

PRACTICAL GUIDANCE FOR THE DIRECTORS

This section sets out practical guidance for you as a director. It is important not only that the steps explained below are carried out, but that they are seen to be carried out, since the actions of the directors will be carefully scrutinised by any future liquidator of the Company for the reasons set out above. It is therefore important for the directors both collectively and as individuals that whatever actions they take in the interests of the Company and its creditors are fully documented.

The tests for solvency

The directors should be aware at the outset of the implications of continuing to trade when the Company is technically insolvent, that is when it is unable to pay its debts within the meaning of s.123 of the Insolvency Act 1986. At least by the time this stage is reached, the directors' duty to have regard to the interests of creditors will have arisen. Indeed, where there is a serious question as to the Company's solvency, directors will be under duties to creditors. If the Company is insolvent, the following dangers should be noted:

the Company is in danger of being compulsorily wound up;

transactions entered into by the Company are at risk of being set aside by the court as undervalues or preferences;

an event of default may occur for the purpose of loans to the Company;

the termination of other commercial contracts and agreements (such as joint ventures) may be automatically triggered; etc.

It is therefore important for the directors of the Company to be aware of the following tests

and to be certain that the Company does not fail them when going through a difficult period.

A company should be regarded as unable to pay its debts whenever it is either:

- unable to pay its debts as they fall due (“cash flow insolvency”); or
- the value of the company's assets is less than the amount of its liabilities, taking into account its contingent and prospective liabilities (“balance sheet insolvency”).

A company is deemed to be unable to pay its debts as they fall due if either:

- a creditor owed more than £750 has served a statutory demand at the Company's registered office and the debt has not been paid for 3 weeks thereafter; or
- execution of a judgment or other court order remains unsatisfied, i.e. following a bailiff's or sheriff's officer's visit.

In addition, the directors need to remain satisfied that there is a reasonable prospect that the Company will avoid insolvent liquidation in order to avoid potential liability for wrongful trading (see section 2 above). If they cease to hold the view that there is a reasonable prospect of avoiding liquidation, they come under a duty to take every step to minimise losses to the Company's creditors.

Accordingly, the current financial position and the prospects of the Company should be kept under close scrutiny, and in particular the directors are recommended to take the actions set out below.

Advice

In order to assess properly the various alternatives open to the Company, all the directors should ensure that they have access to proper financial commercial tax and legal advice as necessary dependant upon the circumstances. It may be essential to involve auditors or independent advisers in discussions on the financial position of the Company. In addition, a

team may need to be assembled to deal with discussions with the company's bankers and other lenders. The Company may have existing advisers who should be involved in this and the formulation of a strategy to avoid insolvency. An assessment should be made of each and every act/omission by you as a director to consider whether any proposed transaction could be vulnerable as a preference or for some other reason (see section 3 above). It may also be appropriate for the Company to retain an Insolvency Practitioner to advise the Company on the alternative strategies.

The directors either individually and/or collectively may wish to take advice individually in view of the personal risks involved in management of a company approaching insolvency. That is what you have done in seeking this advice from us at this stage.

Monitoring the financial position of the Company

The director/s should be able to assess regularly the Company's financial position, in order to assess whether the Company is solvent, and to assess its prospects of avoiding insolvent liquidation. This will generally involve the preparation of regular balance sheets, cash flow projections, and other current financial information.

The director/s should establish a procedure to keep all the director/s informed of the financial position and prospects of the Company. This will generally involve frequent board meetings to consider the implementation of a strategy and for the directors to satisfy themselves that, taking into account their duties to creditors (and shareholders and employees), the Company may properly continue to trade. Where appropriate, the auditors should be involved in preparing or reviewing the cash flow projections and the current financial information.

Formulating a viable strategy

In assessing the prospects of the Company avoiding insolvent liquidation, the director/s will

be relying upon a strategy for restoring the Company to a healthy financial position and avoiding a formal insolvency proceeding. In general terms the strategy may include one or a number of the following:

- different trading strategies;
- disposals;
- maximising existing asset values;
- cutting overheads;
- delaying capital investment;
- further finance (possibly with a grant of security);
- converting debt to equity, converting short-term debt to long-term debt, or raising new equity;
- a debt issue; or
- an informal arrangement with major creditors, or scheme of arrangement or voluntary arrangement.

It is important that this strategy has the support of the board (the full board if possible), that its viability is reviewed by appropriate advisers, and that its implementation is fully monitored.

Provided the director/s are satisfied that the current strategy is reasonable and that it offers a realistic solution to the Company's financial problems, then the Board is entitled to pursue this without taking more immediate steps to protect the Company's creditors.

As a minimum, at each board meeting, the director/s should review the strategy and confirm that, in their view, there is a reasonable prospect of avoiding insolvent liquidation. They should reconsider the various assumptions underlying the strategy and confirm that in their view they are still reasonable. As part of the strategy the board may have committed the Company to cutting overheads, delaying capital investment, relocating premises, selling part of the business, procuring fresh equity etc. At each meeting, the board will need to be updated on the extent to which steps to be taken under the strategy are being fulfilled and whether the underlying assumptions (e.g. as to value of properties etc) are still valid.

