<u>Basic Provisions of United Kingdom Insolvency Law</u>

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1. <u>Sources of Law</u>. The insolvency law in the United Kingdom is codified primarily in the Insolvency Act of 1986 (as amended by the Insolvency Act of 2000 and the new Enterprise Act of 2002) and the Companies Act of 1985, although the common law from before and after 1986 informs the interpretation of these statutes. The Enterprise Act of 2002, in force since September 15, 2003, changes the existing UK insolvency law mostly in the area of administration. The new EU Regulation on Insolvency Proceedings, effective as of May 31, 2002, changes the scope and application of UK insolvency law in some material ways—for example, businesses principal locations in the UK may now be subject to UK insolvency proceedings, even if organized under foreign law.

2. <u>Types of Insolvency Proceedings</u>. The four legal methods for addressing a business insolvency are as follows: (1) administrative receivership for the benefit of a secured creditor (a remedy for secured creditors rather than an insolvency proceeding, per se and not discussed here in detail. This remedy has been, to a significant degree, curtailed by the Enterprise Act of 2002); (2) administration, which, combined with method (4) below, is most closely analogous to Chapter 11 reorganization in the United States; (3) winding up (also called liquidation), which is most closely analogous to Chapter 7 liquidation in the United States; and (4) statutory compositions and arrangements with creditors, for example, a "scheme of arrangement" under Section 425 of the Companies Act or a company voluntary arrangement under the Insolvency Act (a "CVA"). Administration is not a complete process in itself — it is instead a means of reaching a "scheme of arrangement" or CVA for the reorganization of a business, thereby avoiding or postponing liquidation.

3. <u>Two Types of Winding Up</u>. The two types of winding up are as follows: (1) a "voluntary winding up," which is commenced voluntarily by a company's shareholders or its creditors, and (2) a "compulsory winding up," which is commenced by a court upon the petition of a company, its creditors, or its directors. A compulsory winding up is more formal and more closely controlled by the court, because it is a more contentious process and usually takes place when a company is in more dire economic circumstances. The distinction between a members and a creditors voluntary winding up depends on whether or not the directors are prepared to give a statutory declaration that the company is solvent. A statutory declaration of solvency is a statement made by the majority of directors to the effect that, having made a full inquiry into the company's affairs, they are satisfied that the company will be able to pay its debts in full, together with any interest, within a specified period not exceeding 12 months from the commencement of the winding up. If a director makes such a declaration without reasonable grounds, he is liable to imprisonment or a fine, or both. Both types of winding up are aimed at a statutory dissolution of the company following a disposition of its assets and a distribution to its creditors.

4. <u>Process for Creditors' Voluntary Winding Up</u>. For a public company, a creditors' voluntary winding up may be commenced only at a shareholder meeting after 14 days' notice (a

"company meeting"), when at least 75% of those shareholders voting must approve the winding up. For a private company, the notice and meeting may be avoided if all shareholders agree. Following the company meeting or agreement, the company must hold a creditors' meeting within 14 days (usually the creditors' meeting occurs immediately following the company meeting). Notice of the creditors' meeting must be given to the creditors by post not less than 7 days prior to the meeting and a public notice advertising the creditors' meeting must be filed. The directors must also make a full statement of the company's affairs to be presented at the creditors' meeting. At the creditors' meeting, the creditors nominate a liquidator. If there is a period of time between the company meeting and the appointment of a liquidator, the powers of the company's directors are circumscribed, although the directors technically retain control of the company. Once appointed, a liquidator takes control of the business and may admit or reject proofs of debt, collect and liquidate assets, and make distributions to creditors. Unlike a compulsory winding up, much of the liquidator's work may proceed without court approval. A final meeting of the shareholders and a final meeting of the creditors is held prior to dissolution where the liquidator shows the shareholders and the creditors how the company's assets are fully wound up and how this has been conducted by laying an account before them. Both meetings are called by public notice. When the winding up is completed, the liquidator again files a public notice, and the company is dissolved automatically three months later.

