



Phoenixes and Personal Liability

The recent decision of the Court of Appeal in *Churchill -v- Independent Finance Factors Limited (2006)* makes it harder to sell the business and assets of an insolvent company to the incumbent management. It may also lead to directors incurring personal liability where they thought they had followed the rules to avoid this.

Section 216 and Phoenix Companies

Section 216 of the Insolvency Act 1986 was introduced to prevent the “phoenix” phenomenon of directors continuing to trade while leaving a succession of creditors unpaid. The legislation makes it a criminal offence for a director to do this and also makes the director personally liable for the debts of the new company which trades under a similar name.

While prosecutions under section 216 are unusual, anecdotal evidence suggests that there has been an increase in the number of claims made against directors who have re-used a company name in breach of section 216, led, in part, by a number of factoring and invoice discounting companies who have identified this as a way to recover bad debts.

The management team of an insolvent company are frequently the most attractive or even the only possible buyer of the existing business. Unlike independent buyers, the incumbent management team may need the business to continue to preserve their livelihood.

There are three ways in which a name can be re-used:

- Notice can be served on the creditors of the old company after an acquisition from an insolvency practitioner;
- A director can apply to the court for permission to be involved in the new company;

- A company which has used a similar name for more than 12 months before the liquidation can continue to do so.

The 12 month period relates only to the liquidation of the company. If there is a management buy-out from a receivership or an administration, section 216 only becomes a problem if the company goes into liquidation less than 12 months after completion.

The decision in *Churchill -v- Independent Finance Factors Limited (2006)*

Applications to the court are used less frequently than the notice procedure. Until *Churchill -v- Independent Finance Factors Limited (2006)* it was widely believed that the management team could set up a new company, acquire the old company’s name from the insolvency practitioner, and then send the notice to creditors immediately after completion of the sale.

The *Churchill* case decided that this approach does not work. The notice has to be sent before a director of the insolvent company becomes involved in the management of the company buying the business from the insolvency practitioner. If the director is already a director or manager of the purchaser when the notice is sent out, the notice is invalid and the director is then personally liable for all the debts of the new company.

Implications for Insolvency Practitioners

Churchill -v- Independent Finance Factors Limited (2006) makes it much harder to sell the name of an insolvent company to a management buyout team. The MBO team have the following options if they want to trade under a name similar to that of the old company.

- They could apply to the court for permission to re-use the name prior to completion, with no guarantee of success, and delaying completion until the court makes its decision.
- They could buy the name from an administrator or receiver, and monitor the company after completion, making an application for permission to re-use the name before the company goes into liquidation. The purchaser would have to change its name or the director of the old company would have to resign if the application fails.

A sale to an MBO team can be completed without risk or delay if the insolvent company is part of a group, then the management team can use a company with 12 months' trading history under a similar name as the purchasing vehicle.

The notice procedure now only works if the director of the old company is not involved in the management of the buyer until after the notices have been sent out. Notices have to be sent out within 28 days of completion, but the director can become involved with the new company once the notices have been delivered.

It may be possible for the directors of the old company to play no part in the buyer's business or management until after the notices have been delivered to the old company's creditors. This involves a period of several days after completion in which the former managers can have no part in the buyer's business at all. It may make the notice procedure unworkable in many cases, particularly where the business is owner-managed.

Alternatively, the difficulty created by the *Churchill* case may simply encourage MBO teams to use a completely different name.

Paragraph 5.1 of SIP 13 requires insolvency practitioners to ensure that sales to the management are conducted "with due regard to their own and the directors' obligations", which would include section 216.

The IP and his advisers need to think about how to deal with potential problems with the company name as soon as they start serious negotiations with an MBO team.

Liquidators may also need to consider whether a director may be personally liable for the debts of the company which they are liquidating and, if so, whether the creditors need to be informed.

The above is intended as general guidance only and does not constitute legal advice in specific situations and is not to be relied upon as such.

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