

Don't look back in anger: a beginner's guide to reviewable transactions

WHEN A COMPANY IS FEELING THE PINCH, DIRECTORS get nervous about which, if any, bills ought to be paid and whether transactions might later be set aside. This guide will set out a summary of the possible reviewable transactions and some worked examples.

There are five main types of reviewable, or antecedent transactions, described in the Insolvency Act 1986 (the Act) under English law:

- transactions at an undervalue;
- preferences;
- transactions defrauding creditors;
- extortionate credit transactions; and
- avoidance of floating charges.

There are similar transactions under Scottish law described in the Act, but they fall beyond the remit of this article.

Administrators and liquidators have a duty to investigate the prior transactions of the company, in particular looking for any transaction that might be an antecedent transaction that can be set aside and may bring funds back into the estate. Although there are no penalties or liabilities specifically on directors in the event that a transaction is set aside, it may contribute to the officeholder deciding to make a report on the directors' conduct.

TRANSACTIONS AT AN UNDERVALUE

Transactions at an undervalue occur when a company:

- a) makes a gift or otherwise enters into a transaction on terms that the company receives no consideration; or
- b) enters into a transaction for a consideration the value of which, in money or money's worth, is significantly less than the value, in money or money's worth, of the consideration provided by the company (s238(4)).

However, the transaction can only be challenged if it occurred a) during the relevant time (s238(2)) and

b) when the company was unable to pay its debts or became unable to pay its debts as a result of the transaction (s240(2)).

The 'relevant time' in which this transaction must have occurred is the two years ending with the onset of insolvency (s240(1)(a)). Onset of insolvency in administration is defined as being either the date on which the application for administration is made or the date on which the administrator is appointed, depending on the circumstances. If a company goes into liquidation following administration, onset of insolvency is taken from the date of entry into administration, otherwise the date is that of the commencement of the winding up (s240(3)).

The inability of a company to pay its debts in this section refers to the definitions in s123 of the Act. In that section a company is deemed unable to pay its debts, amongst other things, if it:

- 1) a) fails to pay a statutory demand;
- b) if it fails to satisfy an execution in favour of a creditor; ...
- e) if it proves to the satisfaction of the court that it is unable to pay its debts as they fall due; or
- 2) if it proves to the court that the value of the company's assets is less than the amount of its liabilities, taking into account its contingent and prospective liabilities.

Further, there is rebuttable presumption that if the transaction is made to a 'connected person' then the company was insolvent at the time (s240(2)). A court will examine the factual evidence presented to demonstrate the insolvency of the company.

A 'connected person' is defined (s249) as directors, shadow directors, associates of such directors or shadow directors and associates of the company. A company is an associate of another company if the same person has control of both or if they are controlled by people who are associates (s435(6)). A person is defined as having control of a company if the directors of the company, or of another company that has control of it, are accustomed to act in accordance with their directions or they are entitled to exercise or control the exercise of one-third or more of the voting power at the general meeting (s435(10)).

The court can make such order as it sees fit for restoring the position to what it would have been if the company had not entered into that transaction

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(s238(3)). This order may include returning property or proceeds of sale to the company or discharge of security.

There is a defence to the foregoing. The court will not make an order if it is satisfied that:

- a) the company entered into the transaction in good faith and for the purpose of carrying on its business; and
- b) at the time there were reasonable grounds for believing that the transaction would benefit the company (s238(5)).

For example, selling assets at a reduced price in order to ease cash flow would not be a transaction at an undervalue provided that the transaction passed the tests above.

PREFERENCES

A company gives a preference to a person if:

- a) that person is one of the company's creditors or surety or guarantor for any of the company's debts or liabilities; and
- b) the company does anything or suffers anything to be done that has the effect of putting that person into a position that, in the event of the company going into insolvent liquidation, will be better than the position they would have been in if that thing had not been done (s239(4)).

