

Is Liquidation The Only Solution?

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INTRODUCTION: CORPORATE INSOLVENCY

There has always been a difference of opinion as to who is to be taken care of the most, while a company gets insolvent: the creditors, the insolvent, the public, or the other stakeholders? This is the critical question. Certain theories are there to advance their answers as to which stake holder should be preferred to others. These theories include: The Creditors' Bargain Theory, Communitarian Theory and Multiple Values Approach. These theories differ in preferring to the interests of different types of stakeholders, but none of them insists on immediate liquidation of the insolvent companies, because, 'In most liquidations creditors are going to receive only a small percentage of what they are owed'.⁽¹⁾ So, what to do with the insolvents?

PICKING UP AN OPTION:

Liquidation:

In the event of insolvency, the liquidation has been the most common solution to the problem of insolvency of a company. Insolvency, nevertheless, is not the only reason for liquidation of a company. A company may be wound up for a number of reasons, even if it is not insolvent. However, winding up of an insolvent company may be carried out either voluntarily or compulsorily. Voluntary winding up is the one where the share-holders, believing that the company is unable to pay its debts, decide to wind up the same. On the other hand, compulsory winding up is executed under the orders of the court. These orders are passed on the request of the creditors, contributories, the Official Receiver, or the Department of Trade and Industry; or if the court itself is of the opinion that it is just and equitable to wind up the company. Upon winding up, the yield generated by the sale of assets of the company is distributed among the charge holders, in order of preference and according to the principle of *pari passu* (equal treatment of the creditors of the same class).

Though winding up is the fate of most insolvent companies, it is not every insolvency that leads to liquidation.⁽²⁾ At one time winding up was the only real option available when a company was insolvent, but as companies became more critical to commercial life and legislation developed, provision has been made for forms of insolvency administration other than winding up.⁽³⁾ An insolvent company, instead of going directly into liquidation, can choose any of the alternate options. These options include: receivership, administration and voluntary arrangements. These aim at avoiding, or at least minimizing the would-be losses inevitable in the event of liquidation. First preference of any of them is to save the company by having a chance of its rehabilitation. However, if the conditions are hopeless, then, as a last resort, they would go for winding up the company in the most suitable manner, with minimum possible losses.

Receivership:

A secured creditor of an insolvent company, usually a bank, may, instead of going for liquidation, appoint a Receiver to enforce the security. If the security or loan agreement, referred to as 'debenture', covers the entire or almost entire assets of the insolvent company, the receiver steps into the shoes of the directors and administers the affairs of the company, so as to realize its assets to pay off the amount due. In such a case, he or she is called an 'administrative receiver'. An administrative receiver tries to sell the company as a going concern, to get more value of the assets. Some researches show that about 44% of companies in receivership are sold as going concerns.⁽⁴⁾ Sometimes, his efforts to reach a more beneficial solution bear so much fruit, that a rescue becomes possible. Nevertheless there is evidence that receivers do continue to run businesses and on occasions incur a trading loss.⁽⁵⁾ But, primarily, the role of a Receiver is to look after the interests of the secured creditor and ensure the satisfaction of the debts by the proceeds of the assets that becomes available after their realization. Once appointed, he or she acts as the agent of the company, and has power to incur trading liabilities on its behalf, or to procure the breach of its contracts. The company's directors and other creditors have few rights to involvement in the decision-making process. Yet the administrative receiver's primary duties are owed to his appointing debenture-holder, rather than to the company, and this is the main disadvantage of receivership as a major corporate rescue procedure.⁽⁶⁾ Furthermore, the appointment of an administrative receiver greatly restricts the operation of other, more collective insolvency procedures.⁽⁷⁾ Then, the receivership is not a collective insolvency process, and is largely contractual, arising out of a charge/security given by a company to a creditor, usually a bank, often over the whole or substantially all of the company's assets.⁽⁸⁾

Administration:

An insolvent company, instead of going into liquidation, can also choose the option of administration by an external manager. The administration was primarily a procedure for the companies where no secured creditor held as much a charge as amounted to cover the whole or nearly the whole of the undertaking of the company. An external administrator was appointed by the court of the relevant jurisdiction on the satisfaction that a company is, or likely to be, unable to pay its debts. This, too, was an arrangement to dispose off the assets of a company and pay off the debts to the creditors, with the proceeds of the sale, through a neutral person. But, "the primary purpose of the administration now is to rescue the company."⁽⁹⁾ While passing an order of administration, the court takes into account: the possibility of survival of the company or one or more of its components, probable voluntary arrangement

between the creditors and the company, prospective compromise of the creditors on their claims, or at least, better prospects of realization of the assets prior to going for liquidation. Administration, now, is in essence, a temporary measure which either lays down the foundations for the rescue of the company or for its winding up on a more favourable basis.(10)

