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Compulsory liquidation of a company

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Summary

A company is insolvent when it doesn't have enough assets to cover its debts or is unable to pay its debts when they are due. There is no application process to become insolvent: it is something you are.

When a company is involvent, directors need to mainly act in the interests of creditors (people owed money) rather than shareholders. Directors are not meant to continue to trade beyond the point at which they know or shoud know that there is no reasonable prospect of avoiding liquidation. If they do this, they commit wrongful trading and can be personally responsible for losses caused to creditors by their wrongful actions.

Compulsory liquidation (or winding up) is one way of closing an insolvent company down. It involves a liquidator being appointed by the court to wind up (close down) the company.

A company (or a limited liability partnership) can be put into compulsory liquidation by court order if it cannot pay its debts, usually on the petition (request) of a creditor. A common way a company is considered unable to pay its debts is if a creditor presents a written demand for payment (known as "a statutory demand") and the company fails to pay the debt or secure a repayment plan with the creditor.

Compulsory liquidation involves selling off the company's assets and distributing them to creditors (who often will not be paid in full). How long liquidation takes will depend on the complexity of the case, but it ranges from months to many years. Once the process has been completed, the company will be dissolved – it will cease to exist.

This briefing summarises the compulsory liquidation process in England, Wales and Scotland.

1 Introduction

1.1 Relevant legislation

The main legislation governing insolvent companies is the:

- Insolvency Act 1986 (IA);
- Insolvency (England & Wales) Rules 2016 (IR 2016) and the Insolvency (Scotland) Rules 1986 (the IRs);
- Enterprise Act 2002 (EA 2002), and
- Small Business, Enterprise and Employment Act 2015 (SBEEA 2015).

1.2 When is a company insolvent?

A company is insolvent if it can't pay its debts. There are two main tests for company insolvency:

- **cash-flow test:** the company can't pay its debts when they fall due for payment; and
- **balance sheet test:** the value of the company's assets is less than its liabilities.[1]

If either test is met, the company is deemed insolvent.

A company is also deemed insolvent if:

- a creditor owed more than £750 has served a formal demand in a particular form (known as a "statutory demand") for payment at the company's registered office and the debt has not been paid within 3 weeks;[2] or

[1] Sections 123(1)(e) and 123(2) of the IA

[2] A statutory demand is a formal written demand for payment of a debt. If the debtor takes no action for three weeks, the creditor can use the statutory demand to apply to the court for an order that the company should be liuidated.

- a judgment or other court order against the company in favour of a creditor has not been satisfied.[3]

1.3 Consequences of insolvency

There can be serious consequences to a company becoming insolvent:

- Insolvency may be considered an **event of default** under any banking facilities (like loans) taken out by the company, thereby enabling the lender to demand repayment of the whole debt and enforce its security.
- A creditor may **petition (apply) to the court for a winding-up order** against the company. Cnce a winding-up petition has been presented to the court, a company can only dispose of assets (like sell goods or make payments for supplies) if it has obtained permission from the court.[4]
- Once a court has made an order to place the company in compulsory liquidation, the liquidator can review all transactions made in a certain period of time before the winding-up order and apply to the court to reverse those transactions if: (i) the company was insolvent at the time; and (ii) the transaction took place for either less than the market value or gave certain creditors priority over others.[5]
- Any potentially fraudulent transactions are reviewable by the liquidator without time limit.

1.4 Insolvent company procedures

There are different procedures available to a company which is insolvent. Some (like administration or Company Voluntary Arrangements) try to rescue it.

If there is no real prospect of an insolvent company being saved, it will need to be liquidated (closed down). This involves selling off the company's assets to repay creditors (in a particular order of priority), distributing any remainder to shareholders, and then closing the company.

The two types of insolvent company liquidations are:

[3] Section 123(1) IA
[4] Section 127 IA
[5] Sections 238 to 244 IA

1. **Creditors' Voluntary Liquidation** (CVL). This happens when the members (shareholders) vote (by a 75% majority) to close the company down; and

2. **Compulsory liquidation**. This is when a court orders that the company be closed down and appoints a liquidator. Unlike CVL, shareholder consent is not required and court proceedings are usually initiated by a frustrated creditor.

2 Compulsory liquidation procedure

2.1 Who can petition for compulsory liquidation?

All compulsory liquidations start with a winding-up petition (application) at a bankruptcy court.

Often, the person making the petition will be a creditor. However, others can apply, including the company itself, its directors, its shareholders, and the Secretary of State for Business.[6]

The petitioner must serve a copy of the petition on the insolvent company and must, in due course, give notice of the petition in the "The Gazette" (an official government record).

