



## To Disqualify or not to Disqualify

In the December 2006 issue of its newsletter, the Insolvency Service heralded the decision of the High Court to disqualify the directors of Modern Living (UK) Ltd for the maximum period of fifteen years.

The Insolvency Service had been pursuing the Luqman brothers, Shaid and Waheed for some time, following the demise of their company which went into administrative receivership in 2001 owing £1.56 million.

The case centred around, falsification of debtors, disparity in turnover figures and cheques for hundreds of thousands of pounds made out to cash which were, according to the directors, payments to suppliers in Pakistan.

So long did this case take to bring to a conclusion, that there was time for Shaid Luqman to be named 2004 UK Young Entrepreneur of the Year based on the performance of another of his companies, Lexi Holdings Plc, which ironically went into administration in October 2006 on the day after the disqualification order was made!

Surely there has not been a finer vindication of the 1986 Insolvency Act which gave the Insolvency Service the power to prevent dishonest businessmen from operating under the protection of limited liability?

Of course not all directors subject to disqualification orders have been guilty of such spectacular dishonesty.

Most have been found guilty of lesser offences such as trading whilst insolvent and trading at the expense of the Crown by not paying over PAYE deductions and VAT.

The increasing success of the Insolvency Service has led to over 1000 unsuitable directors being disqualified in the year 2005/06 for periods of between 2 and 15 years.

Sadly this is all set to change following a cut in the Insolvency Service budget.

Top priority cases will still be pursued; so dishonest directors will not be able to rest easy, nor will those who continue to trade at the expense of the Crown or recklessly risk creditors or investors money.

However, for lesser offences, those which would attract disqualification orders of between two and four years, it would seem that there will be insufficient funding available.

It is estimated that these cuts will allow around 500 directors per year to escape disqualification and successful prosecutions will fall to a level last seen under the Conservatives.

Just what impact these measures will have on the business community remains to be seen but undoubtedly we will all have to rely upon the inherent honesty of directors if matters are not to take a turn for the worse.

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# A Cautionary Tale

In this brave new world of IVA's, it is easy to forget sometimes just how costly it can be to ignore one's creditors. Simply by failing to deal with a problem early enough, coupled perhaps with an unwillingness to seek appropriate professional advice, can lead to even greater financial disaster.

The experience of Mr. and Mrs. Farrell is a case in point.

Mr and Mrs Farrell were made bankrupt in the summer of last year on joint debts of £11,000. This sum was comprised of council tax arrears, small utility bills and a loan in the region of £6,000.

Prior to his bankruptcy, Mr Farrell was signed off on long-term sick leave having suffered a mental breakdown at work. His wife was caring for their two small children and also worked part-time for a local Primary Care Trust as a student nurse. While Mr Farrell was signed off work he was on reduced pay and as a result of this he and his wife were not earning sufficient between them to cover all their normal outgoings. Things became worse when Mr Farrell eventually lost his job and spent a period out of work receiving only minimum State benefits.

It was at this time that the arrears of council tax and mortgage repayments began to accumulate.

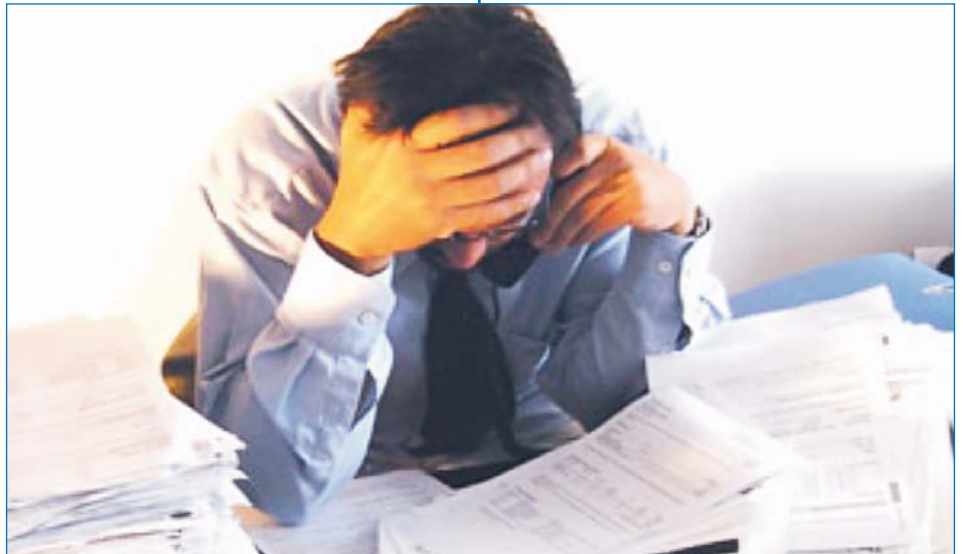
During this difficult time, the Farrells borrowed money from a finance company to help cover their household expenditure but found that they could not meet the loan repayments once Mr. Farrell had lost his job. Faced with mounting arrears, the finance company quickly assigned its debt to a specialist debt collection company which lost no time in issuing bankruptcy petitions against the Farrells.

