KEY POINTS

- Sections 216 and 217 of the Insolvency Act 1986 go further than preventing phoenixing as they catch any person who merely re-uses the name of Oldco, following Oldco entering insolvent liquidation.
- The potential liability could jeopardise a financing project or group restructuring, for instance where Oldco's name is identical to the brand name of the product which NewCo manufactures.
- The court will not grant blanket permission to use what otherwise may be a prohibited name under s 216, so any application for permission should be narrowly drawn.

Author Tim Carter

Beware! Phoenix legislation may extend beyond "scoundrel" directors to frustrating finance/restructuring projects

This article examines what is meant by phoenixing and the provisions – ss 216 and 217 of the Insolvency Act 1986 (IA86) – which are designed to curb this practice, together with how any director who might be caught may be able to avoid criminal and civil liability. It further focuses on the far-reaching implications this legislation may have on "innocent" directors and the (surmountable) hurdle it might have for fund-raising and restructuring projects that a company may typically undertake. Finally, it explores in more detail a recent case in which such issues arose, the way that the author tackled them and summarises the takeaway points.

THE "PHOENIX PHENOMENON"

For the ten years after their introduction by IA86, ss 216 and 217 were little used. However over the past ten years this has all changed and their profile raised, having been regularly used by creditors (especially HM Revenue and Customs) as a debt recovery tool and by being the subject of judicial scrutiny with the resulting plethora of reported case law.

Their introduction originally sought to combat the "phoenix phenomenon" by protecting the public from unscrupulous directors, who habitually transferred the business of their failed old company (OldCo) to a new company (NewCo), leaving the debts of OldCo behind. Often, these directors would operate from the same address and use the same or a similar name for NewCo in order to cash in on any goodwill which OldCo, or its trading name, may have had. Creditors would therefore easily be confused and unbeknown to them, whilst trading with NewCo, would be unable to recover the debts owed to them by OldCo, which typically had then entered some form of insolvency process. These directors simply hid behind the shield of limited liability, leaving disgruntled and unpaid creditors in their wake.

SO WHAT DO SS 216 AND 217 PROVIDE AND CAN LIABILITY BE AVOIDED?

Section 216

Section 216 (Restriction on re-use of company names) provides that where a company – OldCo – has gone into insolvent liquidation and a person was a director or shadow director of that company at any time in the period of 12 months ending with the day before it went into liquidation, a name is a prohibited name in relation to such a person if it is a name by which OldCo was known at any time in that period of 12 months, or it is a name which is so similar to such a name to suggest an association with it.

Except with the permission of the court or where certain exceptions apply (see below), a person cannot for a period of five years:

- be a director of any other company that is known by a prohibited name;
- in any way, whether directly or indirectly, be concerned or take part in the promotion, formation or management of any such company; or
- in any way, whether directly or indirectly, be concerned or take part in the carrying on of a business carried on (otherwise than by a company) under a prohibited name.

The penalty is imprisonment, a fine, or both.

Section 217

Section 217 (personal liability) imposes personal liability for the debts of NewCo on a director of OldCo who is involved, directly or indirectly, in the management of NewCo using a prohibited name in contravention of s 216.

Any director of NewCo, who may be liable under s 216, is presumed to be involved in the management of that company. However, s 217 also catches anyone who allows themselves to be used as a "front man" by a person in breach of s 216.

A "front man" is anyone who is involved in the management of NewCo and acts or is willing to act on instructions given (without the leave of the court) by a person whom he knows at that time to be in contravention in relation to OldCo of s 216.

Liability under s 216 and exceptions

Liability under section 216 of the Act is strict and there is no statutory defence. However, there are a limited number of ways to avoid liability:

- An application for permission under s 216(3) of IA86 to act as director of NewCo may be made before the person acts in the running or formation of the new business.
- If a person comes under one of the three statutory exceptions contained within the Insolvency Rules 1986 (IR86):

- First exception (r 4.228 – notice to creditors) applies where the whole or substantially the whole of the business of OldCo is acquired by NewCo under arrangements made by an insolvency practitioner acting as liquidator, administrator, administrative receiver or supervisor of OldCo. The NewCo must give notice of the acquisition to all creditors of OldCo and publish notice in the London Gazette within twenty-eight days of completion.
- Second exception (r 4.229 – application for leave) applies where a director of OldCo may be excused from liability under s 216 if he makes an application to court for leave to act within seven days of OldCo entering liquidation. The application must also be heard and permission granted within six weeks from when OldCo enters liquidation.
- Third exception (r 4.230 – no application or notice required) applies where the NewCo had been known by the prohibited name for a period of twelve months prior to OldCo entering liquidation and was not dormant during that period. If this can be established, the court's permission will not be required.