Where appropriate, advisors should be asked to provide assistance in preparing the paper. The director/s should not proceed unless the appropriate advisers are prepared to confirm that the strategy has a reasonable chance of success. Where the strategy involves a programme of disposals, or the sale of key parts of the business, the financial advisers should be asked to give their view upon the real prospects of successfully concluding a disposal at the values estimated. This may be a difficult exercise but, if the director/s view as to the prospect of avoiding insolvent liquidation depends upon disposals, it is important that the prospect of these disposals being successfully concluded is independently assessed and confirmed as reasonable.

Holding regular meetings

Board meetings should be held at regular scheduled intervals. All the director/s should endeavour to be present in person. Detailed minutes should be kept of all meetings and circulated in a timely manner. Additional meetings should be called as and when new significant events occur. Briefing papers should be circulated prior to all such meetings to facilitate an informed discussion on the matters in hand. Absent directors should be informed as soon as possible of critical decisions taken at Board Meetings.

Directors of a company will of necessity have different skills and specific functions to perform. It is important to ensure that all the directors are kept fully informed of the progress or otherwise which is being made and, in particular, it is generally helpful if non-executive directors are fully informed and involved in the rescue strategy.

It is in order for specific aspects of the strategy to be delegated to Committees of the board or individual directors but the board as a whole should ensure that Committee discussions are reported on a regular basis and should not hesitate to request additional information if thought necessary.

Valuation problems

The question may arise as to whether, in valuing the Company's assets, the director/s are still entitled to assume a going concern valuation, rather than valuation on a break-up basis. If the director/s are satisfied there is a reasonable prospect of avoiding insolvent liquidation, the directors may be entitled to make valuations on a realistic going concern basis. However, for assets which are to be sold, the valuation should be the price which may realistically be achieved on sale. Where assets are to be retained, the director/s may make a going concern valuation but need to be aware of the extent to which current market conditions may have operated to reduce the value of assets as stated in the last statutory accounts. Discussions with the Company's auditors and/or financial advisors/bookkeepers may be helpful on this point.

Keeping major creditors informed

Information to be released to creditors should be carefully discussed with, and in appropriate circumstances presented by, the company's advisers. Where the strategy to be implemented requires creditors' support (principally the lending banks although this will vary depending upon who are the key stakeholders in the business') a careful and clear presentation is required.

Reviewing Financial Obligations

The board should continually monitor the Company's financial situation and ensure that the Finance Director and Company Secretary are aware of the need continually to review:

- the maintenance of capital imposed by statute;
- the borrowing restrictions imposed by the Company's articles of association;
- the financial covenants in its loan documentation; and

- any regulatory requirements affecting the Company;

and if there is any possibility of a breach, to ensure that appropriate action is taken.

INSOLVENCY PROCEDURES

The following is a brief summary of the insolvency procedures available to the Director/s.

These will need to be reconsidered when (and if) you have confirmed that the Company is insolvent. We can provide more detailed advice at that time, but it is perhaps appropriate for you to have a general understanding of these at this time.

Administration order

The directors, the company or any one or more of the company's creditors can apply to the court for an administrator to be appointed under an Administration order. In making such an order the court must be satisfied that:

- the company is or is likely to become unable to pay its debts; and
- that the administration order is reasonably likely to achieve the purpose of administration.

The purpose of administration is the performance by an administrator of his statutory functions with the objective of:

- rescuing the company as a going concern; or
- achieving a better result for the company's creditors as a whole than would be likely if the company were wound up (without first being in administration); or
- realising property in order to make a distribution to one or more secured or preferential creditors.

An administrator's role is to avoid immediate liquidation and a sharp reduction in realisable value of the Company's assets.

The effect, and great advantage, of an administration order is that, while it is in force:

- the Company cannot be wound up;
- no legal proceedings can be taken against the Company; and
- a receiver cannot be appointed by a charge-holder

Administration is nevertheless a process intended to benefit creditors generally. A charge-holder entitled to appoint an administrative receiver can block the application for an administration order. Once an administrator has been appointed he will take over The Company from the directors in the day to day management of the company. This will relieve the directors from taking the critical day to day decisions and accordingly minimise any risks from that point on.

Voluntary arrangements

The voluntary arrangement procedure is generally used where a liquidator or an administrator has been appointed but may be used in other cases by directors. A liquidator or administrator of a company (or where there is no liquidation or administration order, its directors) may propose a composition in satisfaction of its debts, or a scheme of arrangement of its affairs. The implementation of the arrangement is supervised by a qualified insolvency practitioner. This is a relatively simple procedure which may require meetings of shareholders and/or creditors but not class meetings or the approval of the court. It can therefore be of assistance to small and medium sized companies which urgently need a composition or moratorium without having to follow a more complex and time-consuming procedure. However, until the arrangement takes effect there is no moratorium to prevent creditors from enforcing their rights and so for that reason is often used in conjunction with an administration order which creates a moratorium from the date of the order.