The crucial part of that test is that 'the company does anything or suffers anything to be done'. There is no authority on what 'suffers to be done' means. Commentary suggest 'things which the debtor is able to prevent but does not do so' (*Insolvency*, Totty and Moss, Sweet & Maxwell, para H4/4) or when 'the party concerned fails to take such steps as are reasonably available to him to prevent the action' (*Corporate Insolvency: Law & Practice*, Bailey, Groves and Smith, Butterworths, chapter 23.12).

The company must also be 'influenced... by a desire to produce in relation to that person' the effect mentioned in b) above (s239(5)). Case law shows that this 'desire' is stronger than just intending to act, instead the company must positively wish to put someone in a better position. Paying a creditor who is threatening to issue a statutory demand is not a preference as there is no desire to prefer, only the commercial realities of the situation.

If the person receiving the preference is connected with the company (other than an employee), it is a rebuttable presumption that the company

intended to prefer them (s239(6)). The definition of connected person is the same as for transactions at an undervalue.

As with transactions at an undervalue, the company must be insolvent at the time of the transaction or become insolvent because of the transaction, the definitions are as explained above. However, there is no presumption of insolvency in the event of a preference given to a connected person.

The relevant time for a preference given to a connected person is two years (s240(1)(a)). For an unconnected person it is six months (s240(1)(b)).

The court may make such order as it sees fit for restoring the position to what it would have been if the company had not given that preference (s239(3)). This order may include returning property or proceeds of sale to the company.

TRANSACTIONS DEFRAUDING CREDITORS

Transactions are deemed to defraud creditors if they are transactions at an undervalue (s423(1)) (as described above), which the court is satisfied were entered into for the purpose of:

- a) putting the assets beyond the reach of a person who is making, or may at some time make, a claim against them; or
- b) otherwise prejudicing the interests of such a person in relation to the claim that they are making or may make (s423(3)).

There is no time limit on when a challenge may be made under s423. The court may make an order that:

- a) restores the position to what it would have been if the transaction had not been entered into; and
- b) protects the interests of persons who are victims of the transaction (s423(2)).

'Victim' is defined as a person who is, or is capable of being, prejudiced by the transaction (s423(5)). However, a party who purchased the property in good faith, for value, without notice of the circumstance from a party other than the company being investigated, shall not have its interests prejudiced or be required to pay any sum (s425(2)).

FLOATING CHARGES

Section 245 of the Act is designed to prevent a company benefiting a creditor by giving a floating charge for existing debt for no new consideration. The relevant period for this section is two years for a connected person (s245(3)(a)) and one year

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REVIEWABLE TRANSACTIONS: A SUMMARY OF RELEVANT TIME PERIODS, CONDITIONS AND POSSIBLE DEFENCES

NATURE OF TRANSACTION	RELEVANT TIME	CONDITIONS (eg insolvent at the time?)	DEFENCE
Transaction at an undervalue (s238 of the Insolvency Act 1986)	Two years prior to insolvency	Must be or become insolvent at time of transaction Presumption of insolvency if connected party	Good faith and for carrying on business Reasonable grounds for believing in benefit to company
Preference (s239)	Six months prior to insolvency if unconnected Two years prior to insolvency if connected	Must be or become insolvent at time of transaction Must 'desire' to prefer creditor Presumption of 'desire to prefer' if connected party	Must actively prefer one creditor, not just be side effect of action
Transaction defrauding creditors (s423)	No time limit	No need to be or become insolvent	Purpose must be to put assets beyond reach of creditors
Avoidance of floating charges (s245)	One year prior to insolvency if unconnected Two years prior to insolvency if connected	Must be or become insolvent at time of transaction if unconnected party No solvency test if connected party	New money is given (or debt released) in return for new security
Extortionate credit transactions (s244)	Three years prior to insolvency	Grossly exorbitant payments or grossly contravene fair-dealing principles No need to be or become insolvent	Reasonable terms and behaviour

for anyone else (s245(3)(b)) prior to the onset of insolvency. If the charge is given to an unconnected party, the company needs to be insolvent at the time the charge is given or become insolvent as a result for this section to be applicable, whereas no insolvency test is needed for a charge granted to a connected party (s245(4)). A charge that falls within this section is automatically invalid.

