CAN A STRUGGLING COMPANY EVER JUSTIFY PAYING SOME - BUT NOT ALL - OF ITS CREDITORS?

In light of the financially fragile state some businesses are finding themselves in as result of COVID-19, we discuss in this briefing note when – if ever – payments or other benefits can be given to some creditors but not others, and when such a transaction might fall foul of the unlawful preference provisions of UK insolvency legislation.

This is a fast-moving area and this briefing note sets out the position as at **7 April 2020.**

WHY ARE TRANSACTIONS CHALLENGED?

Unlawful preference transactions can be unwound, leading to court orders to repay funds or return property.

When a company enters a formal insolvency procedure, the insolvency practitioner appointed as liquidator or administrator of the company will review the transactions into which the company entered in the run-up to its insolvency. They will then assess whether any of those transactions might be challenged under the 'antecedent transactions' provisions of UK insolvency legislation. This provides an opportunity to bring money or other assets back into the company's estate, which increases the pool of assets from which a distribution can be made to the company's creditors.

WHAT IS AN UNLAWFUL PREFERENCE?

An unlawful preference can be challenged by an administrator or liquidator under section 239 of the Insolvency Act 1986 (the "Insolvency Act"). Under these provisions, a company gives a preference if:

- the company does anything (or suffers anything to be done) which has the effect of putting a creditor (or a surety or guarantor of a creditor) into a position which, in the event of the company going into insolvent liquidation, would be better than the position it would have been in if the transaction had not taken place;
- that action (or omission) takes place:
    - within six months (or two years, if the party receiving the benefit of the transaction is connected with the company) before the company entered administration or liquidation; and
    - at a time when the company was unable to pay its debts or became unable to pay its debts as a consequence of the transaction; and

- the company was influenced in its decision by a desire to put the creditor, surety or guarantor in a better positon (as described above).

Some examples of preference include:

- repayment (or part-repayment) of a debt such as a directors loan account;
- repayment of a guaranteed loan;
- providing security or further security for an existing debt; or
- returning goods obtained on credit, where those goods were not supplied on a retention of title basis.

Importantly, it is not necessary to show that the company's assets have been unfairly applied in favour of one creditor over another. Indeed, the transaction in question might not involve any disposition of the company's assets at all.

HOW DO I WORK OUT IF A TRANSACTION COULD BE CHALLENGED?

It is crucial to assess whether a transaction that a company intends to enter into during a period of financial uncertainty could be challenged as a preference.

Whether a transaction falls foul of the unlawful preference provisions is ultimately for a court to decide. However, there are three main points that should be considered when deciding if a transaction could be at risk. These are the timing of the transaction, the reason for the decision to enter into the transaction and whether the parties to the transaction are connected. We look at each in turn below.

1. The timing of the transaction

There are two questions to consider here.

Firstly, is the company able to pay its debts? A company can be deemed unable to pay its debts because there is outstanding an unpaid statutory demand for over £750 (or an unsatisfied execution), or if it is proved unable to pay its debts on either a cash flow or a balance-sheet basis.

Secondly, do the directors reasonably believe that the company will avoid insolvency? Note that the onset of insolvency is defined as the date on which a notice of intention to appoint an administrator is filed, or, if no notice is filed, the date on which an administration application is made, or where neither of the first two is applicable, the date on which the administration appointment takes effect. Alternatively, where there has been no prior administration, the date of the commencement of the winding up.

Usually a company can give any creditor a preference without falling foul of the unlawful preference provisions, provided that (i) it is able to pay its debts at the time of the transaction or (ii) the transaction takes place outside of the period of 6 months leading up to it being put into administration or liquidation (this period is extended to two years if a connected party is involved, as explained at point 3 below).

2. The reason behind deciding to effect the transaction

The relevant questions here are:

- does the company wish to put a creditor in a better position than it would otherwise be in should the company go insolvent; and
- is the company's decision to effect the transaction motivated by a desire to bring about this outcome (the improved position for the creditor in question)?

Note that when we talk about the company, we include the operating minds of the company.

Usually, a transaction will not fall foul of the unlawful preference provisions if it was motivated only by proper commercial considerations. If the company's decision was influenced by a wish (which need not be the only motivation), in the event of its own insolvent liquidation, to improve the position of a creditor, it could fall foul of the unlawful preference provisions.

3. Connected parties

A connected party includes other companies in the same group, companies which have one or more directors in common with the company, directors and shadow, relatives of those directors or shadow directors and shareholders holding more than a 33% of the shares in the company.

If the recipient of the benefit of the transaction is a connected party, there are two results.

Firstly, the period during which transactions are at risk of being challenged is extended (from six months) to two years prior to the commencement of the company's administration or liquidation.

Secondly, the connection triggers a presumption that the company's decision to effect the transaction was influenced by a desire to put a creditor in a better position than it would otherwise be in should the company go insolvent. In practice, this means that, in the ensuing court proceedings, the onus would be on the beneficiary of the transaction (and/or on the directors of the company) to prove to the court's satisfaction that the company was motivated by proper commercial considerations in effecting the transaction, rather than by a desire to prefer the connected party in question.

WHAT HAPPENS IF A TRANSACTION FALLS FOUL OF THE UNLAWFUL PREFERENCE PROVISIONS?

