Company Insolvency and Liquidation

Business Information Factsheet BIF199
March 2021

Here for Business

Introduction

If a company gets into financial difficulties, it can quickly become insolvent and may have to be wound up. This process is known as liquidation.

This factsheet defines insolvency, notes how to tell if a company is insolvent and explains why companies become insolvent. It describes the various liquidation procedures that apply to private limited companies. It also outlines the responsibilities of the directors of companies in severe financial difficulties and lists alternatives to liquidation, such as informal creditors' agreements, company voluntary arrangements and administration.

Note that this factsheet is not a complete guide to the rules regarding insolvency. If a company is at risk of insolvency it is essential to seek professional advice.

What is insolvency?

Insolvency occurs in two situations: first, when a business cannot meet its debts when they fall due (the 'cash flow test'); or second, when the total value of its assets falls below the total level of its liabilities (the 'balance sheet test'). Either may result from poor trading over a period of time or can occur very suddenly if there is a major change in the company's trading position.

Key legislation

The main legislation covering insolvency is the Companies Act 2006 and the Corporate Insolvency and Governance Act 2020, though some aspects of the Insolvency Act 1986 and the Insolvency (England and Wales) Rules 2016 still apply.

For companies registered in Scotland, the relevant rules are set out in the Insolvency (Scotland) (Company Voluntary Arrangements and Administration) Rules 2018 and the Insolvency (Scotland) (Receivership and Winding up) Rules 2018. In Northern Ireland, companies are covered by the Insolvency (Amendment) Act (Northern Ireland) 2016 and the Insolvency (Amendment) (2016 Act) (Commencement No. 1 and Transitional Provisions) Order (Northern Ireland) 2016.

The legislation sets a framework for dealing fairly with the assets of an insolvent company and the claims of its various creditors.

Causes of company insolvency

Companies become insolvent for many reasons, some of which are within the directors' control. The most frequent cause is poor financial management, resulting in irregular or ineffective financial reporting.

Other reasons include:

- Declining revenues while the costs of the business stay the same.
- Loss of a major contract (which is essentially the same as the first point, but likely to be more sudden).
- Rapid growth without sufficient working capital to fund it (working capital is current assets minus current liabilities).
- Poor credit control procedures leading to extended customer credit and a growing level of bad debts.
- Late payments from customers leading to a cash flow crisis.
- Increased prices from suppliers of raw materials or other major costs such as energy and fuel which are not then reflected in higher prices.

A company's balance sheet is a key indicator of whether a company is at risk of insolvency. It shows the company's net asset value: if this is negative, the company is technically insolvent, though the terms of loans or guarantees may mean that the company is not legally insolvent. The balance sheet also shows:

- The amount of money owed to the company by its customers.
- The amount of money owed by the company to its suppliers and other creditors.

If the current liabilities are higher than the current assets, then the company may not be able to pay its debts as they fall due and the company may thus be insolvent.

Directors' responsibilities

Trading while insolvent has serious legal consequences for all the directors of a company. They may be held personally liable for some of the company's debts or be disqualified from acting as a director.

If the company runs into serious financial difficulty, its directors must take swift action and keep evidence of that action. They should also seek advice from an insolvency practitioner.
A director who allows a company to carry on trading when they knew (or should have known) that insolvency was unavoidable may be found guilty of wrongful trading. In these circumstances, the directors may become personally liable for any losses incurred by trading after that point in time. Resigning as a director when the company is finally declared insolvent does not remove the potential liability for wrongful trading.

Once a company actually becomes insolvent, there is a shift in the directors' duty of care from acting for the shareholders to minimising the potential loss to the company's creditors.
A key provision in the Corporate Insolvency and Governance Act 2020 is the introduction of the role of 'monitor'. This is a licensed insolvency practitioner who is appointed to oversee a corporate moratorium - an extendable 20-day breathing period during which the business is protected from creditor action while it seeks professional advice on the scope for restructuring.

The Act introduces the scope to implement restructuring plans, sanctioned by the court, and can potentially bind the creditors to the plans.

Alternatives to liquidation

There are several alternatives to liquidation. These can work if the company's position might be viable once its current financial pressures have eased.

- Informal creditors' agreement. The company contacts its creditors and proposes negotiating a mutually acceptable agreement to repay all or some of the existing debt. The directors retain control of the company. However, any of the creditors can refuse the proposal and take action that could result in the company being liquidated.
- Company voluntary arrangement (CVA). The directors appoint an insolvency practitioner and apply to the courts to establish a formal arrangement with their creditors to make payments under an agreed plan (the CVA). At least 75% (by value) of the creditors who vote must agree to the arrangement. The directors retain control of the company provided that it meets the scheduled payments agreed in the CVA.
- Administration. Under this arrangement, an insolvency practitioner is appointed and attempts to rescue the company while it is protected from its creditors. The administrator acts to achieve the best result for all the company's creditors, either by setting up a CVA, by selling the business as a going concern, or by selling the company's assets. The directors lose control of the company but may be asked to continue to run it under the administrator's guidance.

