Not-for-profit Insolvency Triage Guide

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1. Introduction

This memorandum is intended to provide an overview of insolvency considerations for small not-for-profits, and identifies considerations for directors/ trustees to consider when contemplating winding up their organisation.

2. When is the not-for-profit insolvent?

- Not being able to pay the not-for-profit's debts as they fall due (the *cash flow* test).
    - If a creditor serves a statutory demand on the not-for-profit for an amount greater than £750 and the not-for-profit cannot/ does not pay this within three weeks, then the not-for-profit will be deemed to be unable to pay its debts as they fall due and therefore be presumed insolvent.
- When the value of the not-for-profit's assets is less than the amount of its liabilities (the *balance sheet* test).

3. Personal duties in insolvency

The not-for-profit's directors/ trustees have a statutory duty to exercise their powers in a way that they consider, acting in good faith, is most likely to further the purposes of the not-for-profit. However, at the point the directors/ trustees either (a) realise that there is no reasonable prospect of the not-for-profit avoiding liquidation or (b) ought reasonably to have realised that there is no reasonable prospect of the not-for-profit avoiding liquidation, their duties switch to acting in the best interests of the not-for-profit's creditors.

At this point, to avoid incurring any potential liability for wrongful trading, the directors/ trustees must take every step to minimise potential losses to creditors. This would include sensible measures such as seeking professional advice, reducing expenses where possible, and constructive engagement with the not-for-profit's main creditors. Please note that the directors/ trustees must still exercise caution not to prefer paying one creditor over another. The directors/ trustees should continue to act in accordance with their statutory fiduciary duties, including:

- exercise such skill and care as is reasonable in the circumstances, having regard in particular to:
    - any special knowledge or experience that they have, or purport to have; and
    - in the course of the charity's business, any special knowledge or experience that it is reasonable to expect a person acting in the course of that kind of business to have;

- not benefit personally from an arrangement or transaction entered into by the not-for-profit if, before the arrangement or transaction was entered into, the charity director/trustee did not disclose to all the charity directors/trustees of the not-for-profit any material interest (whether direct or indirect) that the charity director/trustee had in it or in any other person or party to it; and

- not accept a benefit from a third party for either:
  - being a charity director/trustee; or
  - doing (or not doing) something as a charity director/trustee.

4. Insolvency procedures available for different not-for-profit bodies

Type	Administration	CVA	Compulsory Liquidation / Winding Up By Court	Creditor's Voluntary Liquid.	Member's Voluntary Liquid.	Notes:
Co-operative and Community Benefit Societies	*					*Administration not available societies which are housing associations.
Royal Charter Companies			*	**		*Wound up by order of Court rather than compulsory liquidation. **In principle could enter a creditor's voluntary liquidation but no clear authority so we suggest this is avoided.
Charitable Company Limited by Guarantee						
Charitable Incorporated Organisation (CIO)		*				*CIO can enter a modified CIO Voluntary Arrangement. There is also a bespoke dissolution procedure, outside of the IA 1986, for winding up a CIO that has made provision for its liabilities (Part 3 of the CIO Regulations). Under this regime, a solvent CIO can apply to the Charity Commission for voluntary dissolution or the Charity Commission can dissolve a CIO of its own volition in certain circumstances.
Community Interest Companies						
Unincorporated Associations			*			*Would only qualify under s.221 IA 1986 where the unincorporated association is formed for a 'commercial purpose'. The process of winding up the unincorporated association's affairs will

						generally depend on the provisions of its constitution documents. However the court reserves an inherent jurisdiction to order the winding up of any association, including an unincorporated association, if there is no other method available.
Trusts						A trust does not have separate legal personality, and no insolvency procedure applies as such to an insolvent charitable trust. The insolvency procedures applicable to individuals may be applicable.

5. Insolvency Procedures: Overview & Key Considerations

Administration	
Overview:	• Where a company is in financial difficulty and the company has an inability to pay its debts and an insolvency procedure is inevitable, creditors are applying pressure or seeking to enforce claims which could jeopardise any rescue or restructuring, consideration should be had as to whether the company should be placed into administration. • The key advantage of commencing the administration is to give the company time in which its shareholders can consider its options, as a moratorium against creditor actions is imposed. • Together with the administrator, the directors can then consider the best options for the company, be that reconstruction, sale of the company's assets, a scheme arrangement, CVA or liquidation.
Key Considerations:	• Administration will only be commenced however if it is reasonably likely to achieve the overriding purpose of administration as contained in the Insolvency Act 1986 which is namely: ○ the rescue of the company as a going concern; ○ achieving a better result for the company's creditors as a whole than would be likely if the company were to be wound up; or ○ realising the company's property in order to make a distribution to one or more secured or preferential creditors. • An administrator may be appointed by the company, its directors, and

