Winding-up

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1. Introduction

This chapter focuses on exits by way of a sale by the investment holding company of an operating group and the impact of insolvency and winding-up on that investment vehicle. The sale could arise for any number of reasons. It might be a trade sale, an auction or a secondary buy-out, or it might form part of a portfolio sale or a sale 'forced' by the secured lenders which have partly financed the original buy-out in circumstances where they would otherwise enforce their security over the operating group. Whatever the type of sale, the issues arising from the holding company's insolvency and winding-up will be the same. Investors in the holding company (ie, the private equity backer, management and possibly others) might, and frequently do for tax and other reasons, sell their shares in the holding company directly. In such cases the themes and issues highlighted in this chapter may well hold good and remain of relevance and concern, although this will depend on the type of entity that holds the shares and the relevant laws governing its insolvency. However, given the scope of this chapter, only English law and its application to companies are specifically addressed.

1.1 Why are insolvency law and related considerations of concern on exit?

Insolvency law and related considerations are of concern on exit for two principal reasons:

- For the exit to mark the end of a successful investment, there is a need to ensure that it is not soured by leaving the otherwise solvent holding company – whose board of directors might include personnel employed or engaged by the private equity investor (referred to in this chapter as 'investor directors') insolvent as a result of or in consequence of the exit.
- The exit itself might have been precipitated by or be in circumstances where the operating business, and with it the holding company, is in a financially distressed situation (ie, it is insolvent or close to insolvency).

For convenience, the former scenario is referred to as 'non-distressed' and the latter as 'distressed'.

In each scenario, where possible, the common aim is to give the holding company a 'solvent burial' – that is, to ensure that it is a solvent as opposed to an insolvent winding-up. This is important because of the myriad of issues, both legal and commercial, that flow from insolvency and an insolvent winding-up of the holding company for its directors, its private equity investor and a purchaser (see section 3).

2. Winding-up

2.1 Overview

The Insolvency Act 1986 and associated rules govern the winding-up of companies.[1]

The purpose of the winding-up of a company is to ascertain its liabilities, get in and realise its assets and then apply the proceeds of realisation pari passu in satisfaction of its (unsecured) liabilities. A liquidator is appointed to conduct the winding-up.

A winding-up may be commenced by, among others, the company's members or by the court. Where it is commenced by a company's members, it is referred to as a 'voluntary' winding-up. Where it is commenced by the court, it is often referred to as a 'compulsory' winding-up.[2]

2.2 Solvent winding-up

To commence what is commonly referred to as a 'solvent' winding-up following a sale of the operating group, the directors of the holding company will have to swear a statutory declaration of solvency. Assuming that they can do this and the declaration is made, then if the holding company's members commence a liquidation by passing a special resolution that the company be wound up voluntarily, the voluntary winding-up will be a 'members' voluntary liquidation'.[3] Along with the special resolution, the company's members will also pass an ordinary resolution appointing one or more liquidators. Although, in theory, a solvent winding-up can be commenced by the court, this is unusual and, in practice, a solvent winding-up will be commenced voluntarily after careful planning by the holding company and its private equity investor.[4]

A statutory declaration of solvency is a statement that the directors, having made a full enquiry of the company's affairs, are satisfied that the company will be able to pay its debts in full with interest within a maximum period of 12 months starting from the commencement of the winding-up (which is on the passing of a members' special resolution for the winding-up). The declaration, which must be sworn by at least a majority of the directors, is supported by a statement of the company's assets and liabilities, and must be made no more than five weeks before the passing of the members' special resolution. The careful diligence and planning that the directors will need to undertake in order to assess whether such a declaration can be made will have

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1 The Insolvency Rules 1986.

2 The terms 'winding-up' and 'liquidation' are synonymous and used interchangeably. The other key insolvency proceeding under English law of relevance in this context is administration. The primary objective of an administration is to rescue the company as a going concern. If this is not possible, then the administration may be conducted for the purposes of achieving a better result for the company's creditors as a whole than would be the case if the company were wound up. This is effectively a 'winding-up' through administration. Issues that flow from an insolvent winding-up are also likely to apply in the event that a company enters into administration. Where the consequences and issues arising from administration differ from the winding-up regime, they are noted in this chapter.