BIF294 Administration and Company Voluntary Arrangements provides further information on these specific procedures.

Liquidation

Liquidation is a legal process that dismantles a company so that it ceases to exist. It involves converting the company's assets into cash by selling them in order to pay off the company's debts. An insolvency practitioner is appointed as liquidator to manage the company's assets as part of this process.

The purpose of liquidation is to ensure that a company's affairs are resolved properly and in an orderly way. Following liquidation, the liquidator applies to the registrar of companies at Companies House for the company to be formally dissolved. A company may be wound up either voluntarily or through the courts.

Voluntary liquidation
If a company faces serious financial difficulties, its shareholders or directors may decide that liquidation is the only option. However, only the shareholders can put a company into voluntary liquidation. To do this, shareholders must hold a general meeting and pass a voluntary winding-up resolution.
There are two types of voluntary liquidation:

- Creditors' voluntary liquidation (CVL). If a company is already insolvent, the directors can propose a CVL, provided they have the backing of 75% (by value of shares) of the shareholders. The directors must call a shareholders' meeting and ask them to vote on a resolution to wind up the company. If the resolution is passed by the required majority, the directors must:
- Appoint an insolvency practitioner to manage the liquidation of the company.
- Notify Companies House of the resolution within 15 days.
- Advertise the resolution in 'The Gazette' (www.thegazette.co.uk) within 14 days.

Since 2017, a company no longer needs to hold a meeting with its creditors after passing the winding-up resolution. Instead, it must deliver a notice to creditors asking for their decision on the nomination of the liquidator under the deemed consent procedure rules.

The decision date must be no earlier than three business days after the notice is delivered and no more than 14 days after the winding-up decision has been passed. The directors must prepare and send to the creditors a statement of the company's financial affairs, detailing the company's assets, liabilities and creditors. This must be sent at least on the business day before the decision date, and within seven days of passing the winding-up resolution.

The creditors may still ask for a physical meeting. This must be attended by a company director and at least one of the following:

- The company secretary.
- The liquidator.
- Another company director.

Creditors are given the opportunity to question the company directors and to nominate an alternative insolvency practitioner as liquidator. Their decision takes priority over any nomination made by the company. The liquidator must send the statement of affairs to Companies House within five business days of the decision or deemed consent.

- Members' voluntary liquidation (MVL). This option is only available if a company is still solvent, ie it has enough assets to meet all its debts when the shareholders decide to put it into liquidation.

In the five weeks before a resolution to wind up the company is passed, a majority of the directors must sign a statutory declaration of solvency, which includes a statement that they believe the company will be able to pay off all its debts within 12 months from the start of the liquidation. The declaration must also include an account of all the company's assets and liabilities, which must be as up to date as possible.

The liquidation starts when a general meeting of shareholders passes a resolution to wind up the company voluntarily and appoints an authorised insolvency practitioner as liquidator. The company must advertise the winding-up resolution in 'The Gazette' within 14 days and send the declaration of solvency to Companies House within 15 days.

The liquidator will handle the company's affairs and distribute its assets to pay off creditors.

If the liquidator discovers that the company is, in fact, insolvent, the liquidation becomes a creditors' voluntary liquidation.

With either type of voluntary liquidation, a liquidator must be appointed to take control of the company's affairs and assets. The directors can no longer act on behalf of the company. They must co-operate with the liquidator and provide all the papers and information required. The liquidator oversees the disposal of the company's assets and distributes any surplus money, after costs, to the creditors. The liquidation process ends when the company is dissolved after its affairs have been fully wound up.

Compulsory liquidation

Compulsory liquidation occurs when a court orders a company into liquidation. This normally happens following a winding-up petition from a creditor, or group of creditors, who must be owed an undisputed total debt of at least £750. Occasionally, a company itself may file a winding-up petition, as may its directors or shareholders. Following a court order, an official receiver is appointed by the court to handle the winding-up of the company and investigate the possible causes of the liquidation.

While it is not common, the Government can also petition for a company to be liquidated if it believes the company is contravening law such as trading standards legislation.

Penalties arising from insolvency

Following the failure of a company, those responsible for overseeing the insolvency procedure are responsible for investigating the circumstances leading up to the insolvency.

Each appointee (the liquidator, the administrator or the official receiver) must send a report to the Secretary of State detailing the conduct of all directors in office over the previous three years. This covers topics including continuing trading when the company was insolvent, failing to keep proper accounting records, and failing to send in tax returns or pay tax due.