	a qualifying floating charge holder or by order of the Court on application by any of the above or by any unsecured creditor. • In the majority of cases the costs and consequences of administration (and difficulties with customers and suppliers) means that rather than rescuing the company the business of the company is saved through sale. Inevitably however, the value of the business is likely to be depreciated.
Company Voluntary Arrangement	
Overview:	• In the absence of an informal agreement with creditors it may be appropriate to consider a company voluntary arrangement (CVA). A CVA is a statutory form of binding agreement between the company and its creditors. There is no requirement that the company should be insolvent or be unable to pay its debt.
Key Considerations:	• The CVA proposal is made by directors of the company and put to the company and its creditors. At its simplest is a deal between the company and its creditors by nature of a contract. • However it should be remembered that the creditors are bound to the terms of the CVA even if they have not accepted the terms or even voted, hence it is regarded legally as a statutory binding as opposed to a contract. • There is a requirement to obtain the agreement of 75% in value of the unsecured creditors' votes at the meeting.
Liquidation	
Compulsory Liquidation	
Overview:	• Formal insolvency procedure whereby the company is forcibly liquidated, usually initiated by an outstanding creditor of the company. • Creditor serves a statutory demand on the company for a debt of £750 or more. • If this is unpaid after at least 21 days the creditor issues a Winding Up Petition (WUP). • Court hearing later takes place and the judge makes a Winding Up Order against the Company if one of the grounds in s122 IA 1986 is met. • Official Receiver appointed, who begins realising the company's assets

	to meet its liabilities. • Company is dissolved and is removed from the register at Companies House.
Key Considerations:	• If the statutory demand is not paid after 21 days from the date of service of the demand, the company/charity will be deemed unable to pay their debts.
Creditors' Voluntary Liquidation (CVL)	
Overview:	• In a CVL, the directors of the company do not make a statutory declaration of solvency. Like an MVL, a CVL commences when the members of a company pass a special resolution that the company should be wound up.
Key Considerations:	• Members pass a special resolution for its winding up, with a majority of at least 75% (s84, IA 1986). • The members nominate an insolvency practitioner to act as liquidator. • The liquidation is deemed to commence from the passing of the resolution (s 86, IA 1986). • After the resolution to wind up, the company's creditors may nominate a person to be a liquidator. • The directors must deliver a notice to creditors seeking their decision on the nomination of the liquidator by the deemed consent procedure or a virtual meeting. Creditors may also request a physical meeting.
Members' Voluntary Liquidation (MVL)	
Overview:	• An MVL commences by the members passing a special resolution that the company should be wound up. • The directors of the company swear a statutory declaration of solvency (i.e. they are satisfied that the company will be able to pay its debts in full within 12 months (s89(1),IA 1986).
Key Considerations:	• In order to qualify for an MVL the company must be solvent – that is able to settle its liabilities in full within 12 months. All creditors of the company are paid in full. • Can have tax advantages in certain circumstances.

6. Personal liabilities: potential claims against trustees

The term 'charity trustee' is defined in section 177 of the Charities Act 2011 (CA 2011) as anyone who has general control and management of the administration of a charity. As such, charity trustees can encompass directors of charitable companies and community benefit societies, charity trustees of charitable incorporated organisations as well as management committee members of unincorporated associations and trustees of charitable trusts. The meaning of 'director of a company' itself is modified to include a charity trustee of a CIO through Schedule 1, *CIO Insolvency and Dissolution Regulations*.

The following claims are capable of being pursued against directors of incorporated not-for-profits, Royal Charter companies aside, in the event of specific insolvency scenarios:

Claim	Key Considerations
Wrongful Trading	In the course of the winding up of the company a liquidator may apply to the Court for a declaration that a person who is, or was, a director of the not-for-profit should make such contribution to its assets as the Court thinks fit. An application can be brought if: 1. the company has gone into insolvent liquidation; 2. sometime before the commencement of the winding up of the company, that person knew or ought to have concluded that there was no reasonable prospect that the company could avoid going into insolvent liquidation; and 3. that the person was a director of the company at that time. The Court will not make an order if at the time the director concluded the company had a reasonable prospect of avoiding insolvent liquidation and took every step to minimise the potential loss of the company's creditors. The test to be applied to the director is an objective test but will also take into account the general knowledge, skill and experience of the director. It is therefore both an objective and subjective test. Directors cannot rely on the fact that they have been provided with poor financial information, possibly due to the nature of their accounting system. Directors should obtain the necessary degree of financial information appropriate to the circumstances. Directors are not entitled to rely on their lack of skill and inexperience. It should be noted that the contribution that a director of the company may be ordered to pay is a matter at the Court's discretion. As a starting point the Court may look at the depletion of the not-for-profit's net assets occurring between the date that the directors should have concluded that the company could not have avoided insolvent liquidation and the date that it entered into an insolvency process. The award is not intended to be punitive but compensatory and the directors' liability is several and not joint.

