PRIVATE CLIENT

What is insolvency?

FRANCIS WILKS & JONES

People focused.
Solutions led.
Results driven.

INTRODUCTION

Insolvency is classically a measure of either the net assets an individual or company owns, or the ability of that individual or company to pay its debts as and when they become due. This booklet addresses corporate insolvency, i.e. as it relates to companies, and the various mechanisms that exist under UK legislation to deal with company insolvency. For information relating to personal insolvency, please review our other booklets available to download on our website.

Just because a company is technically insolvent doesn't necessarily mean the end of company's life. There are a range of options open to help businesses in difficulty, such as refinancing and restructuring. Many companies in the UK are insolvent but with the right assistance can recover and thrive.

However, as a director of a business it is vital to understand the issue of solvency and this booklet helps explain the two main tests of insolvency and what can be done to assist you if you are concerned.

HOW DO I KNOW IF A COMPANY IS TECHNICALLY INSOLVENT?

There are two main tests to determine whether a company is insolvent:

1. **The balance sheet test.**
2. **The cash flow test.**

These will now be explained below

1 The balance sheet test

This test determines insolvency as where the value of a company's assets are less than the amount of liabilities, taking into account its contingent (i.e. not yet due) and prospective (i.e. those which are intended to be incurred very soon or which accrue as a fixed ongoing cost of the business e.g. utilities) debts.

This calculation can often be difficult to make for a director to make as that person has to decide and agree the basis on which assets and liabilities are valued. This is especially true if a director does not have much financial expertise. However, getting this right is critical to determining the true position of a company's solvency. There are numerous factors which might affect the balance sheet test which are not immediately obvious – some examples of which are set out below.

EXAMPLE 1

If an outstanding debt which is quite large is shown in the company's accounts, but is unlikely to be paid, then accounting standards require that directors be prudent and include a provision for the loss of this debt. If a large debt is not so provided for in the accounts then, in certain circumstances, this may mean that the company is actually insolvent (if the debt should be provided for as a write off).

EXAMPLE 2

Quite often an optimistic director will be convinced that the company is not insolvent because of anticipated funding, either from a lending institution or third party. If such lending is not yet secured (despite the verbal or other assurances that are provided) then the company may be insolvent with the

consequences for directors (for more details see "Directors and liabilities: A handy guide" also located on our website).

EXAMPLE 3

As with book debts described above, any asset that is valued in the company's accounts but which may have depreciated since (for example plant and machinery) will mean that the company is balance sheet insolvent, even if the financial accounts do not reflect this. In more recent times, the reduced value of commercial property may also have a similar affect to make a company insolvent.

EXAMPLE 4

Pension scheme deficits are often undervalued because the basis of a valuation may be outdated or may be not up to the current accounting standards. A revaluation of the pension scheme deficit on a regular basis is important to ensure that the financial statements of a company reflect the true and fair view of the company's financial position.

EXAMPLE 5

A company's accounts are normally drafted on the basis that a company is an active going concern. As a result there may intangible assets valued in these accounts which depend on this going concern basis (for example goodwill, trading names and other intellectual property of the company). If the company is then facing difficulty in continued trading or something changes which means that its going concern status is jeopardised (for example a change in regulations affecting the business or the inability to renew a franchise licence) then the balance sheet needs to be valued on a break-up basis. This may reduce the value of the company's balance sheet and mean that it is insolvent.

2 The cash flow test

Insolvency on the basis of the cash flow test applies is when a company is unable to pay its debts as and when they fall due.

Section 123 of The Insolvency Act 1986, defines a company as being unable to pay its debts "as and when they fall due" in any of the following circumstances:

a. **If a creditor to whom the company is indebted in a sum exceeding £750 then due serves a statutory demand on the company to pay this sum AND this sum is not paid or secured (for example by a charge over property) within the period of three weeks after service of the statutory demand.**
b. **Where a county court judgment or other court judgment is made and enforcement of the judgment is unsatisfied.**
c. **This applies to Scotland, with similar provisions to (b) above.**
d. **This applies to Northern Ireland, with similar provisions to (b) above.**
e. **It is proved to the court that the company is unable to pay its debts as they fall due (and a failure by the company to pay an undisputed debt may be sufficient proof for these purposes).**

Cash Flow Insolvency can occur even where companies are solvent on a balance sheet basis but may have all of their assets and available capital locked-up in, for example, plant and machinery or property and otherwise be generating insufficient funds to meet the cost of trading.

It is often the case that a debt may or may not be disputed. In such circumstances a creditor will often present a statutory demand under s.123 (a) to clear the way for a winding-up petition to be presented under Section 124 of the Insolvency Act 1986. From the debtor's perspective, it is important to deal with this early by way of setting out why the debt is disputed (if it is) or by making arrangements to settle the debt within the three week period unders.123 (a) above.

3 The responsibility for getting this right

The responsibility for properly monitoring a company's solvency rests squarely with the directors of the business. They have a legal duty to ensure they are always aware of the company's financial position (regardless of their role) and that they monitor the company's level of solvency status. Some of the reasons for this are listed below and not all are obvious to even the most experienced of directors.

1. **The company can be wound-up on the basis of a relatively small undisputed debt. This could lead to directors facing personal sanction, the loss of business to suppliers and the redundancy of employees.**
2. **Directors can be personally liable to repay or restore the company's position as a result of any transactions that occur whilst a company is insolvent (whether the accounts show this or not, as described above). Full details of the personal risk to directors can be found in our booklet "Directors duties and liabilities: A handy guide".**
3. **Directors can be disqualified from acting in the management of a company by the Secretary of State for Business, Innovation & Skills (which may mean the loss of their livelihood). This is usually as a result of perceived improper acts by directors, although this is an objective test. For example paying a supplier that has pressured the company in the final days, or not paying any outstanding tax to Her Majesty's Customs & Revenue, are examples of many situations which may lead to directors being disqualified. Please see our booklet "10 common mistakes in director disqualification claims" for more information on this area.**
4. **The normal difficulties relating to insolvency can also arise – for example suppliers being unwilling to do business with a new company (following the failure of the old company) and/or the damage to the goodwill of the underlying business, which the director may seek to continue.**

3 Get this right

Getting this right can be critical for your business. We can assist you if you find such matters difficult. You might not even require legal advice at all. However, with our excellent contacts with trusted third party professionals (such as accountants, turnaround specialists, financiers and providers of specialist finance directors) we can refer you to professionals we have worked with **for** many years and take the risk and worry out of the situation as far as we can.

Early advice can make all the difference.

Talk to our team

- Speak in confidence
- No obligation
- Expert advice from a friendly team

CALL 020 7841 0390

SEND US AN ENQUIRY

VISIT OUR WEBSITE