Decisions should be taken carefully, as a board, with legal and financial advice where appropriate.

If a court finds that a transaction falls foul of the unlawful preference provisions, the court can make such order as it thinks fit to restore the position to what it would have been if the company had not given the preference. For example, this could be an order (i) for the beneficiary of the transaction to repay money received or (ii) avoiding a guarantee provided to the beneficiary of the transaction by the company. The court's powers are very broad in this regard.

CAN A STRUGGLING COMPANY MAKE PAYMENTS TO SOME - BUT NOT ALL - OF ITS CREDITORS?

Where a company is struggling, it can pay some creditors rather than others - so long as:

- either the company can pay its debts as defined above, or if not, the directors otherwise reasonably believe the company can avoid insolvency; and
- the company only pays creditors for commercially justifiable reasons, being reasons related to the efforts to secure the company's survival.

Examples of commercially justifiable reasons include paying the electricity bill in order to allow the office to remain open (which would facilitate the collection of debtor payments) or making payments to a critical supplier, without whose continuing support the company would fail.

WE ARE STRUGGLING BUT NEED TO PAY SOME CREDITORS TO KEEP GOING - WHAT SHOULD WE DO?

A struggling company which is considering picking and choosing which creditors to pay and which to defer should take the following steps:

- seek professional advice at the earliest opportunity, for example from the company's solicitors or from a firm of insolvency practitioners;
- properly evaluate decisions to pay creditors, for example by discussing payments to creditors at regular board meetings;
- record the reasons for making any payments to particular creditors, for example by using board minutes to record discussions and the decisions made; and

- assess the company's finances on a regular basis, including considering the company's position against the insolvency tests to ensure the directors are properly informed and still reasonably believe the company can avoid insolvency.

IS THERE ANYTHING ELSE THAT A STRUGGLING COMPANY SHOULD BEAR IN MIND?

The usual framework of insolvency provisions and directors' duties continue to apply – so even if a transaction is not a preference, there may be other pitfalls to be careful to avoid.

Directors of struggling companies should also be aware of:

- the fraudulent trading provisions under section 213 of the Insolvency Act, whereby a director or former director can be ordered to make a contribution to the assets of a company if, in the period leading up to the winding up the business, the company has been carried on with the intent to defraud a creditor of the company or any other person or for any fraudulent purpose. This can include a situation where a company incurs credit (either to a bank or to a supplier who provides goods on credit terms) in the knowledge and expectation that the company will not be able to repay the sums in question.
- the statutory and common law duties of directors which, in times where a company finds itself in financial difficulty, must also be exercised for the benefit of creditors in order to minimise the potential loss to them.
- the directors' disqualification provisions under section 6 of the Company Directors Disqualification Act 1986, whereby a director or former director of a company which has become insolvent can be disqualified from acting as a director or in the formation or management of any company for up to 15 years if their conduct as a director makes them unfit to be concerned in the management of a company.
- the misfeasance provisions under section 212 of the Insolvency Act, whereby a director can be ordered to repay, restore, account for or contribute towards the company's assets if a director or former director has misapplied or retained, or become accountable for, any money or other property of the company, or been guilty of any misfeasance or breach of any fiduciary or other duty in relation to the company.
- the undervalue provisions under section 238 of the Insolvency Act, whereby a court can make an order avoiding any transaction made at an undervalue by the company in the two years before the administration or liquidation of the company. A transaction at an undervalue means a transaction where the company gave a gift, received no consideration or received consideration worth significantly less than the value provided by the company.
- any personal guarantees provided by directors. Depending on the wording of the guarantee, a director could be personally liable for one or all of the company's debts if the company is unable to settle them itself.

For more information on directors' duties and considerations, including in circumstances where a company's solvency has come under doubt, our practical guide to director's duties can be found here.

David Steinberg, co-head of Stevens & Bolton's Restructuring & Insolvency practice, commented:

Since the COVID-19 pandemic struck, directors of struggling companies are routinely required to engage in the invidious task of deciding which creditors to prioritise when considering how to deploy their company's fast-diminishing cash reserves, in circumstances where they cannot yet see a clear route back to normality. The Government's announcement that it intends to suspend the 'wrongful trading' provisions of the insolvency legislation is very welcome in this context but directors will still need to be wary of the other elephant traps posed by the insolvency legislation (such as the 'unlawful preference' provisions discussed in this article) which, it appears, will not be similarly 'switched off' for the duration of the pandemic.

Stepping back from the extraordinary context of the pandemic, the English rules on 'unlawful preference' continue to have the rather incongruous feature that a transaction can be caught by the section even if no discernible prejudice has been caused to other creditors by the offending transaction. I say 'incongruous' because all the other 'antecedent transactions' provisions in UK insolvency legislation – wrongful trading, fraudulent trading, transactions at an undervalue, voidable floating charges, transactions defrauding creditors – are underpinned by an objective to ensure that, as far as possible, the insolvent company's assets are preserved for the equal benefit of all unsecured creditors and, to that end, to provide a mechanic for clawing back assets into the company where that principle has been infringed. By contrast, the 'unlawful preference' provisions can 'bite' even where no asset of the company has been dissipated to the disadvantage of other creditors.

KEY CONTACTS

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