FAR-REACHING IMPLICATIONS

Sections 216 and 217 are designed to punish the actions of such directors with criminal sanctions (assuming the conditions set out in the boxes above are satisfied) and allow creditors to pierce the corporate veil and pursue the directors personally for the debts of NewCo. However these sections go wider than preventing phoenixing, as they catch any person who merely re-uses the name of OldCo, following OldCo entering insolvent liquidation. There is no need to prove intent on the directors' part to exploit the goodwill. If the conditions are satisfied, the offence under s 216 is of strict liability and once established, personal liability of the director under s 217 is automatic.

This can be highly problematic where the same director has innocently been involved with a company which has entered liquidation, together with a new company which has some association with OldCo's name, which may not be as obvious as NewCo using the same or similar company registered name or trading name.

This was the position in which a number of our clients (including directors) have found themselves and our advice sought when issues surrounding ss 216 and 217 have arisen range from a due diligence exercise undertaken as part of a fund-raising exercise to a group restructuring and acquisition of a distressed business. In each case, our advice focussed on trying to side-step the potential liability for the common directors, which could have jeopardised respectively the fund-raising, restructuring and purchase plans. For the rest of this article, we will focus on the fund-raising case in more detail.

BACKGROUND FACTS

Our clients were directors (Directors) of NewCo, which itself was part of a group restructuring, and in the process of undertaking a fund-raising exercise in relation to a £25m placing in the US and UK. NewCo's business had initially been operated through another company, Oldco, which had entered creditors' voluntary liquidation. The Directors had also been directors of OldCo. Despite experiencing initial financial success, OldCo had become embroiled in litigation on a number of fronts, the subject matter of which had caused a dramatic reduction in its turnover and due to escalating legal costs, the Directors were advised that OldCo was insolvent and acted responsibly in placing it into liquidation.

NewCo's registered name, and indeed trading name, was very different to that of OldCo. However, OldCo's name was identical to the brand name of the product, which NewCo manufactured and distributed. Therefore, there was a concern that this brand name was one with which NewCo was associated. We therefore advised the Directors that they may unknowingly be committing an offence under s 216, notwithstanding the fact that NewCo had acquired the relevant trademarks relating to the brand name from the liquidators, although had not acquired the name of OldCo itself. This was of course of concern to them as they sat on the board of NewCo and hence were part of the team seeking substantial third party investment and did not want their (essential) involvement to jeopardise NewCo's ability to secure such funding.

Therefore, an application to the court under s 216(3) of the Act was made on a precautionary basis, to remove the risk of any argument going forwards that the Directors were acting in breach of s 216, for permission to use (directly or indirectly) the name as directors of NewCo and also as directors of a proposed new group parent company (NewCo Two). It assisted that there were other highly qualified directors already sitting on the boards of NewCo and NewCo Two. Equally, we wanted to ensure that any risk for the Directors under s 217 for personal liability was minimised.

RESULT AND POINTS TO BE CONSIDERED

The application was successful and the High Court granted the Directors permission to use what otherwise could have been considered a prohibited name. Accordingly, all risk of any action going forwards being taken against the Directors under ss 216 or 217 of the Act in relation to their directorships of NewCo and NewCo Two were removed. Although dependent on the court's availability to hear it, such an application can be made on an expediated basis, if a case for urgency is made out.

When making such an application, the following should be considered:

- The court will not give blanket permission so therefore any application should be narrowly drawn and specifically include all the companies in connection with which permission is sought to have a chance of succeeding. In this case, it was anticipated that the prohibited name may be used in the future (because of the value associated with the brand) for other companies with which the Directors might be involved within the five years from OldCo entering liquidation. As their inclusion would have seriously jeopardised the application's success, the speculative companies were

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omitted. If the Directors were to be involved with these companies in the future, a further precautionary application could then be considered.

- Permission (if granted) is not retrospective, so any director may still potentially face prosecution for the period from when OldCo enters liquidation to the granting of permission by the court; therefore technically any person remains potentially exposed personally for the debts of NewCo for that intervening period. Although each case will turn on its own facts, if the court grants permission going forwards, it remains unlikely that the Secretary of State would be interested in prosecuting any intervening breach of s 216.
- The ability to rely upon one of the prescribed exceptions should be explored before making an application for permission under s 216(3). In this case, NewCo had acquired only the use of the intellectual property rights which attached to the brand and not the brand name itself. Therefore although we looked at whether the Directors could rely upon the automatic exception under r 4.228 of IR86, the use of the name alone does not circumvent s 216 and even if the name had been acquired, in the absence of other assets, it is questionable whether the business or substantially the whole of it would have been acquired from the liquidator. In circumstances where the business or substantially the whole of it is acquired, one also has to ensure that the necessary prescribed notices have been given to be able to rely on this exception. One client did not give notice within the prescribed period and an application for permission under s 216(3) had then to be made … an expensive mistake! ■

Further Reading:

- How to make a successful application for leave to use a prohibited name [2014] 1 CRI 36.
- Identifying restructuring risks in Germany: liability for continuing the business of a distressed company [2014] 4 CRI 149.
- LexisNexis RANDI blog: Could deregulation benefit insolvency practice?