At a court hearing, the judge decides whether to make the winding-up order.[7] The court will only make a winding-up order certain grounds are met. The most common ground used is that the company is unable to pay its debts as they fall due (assessed using the insolvency tests mentioned in section 1.2 above).

2.2 Appointment of a liquidator

When making a winding-up order, the court initially appoints an Official Receiver (a civil servant) as the liquidator.[8] Subsequently, creditors and contributories[9] can choose to replace them with a registered private sector insolvency practitioner if there are sufficient assets to meet the expenses of the liquidation.[10] If the assets of the company are insufficient to meet this expense, the Official Receiver will remain in office to wind up the company. In either case, the appointed liquidator is an officer of the court[11] so has a duty to act fairly and impartially.[12]

6 Section 124 IA
7 Section 125 IA
8 Section 136 IA
9 In practice, "contributores" tend to be shareholders who have not paid for their shares in full (section 79 IA)
10 Section 139 IA
11 Re Oasis Merchandising Ltd (1998) Ch. 170
12 Condon, ex parte James [1874-80] All ER Rep. 388)

Even if a private sector liquidator is appointed, the Official Receiver has a duty to investigate the cause of the company's failure and the actions of directors come under scrutiny. The Official Receiver must report any evidence of wrongdoing or potential misconduct by the directors, to the Secretary of State for Business.

In Scotland, there is no Official Receiver so a private sector insolvency practitioner must be appointed.[13]

2.3 What happens to the directors?

Once a compulsory liquidation order has been made by the court, the Official Receiver (or the appointed liquidator) takes control from the directors.[14] However, directors have a duty to co-operate with the liquidator and must identify all assets and liabilities of the company and provide details of its affairs.[15]

2.4 What happens to employees?

In most cases, a compulsory liquidation order will result in the automatic dismissal of the company's employees. The Employment Rights Act 1996 and the IA 1986 provide two broad avenues through employees can seek payment of debts owed to them by an insolvent employer:

- First, the UK National Insurance Fund guarantees certain employee debts. It is administered by the Secretary of State for Buinsess (acting through the Redundancy Payments Service, which is part of the Insolvency Service). This ensures employees get a minimum amount of pay like unpaid wages and notice pay;[16] and

- Second, employees owed money are creditors, so they can seek payment from the company as part of the liquidation process. Certain payments (like wages or sick pay, up to a cap of £800) owed for the four month period before liquidation count as "preferential debts" ranking high up in the order of priority. Any debt owed to employees will rank much lower, as an unsecured debt, however. In practice this means only a small

[13] See The Gazette (Brodies LLP), Scottish insolvency vs England and Wales - What you need to know, last updated 17 December 2019

[14] Measures Brothers Ltd v Measures [1910] 2 Ch 248

[15] Section 131 IA

[16] The guarantee scheme has its origins in the EU Insolvency Directive (2008/94/EC)

percentage of unsecured debts owed is likely to be received by the employees.

Information about the options open to employees is available from a separate Library's briefing paper "Employment rights and insolvency" (CBP 0651).

2.5 Realising company assets

In a compulsory liquidation, once a appointed liquidator has taken control of the company, they are under a statutory duty to act in the interests of all the creditors and to ensure an orderly winding-up of the company. This may involve:

- ensuring all company contracts (including employment contracts) are completed, transferred or ended;
- ceasing the company's business;
- selling assets;
- collecting in money owed;
- settling legal disputes; and
- distributing funds to creditors.

The liquidator has a duty to creditors to dispose of the company's assets for the best possible price. The aim is for creditors to receive as large a return as possible (after the costs and expenses of the liquidation have been paid).

A liquidator may apply to court for an order restoring property which a company has disposed of in a way that is unfair to their creditors - for example, if property was transferred to a person connected to the company for less than its full value immediately before the company went into liquidation.

In certain limited circumstances, a liquidator may begin a court action against the directors or former directors personally (for example, for the offence of wrongful trading) for the benefit of creditors.

2.6 Creditors' claims: proof of debt

Once the court has made a compulsory liquidation order, all creditors (including employees) must formally register their claim (known as a "proof of debt"). This is done by notifying the liquidator of their claim in writing, supported by evidence of the debt if required.

Creditors are entitled to receive reports on the progress of the liquidation from the liquidator.[17] They can also form a liquidation committee to help the liquidator fulfil their functions.[18]

After a winding-up order is made there is an automatic stay (i.e. "stop") of legal proceedings against the insolvent company or its assets. If a creditor wants to bring or pursue legal proceedings against the company, they must first apply to the court for permission. [19]

2.7 Order of payment

The order in which creditors are paid is set out in the IA and the IRs. In summary, the order is:

1. Secured creditors (like a bank with a mortgage against a property);
2. Expenses of the liquidation (like the fees of the liquidator);
3. Preferential creditors (like certain debts owed to employees. From December 2020 this also included HMRC);[20]
4. Floating chargeholders (like a bank with security over company assets which fluctuate, such as stock). However, a proportion of the value of assets subject to a floating charge must be set aside by the liquidator for unsecured creditors (up to a maximum of £800,000);[21]
5. Unsecured creditors (like a supplier or a bank without security); and
6. Shareholders (for any surplus).

