receiver of the company or any other person materially connected to the company from its inception.

By definition, it is easy to see that misfeasance can include an action for negligence or breach of fiduciary duties by directors such as the duty to act in the best interests of the company, or not to act in situations which would create a conflict of interest. Directors of insolvent companies may breach their duties to creditors by making gratuitous distributions of assets such as the disposal of the coffee roasting machines at undervalue, thus putting the assets beyond the reach of the creditors.

An application of this nature is a summary procedure and offers benefits associated with costs and time delays.

Thirdly, and where the facts sustain a conclusion that the transaction at undervalue was entered into fraudulently, the liquidator may apply for a contribution order under section 213 and 246ZA of the Act.

The liquidator must prove that subjectively speaking, the trade was reckless at the very least, if not made with the intention to defraud.

The Court may grant a contribution order as against any party who knowingly continued to carry on business for or with the company.

Where the Court makes such an order in terms of section 213 the liquidator would be wise to bring to the Court's attention the provisions of section 10 of the Company Directors Disqualification Act 1986 (CDDA), for which the Court can order disqualification of a director.

Application of Law to the facts:

The liquidator has good prospects of success in bringing an application under the ambit of section 238 of the Act as it can be seen that the coffee machines were sold to Ann Young:

- At a value significantly lower price than the value of the item,
- Within the two year period prior to the commencement of liquidation, and
- All while the company was unable to pay its debts as defined under section 123 of the Act.

However, because Anne Young is a connected person to the company, the presumption in section 123 does not apply.

The liquidator has further prospects of success in terms of section 212 of the Act for an action for misfeasance against the directors, including Ann Young. This is because the transaction has occurred between the directors of the company who acted negligently, or, put differently, who did not act in the best interests of the company.

Lastly, the liquidator, in formulating the application under sections 238 and 212 of the Act, can also proceed in terms of section 213 of the Act read with the provisions of section 10 of the CDDA. This is because, at a minimum, the sale was conducted at a time at which the company was unable to pay its debts ("suffered cash flow problems") within the meaning of section 123.

The liquidator must take care to demonstrate that, taking into account all the facts of the matter, the sale could not have been made in good faith, as it is unreasonable to sell off coffee machines while authorizing payment for coffee beans, both of which are integral to the running of the business and which cannot be supported without the other. This will ensure a finding of recklessness, or an intention to defraud creditors can be made to sustain an order that the director/s are liable to contribute to the assets of the company, as enshrined in section 213 of the Act.

Question 4.3 [maximum 4 marks]

The payments to Beans and Leaves Ltd.

ISSUE: Whether the payment to Beans and Leaves may be statutorily voided?

LAW:

Section 214 and 246ZB of the Act – wrongful trading.

In light of the circumstances peculiar to the matter, the liquidator may be of the opinion that the transaction to Beans and Leaves amounts to wrongful trading as found in section 214 of the Act.

If the liquidator chooses this route, requesting a contribution from a director or directors, he cannot expect his path to be cleared for him, as the burden of proof rests upon the liquidator to prove:

1. The company is insolvent; and
2. That the person, prior to the commencement of insolvency, knew that any rescue of the company would be futile or that the company could not avoid liquidation;¹¹ and
3. The conclusion reached in (2) above was one drawn by a director of the company.

Assuming that the liquidator discharges this burden, the onus then shifts to the director to show that reasonable steps were taken to minimize loss to creditors.

Section 214(4) creates a two-fold threshold test, by which the acts or omissions of a director are analyzed objectively, with regard to the general knowledge, skill and experience of the reasonable man; and, thereafter, with reference to the skill-set of the particular director in question.

Using section 214(4) the Court can then assess whether the decision made by the director was made with the prudence expected of a directorship, i.e. the objective test.

Thereafter the Court employs the second test to judge whether the director, bearing a higher degree of skill, knowledge and expertise acted to minimize further envisaged potential losses.

¹¹ Insolvency Act 1986, s214(2)(a) – (c).

Commented [WPA16]: 3/4 a reasonable effort. Section 214 cannot apply to the payments as the winding up had already begun. The s 127 point is the issue which is dealt with quite well although the application to the facts might have been a little clearer.

If the director or directors can prove that the steps taken were the best available courses of action that could be legitimately pursued under the prevailing circumstances, then the statutory defence succeeds.

If the directors, having become aware that the company may be facing insolvency, continue to trade thus increasing their liabilities, or do nothing such as obtaining expert advice, or placing the company into liquidation, then the defence will not succeed. The Court can order the directors compensate the company for the approximate amount by which the liabilities increased from the time it ought to have been clear that insolvency was on the horizon.

Section 127: Disposition void unless validated

In terms of section 127, any disposition of property including money, made after the presentation of the petition to wind up may be avoided unless otherwise ordered by the Court.

Where the property is not avoided, the Court makes a validation order, and can, depending on the facts of the matter, further make an order allowing the company to continue trading.

Payments made honestly in the course and scope of business - such as wages, will be validated.

In deciding whether the payments, such as the ones made to Beans and Leaves should be avoided, the Court will take into account the following:

1. It will weigh up the supplies which were need for continuation of the business as against whether the decision to continue purchasing such essentials is in the best interests of creditors.
2. It will consider whether the transaction diminished the company's assets or increased its net value, or whether those assets were preserved from harm.
3. It will validate a transaction made in good faith where the innocent party had no knowledge of the petition.
4. Where payments are made on a Cash on Delivery basis, the Court will assess whether such a method allowed the continuation of the business for its overall benefit.
5. The Court will have at the forefront of its mind, the *pari passu* principle, or collective debt collecting procedure, and it will be hesitant to depart therefrom especially when the payment would benefit only one creditor to the detriment of others.

APPLICATION OF THE LAW TO THE FACTS:

The liquidator has to consider whether the acts of payment to Beans and Leaves amounts to wrongful trading as under the ambit of section 214 of the Act and should therefore be voided under section 127.

Both sections envisage an enquiry which is the corollary of the other: in assessing whether the payment was one for the overall benefit of the company and should be validated, the Court will also have regard to the skill level required of a director, and the specific skill-set of the director/s making the decision warranting validation of the payment.

The payments to Beans and Leaves have been made on a cash on delivery basis.

The transactions have been for essentials in order to keep the business running.

There were two separate payments made: The first payment was for £8000, which was to cover existing liabilities.

This payment was made subsequent to the filing of a creditor's petition on the 14th October 2021.

On the basis of the above, it is not unreasonable to draw an inference therefrom that this payment was made in order to prefer one creditor above the other, especially as the company was aware at the time at which it negotiated a cash on delivery agreement, that it was heading into liquidation.

This point is emphasized by the fact that the agreement for Beans and Leaves to supply coffee beans on a cash on delivery basis did not benefit the company in anyway whatsoever, but only served to increase the net value of its liabilities by £3000, being the second payment made.

In addition, and in view of the fact that the coffee machines had already been sold off to one of the directors some three months before the cash on delivery agreement came into effect, it is difficult to envisage on what basis it may be said that the payments to Beans and Leaves were for the overall benefit of the company.

If on the other hand, Beans and Leaves were unaware of the petition filed, and traded in good faith, the payment could be validated so long as it can be shown to have benefitted the other creditors.

*** End of Assessment ***