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An introduction to English insolvency procedures (and practical action to take)

(English and Welsh construction focus)

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Insolvency continues to plague construction supply chains across the UK, causing widespread financial distress and disruption not only for businesses and their employees, but also for those they work with and the projects they work on. Monitoring site activity and your trade partners for signs of distress has become an essential part of project management – as has the need for collaboration across the supply chain, and early action to support business partners and avoid project disruption. (You can read our checklist on how to spot the warning signs of insolvency in the supply chain here.)

Unfortunately, many in the industry will know from experience when a trade partner is struggling, but what about when insolvency does occur? What procedures are triggered and what, for example, is the difference between administration and liquidation?

In this briefing, we explain the most common, formal restructuring and insolvency processes in England: administration and liquidation (or "winding-up"). We also explain some insolvency issues of interest to those dealing with a counterparty in an insolvency process including: (i) communication between the liquidator/administrator and creditors; (ii) how creditors claim against a counterparty in administration/liquidation; and (iii) what is the pari passu principle (which deals with the order in which creditors are paid). Finally, we provide some practical action steps for those managing construction projects when one party is in financial difficulty.

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- What is the pari passu principle and in what order are creditors paid?
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- Other insolvency processes
- Practical action for those managing construction projects when one party is insolvent

Insolvency: some basics	
What is insolvency?	A business in financial difficulties becomes insolvent if: (i) it fails to meet a statutory demand; (ii) it is proven that its assets are less than its liabilities; and/or (iii) it is unable to pay its debts as they become due. In this article, we focus on the two key procedural options available to distressed businesses and their creditors for dealing with insolvency: administration and liquidation. The effects of these procedures and their outcomes are very different and it is therefore important to understand how they operate.

Administration	
What is administration?	Administration is the main formal rescue procedure in England and Wales. There are three ways to appoint an administrator, namely: (i) the company, a creditor, court official or existing insolvency officeholder applies to the court for an administration order; (ii) a holder of a "qualifying floating charge" appoints out of court (via electronic filing to the court); or (iii) the company itself or its directors appoint out of court (again, electronically).
The court has discretion to order an administration	The court always has a discretion as to whether to make an administration order. To do so, the court must be satisfied that "the company is, or is likely to become, unable to pay its debts" as defined in Section 123 of the Insolvency Act 1986 (the **Act**). The court must also be satisfied that the administration appointment is reasonably likely to achieve its purpose.
The three statutory objectives of administration	The statutory purposes of an administration are compulsory. Ranked in order of priority, they are: (i) to rescue the company as a going concern; (ii) to achieve a better result for creditors as a whole compared to a liquidation; and (iii) to realise property to distribute to the company's secured or preferential creditors. The priority ranking matters – only if the administrator "thinks" the first purpose is not reasonably practicable will the second purpose of the administration apply and so on.
Key benefit: the moratorium	Once in administration, the company benefits from a "moratorium" immediately, either on the appointment of an administrator (whether in or out of court) or by way of interim moratorium when someone: (i) applies to court for an administration order (but before the court makes the actual order); or (ii) files a notice of intention to appoint an administrator out of court.
What is the moratorium: what effect does it have?	The administration moratorium gives the distressed company breathing space during which it is protected from its creditors in a number of crucial ways. Creditors cannot bring or continue legal proceedings against the company or its assets without the administrator's or court's permission. Shareholders cannot pass a winding-up resolution. Securities against the company cannot be enforced, nor can goods be repossessed. Winding-up petitions will either be dismissed or suspended. An administrator can also require a fixed charge receiver appointed by a secured creditor to leave office.

What does the administrator do?	An administrator will work out a plan for the company based on the statutory objectives – often to sell the business as a going concern if it cannot continue to trade – which is then put to the creditors for approval by a simple majority. If approved, the administrator will carry out the plan and then leave office. The administrator is not traditionally the one who pays out realisations to creditors (this tends to be a subsequent liquidator) but it can do so. The administrator is an officer of the court and acts as the company's agent. An administrator can allow directors to exercise such management roles as appropriate but will usually take over control of the company. The administrator can also pay secured and preferential creditors and distribute to unsecured creditors with the court's permission.
Potentially ... on to liquidation	Within 12 months (or longer if extended), and after the administrator has either achieved the administration's objectives or decided they are no longer achievable, the administrator will move the company into liquidation.
Note – if you are a creditor of a distressed company	… you can end contracts but, if you breach a contract with the distressed company, it can still sue you. The moratorium often prevents you, the creditor, from enforcing your rights. If the company breaches or fails to perform its contractual obligations, you cannot sue.

