

ERDF - FINANCIAL DIFFICULTIES, FRAUD, ETC.

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4.A1 INVOLVEMENT OF OFFICES WITH COMPANIES IN FINANCIAL DIFFICULTIES

1. This annex deals with the implications for Government Departments, Government Office officials or other staff in becoming involved in either fraudulent or wrongful trading by companies in financial difficulties. This involvement can arise through the provision of financial assistance to companies or through an appointment to a company e.g. as an observer at meetings of the Board or as a non-executive director. Staff should avoid becoming a "shadow director".
2. The paragraphs that follow are an extremely simplified guide to the legislation in this area. You can get detailed advice on these matters from Solicitors. You must consult Solicitors and FRM (for DTI staff) as soon as possible on any cases where there is a risk of wrongful or fraudulent trading.

4.A1.1 Fraudulent Trading

It is a **criminal offence** under Section 458 of the Companies Act 1985 for anyone:

to carry on any business of a company;

- i) with the intention of defrauding the creditors of the company or the creditors of anyone else; or
- ii) for any fraudulent purpose; or

to be knowingly party to the carrying on of business in either of these ways.

1. The Government should behave as if Section 458 is binding on the Crown. Offices should not provide assistance to a company which is not likely to be able to pay its debts as they become due. Therefore, both before any assistance is given and as part of the project monitoring, you should establish as far as possible that the company is or remains capable of carrying out the project.
2. In addition, in the course of winding up a company, a liquidator may apply to the civil court for a declaration that **anyone** who was involved in the fraudulent carrying on of the business is liable to contribute to the company's assets, if it appears that fraudulent trading has occurred. (Section 213 of the Insolvency Act 1986).

4.A1.2 Wrongful Trading

1. The risk of involvement in wrongful trading arises if a company goes into liquidation. A liquidator will then be appointed to try and ensure that all the company's creditors are correctly paid. To meet the company's debts, the liquidator needs to assess all the company's assets, and may look also at the assets of the directors and any "shadow directors" of the company.
2. If it appears to the liquidator that, at some time before the winding up began, a director or "shadow director" **knew or ought to have known** that there was no reasonable prospect the company would avoid going into insolvent liquidation, the liquidator may make an application to the civil court for a declaration that the director or shadow director be liable to contribute to the company's assets.
3. Before making such a decision, the court will consider whether the director or shadow director took every step possible to minimise the loss to the creditors, (assuming him to have known there was no reasonable prospect that the company would avoid going into insolvent liquidation). (Section 214 of the Insolvency Act 1986).
4. A "**shadow director**" is defined in the Insolvency Act 1986 (section 251) as a person in accordance with whose directions or instructions the directors of the company are accustomed to act". The identification of a shadow director will depend on the facts of any particular case, and any officials should avoid acting in a way that suggests they or the Office could be a shadow director.
5. It is therefore important that Offices should avoid being drawn into substantial involvement in the decision-making processes of a company during a time when it is in financial difficulties. If the decisions made by the company in that period are made by or on behalf of the Office, or by the directors subject to the Office's approval, (whether on a detailed day to day basis or within a framework of strategic approval), the Office runs a considerable risk of being held to have become a "shadow director" of the company during the period of financial difficulty, and of therefore being liable to make a contribution to the company's assets. The risk will be much greater where the Office has exercised this type of control before the financial difficulties became apparent.
6. Although these provisions may not bind the Crown, it is important that the Secretary of State and officials do not act in a manner contrary to them. Even if they do not bind the Crown, they may bind officials in particular cases if they are deemed to have acted in a personal capacity, for example where they hold non-executive directorships for career development purposes. It is generally undesirable that officials should act in ways that Parliament has tried to deter, in particular in an area for which the Office itself has policy responsibility.