EXTORTIONATE CREDIT TRANSACTIONS

This provision (s244 of the Act) applies where the company is, or has been, a party to a transaction for, or involving the provision of, credit to the company. A transaction is considered extortionate if, having regard to the risk accepted by the person providing credit, the terms:

- a) require grossly exorbitant payments to be made; or
- b) otherwise grossly contravened ordinary principles of fair dealing (s244(3)).

The review period is three years from the date that the company entered administration or liquidation (s244(2)).

PENALTIES

The directors do not have any personal liability for antecedent transactions. In the event of an administration or liquidation, the officeholder will investigate the conduct of directors and may make a report under the Company Director's Disqualification Act 1986. However, no director is personally liable solely because there was an antecedent transaction in their company.

EXAMPLES

Here are some examples of payments and transactions that a company might make and whether they might be deemed to be antecedent transactions. In each case, the company is balance-sheet insolvent, therefore all the transactions are potentially reviewable.

- 1) **Landlord demands payment of quarter rent, threatening forfeiture**
Preference? No. Although the landlord is in a better position because it has been paid, the company has not desired to put it in a better position. The company made the payment to avoid forfeiture and to continue having access to the premises. However, the payment might be

Re MC Bacon Ltd [1990] BCC 78

Re Mistral Finance Ltd [2001] BCC 27

challengeable if, for example, the landlord was not threatening action, if rent was paid ahead of time, if the company did not need the premises, or if the landlord was a connected person, and so there was a rebuttable presumption to prefer. Review period: six months for unconnected party.

- 2) **Taking out a new loan secured by a debenture with fixed and floating charge**
Transactions at an undervalue? No. *Re MC Bacon Ltd* [1990] held that the creation of security over a company's assets was not a transaction at an undervalue, since the value of the assets was not diminished.

Preference? No. Assuming that the new loan was necessary for the company to continue to trade and if the lender was insistent, the company would not have the necessary desire to prefer the lender.

Avoidance of a floating charge? No, assuming that the security offered was equal to the value of the loan and the loan was granted at the same time or after the creation of the security.

- 3) **Granting new security for an existing loan**
Transactions at an undervalue? No, for the same reasons as above.

Preference? Possibly. In *Re MC Bacon Ltd* it was held that if the only way that the lender would continue to lend, and so allow the company to trade, was if the new security was granted, then the company would not have the necessary desire to prefer the lender, since the alternative was liquidation. However, in *Re Mistral Finance Ltd* [2001] it was held that granting security over existing borrowings was a preference on the facts in that case. Review period: six months for unconnected party.

Avoidance of a floating charge? Yes. To the extent that the security contained a floating charge, it can be deemed invalid if there is

no commensurate value received (or liability reduced). Review period: 12 months for unconnected party.

- 4) **Selling a part of the business and/or assets**
Transaction at an undervalue? Possibly. If the company sells part of its business and/or assets for significantly less than the notional value, then it may be a transaction at an undervalue. The court will look closely at whether the company entered into the transaction in good faith and for the purpose of carrying on its business, and if there were reasonable grounds for believing that the transaction would benefit the company. Review period: two years, whether connected or unconnected party.

- 5) **Paying a supplier ahead of schedule**
Preference? Yes. If the supplier is not crucial to the business, is not threatening action that might jeopardise the business, or there is not some other good reason why they should be paid out of turn, then the company is likely to be found to have desired to better the supplier's position. Review period: six months for unconnected party; two years (and a rebuttable presumption to prefer) for connected party.

CONCLUSION

Directors should be mindful of potentially reviewable transactions whenever they enter into arrangements. However, where a transaction involves an unconnected party – unless a company is insolvent at the time of the transaction, or becomes insolvent because of it – there is seldom a problem. Where a connected party is involved or where the company is (or could later be considered to be) insolvent, greater consideration needs to be given to the reasons behind the transaction. In any event, detailed board minutes or other documents supporting the rationale of the transaction will assist the company in demonstrating the 'good faith' and 'lack of desire' tests.

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