Liquidation (or "winding-up")	
What is the effect of a liquidation?	Commonly known as a "winding-up", a traditional liquidation usually ends a company's existence. A liquidation can last years and ends in the company's dissolution. A company in liquidation continues to exist – it does not end until the liquidator dissolves it.
What happens in liquidation?	The liquidator: (i) gathers in the company's assets; (ii) calculates its liabilities; (iii) unwinds any objectionable transactions according to insolvency laws; (iv) reports on the conduct of the relevant officers; (v) divides the assets among the creditors according to the set priority laid out in the Act; and (vi) finally dissolves the company.
What are the three types of liquidation?	A members' voluntary liquidation (**MVL**) is a solvent liquidation (i.e. where the company is able to pay its debts). A creditors' voluntary liquidation (**CVL**) is an insolvent liquidation – the company is unable to pay its debts within the meaning of Section 123 of the Act. It is started by the shareholders (not the creditors) who pass an extraordinary resolution to wind up the company and an ordinary resolution to appoint a liquidator. The directors must call a creditors' meeting within 14 days of the shareholders' meeting at which the creditors decide whether to approve the members' choice of the liquidator or substitute a liquidator of their own choice (hence the name "CVL"). In a compulsory liquidation, a creditor (usually) presents a petition to court to wind up the company. However, the company, its directors, the Secretary of State, a voluntary liquidator, an administrator or an administrative receiver may also petition. If satisfied the company is unable to pay its debts within the meaning of Section 123

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	of the Act, or it is just and equitable to do so, the court can make a compulsory winding-up order. The Official Receiver acts as liquidator until the creditors' first meeting.
What is the effect of a liquidation?	A liquidation effectively ends the company. The liquidator takes control and the directors' powers end. In addition: • the court stays (i.e. pauses) all actions against the company in a compulsory liquidation and may stay actions against the company in an MVL or a CVL; • there are limits on re-use of the company name; • no one may enforce rights on goods, land or debt; • employment contracts impliedly end (except on voluntary liquidation); • other contracts usually end expressly on their terms; • a liquidator can disclaim (i.e. end) any onerous contracts; and • secured creditors can (and should) realise their security and usually prove as unsecured creditors for any balance.

Communication between the liquidator/administrator and creditors	
Notices to creditors (and filing a proof of debt in the insolvency process)	The liquidator/administrator must inform the known creditors of the company that the insolvency procedure has started. Creditors will be required to give official notice of their claims against the company (the timing for which will depend on the particular process) (see below for how creditors make claims). These notices (or "proofs of debt") decide a creditor's rights both to vote on certain aspects of the insolvency procedure and to be paid under the order of priority. An administrator must prepare proposals for the conduct of the administration within eight weeks of appointment and send them to all creditors whose claim and address is known. The creditors vote on the proposals at a creditors' meeting and the value of each creditor's vote is generally in proportion to the value of their claim.
How creditors make claims in an administration/ liquidation	The procedure for a creditor to make a claim ("file a proof") is similar in administration and liquidation. Broadly speaking, any creditor wishing to take part in or be told of any later dividend should: • notify the administrator/liquidator of their claim in writing; and • specify the details of the documents proving the debt in the proof and may (but does not need to) enclose copies. The administrator/liquidator may require additional evidence, where necessary. A creditor does not need to file a proof but, if it does not do so before the first

Communication between the liquidator/administrator and creditors	
	creditor's meeting, the opportunity to vote and influence the meeting's outcome will be lost. A proof can be filed later. If the company moves from administration to liquidation, proofs will be passed to the liquidator – a creditor who has filed a proof in the administration does not need to file a proof in the liquidation. If the creditor did not file a proof in any prior administration, it will need to file a proof in the liquidation.
Creditors' rights	If an administrator or liquidator rejects a proof in whole or in part, he/she must give reasons for the decision to the creditor. The creditor can then apply to the court to reverse or vary the decision.