4.A2 RECEIVERSHIP, ADMINISTRATION AND VOLUNTARY ARRANGEMENTS

4.A2.1 Receivership

1. A receiver, including an administrative receiver, is appointed for the purpose of realising sufficient funds or assets of a company in order to meet the claims of the secured creditor or creditors who appointed him. Once the debt is fully discharged the receiver ceases to act.
2. Some types of creditors, for instance banks providing loans, will require security in the form of a charge on company assets. The terms are set out in the document creating the charge. If there is a fixed charge (ie secured against identified assets), the receiver's role will be to realise the value of those particular items sufficient to pay the creditor.
3. If the creditor has a floating charge over all, or substantially all of the company's assets, he may be entitled to appoint a receiver and manager, who is called an administrative receiver. He usually acts as agent to a company.
4. The receiver's powers are set out in the charge document and, for an administrative receiver, in Schedule 1 to the Insolvency Act 1986. They usually include:
 - a. power to take possession of all the property charged;
 - b. for an administrative receiver, power to carry on, or to concur in the carrying on of, the business of the company;
 - c. power to sell, or concur in the selling of, all the property charged; and
 - d. to make any arrangements or compromise which the receiver considers expedient in the interest of the debenture holder.
5. The priority of debts in administrative receivership are:
 - i. debts due to fixed charge holder creditors;
 - ii. preferential debts (for example, certain sums owed to the Inland Revenue and Customs and Excise, Social Security contributions, contributions due to occupational pension schemes, employees remuneration);
 - iii. debts due to the floating charge holder.

6. Subject to the terms of the charge document under which the receiver is appointed, it is the sole responsibility of the receiver to decide what action to take once he is appointed. An administrative receiver usually makes an initial visit to the company to assess the situation: the broad decision is whether to carry on the business of the company or to close it down and realise the assets. Subject to the availability of funds to pay wages and to acquire essential trading stocks, his initial decision is usually to complete contracts and continue the business for a limited period while he makes a fuller assessment of the possibilities. This leads to one or more of the following courses of action:
 - a. continued trading in order to achieve an orderly run-down of stocks or to complete some partly executed orders;
 - b. continued trading to allow time for the negotiation of an arrangement of the kind described in (c) or (d) below;
 - c. continued trading on a longer-term basis. This may be justified if the receiver sees prospects of the company being restored to a profitable basis; and
 - d. arranging a sale of the assets, including goodwill, with or without all or some of the liabilities.
7. The secured creditor who appoints the receiver may replace him if he so wishes. The court can only remove an administrative receiver.

Unsecured Creditors

8. Departments would be unsecured creditors. The administrative receiver has no obligation to meet the amounts outstanding to unsecured creditors incurred before his appointment, who would need to petition for the winding up of the company if their claims are not met. However, this process should not be initiated as part of an RSA claim. An administrative receiver can himself petition the court for a compulsory liquidation.
9. The only obligation the administrative receiver has to unsecured creditors is informational:
10. Every company letter, invoice or order for goods must state that the company is in receivership.
11. The administrative receiver must tell all creditors within 28 days that he has been appointed. He must also advertise his appointment in the Gazette and in the newspaper that he considers most appropriate for ensuring that it comes to the notice of creditors.

12. The administrative receiver is required within 3 months of his appointment to prepare a report covering:
 - a. the events leading to his appointment;
 - b. his disposal of assets of the company and the extent to which he is carrying on the business of the company, as appropriate, and any proposals for these;
 - c. the amounts payable to the debenture holders who appointed him and to preferential creditors; and
 - d. the amount likely to be available for the payment of other creditors.
13. The report should have attached to it a copy of the summary of the statement of affairs produced by officers, or previous officers of the company showing assets, debts liabilities and various other information. The report need not, however, include any information likely seriously to prejudice the carrying out of the administrative receiver's functions.
14. The administrative receiver is required to send the report to the registrar of companies, to any trustees for secured creditors and to all secured creditors. If a liquidator is appointed, the administrative receiver must also send a copy to the liquidator. If the administrative receiver is able to send the report to the liquidator within 3 months of his appointment as administrative receiver, then he does not have to send the report to unsecured creditors or communicate it to them in any way. However, if the report is not sent to the liquidator within the 3 month period, then the receiver must:
 - a. either send a copy of the report to all unsecured creditors; or publish a notice in the newspaper in which his appointment was advertised stating that the report is available on request; and
 - b. present a copy of the report to a meeting of the unsecured creditors, unless the court otherwise directs. If that meeting appoints a creditors' committee, the administrative receiver can be required to meet them and provide them with such information as they may reasonably require.

