

The UK bankruptcy and insolvency laws have developed dramatically over the centuries, says *Sally Morgan* – in some ways but not in others



The first English bankruptcy statute was in 1542, when bankrupts were generally seen as being evasive and fraudulent. The legislation contained severe penalties, and there was no discharge from bankruptcy until 1705. Even then, things worsened and some discharged bankrupts were bankrupted several times.

The 1705 law was a turning point; however, there was still no disclosure of assets. Some bankrupts were reckless and would indulge in several overseas businesses and much overtrading. The 1705 Act was amended and came into force as 'An Act to Explain and Amend. An Act of the Last Session of Parliament for preventing frauds Frequently Committed by Bankrupts'. But this moralistic-sounding document actually enabled more people to declare bankruptcy because they were able to discharge all of their bills.

Creditors were angry about this and lobbied Parliament about the means by which bankrupts hid their wealth. This forced the introduction ten years later of the creditor's consent to discharge, which is known as the first step in creditor control in business and demonstrates that, from 1542 to 1715, bankrupts were very much seen as fraudulent.

Today there is the Insolvency Act 1986. This encourages the identification of financial problems at an early stage, so that a company with a sound financial base but a poor cash flow can be rescued to avoid liquidation.

Administration begins by freezing the assets of a company. Shareholders have a say and provide one obstacle to such action, while creditors may apply to the court under Section 123 of the Insolvency Act 1986 to make a company insolvent.

Section 123 deems a company unable to pay its debts:

- ❑ if a creditor is owed more than £750 and has served a written demand to the company to pay the amount due, and if the company has failed to pay for three weeks or has failed to come to some other arrangement to the creditor's 'reasonable satisfaction'; or
- ❑ if execution or other process issued on a judgement or other court order in favour of the creditor is returned unsatisfied in whole or in part; or
- ❑ if it is proved that the value of the company's assets is less than the amount of its liabilities, taking into account its contingent and prospective liabilities.

Let us look at creditors and at 'creditor control'. There are court cases in which it was decided that directors should have regard to the interests of creditors. But this was not a ruling – so there is no law to state that directors of companies have a legal obligation to creditors. But a creditor could establish a *prima facie* case of fraud on the part of those in control of the company.

Equitable fraud

Fraud can extend beyond its normal context to embrace an apparent lack of probity; this is called 'equitable fraud'. An example of this is the case of *Daniels v Daniels* [1978] 2 WLR 73, where it was not fraud that was alleged, but a sale of a corporate asset to a director at a price which appeared to be substantially below its market value. The court held that this action fell within equitable fraud, since the benefit to this director was £115,000.

A more recent case is *Bednash v Hearsey*, Court of Appeal, 15 May 2001, where excessive remuneration to the pension fund

while the company went into creditors' voluntary liquidation was held to be the cause of the liquidation – hence, arguably, an equitable fraud.

The insolvency law today is much more detailed and documented than in 16th century England. Now there are definitions for secured and unsecured creditors and strict rules on who is not paid when a company is insolvent. For example, the following debts are non-provable:

- ❑ claims for unliquidated damages in tort (damages for breach of contract and certain debt are provable on an estimate);
- ❑ debts incurred after notice was given by the administrator;
- ❑ contingent debts when the value cannot be fairly estimated;
- ❑ debts after the six-year period as per the limitation period in the Statute of Limitation;
- ❑ illegal debts (a sale of land without being in writing is illegal, for example);
- ❑ deferred debts that are provable, but only after all other provable debts have been paid with interest; and
- ❑ in the case where a person sells a company and receives a share of the profits as payment, it is treated as a deferred debt – the ex-owner must wait until all other provable debts have been paid with interest.

In general, if a debt cannot be proven, the creditor has no rights. Unlike the minority shareholder, the creditor has no right of attendance at a company's meetings or any influence over decisions. It is as if creditors' rights have hardly progressed since 1542 – in stark contrast to those of bankrupts.

Sally Morgan is a solicitor and lecturer in law at the University of Liverpool.