What is the pari passu principle and in what order are creditors paid?	
What is the pari passu principle?	An administrator/liquidator should divide the net assets of an insolvent entity equally among each class of creditors in proportion to the value of their claims (the pari passu insolvency principle). This principle can override contractual terms providing otherwise. Mandatory and statutory insolvency set-off rules provide that an administrator/liquidator must take an account of mutual credits, mutual debts or other mutual dealings between the company and any creditor in the administration/liquidation. The set-off rules are complex and the outcome will depend on the particular facts. For an assessment of the effect of these rules on you, and what is or may become payable, speak to one of the Key Contacts.
In what order of priority will creditors be paid?	The pari passu principle and mandatory insolvency set-off applies within classes of creditors. However, between classes of creditors, there is a defined order of payment known as the "waterfall". Where an administrator/liquidator distributes the assets, payments will generally be made in the following order: • those owed insolvency procedure expenses (including the insolvency officeholder's pay); • holders of fixed charges; preferential creditors (including employees for certain benefits and wages); • unsecured creditors up to a maximum of £800,000 (on prescribed assets only); • floating charge holders; • unsecured creditors; and, lastly • shareholders.

Protecting companies in financial distress (the Corporate Insolvency and Governance Act 2020)	
What are the aims of the Corporate Insolvency and Governance Act 2020 (CIGA)?	CIGA is designed to: • provide protection for companies in distress by safeguarding supply of goods and services to promote rescue; • avoid key suppliers holding the insolvent company to ransom and taking advantage of the company in its time of need (by terminating, threatening to terminate, charging inflated prices etc.); and • keep in step with other countries, including the US, which have similar (but arguably more far-reaching/effective) rules on preservation of contracts. In effect, any term in a contract that allows a supplier of goods or services to terminate on a company's entry into an insolvency process will be invalid. It does not matter whether that provision operates automatically or requires an election to be made or notice given by the other party. Further, a supplier cannot demand payment of outstanding pre-insolvency charges as a condition of continuing supply.
What does CIGA provide? (the "ipso facto" provisions)	CIGA, which came into force on 26 June 2020, introduced permanent changes to UK insolvency law (in what are known as the "ipso facto" provisions) which, in theory at least, apply to all contracts for the supply of goods and services. In essence, CIGA provides that, when a company enters into certain formal insolvency processes (including administration and liquidation), a supplier to that company is not entitled to cease supplying goods or services under their contract simply because of the insolvency or restructuring process *unless*: • the supply company or the supply contract/arrangement falls within certain exceptions as set out in CIGA. Broadly speaking, these exceptions include financial contracts (for example, finance leases and guarantees) and those cases where the insolvent company or supplier is a form of financial institution/business (such as a bank/insurer/e-money business etc.); • the defaulting company or its insolvency office holder agrees to the termination; or • the court finds (on the supplier's application) that continuation of the contract would cause the supplier "hardship".

Other insolvency processes	
Other processes **(e.g. Scheme of Arrangement or Company Voluntary Arrangement)**	As well as any consensual and informal/contractual restructuring and compromise arrangements that a company may agree with its creditors, a company can propose a scheme of arrangement or Company Voluntary Arrangements by appointing an insolvency professional to oversee a compromise with its creditors. These are still relatively formal processes (governed by statute or sanctioned by the court) but are usually started by the company itself. A company may also take advantage of a new standalone moratorium procedure if it meets certain criteria.

Other insolvency processes	
	For more information on these processes, please contact one of the Key Contacts.

Practical action for those managing construction projects when one party is insolvent	
Monitor	Collate as much information as you can from and about the distressed business on the issues they face.
Manage	Review your contracts: check the terms closely. What can you do now? Can you terminate? (Is it prudent to do so? Termination could lead to a number of consequences. Seek legal advice before acting.) Plan for the worst. If the distressed business fails, do you have a replacement lined up? How quickly can you get them signed up? Have you assessed the costs?
Mitigate	Continue to monitor the solvency of the current business but take prompt action if an insolvency appointment is made. The earlier you take action, the better the chances of avoiding disruption, keeping costs to a minimum and the project programme on track.

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