Insolvent debtors: a little more power to the unsecured creditor?

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DEALING WITH INSOLVENT SUPPLIERS AND OTHER debtors can be an ongoing headache for many companies. There are obvious preventative measures, such as including retention of title claims in contracts or demanding cash on delivery, but there are fewer self-help remedies available to a creditor once the debtor has said that it is not able to pay. It is particularly galling when one suspects that the non-paying debtor may be disposing of property or dealing in a dubious manner with its assets and minimising the return for creditors.

Although creditors have always been able to petition for a company to be wound up or put into administration, if the debt on which the creditor relies is challenged by the debtor company, traditionally these petitions have been dismissed until the dispute is resolved. This can be costly, time-consuming and frustrating, especially when it is thought that the debtor's challenge is a fabricated play for time. Even if it has some basis, the challenge can still delay proceedings. A recent judgment has added a little more strength to a creditor's hand, especially when there are antecedent transactions that merit investigation by a neutral officeholder.

CURRENT POSITION

Under the Insolvency Act 1986 (as amended) (the Act), a creditor (including an unsecured creditor) is able to petition for the debtor company to be wound up or put into administration. The rationale behind the power is one of public interest. A creditor can have its interests protected by an independent officeholder appointed to monitor the payments by a debtor company and investigate its prior dealings. More generally, administration or liquidation protects others losing money to the company in the future, and can prevent its directors from starting new companies that may fail again.

Secured creditors are more protected, because legislation grants them greater power – and accordingly their rights are not addressed in this article.

The methods by which an unsecured creditor petitions for administration and liquidation are outlined below.

Applying for administration and liquidation

Under paragraph 12(1) of Schedule B1 to the Act, one or more creditors may make an application to the court for an administration order. In this case 'creditor' may include a contingent or prospective creditor. The creditor also has to include a statement of its belief that the company is, or is likely to become, unable to pay its debts. The application needs to include a statement from the proposed administrators that the order is 'reasonably likely to achieve the purpose of administration'.

Under s124(1) of the Act, a creditor (including any prospective or contingent creditor) may petition the court to wind up a company. Section 122(1) provides the grounds on which a company may be wound up, these include:

f) if the company is unable to pay its debts,

g) if the court is of the opinion that it is just and equitable that the company should be wound up.

Evidence of insolvency

In both administration and liquidation, the phrase 'unable to pay its debts' is defined by s123 of the Act:

1) A company is deemed unable to pay its debts –

   a) if a creditor to whom the company is indebted in a sum exceeding £750 then due has served on the company... a written demand requiring the company to pay... and the company has for three weeks thereafter neglected to pay the sum [also known as the 'statutory demand']... or

   ...

   e) if it is proved to the satisfaction of the court that the company is unable to pay its debts as they fall due.

An alternative definition is provided by s123(2), which states that:

> 'A company is also deemed unable to pay its debts if... the value of the company's assets is less than the amount of its liabilities, taking into account its contingent and prospective liabilities.'

Sub-clause 123(1) is sometimes referred to as the 'cash-flow' test and (2) as the 'balance-sheet' test.

The failure to pay a debt that is due and not disputed has been held to be evidence of insolvency, even though a statutory demand had not been served on the company (see *Re Taylor's Industrial Flooring Ltd*).

Obstacles for creditors

It has been established that a creditor cannot bring a petition for administration or liquidation as a means of intimidating the debtor or otherwise using it as an abuse of process (see, for example, *Re a Company (No 2507 of 2003)*). Further discouragement for a

creditor wanting to bring a petition or application is the general practice for courts to dismiss or stay any application where the debt is contested until the dispute is resolved. Again, the rationale is to prevent the creditor using intimidatory tactics or using such petitions as a debt recovery process. The downside for the creditor is that debtors will sometimes challenge the debts to thwart the petition. Even where the challenges are found to be spurious, this delays the creditor from proceeding with the petition.

A GLIMMER OF HOPE?

Yet, *Hammonds (a firm) v Pro-Fit USA Ltd* has recently offered encouragement to creditors seeking an administration order despite a challenge from the debtor company.

The claim

Hammonds had advised Pro-Fit on various legal matters and invoiced Pro-Fit accordingly. Pro-Fit entered into negotiations with Hammonds to compromise the debt, which eventually failed and the firm indicated that it would have no option but to seek some sort of insolvency process. Hammonds was also concerned about a licence to use certain IP rights that Pro-Fit had granted to a group company, allegedly at an undervalue, during the time that Pro-Fit was negotiating to reschedule its debt to Hammonds. The firm sought the appointment of an administrator, in part to investigate this apparent transaction at an undervalue.

The defence

At the same time as Hammonds suggested that it would commence an insolvency process, Pro-Fit made a complaint about the advice received from Hammonds. It subsequently issued a substantial claim against Hammonds. Pro-Fit's counsel argued that as Hammonds' claim was disputed, it did not have standing as creditor to apply for an administration order.