Unfortunately, the Farrells' misfortune was compounded when during this period Mrs Farrell also began to suffer from ill health. As a result, she had to undergo a serious bowel operation.

Naturally, Mrs. Farrell then had to

spend some time recuperating from the operation, which meant that she too was on reduced pay for a spell.

Shortly after they had been made bankrupt, the mortgage company threatened to take proceedings for possession of the family home to recover the repayment arrears, but, fortunately, a relative came to the rescue and paid off the amount due which enabled them to retain their home.



This was only a temporary reprieve as the Farrells still remain bankrupt and, therefore, have no control over their assets. The equity in their family home of £44,000 must be realised to pay off the bankruptcy costs and their creditors.

For those unaware of the extent of bankruptcy costs, they comprise the Official Receiver's costs, the petitioning creditor's costs, the Trustee's fees and disbursements, and VAT. The disbursements will include valuation fees and legal costs associated with possession of the Farrells' home, along with any other miscellaneous property expenses (e.g. bailiff's and insurance cover payable following possession).

As things stand, the total costs would amount to over £17,500 per bankruptcy. In addition, statutory Department of Trade fees are payable on amounts realised which, for these two bankruptcies, will amount to over £7,000.

So, having both been made bankrupt

for a joint debt of £11,000, the Farrells now find that they are additionally liable for costs of £42,000. Not only is this extremely bad news for the Farrells, it also prevents the creditors receiving full repayment of their debts. This is because the bankruptcy costs have to be paid first; which means that of the equity of £44,000 in the Farrells' home, there will be only £2,000 available to the creditors for whose benefit the bankruptcy proceedings were initiated in the first place.

This case clearly shows how important it is for people with personal debt problems to contact a professional at the earliest possible opportunity to avoid getting into the same situation as the Farrells.

Fortunately for them, Benedict MacKenzie is now advising the Farrells to enter into IVA's with their creditors. This will enable them to pay off the bankruptcy costs incurred to date and their creditors in full. This will leave them an additional £12,000 in pocket which would have been payable had they remained in bankruptcy. As part of this exercise, we will also assist them with their applications for annulment of their bankruptcies.

Of course, had the Farrells consulted us when they first experienced financial problems, there would have been no bankruptcy, therefore no bankruptcy costs, and by re-mortgaging under the protection of an IVA at the outset, they would have retained the majority of the £44,000 equity in their home.

# Falling Foul of Dividends

Queensway Systems Ltd (in liquidation) v D & H Walker is another recent case which highlights the consequences of improperly declaring dividends to directors.

Mr. and Mrs. Walker were the directors and shareholders of Queensway and apart from a salary of £300 per week paid to Mrs Walker all drawings by them were treated as loans in the company's accounts. These loans accumulated year on year and were in some years reduced by the declaration of dividends.

In 2001 the company started to have severe financial problems. HM Revenue and Customs assessed the company for £38,000 in January and in March the management accounts revealed a loss for the month of £26,000. At the end of March Mr. Walker declared a dividend of £190,000 (to be paid from profits and reserves) at a directors' meeting where he was the only attendee.

The company's financial position continued to deteriorate through the year and eventually it was liquidated in October 2001.

Once appointed, the liquidators challenged the dividend payments to the Walkers on the grounds that there was no proper board meeting convened to approve the declaration of the dividend in the sum of £190,000.

The liquidators had identified a sum of £147,000 paid to the Walkers since March 2001 which they were seeking to recover, on the basis that these were unlawful loans under section 330 of the Companies Act 1985.

The Court found that Mrs. Walker knew that payments had been made for the benefit of both herself and her husband and despite the fact that she took no part in the running of the company, other than to receive her salary of £300, she was under an obligation, as a director, to ensure that the payments were justified.

As such, the Court deemed that Mrs. Walker had authorised the transaction in contravention of s.330 and therefore was liable to account to the company for the monies which she had received.

In this, she was jointly and severally liable with her husband to indemnify Queensway Systems from the £174,000 loss suffered. She had failed in her duty of care as a director and was liable for a breach of duty.



The Walkers argued that they had acted honestly and reasonably and as such sought relief under section 727 of the Companies Act 1985 that they had not committed a breach of duty.

The Court found no evidence of dishonesty but would not concede that the Walkers had acted reasonably and therefore in the interests of the company's creditors no relief was given.

In our experience, this is not an unusual set of circumstances. In many small companies where husband and wife are the directors and shareholders, there are often no properly convened meetings of directors and often no meetings at all. The practice of taking dividends to reduce tax payable is also commonplace and when operated properly, highly beneficial.

Unfortunately, by paying scant attention to the duties imposed upon them, directors can leave themselves

exposed. There was no excuse for Mrs. Walker; even though she was not involved in running the business, as a director she had responsibilities. If nothing else, the Queensway case highlights the dangers involved where directors' loans and dividends are concerned and the huge financial repercussions of getting it wrong.