3 Section 90 of the Insolvency Act.

4 Section 124 of the Insolvency Act permits the company to apply to the court for its winding-up on the range of grounds set out in Section 122 of the Insolvency Act. These include the ground that the company has resolved by special resolution that it be wound up by the court. This particular ground is rarely used in practice and, in the context of a planned winding-up of an investment holding company following a successful exit, it would be usual for the company to be wound up voluntarily.

to take into account not only the company's actual liabilities, but also, as the declaration covers a future period, its prospective and contingent liabilities.[5] Therefore, in structuring and agreeing the terms of the exit sale, the directors of the holding company will also need to consider carefully the liabilities that will be incurred as a result. To make the declaration, the holding company need not necessarily be 'solvent' in its own right. If a third party has agreed to meet its liabilities, presumably on non-recourse terms to the company, the directors may well conclude that they are able to make the declaration. Realistically, it is likely to be only the private equity investor that could be expected to provide such support if necessary; but the terms of the particular investment fund's constitution may prohibit such support and there may also be issues of commercial precedent which make this undesirable, bringing the structure and terms of the exit sale into sharp focus. A director found to have sworn the declaration of solvency without reasonable grounds will be liable to imprisonment, a fine or both.[6]

2.3 Insolvent winding-up

Perhaps surprisingly, there is no definition of what it means to be 'insolvent' in the Insolvency Act. However, a winding-up will be regarded as an 'insolvent' liquidation if it takes one of two forms. The first is a voluntary winding-up commenced by special resolution of the company's members in circumstances where the directors have not made a statutory declaration of solvency. A voluntary winding-up in such a case is a 'creditors' voluntary liquidation'.[7] Although the members may appoint, by ordinary resolution, one or more persons to act as liquidator, a creditors' meeting must be held within 14 days of the commencement of a creditors' voluntary liquidation; at that meeting the creditors may vote to appoint a liquidator of their own choosing in its place (the creditors' interests being paramount on account of the insolvency).[8]

The second winding-up option – which may be instigated not only by the company's members, but also by others, including its directors and its creditors[9] – is a compulsory winding-up by the court on the grounds that the company is unable to pay its debts. 'Inability to pay debts' is defined in Section 123 of the Insolvency Act. It includes the two classic formulations of 'insolvency' under English law:

- 'cash-flow' insolvency, where a company is unable to meet its debts as they fall due; and
- 'balance-sheet' insolvency, where the value of a company's assets is less than the amount of its liabilities, taking into account its contingent and prospective liabilities.[10]

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5 In this regard the analysis in *BNY Corporate Trustee Services Limited v Eurosail-UK 2007-3BL plc* [2011] EWCA Civ 227 may be useful, even though the case concerned Section 123 of the Insolvency Act.

6 Section 89(4) of the Insolvency Act.

7 Section 90 of the Insolvency Act.

8 In practice, the company and creditor meetings are usually held on the same day, with the company meeting being held first. See Sections 98–100 of the Insolvency Act.

9 Section 124 of the Insolvency Act.

10 In light of recent case law (*BNY Corporate Trustee Services Limited v Eurosail-UK 2007-3BL plc* [2011] EWCA Civ 227, as applied in *Deiulemar Shipping SpA v Transfield ER Futures Ltd* [2012] EWHC 928 (Comm), the 'balance-sheet' description is misleading in that the test, the details of which are outside the scope of this work, is not based on a simple snapshot of the balance sheet. It requires some assessment of future prospects and an assessment of both legal and accounting/financial matters (ie, it is not solely an accounting test).

Although there are important differences between a creditors' voluntary liquidation and a compulsory winding-up on grounds of inability to pay debts, the effects of each which are of concern in the context of the matters addressed in this chapter are the same, and as such are referred to collectively as 'insolvent winding-up'.