4.A2.2 Administration

1. The Insolvency Act 1986 introduced a procedure whereby a company that is, or is likely to become, unable to pay its debts may obtain a moratorium on actions for repayment of debts by creditors while, under a court administration order, a qualified insolvency practitioner (the administrator) formulates a plan for dealing with the company. In effect the order normally needs to be agreed by all the secured creditors who are entitled to appoint an administrative receiver. It must be agreed by any creditor who had actually appointed an administrative receiver. An administrator has three months in which to prepare proposals and to put them to a meeting of the company's creditors. The aim is normally likely to be the survival of the company. If the creditors' meeting agrees a proposal, the administrator is required to manage the business accordingly. If the meeting doesn't agree to the proposals the court may discharge the administration order. The moratorium on creditor action also prevents the company being wound up or an administrative receiver being appointed. The administrator must apply to the court for the Administration Order to be discharged or varied if the purpose for which it was made has been achieved, is incapable of achievement or if he is required to do so by a duly convened meeting of the company creditors.

4.A2.3 Voluntary arrangements (CVAs)

- 1) Under the Insolvency Act 1986, a CVA is an arrangement between a company (which could be proposed by its directors, an administrator or liquidator) and its creditors. The aim is to give the company a breathing space by delaying and/or reducing debt payments to creditors so that the company business can continue. Meetings of the company's creditors and of the company's members (shareholders) are summoned and if both a 75% majority of the creditors' meeting and a simple majority of the members meeting approve the proposed arrangement, it is binding on all creditors who had notice of the meeting and were entitled to vote. The arrangement covers 'compositions' and 'schemes', which might include a number of possibilities such as debt repayment by instalments, transfer of company assets to another company with creditors obtaining an interest in the new company, or a trustee running the business for a number of years. A qualified insolvency practitioner must act as the 'supervisor' of the CVA.

Recovery and write-off

- 2) Receivership, Administration and Voluntary Arrangements might all result in the survival of a company and its project. If it becomes clear that a project will not survive, procedures for recovery and write-off will need to be followed. If a project has failed, but the company itself is legally continuing

to trade, Offices will need to take particular care to ensure that any recovery action does not put a company's remaining jobs at risk.

4.A3 LIQUIDATIONS AND DISSOLUTIONS

4.A3.1 Liquidations

Introduction

2. Winding up ("liquidation") is the first stage in a process by which the existence of a company is terminated. Some companies are dissolved, however, without insolvency proceedings. The Insolvency Act 1986 provides that a company may be wound up compulsorily by the court or voluntarily by the members (shareholders) or creditors.
3. Voluntary liquidation follows a resolution by the company members that it should be wound up. In a members' voluntary liquidation, the Board must first make a statutory declaration that the company is solvent. The Members appoint the liquidator. If there is no such declaration, or the company is found not to be solvent, it is a creditors' voluntary liquidation, where the creditors have primary power to appoint the liquidator.
4. Compulsory winding up most commonly follows a petition to the Court from a creditor on the basis that the company is unable to pay its debts: if, for example, the company is indebted to the creditor for a sum exceeding £750 which it has failed to pay (or otherwise made arrangements to the reasonable satisfaction of the creditor) within 3 weeks of being duly served with a written demand in the prescribed form. There are, however, wide powers for interested parties to petition the court on a number of other possible grounds. Unless the court orders otherwise, the official receiver, by virtue of his office, becomes liquidator on the making of a winding up order. The creditors or contributories, the court or the Secretary of State may subsequently appoint an insolvency practitioner as liquidator in place of the official receiver.

Powers and duties of the liquidator

5. In a winding up, the management of a company's affairs is taken out of its directors' hands and placed in those of a liquidator. The liquidator has to establish the liabilities of the company and realise the assets to satisfy those liabilities in due order of priority and as fully as possible. Any balance of funds remaining after the expenses of the liquidation and liabilities have been met is distributed among the members according to their rights or to the persons entitled to it.
6. The company is subsequently dissolved, usually three months after the liquidator notifies the Registrar that the liquidation is completed.

Meetings of creditors

7. Meetings of creditors are convened in accordance with the Insolvency Act and the Insolvency Rules 1986. In a compulsory liquidation, the official receiver must decide whether to summon first meetings of creditors for the purpose of appointing a liquidator other than the official receiver. In general, resolutions may be passed at first meetings of creditors in both creditors voluntary and compulsory liquidation in order to, for example, establish a liquidation committee or specify the terms on which the liquidator is remunerated.
8. The liquidator has a statutory duty in certain circumstances to summon periodic meetings of creditors at which, for example, he is required to report on the conduct of the liquidation. Where the Department is an unsecured creditor, it may be appropriate to attend the creditors' meeting and to vote.