An alternative procedure is available under section 425 of the Companies Act 1985 whereby a scheme of compromise between a company and its creditors can be approved by the court.

Such a scheme will be binding on all creditors but does not otherwise create a moratorium. In practice a voluntary arrangement or administration order is likely to be a more appropriate solution for the Company.

Voluntary winding-up

There are two types of voluntary winding-up. Both have the same end result in that the life of the company is brought to an end.

The first type is a members' voluntary winding-up which depends on a declaration of solvency being sworn by the directors to the effect that they have made a full enquiry into the company's affairs and have concluded that the company will be able to pay all its debts together with interest at some time within 12 months from the date of the declaration. The company, at a general meeting, must pass a special resolution to wind the company up and must appoint an Insolvency Practitioner as liquidator.

The other type of voluntary winding-up is a creditors' voluntary winding-up. This is commenced by the shareholders passing an extraordinary resolution that the company cannot by reason of its liabilities continue its business and that it is advisable to wind up. In this case the creditors' wishes regarding the appointment of the liquidator and the conduct of the winding-up generally override the shareholders' wishes.

In the case of a members' voluntary winding-up the wrongful trading provisions will not apply as the company is not in insolvent liquidation. In a creditors' voluntary winding-up only the directors' conduct prior to the winding-up resolution being passed is relevant when considering the wrongful trading provisions.

Compulsory winding-up

Unlike a voluntary winding-up a compulsory winding-up can be commenced without the involvement of the Company's shareholders. A petition is filed at court, and at a hearing some weeks later the court will decide whether to make a winding-up order. If it does, the company is then in liquidation.

A petition will usually be filed by a creditor, but it is also open to the company, certain shareholders, and the directors to do so. If the directors feel that this is the best route for the company a unanimous resolution of the board should be obtained. In most cases, however, a voluntary winding-up or petition for an administration order is likely to be a more appropriate course of action.

A petition can be applied for on the ground (inter alia) that a company is unable to pay its debts. This can be shown by failure to comply a statutory demand for payment of a debt exceeding £750 or by showing that the Company's liabilities exceed its assets. Wilful failure to pay a debt has also been held to be sufficient evidence of inability to pay.

The consequences of a winding-up petition being filed are that disposals of property will be invalid from the date of filing the petition if a winding-up order is ultimately made. Hence the company's cheques will be dishonoured immediately. If a winding-up petition is filed the directors will wish to consider whether to convert to the administration procedure or a voluntary arrangement. Other courses of action include paying the debt or challenging the order, but these steps may constitute giving a preference and/or wrongful trading.

Receivership

A receiver or administrative receiver(pre 15 September 2003 debenture only)or administrator will be appointed by a charge-holder under a fixed or floating charge granted by the Company. Typically the Company will be served with a demand for repayment of the monies due, which will be followed within hours by the appointment. Alternatively the Company may

invite the charge-holder to appoint a receiver. An administrative receiver will be appointed under a floating charge over the whole or substantially the whole of the Company's property and has wider statutory powers than a receiver. The primary duty of a receiver or an administrative receiver is owed to the charge-holder (subject to the rights of prior charge-holders). His main function is to realise the Company's property and to apply the proceeds to satisfy the debt owed to the charge-holder. He will have powers to manage the Company's business and to dispose of the Company's property.

The consequences of the Company being placed in receivership are that the Directors will be relieved of their power to manage the Company's affairs, though they will remain subject to their statutory duties. An administrative receiver has powers to obtain information from officers of the Company and can examine persons capable of giving information concerning the Company or its property. It is usual for a company to be placed in liquidation at the end of receivership.

SUMMARY

Practical considerations

When considering the possible relevance and impact of the various provisions referred to in this letter, you, should:

Ensure that all the deliberations of the board are fully minuted thus ensuring that a future liquidator or administrator can see what attempts the board or individual directors took to protect the company's creditors;

Carefully consider the company's ability to pay before arranging for the receipt of any further goods or services on credit and the board should, on a regular basis, review the company's financial position. These reviews should be fully minuted.

You should also make your opinion known to all your fellow directors, preferably by means of a full board meeting. For your own protection you should ensure that the board minutes for that meeting fully describe your views and your reasons for holding those views;

If your fellow directors refuse to accept the position then you should take no part in incurring further indebtedness and you should continue to point out your opinion at every opportunity and, as a last resort, if your views are still not accepted, you should consider resigning. However, it should be noted that mere resignation by itself will not necessarily enable you to avoid liability under the various provisions referred to above as the court could take the view that any director acting in this manner is merely shirking his responsibilities to the Company and its creditors rather than take "every step" to minimise potential losses to creditors.