2.4 Insolvent winding-up: EU and other overseas law

The impact of EU law on English insolvency law has been profound. One of the many important developments has been in the area of cross-border insolvency, with the entry into force of the EU Insolvency Regulation (1346/2000).[11] The EU Insolvency Regulation allocates and regulates insolvency jurisdiction between EU member states[12] in relation to the insolvency of entities other than (among others) insurance undertakings and credit institutions.[13]

While the impact on English insolvency law of the EU Insolvency Regulation and the detail of the regulation are relatively complex, the following points should be noted in the context of the winding-up of an investment holding company following a sale:

- As the EU Insolvency Regulation is concerned only with the allocation of insolvency jurisdiction between the courts of member states, it has no bearing on the commencement or conduct of a company's solvent winding-up by way of a members' voluntary liquidation and does not impose the law governing such a winding-up. As a matter of English law, the law of the jurisdiction of a company's incorporation or registration will be the proper law governing its solvent winding-up.[14]
- Where a holding company is insolvent and has either its centre of main interests (COMI)[15] or an establishment[16] in England, then it could be subject to an insolvent winding-up in England either by the court or pursuant to a

11 The Commission published its proposal to amend Regulation 1346/2000 on 12 December 2012, together with a number of accompanying reports. On 5 June 2015, the amended or 'recast' Insolvency Regulation was published in the Official Journal of the EU, as Regulation (EU) 2015/848 of the European Parliament and of the Council of 20 May 2015 on insolvency proceedings (recast). This concludes the legislative process. The majority of the provisions of the Recast Regulation will apply from 26 June 2017.

12 Excluding Denmark, which has opted out of the EU Insolvency Regulation. Therefore, references in section 2.4 to 'member states' should be taken to exclude Denmark.

13 The excluded entities are subject to separate regimes and legislation.

14 Brussels Convention (1982) Article 16(2) and Lugano Convention (1988) Article 53; Civil Jurisdiction and Judgments Act 1982, Section 43(2); EU Council Regulation 44/2001, Article 22(2); SI 2001/3929, Sch 1, para 10.

15 'COMI' is not defined in the EU Insolvency Regulation, but there is a rebuttable presumption that it is in the same jurisdiction as the registered office and it is generally understood to correspond to the place where the business conducts the administration of its interests on a regular basis and is ascertainable by third parties (paragraph 13 of the preamble to the EU Insolvency Regulation (Council regulation (EC) No 1346/2000). NB this is to be replaced by Regulation (EU) 2015/848. The Recast Regulation entered into force in principle on 25 June 2015, and the majority of its provisions will apply from 26 June 2017 (Article 92, Recast Regulation)).

16 'Establishment' is defined by Article 2(h) of the EU Insolvency Regulation and Article 2(10) of the Recast Regulation as being any place of operations where a debtor carries out or has carried out in the three-month period prior to the request to open main insolvency proceedings a non-transitory economic activity with human means and assets. In general terms, companies that are holding vehicles in the strict sense are unlikely to have an 'establishment' and will have only a COMI, although each case will turn on its own facts.

creditors' voluntary liquidation. Therefore, it should not be assumed that English insolvency law and its effects are irrelevant because the holding company is registered or incorporated outside, or has its seat somewhere outside, the United Kingdom. If the group or holding company has connections with the United Kingdom – be they operations, creditors (suppliers, financiers or otherwise) or customers or directors who are based and work in the United Kingdom – then careful consideration must be given as to whether the holding company has its COMI or an establishment in England.

- This may be particularly relevant in the context of the anti-avoidance provisions contained within the insolvency legislation and directors' duties and liabilities, where the directors of a company incorporated in one jurisdiction may be subject to insolvency proceedings in another jurisdiction, and as such may also be liable to directors' duties in that jurisdiction.[17]

In addition, companies with their COMI outside of the European Union may be wound up in England under Part V of the Insolvency Act where, among other things, they have a sufficient connection with the United Kingdom.

- Further, under Section 426 of the Insolvency Act at the request of a court in a relevant country or territory (these are prescribed by statutory instrument and include the Cayman Islands, Gibraltar, Hong Kong, Ireland and the Virgin Islands) the English court may grant assistance to the requesting court, which may include the opening of English proceedings and the application of English law or alternatively apply the relevant overseas law.
- In addition, under the Cross Border Insolvency Regulations 2006 foreign insolvency proceedings may upon an application to the court be recognised in England and certain relief may be granted, which includes the anti-avoidance provisions included in the Insolvency Act 1986.

This is an extract from the chapter 'Winding-up' by Philip Hertz, John MacLennan and Gabrielle Ruiz in Private Equity Exits: A Practical Analysis, Second Edition*, published by Globe Law and Business.*

17 See *Kornhaas v Dithmar* C-594/14 and in the context of anti-avoidance measures see *Nike European Operations Netherlands* [2015] EUECJ C-310/15.