Liquidation Committee

9. The liquidator is required to report regularly to the liquidation committee, which is a committee of the creditors, and certain of his powers can be exercised only with the sanction of the court or the liquidation committee. In those liquidations where the official receiver is liquidator, or where a liquidation committee is not established, the Secretary of State exercises the functions of the liquidation committee. It is preferable that offices should neither seek, nor accept, nomination to the liquidation committee unless there is some special reason for doing so.

4.A3.2 Dissolved companies

1. Under Section 652 of the Companies Act 1985, the Registrar of Companies may strike a company name off the register and dissolve it if he believes that the company is no longer trading. If no response is received from two letters issued to the company's registered office enquiring if it is still in business, a notice is published in the London Gazette stating the intent to strike off the company in 3 months. If cause has not been shown to the contrary, the company is subsequently dissolved by notice in the London Gazette. If an objection is received, the Registrar may delay strike off. Assets held by a company are passed, in most cases, to the Crown.

4.A4 NOVATION AGREEMENTS

1. Paragraph 4.13.2 explains that a novation agreement is necessary when an offer is transferred from one organisation to another. The following is a standard text of a novation agreement when the offer is being transferred from one company to another. The terms will need to be varied appropriately where the organisations involved are not companies. Solicitors will need to be involved in all cases.

4.A4.1 DRAFT NOVATION AGREEMENT - COMPANY

THIS AGREEMENT is made the _____ day of _____ Two Thousand and _____
BETWEEN the SECRETARY OF STATE FOR _____ ("the
Secretary of State") of the first part [NAME OF ORIGINAL OFFER COMPANY]
[(Company No. _____) whose registered office is at [_____
] ("the Transferor Company") of the second part and [NAME OF NEW
COMPANY] [(Company No. _____) whose registered office is at [_____
] ("the Transferee Company") of the third part

WHEREAS

(A) By letter under reference [_____] dated [_____] [as amended by letter dated _____] ([as so amended] "the offer letter") the Secretary of State offered the Transferor Company a grant not exceeding [_____ Pounds] (£[____]) to carry out the project therein described ("the Project") and the terms of the offer letter were accepted by the Transferor Company

(B) By [an Agreement] dated [_____] the Transferor Company agreed to transfer its whole undertaking business and assets (including the Project) to the Transferee Company with effect from [_____]

(C) The Transferee Company and the Transferor Company have asked the Secretary of State to agree to the transfer to the Transferee Company of all the rights, duties, liabilities and obligations of the Transferor Company contained in the offer letter

(D) The Transferor Company desires to be released and discharged from the duties, liabilities and obligations contained in the offer letter and the Secretary of State is willing to release and discharge the Transferor Company upon terms that the Transferee Company shall undertake to perform all the duties and accept all

the liabilities and obligations contained in the offer letter [and subject to the Transferee Company accepting the amendments to the offer letter set out in Clause (4) below].

IT IS HEREBY AGREED: -

(1) The Transferor Company with the agreement of the Secretary of State transfers to the Transferee Company all the Transferor Company's rights, duties, liabilities and obligations under the offer letter and the Transferee Company accepts the transfer.

(2) In consideration of the Secretary of State consenting to enter into this Novation Agreement the Transferee Company undertakes to the Secretary of State to comply with and be bound by the offer letter [as amended by Clause (4)] in every way and to discharge all duties, liabilities and obligations, whether attributable to the Transferor Company under the offer letter or attributable to the Transferee Company under the offer letter as so amended as if the references in the offer letter to [NAME OF ORIGINAL OFFER COMPANY] were and had always been references to the Transferee Company.

(3) The Secretary of State releases and discharges the Transferor Company from the performance of its duties, liabilities and obligations under the offer letter and accepts the Transferee Company under the offer letter as so amended in lieu of the Transferor Company.

[(4) The offer letter is henceforth amended as follows:-

(i) List amendments to the offer if any are to be made.]

IN WITNESS WHEREOF the Corporate Seal of the Secretary of State has been hereunto affixed and the Transferor Company and the Transferee Company have caused this Novation Agreement to be executed as a deed the day and year first above written.

THE CORPORATE SEAL OF
THE SECRETARY OF STATE
FOR [DEPARTMENT]
hereunto affixed
is authenticated by

An Official in the Department
of [Department]

EXECUTED as a Deed and
delivered on the date hereof by

Director

Director/Secretary
[ORIGINAL OFFER COMPANY] Ltd

EXECUTED as a Deed and
delivered on the date hereof by

Director

Director/Secretary
[NEW OFFER COMPANY] Ltd