“It involves the appointment by the court of an administrator to manage the company for the benefit of creditors generally with a view to securing the survival of the company as a going concern, the approval of a voluntary arrangement under Part I of the Insolvency Act 1986, the sanctioning of a compromise under section 425 of the Companies Act 1985 or a more advantageous realization of the company’s assets than would be effected on a winding up.”(11)

Administration order brings about an automatic stay order: moratorium, dismissing any winding up petition, removing any administrative receiver and placing an administrator with the full authority and powers of the directors to manage the company, and take all appropriate decisions about its future. The moratorium provides the administrator with an opportunity to take and execute the decisions about the fate of the company, whether for its rescue or to make some other more beneficial arrangement for its winding up, without any pressure or harassment by the creditors. An administrator is usually an Insolvency Practitioner, officer of the court, or representative of the Department of Trade and Industry; and an administrator owed a duty to a company over which he was appointed to take reasonable care to obtain the best price that the circumstances as he reasonably perceived them to be permitted, including a duty to take reasonable care in choosing the time at which to sell the property.(12) Insolvency Act 1986 requires an administrator to act with the purpose of (i) rescuing the company as a going concern, or (ii) achieving a better result for the company’s creditors as a whole than would be likely if the company were wound up, or (iii) realizing property in order to make a distribution to one or more secured or preferential creditors.(13)

Voluntary Arrangements:

In most jurisdictions insolvent companies can enter into a voluntary arrangement with the creditors. There are many different forms of agreement and these possess a bewildering variety of names: composition, compounding, compromise, arrangement, scheme of arrangement, voluntary arrangement, moratorium, workout _ in the case of an individual insolvent, an assignment (to trustees) for the benefit of his creditors.(14) However, these are categorized in two types: Formal Voluntary Arrangement, where an arrangement is made with the involvement of the court, under the cover of law _ in UK, a company can opt for a Company Voluntary Arrangement (CVA) _ and Informal Arrangement, where the debtor reaches an agreement with the creditors outside the court, without an appropriate shelter of law. In the event of any type of arrangement, if a company seems to be unable to run as a going concern, then a voluntary arrangement would usually require the creditors to compromise over the quantity of amount due as debt (though, at a rate, better than what would be expected in case of liquidation); and if it has a potential of rehabilitation, then it would normally require negotiation on time for repayment of the debt, for example, a break for a certain period of time, or payment in installments spread over a longer period. The purpose, again, is to save the company from liquidation, or at least, liquidation with minimum loss.

Informal arrangements could be more efficient, time saving and cost effective, if, however, they can work. To persuade the creditors to come to a new agreement may be a bit difficult, though in benefit of all the concerned. While it is not too difficult to make the creditor understand that ultimately get much more than is likely in case of winding up, it is nonetheless, not easy to maintain such a deal with a relatively larger number of creditors for a longer period of time.

Formal arrangements are provided in the law, hence more workable, under the auspices of the court after the company goes into administration, or even prior to that. CVA is a significant feature of UK insolvency regime. A company in administration can achieve the object of rescue by approval of CVA.(15) Before order of administration, the directors, and after that the administrator or receiver have to make a proposal for rehabilitation of the company or rescheduling the debts of the company etc. The proposal, after the approval of the court is to be put up before the creditors in a meeting. If 75% of the creditors agree _ in some jurisdictions the number may vary, like 66% in USA _ it becomes binding on everyone else. The whole idea of pushing through a CVA is to prevent the creditors putting the company into winding up.(16) CVA, once agreed, becomes binding on all who had notice of and were entitled to vote at the meeting.(17) Case law has described it as ‘statutory binding,’(18) ‘commercial agreement’(19) and a ‘trust’(20) . This legal status makes a CVA more workable than an informal arrangement.

All the above options are available prior to going for liquidation of an insolvent company.

CORPORATE RESCUE:

There is increasing scope for business rescues through restructuring and reorganization where the enterprise is fundamentally sound and has good prospects of being restored to profitability. The so-called “rescue culture” has developed significantly in recent years.(21) ‘The purpose of business rescue is not necessarily to prevent a company from being wound up or liquidated,’ says University of Pretoria associate professor David Burdette. ‘But even if the business cannot be restored to a solvent and profitable status, business rescue has shown that the return to creditors in the long run will be higher’.(22) It is very difficult to argue against the concept.(23) Certain measures can be adopted to attempt a rescue. In addition to negotiations with the creditors, company’s rescue may require some other measures to be adopted. A change in management, sometimes along with other measures can help a company survive. Turnarounds are often accompanied by management changes, asset sales, and new finance or directors’ guarantees. There is evidence that these changes significantly influence the bank’s response and the likelihood of a

successful outcome.(24) An insolvent company that wishes to raise working capital urgently can opt, after careful analysis, for issuance of shares at a discount, but it would require approval from its shareholders and the relevant regulatory body.(25)