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Judgment

Warren J held that a person is a creditor within paragraph 12(1)(c) of Schedule B1 to the Act 'so long as he has a good arguable case that debt of sufficient amount is owing to him'. Even in the event of a disputed debt, or a cross-claim, a person falling within the definition above may make an application for an administration order. Warren J went on to say that it was then within the discretion of the court as to whether to make the order, but the court has jurisdiction to deal with the administration application without having to resolve the dispute about the debt first. He added that this would be especially true where dismissing the application because it was disputed would deprive the creditor of a remedy or otherwise some injustice would arise. In his opinion, it had been established as a matter of practice, rather than of law, that such applications were dismissed.

Pro-Fit's lawyers had, unsurprisingly, argued that the application was an abuse of process and an attempt to intimidate. Warren J dismissed this argument on six grounds, most of which relate to the facts in the case. One of the grounds argued by Pro-Fit was that Hammonds used the application to silence it, knowing that administration would mostly likely stifle the negligence claim against Hammonds. The judge rejected this approach, asserting that administrators are officers of the court and if a good case against Hammonds were found, the administrators would proceed with it, especially as, on the facts of the case, there was some money in the estate to pursue the litigation.

TRANSACTION AT AN UNDERVALUE

All of the above is good news for creditors who might otherwise be thwarted from making an administration application. But, there are some important factual points that encouraged the judge to find for Hammonds, the most crucial of which was that Pro-Fit had granted the IP licence seemingly at an undervalue and an administrator would therefore have the power to investigate the transaction. In fact, Warren J said that were it not for the granting of the licence, he would not have made the administration order.

The final twist in this particular tale is that the administration order was granted, but subject to an unusual proviso. Warren J gave Pro-Fit the opportunity to obtain a surrender of the licence on proper terms from the other party. If Pro-Fit obtained such a surrender, the administration application would not be granted. This adds to the judge's argument that he granted the administration order despite the disputed debt only to allow for the investigation of the alleged undervalue transaction.

A SHARP DISTINCTION

Warren J was careful to distinguish between the authorities presented to him that concerned winding-up petitions and those that were applications for administration. There is common ground that where the debt is either disputed or the subject of a cross-claim, the creditor may still apply for a winding-up petition or an administration order. However, the circumstances in which a creditor with an unresolved debt will be granted its winding-up petition are much narrower and will need to be extraordinary, whereas for an administration order it will be at the court's discretion. That said, it is clear on this judgment that creditors whose debt ›

is disputed will have to establish strong reasons why an administration order should be granted before the dispute over their debt is resolved.

Why should there be a difference? It was held (and common sense concurs) that there was a sharp distinction between winding-up (leading to liquidation) and administration. Liquidation brings the life of a company to an end and represents an end in itself. Administration, on the other hand, is part of an attempt to rescue the business, if not the company, and is only ever an interim measure. While an administration order should not be granted lightly, a winding-up petition should be treated with even more care.

INSOLVENCY

Of course, simply having a debt against a company, even one that is not challenged, is not in itself sufficient to merit an administration order. The court will also need to be persuaded that the company is insolvent. In his judgment, Warren J considered the question of the onset of insolvency. His full consideration on the point is beyond the scope of this article, but it is worth briefly reviewing his thoughts.

The test for insolvency in administration is set out above. The phrases 'likely to become unable to pay its debts' and 'reasonably likely to achieve [the statutory purpose]' have been opined on in various judgments since their introduction into the Insolvency Act in 2003. With respect to the need to show a company's inability to pay its debts, Warren J (following the *Re Colt Telecom plc* judgment) states that for administration it is not necessary to show present inability to pay debts, merely that it is 'likely', where 'in this context "likely" means "more probable than not"'. As for being 'reasonably likely to achieve' the statutory purpose, Warren J again follows recent judgment and concludes that here 'reasonably likely' means that 'there is a real prospect that the purpose of the administration will be achieved'.

CONCLUSION

This case does not create a trump card for any creditor to seek an administration order irrespective of a challenge from the debtor company, and neither would that be desirable, but it does open the door a little for *bona fide* creditors. Although subject to certain caveats, and the request for the alleged undervalue transaction investigation seems to have been key in the final decision, this case does potentially strengthen a creditor's hand in dealing with insolvent debtors. It provides that a disputed debt, or one that is subject to a cross-claim, may still permit a creditor to make an application for administration, and that such an application, if made *bona fide*, does not constitute an abuse of process. Warren J opines that the test for granting an administration order in such circumstances is lower than for granting a winding-up petition.

This case is also interesting because it provides some insight into the factors that a judge considers when exercising their discretion to grant an administration order. Ultimately, although a creditor whose debt is disputed will have to work hard to convince a court of the need to appoint an administrator before the dispute over the debt is resolved, the option has gained a little extra judicial support from this judgment.

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Re Taylor's Industrial Flooring Ltd [1990] BCC 44

Re a Company (No 2507 of 2003) [2003] EWHC 1484

Hammonds (a firm) v Pro-Fit USA Ltd [2007] EWHC 1998 (Ch)

Re Colt Telecom plc [2002] EWHC 2815