After assessing the directors' conduct, the Secretary of State has to decide whether it is in the public interest to seek a disqualification order against them. Criminal convictions can be made under the Company Directors Disqualification Act 1986, which may lead to individuals being disqualified from acting as a director for any company for up to five years.

Transactions prior to the liquidation can be challenged in the courts. These may include preferences (where a particular creditor has been put in a more beneficial position than other creditors) or transactions at an undervalue (when a company sells an asset before liquidation for much less than it is actually worth - or gives it away). Directors can also be personally liable for the company's debts if wrongful trading is proved, while the more serious charge of fraudulent trading carries a potential prison sentence.

How does insolvency affect employees?

If a company becomes insolvent, it may not be able to pay employees' salaries. The appointment of a liquidator will automatically terminate all staff contracts of employment.

Employees have a special status in any formal insolvency process such as liquidation. If the employer is unable to pay the employees the sums that they are due following insolvency, the employees can claim some of the specific monies owed from the Government.

Claims can include up to eight weeks' wages, up to six weeks' holiday pay, statutory notice period pay, redundancy pay and basic compensation for unfair dismissal. Employees may also be able to claim for unpaid pension contributions. Any payments made are limited to a maximum of £538 per week for each claim per employee.

Preventing insolvency

There are various ways to prevent insolvency. Many companies run into financial trouble because of unrealistic assumptions about their cash flow. It is important to use realistic forecasts and 'what if...?' scenarios to see what would happen if there was a sudden drop in sales or an increase in costs.

Credit management should be carefully controlled. A company should avoid offering credit on terms it cannot afford or giving credit to customers who may not be financially sound.

Directors should meet regularly and keep track of the company's financial health. Monthly management accounts can be used to assess the company's current financial position and to compare its performance against its forecasts.

Speed is vital if financial problems seem likely. If the problems are short term, it may be possible to improve cash flow by obtaining support from the bank, selling non-essential assets and recovering debts. Companies should contact suppliers and other creditors informally to arrange new payment terms and be rigorous in pursuing customers for outstanding payments.

If a company cannot meet its debts, its directors must seek help immediately. The company accountant should be able to advise on the best way to handle the situation and recommend an appropriately qualified insolvency professional if required. Alternatively, relevant professional associations, such as the Insolvency Practitioners Association (https://insolvencyipractitioners.org.uk) or the Association of Business Recovery Professionals (www.r3.org.uk), provide details of local insolvency professionals.

Hints and tips

- Anyone who is worried that their company is, or is about to become, insolvent, should contact the Insolvency Service
- Financial difficulties are not always a sign of bad management. But it is important to monitor company performance closely and be aware of the implications should the business face insolvency.
- Advice on insolvency can be obtained from solicitors, accountants and licensed insolvency practitioners.
- Insolvency practitioners' fees can vary greatly, but initial consultations are generally free of charge.
- If a company director is required to sign a personal guarantee to support a bank loan or other form of finance, they will be personally liable for any debts that are not fully repaid during the liquidation process.

Further information

BIF171 Bankruptcy Procedures in the UK
BIF294 Administration and Company Voluntary Arrangements
BIF199 Company Insolvency and Liquidation

Useful publications

'Liquidation and Insolvency' Companies House Website:
www.gov.uk/government/publications/liquidation-and-insolvency/liquidation-and-insolvency

Useful contacts

The Insolvency Service is a statutory body that provides information on insolvency, redundancy and related matters in England and Wales.
Website: www.gov.uk/government/organisations/insolvency-service

Accountant in Bankruptcy (AiB) administers bankruptcy and insolvency processes in Scotland. It publishes information on corporate insolvency.
Website: www.aib.gov.uk

The Insolvency Service for Northern Ireland is part of the Department for the Economy. It is responsible for administering bankruptcy and corporate insolvency in Northern Ireland and provides information on bankruptcy and liquidation.

Website: www.economy-ni.gov.uk/topics/insolvency-service

Companies House is the government department responsible for the registration, filing and winding up of companies in the UK.
Tel: 0303 1234 500
Website: www.gov.uk/government/organisations/companies-house

The Insolvency Practitioners Association (IPA) is a membership body for practitioners of insolvency-related work in the UK. It has an online directory of insolvency practitioners.
Tel: 0330 122 5237
Website: https://insolvency-practitioners.org.uk

The Association of Business Recovery Professionals (R3) is a professional association for turnaround specialists in the UK. It has an online 'Find a Practitioner' search facility.
Website: www.r3.org.uk

Business Debtline provides free advice and information about debt problems. It covers England, Wales and Scotland.
Tel: 0800 197 6026
Website: www.businessdebtline.org

Advice NI is a network of independent advice services in Northern Ireland. It provides a free helpline for small businesses that are struggling with debt.
Tel: 0800 915 4604
Website: www.adviceni.net/business-debtservice

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