Transnational Legal Scene:

Currently, companies facing difficulty in Hong Kong have little choice other than liquidation or receivership. An effective rescue procedure exists in other jurisdictions, such as the US (Chapter 11 of the Bankruptcy Act), UK and Australia (the process of "Administration"). In the case of Australia, the introduction of the corporate rescue regime has led to a marked decrease in the number of receiverships (from 380 cases in the year ended March 1997 to 240 the following year) and a rise in the number of "administrations" (from 421 in 1997 to 503 in 1998).(26)

Although, practically, in New Zealand liquidation is the primary (and strictly speaking the only) collective legislative procedure for dealing with distribution and realization of assets of an insolvent company, yet aspects of statutory management procedure could be preserved in any rescue procedure, such as the moratorium and the powers of the manager.(27)

While there is no developed practice regarding informal corporate rescue processes in Pakistan, formal corporate rescue processes that are available to corporate debtors and creditors are almost similar to those of the UK. The Federal Government of Pakistan has also set up a Task Force for Revival of Sick Industrial Units. The issue in Pakistan is not the lack of an adequate and comprehensive legislative framework, but rather the lack of a speedy and efficient implementation process.(28)

South Africa is one of the most competitive countries in which to do business, it has an unhealthy number of liquidations. Though SA was one of the first countries to make provision for business rescue – through the judicial management provisions in the Companies Act – there hasn't been much success in implementing it.(29)

UK insolvency procedures are highly creditor oriented. Contractual rights are strictly enforced, and the courts have no power to intervene in the way the bank exercises its rights, say, to sell the business as a going concern, or sell the assets piece meal. However, where there is a possibility of a rescue being implemented, the courts will make a space, sometimes being most reluctant to help a judgment creditor to obtain execution.(30) Still there exists an elaborate rescue process outside formal procedures. About 75% of firms emerge from rescue and avoid formal insolvency procedures altogether (after 7.5 months, on average).(31)

Chapter 11 Regime:

It is commonly acknowledged that no other jurisdiction currently has a statutory procedure as effective as the US' chapter 11 in supporting business restructuring.(32) Rescue procedures are available to struggling companies immediately, at their instigation and timing, and at a far earlier stage in the process than would be the case in many other jurisdictions.(33) In many jurisdictions in Europe, including in the UK, France and Germany, insolvency proceedings are usually only capable of being implemented where the entity is, or is on the brink of insolvency. From management's perspective, the main driver in instigation insolvency proceedings in these jurisdictions is likely to be (at least in part) defensive – the directors will be motivated in starting proceedings by a desire to ensure that they are not personally (and in some case criminally) liable in respect of the company's indebtedness. In contrast, management in the US can plan for a chapter 11 restructuring, usually without the fear of personal liability and preferably at a point when rescue and rehabilitation of the company has good commercial prospects of succeeding.(34) It is no surprise to see the influence of chapter 11 on recent or prospective reforms to insolvency laws world wide as many jurisdictions move towards a more debtor-friendly approach.(35) The debtor friendly nature of Chapter 11 suggests that less distressed firms (or even profitable ones) may enter Chapter 11 thereby increasing the incidence of going concerns compared with the UK sample.(36)

Complete harmonization of insolvency laws worldwide is not currently regarded as feasible.(37) However, most of the jurisdictions are aiming at the Chapter 11 model of insolvency regime.

CONCLUSION:

Liquidation of insolvent companies is comparatively an easier phenomenon. Court, liquidator or administrator has to assess the assets and liabilities of the company. Assets are sold out. Preferences of the creditors are determined. After making payments to the preferential and secured creditors, residual amount generated by materialization of assets is distributed among the unsecured creditor, and the company gets buried. An already dying company's affairs involve no risks, as such. No challenges are to be faced. No big decisions are to be made. Creditors, already prepared to face the consequence, get pacified without causing much trouble to the persons involved in the process of administration. There are least uncertainties, actually, about the time to come. No liabilities of future results are there on the shoulders of the people responsible for the process, except for performing the immediate duties. An attempt to rescue the company is like one of treatment of a dying patient. If, despite putting all possible efforts, life could not be brought to him, the relatives would blame the doctor. Then, what is the need to get into such an exercise? Why not to let the leaving souls leave?

Needless to say, rescue is not always guaranteed under rescue processes, but there may be an opportunity for companies to revive the business, for jobs to be preserved, for debts to be satisfied, and in the event that liquidation is

inevitable, for a better return to be provided for creditors.(38)

The resources used and the risks involved in an attempt to save a company from liquidation might be a matter of concern, yet even only small success rate would be desirable, as in the event of liquidation the percentage of recovered money does not reach the double digit, for most of the creditors.

From communitarian point of view, that attracts me the most, a single instance of successful rescue would be more beneficial to the society than tens of efficient liquidations.

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