## Money on Credit & IVA's for Free

In an exciting new development in the field of insolvency, a charity, the Consumer Credit Counselling Service (CCCS), has announced that it will be offering free IVA services to debtors.

Their aim is to reduce the amount of people who are forced to use companies which charge fees for advising debtors and acting as nominee and supervisor in respect of IVA's.

The service was scheduled to start in April this year although as we go to press, there are no details as to how the CCCS proposes to operate this new system. We can only presume that they have lined up a number of Licensed Insolvency Practitioners who are willing to act for no remuneration.

Whilst we share the CCCS's concern that many people are entering into IVA's without being made aware of the long-term consequences, we seriously doubt that the Charity will be able to provide an efficient and accessible service.

With personal insolvencies approaching 10,000 per month, just how many will be turning to the CCCS for financial salvation once the word is out that salvation is now free and how long will it take for each individual to be seen?

Whilst struggling to suppress all cynical inclinations, we predict that by comparison, the National Health Service will be seen as a model of efficiency.

# Another Nasty Sting in the Tail

Attentive readers of 'Rescue' may well recall an article in issue 10 under the heading 'A Nasty Sting in the Tail'. This highlighted the dangers of acting in contravention of Section 216 of the Insolvency Act and for those readers with short memories, can be summarised as follows:

A director of a liquidated company subsequently acted as a director of a successor company which traded under a prohibited name for a period of five years until it too was liquidated. Unfortunately, the successor company went down owing HM Revenue and Customs £87,000 and HMRC were quick to pursue the director personally for repayment of the debt as she was in contravention of Section 216. In the article we outlined the ways in which the director could have avoided personal liability which were:

1. Where the successor company buys the business or most of its assets from the liquidator.
2. Where the director obtains leave of the Court to use a prohibited name.
3. Where the successor company has been trading for a year prior to the liquidation of the subject company.

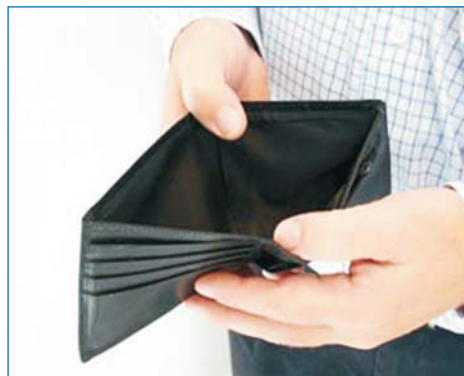
Since 1986, directors have been able to rely upon the protection of the three exemptions above where they have been involved in a company that traded under an otherwise prohibited name. Indeed it was fairly common for directors of successor companies to buy the business, or most of the assets, from the liquidator of their former insolvent company. In a large percentage of cases they were the only realistic bidders.

For twenty years these statutory exemptions have been understood and

utilized successfully until a particularly capricious decision was reached in the case of Churchill v Independent Factors and Finance Limited.

To qualify for exemption under 1 above, rule 4.228(2) of the Insolvency Rules states that notice must be given within 28 days from completion of the arrangements, to all creditors of the insolvent company and it must specify—

- (a) the name and registered number of the insolvent company and the circumstances, in which its business has been acquired by the successor company,
- (b) the name which the successor company has assumed, or proposes to assume for the purpose of carrying on the business, and
- (c) any change of name which it has made, or proposes to make.



The rule goes on to state, under (3), that the notice may name a person to whom Insolvency Act section 216 may apply as having been a director or shadow director of the insolvent company, and give particulars as to the nature and duration of that directorship, with a view to his being a director of the successor company or being otherwise associated with its management.

The decision reached in the Churchill Case hinged upon the interpretation of the words 'with a view to his being a director.' The Court held that this phrase should be interpreted as, 'with a view to his becoming a director.'

Consequently, the notice to creditors will only be valid if it is sent out before the director concerned becomes



involved in the successor company. In most cases this will be very difficult to manage and the only alternative will be to apply to the Court for leave to act as director or to trade under a completely different name.

The effect of this decision is that an existing director of a successor company will not be protected under the first exemption above and could subsequently be held personally liable for the debts of the successor company if it too went into insolvent liquidation. It is interesting to note that under Rule 4.228 (2) the prescribed information must be given but under Rule 4.228 (3) the information covered by that paragraph may be given.

In the event that no information was given under 4.228 (3), would the decision in the Churchill Case have been reached as it would then seem that the phrase 'with a view to his being a director' would not be available to the Court for (re)interpretation?

Or would the Court simply have decided that the information under 4.228 (3) should have been given, despite the use of the word 'may' which implies an option to either provide or not provide that information?

Whilst this may be fascinating from an intellectual point of view, perhaps we should spare a thought for those directors who had previously relied upon 4.228 and may now find themselves financially exposed.

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