5. Process for Members' Voluntary Winding Up. To commence a members' voluntary winding up requires 75% of the shareholders to pass the resolution. The resolution must be passed within 5 weeks of the directors making a statutory declaration of solvency but it need not state any reasons in its wording. The members then appoint a liquidator for the purpose of winding up the company and distributing its assets. On the appointment of a liquidator, the powers of the directors cease, unless the liquidators or the shareholders in general meeting allow them to continue in any way. The liquidator collects in the assets and distributes them in the required order and then a final meeting of the members is held prior to dissolution where the liquidator shows the shareholders how the company's affairs are fully wound up and how this has been conducted by laying an account before them with a full explanation.

6. Process for Compulsory Winding Up. A compulsory winding up is commenced by a petition of creditor or other party with standing, which is heard and may be approved by a court. Upon approval of the petition, a liquidator is appointed, and the winding up continues broadly along the same lines as a creditors' voluntary winding up. In a compulsory winding up there is more likely to be a dispute as to whether the company is insolvent. There are various grounds for seeking a winding up order, but usually a petitioner must show that a company is "unable to pay its debts as they become due" or that winding up the company is "just and equitable." The "unable to pay its debts" test may be satisfied through proof of insufficient cash flow or insufficient assets as compared to liabilities (a "balance sheet" test) taking into account its contingent and prospective liabilities.

7. Process for Administration and Reorganization. If an insolvent or nearly insolvent company is not a candidate for winding up but has not reached an agreement with its creditors, it may petition the court for an appointment of an administrator. The Enterprise Act of 2002 has also introduced an alternative out of court route into administration. The administration provides a "breathing spell" similar to that available through a Chapter 11 filing and permits a company to seek a scheme of arrangement, a CVA, or an alternate disposition of assets that is more efficient

than a winding up. Upon appointment, the administrator takes over operation of the company's business and proposes a method of achieving the purposes of the administration as ordered by the court. The administrator's proposal must be approved by the debtor's creditors or modified by agreement — or else the court may dismiss the administration case. When the administration's purposes have been achieved or are incapable of achievement, the case is dismissed (and, in the case of a going-concern, power is restored to the company's board of directors). The administrator is then released of liability and the creditors are restored to their respective pre-administration rights — except as modified by a scheme or arrangement or a CVA, if one has been adopted. Under the Enterprise Act of 2002, the administrator is expressly charged with a duty to act in the interest of the company's creditors as a whole and as quickly and efficiently as reasonably practicable.

8. <u>Automatic Stay</u>. Creditors' actions against the debtor are stayed in an administration and a compulsory winding up (which proceedings are based on court orders) but not in a creditors' voluntary winding up. If a creditors' action threatens a creditors' voluntary winding up, the likely result will be a compulsory winding up, although liquidators may apply to the court for a stay in proceedings against the company. The stay that takes effect in an administration prevents both a creditors' voluntary winding up and a compulsory winding up.

9. <u>Power of the Debtor-In-Possession</u>. There is no "debtor-in-possession" concept in the United Kingdom. Only in out-of-court creditors' agreements does a debtor remain in control of its business. In some instances, a debtor may be able to choose an administrator with whom the debtor is comfortable and who, as a practical matter, will act toward the same general ends sought by the debtor.

10. <u>Avoidance Actions</u>. A liquidator or an administrator has the power to avoid preferential and fraudulent transfers, but an administrative receiver does not.

11. <u>Assumption and Rejection of Contracts and Leases</u>. A liquidator may assign contracts and leases or reject them. An administrator may operate a company's business pursuant to its contracts and leases, but an administrator does not have assumption or rejection powers. Assumption and rejection may be part of a scheme of arrangement or CVA.

12. <u>DIP Financing</u>. Although new financing may be arranged for a company in the midst of insolvency proceedings, there is no formal process for court approval of the financing and no special statutory rights of a secured DIP lender as compared to prepetition secured lenders.