Claims by unsecured creditors are paid by the liquidator on a "pari passu" basis.[22] This means all unsecured creditors must share equally any available cash in proportion to the debts due to each creditor. Unsecured creditors may receive a dividend paid "pro rata"[23] at the end of the liquidation; in some cases, an interim dividend may also be paid.

How much the creditors will recover will depend on many factors, including the value of company assets and the total number of creditors.

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[17] Rule 7.48, 18.3 and rule 18.14, IR 2016

[18] Sections 141 and 142, IA and rule 17.3, IR 2016

[19] Section 130, IA. This stay does not generally extend to the enforcement of security or the forfeiture of a lease

[20] See HMRC, HMRC as a preferential creditor, 30 November 2020

[21] See The Insolvency Act 1986 (Prescribed Part) Order 2003 (as amended in 2020)

[22] **Pari passu** means "equal in right of payment"

[23] **Pro rata** means "proportionately allocated"

Because they are at the bottom of the order of priority, it is often the case that payments to unsecured creditors or shareholders are just a few pence in the pound or nothing at all.

2.8 When does the liquidation process end?

The compulsory liquidation process is complete when all the assets have been distributed and all creditors' claims have been dealt with.

The liquidator gives the Registrar of Companies notice that the winding-up is complete.

Unless a request has been made to postpone the dissolution of the company, the Registrar will dissolve the company after three months – it will cease to exist.[24]

The legnth of the entire process takes depends on a number of factors, including the size of the company and the complexity of the case (for example, the number and location of company assets and the number of creditors) and ranges from months to many years.

For example, Carillion went into compulsory liquidation following a court order on 15 January 2018. In September 2019, the Official Receiver estimated total liquidation costs would reach £62 million,[25] and over three years later the process is still ongoing.[26]

[24] Unlike administration, where jobs may be saved if a buyer can be found to take over all or part of the business. In such cases employees can be transferred to the buyer.

[25] Institute for Government and Burges Salmon, Carillion: Two years on, March 2020, p7

[26] See Financial Times, Carillion liquidators agree funding deal for £250m lawsuit against KPMG, 19 May 2021

3 Liquidator's role and powers

The main objective of the liquidator (whether the Official Receiver or a private sector insolvency practitioner) is to realise (sell off) the insolvent company's assets, and to distribute the proceeds to the company's creditors.[27]

To achieve this, a liquidator has wide powers, including bringing legal proceedings in the name of the company, carrying on the business of the company, and paying debts.[28]

3.1 Is the liquidator bound by contracts agreed prior to their appointment?

No. In England and Wales, the liquidator may refuse to perform or formally disclaim any onerous or unprofitable contract entered into by the company prior to liquidation. The other party will then have a claim for breach of contract, which ranks as an unsecured claim. However, a contracting party that has acquired a beneficial interest in property of the company will still be able to enforce it.[29]

The situation is more complex in Scotland, where there is no legislation allowing liquidators to disclaim contracts. In practice, a liquidator might simply not choose to perform such a contract and place the company in breach of contract, requiring the other party to claim for amounts owed as an unsecured creditor.[30]

3.2 Is the liquidator bound by contracts agreed after their appointment?

The liquidator can cause the company to enter into new contracts, in which case the obligations of the company rank high up in the order of prioriy as an expense of the liquidation.

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27 Section 143 IA
28 Schedule 4 to the IA
29 Section 178 IA
30 See the case of Clark and Whitehouse (Joint Administrators of Rangers Football Club Plc), Noters [2012] CSOH 55

3.3 Can a liquidator's decisions be challenged?

The liquidator's decision in relation to a proof of debt (claim for payment) may be challenged by a creditor or a contributory.

A liquidator may be removed by a court order or the company's creditors.[31]

3.4 Can a liquidator's fees be challenged?

The liquidator's fees are generally paid high up in the order of priority, as an expense of the liquidation. This means the liquidator is paid out of the company's assets, after secured creditors holding fixed charge security have been paid, but in priority to creditors who either have no security or have a floating charge security over the company's assets.

Creditors have an obvious interest in controlling the liquidator's fees, since these fees reduce the amount available in the company to go to them. The fees of liquidators can therefore be controlled by creditors.

A separate Library briefing paper on "Insolvency practitioners' fees" (CBP 7402) provides further information.

[31] Section 172 IA