13. <u>Asset Sales</u>. A liquidator is charged with selling assets and may do so with the court's approval (in a compulsory winding up) or with the creditors' approval (in a creditors' voluntary winding up). However, goods subject to a retention of title clause or assets held on trust will not be included in the company's assets for these purposes. An administrator may sell assets with court approval. An administrator has the advantage of an on-going business that can engage in asset sales on a going-concern basis, rather than on a liquidation basis.

14. <u>"Plan" Options</u>. A "plan of reorganization" may be agreed between a company and its creditors as part of an administration or a winding up or in a "stand-alone" context. The two primary statutory methods for effecting a plan are a CVA and a scheme of arrangement.

15. CVA Process. In a CVA, a company proposes that a nominee consider serving as an intermediary between a company and its creditors. If it accepts appointment, the nominee will decide within 28 days (or a longer period if the court allows) whether meetings between the company and its creditors will take place. There is no statutory stay or standstill in a CVA, but one may be agreed by the creditors. Once negotiated, the creditors vote on the CVA. Creditor approval requires favorable votes by ¾ of creditors (measured by monetary value of claims) and ½ of shareholders (measured by relative value of shares), in each case measured only against those creditors or shareholders casting votes. A company may seek a CVA even if it is solvent, and the CVA need not include all of the company's assets. There are several categories of creditors, such as those holding unliquidated claims, that may not be bound by a CVA. If these claims are a concern, a scheme of arrangement is a potential alternative. A CVA may be approved by a court, but need not be so approved—creditor and shareholder consent is the key. Interested parties may have standing to raise some limited challenges to a CVA, for example challenges that the CVA causes unfair prejudice or contains a material irregularity.

16. Scheme of Arrangement Process. Although scheme of arrangement under Section 425 of the Companies Act of 1985 is similar to a CVA, there are some important distinctions. A scheme of arrangement is more complex and may take more time to implement, but it binds all creditors without exception, making it more powerful than a CVA. The role of the court is greater in a scheme of arrangement and the scheme of arrangement must be sanctioned by the court, making the proceeding more cumbersome but also more compelling in the face of strong creditor resistance.

17. Director Liability. In the UK, there are concepts of "wrongful trading," or a director's continuing to permit the company to do business when the director knows or should know that there is no reasonable prospect of avoiding liquidation, and "fraudulent trading," which involves a director's intent to defraud creditors. Both concepts can give rise to director liability that is in addition to ordinary breach of fiduciary duty liability.

18. Employee Claims. Employees (not automatically including directors) have long been entitled to have four months of arrears of remuneration up to a specified maximum amount, rank as a preferential debt upon the insolvency of the company. Under the Employment Rights Act 1996, certain other payments are deemed to be wages and accordingly rank in priority to other debts. Any remuneration which exceeds the maximum amounts can only be claimed pari passu with other creditors.

19. Recognition of Foreign Judgments and Cooperation with Foreign Courts. In 2000 the EU Council adopted the Regulation on Insolvency Proceedings with effect from May 31, 2002. The Regulation aims to introduce uniform conflicts of law rules for insolvency proceedings and connected judgments (based on principles of mutual recognition and co-operation), however it does not seek to harmonise substantive law or policy between different EU countries. In broad terms, the Regulation provides that main insolvency proceedings are to be opened in the member state where the debtor has the centre of his main interests. These proceedings have universal scope and encompass all of the debtor's assets and affect all creditors, wherever located. The Regulation also provides that secondary proceedings may be opened in one or more other member states. In terms of recognition and cooperation with non-EU countries, the UK is likely (together with countries such as the US and Australia) to adopt the UNCITRAL model on cross

border insolvency in the near future, which will provide uniform legislative provisions to deal with cross-border insolvency and to promote the objectives of co-operation between courts and fair and efficient administration of cross-border insolvencies.