Fraudulent Trading	If in the course of the winding up of the company it appears that any business of the company has been carried on with an attempt to defraud creditors or for any fraudulent purpose the Court may, on application of the liquidator, declare that any person who has knowingly been a party to this should make such contribution to the company's assets as the Court thinks fit. Fraudulent trading is significantly more difficult to prove than wrongful trading as there needs to be proof of actual intent to defraud, actual dishonesty involving moral blame, wilful blindness or reckless indifference.
Misfeasance	During the course of the winding up of the company, if it appears that the director of the company or person who has taken part in the promotion, formation and management of the company and has misapplied, retained or become accountable for monies or property of the company or being guilty of any misfeasance or breach of fiduciary or other duty in relation to the company, the Court may on application of the liquidator order that person to repay, restore or account for money or to contribute to the company's assets as they think fit.
Transactions at Undervalue	During the course of the insolvency office holder's investigation it may be discovered that certain transactions were, in retrospect, in breach of insolvency legislation. Proceedings to adjust and/or set aside the transactions can be taken to augment the company's assets and provide for a greater return to creditors. A transaction at an undervalue occurs where the company enters into a transaction on terms that provide that the company is to receive no consideration, or the value of the consideration is significantly less than the value in money or money's worth of the consideration provided by the company. The transaction can only be set aside if the company is in an insolvency process, the right of action vesting in the office holder. To be capable of challenge, the transaction must have occurred during a period of two years ending with the onset of the insolvency process (i.e. the resolution to wind up/the issue of a winding up petition). It must also be proved that at the time of transaction the company was insolvent. Where the transaction is with a person connected to the company, the insolvency officer holder is assisted by a presumption that the company was insolvent. This is a rebuttable presumption and in this case much may rest upon whether the company could be deemed insolvent at the date of the claim or whether there is a later date upon which insolvent liquidation became inevitable i.e. there was a later date where after investigation and legal advice in regards to the claim the company's directors/ trustees knew or ought to have concluded that insolvent liquidation was inevitable. The Court will not set aside a transaction if it is satisfied that the company has entered into the transaction in good faith for the purposes of carrying on its business and that at the time it did so there were reasonable grounds for believing the transaction would benefit the company. The burden of proof is on the party seeking to uphold the transaction and the Court need to be satisfied on an objective basis that the transaction would benefit the company. Where the Court is satisfied that the Liquidator has fulfilled the conditions of the

	legislation it may make such order as it thinks fit including requiring the property transferred to be vested back to the company or requiring any person to pay such sums to the Liquidator in respect of the benefit received by him from the company. In circumstances where it was found that the transfer was made with the intention of putting assets beyond the reach of creditors, insolvency does not need to be evidenced at the time of the transaction, nor is there any limitation as to how far before the commencement of the insolvency process the transaction should have occurred. This provision (section 423 Insolvency Act 1986) requires evidence of dishonesty.

7. Personal liabilities: financial considerations for trustees & members

A Charitable Company Limited by Guarantee, Charitable Incorporated Organisation (CIO) and Community Benefit Society are examples of incorporated legal entities. In the majority of circumstances, when a not-for-profit is incorporated it is the entity itself, rather than its trustees, that bears responsibility for debts or other liabilities. Conversely, in unincorporated forms, such as a trust or unincorporated association, trustees are potentially exposed to personal liability for outstanding debts. However, there are a number of financial considerations for members & trustees where a not-for-profit is insolvent, detailed in the following table:

Not-for-profit Type	Personal Liability for Directors/ Trustees
Co-operative and Community Benefit Societies	• Members could be liable to contribute towards the payment of the society's debts and the expenses of winding up; their contribution will be no more than any amount not paid up on their shares. On the whole, shares will be fully paid up when issued and so no further payment will be required by members who will simply lose the value of their shares.
Royal Charter Companies	• Members of a Royal Charter body have no liability for the debts of the body. This is because the Crown has no power at common law to attach liability to its individual members.
Charitable Company Limited by Guarantee	• In the event of winding up, each member guarantees to contribute a certain sum to the company. Each member's liability is limited to the amount that they each agree to contribute (section 74(3), Insolvency Act 1986).
Charitable Incorporated Organisation (CIO)	• Like a regular company limited by shares, a CIO has a separate legal personality. The liability of its charity trustees and members is limited. The members are either liable to contribute up to a specified amount to the assets of a CIO if it is wound up or not liable to make any

	contribution at all. Such amount may be stated in the CIO's constitution (section 206(1)(d), ChA 2011).
Community Interest Companies (CIC)	• A CIC is a limited liability company (by shares or by guarantee). It thus has a separate legal personality and its members' liability will be limited to either their shareholding or an amount they have agreed to contribute.
Unincorporated Associations	• An unincorporated association has no legal personality distinct from its members. There is no separate entity with limited liability, as in the case of a company. • As an unincorporated association has no separate legal identity, any liabilities that it has will legally be the liabilities of some or all of its members, depending on the circumstances. The provisions of its constitution documents should be consulted in this regard as, in order to wind up the affairs of such an association, such liabilities will need to be discharged.
Trusts	• A trust does not have separate legal personality, so the trustees act on behalf of the trust in their personal capacities. Legal liability for the trust's debts falls on those who were trustees at the time the debt was incurred. • As such, if the trust assets are insufficient to settle the trust's liabilities, the trustees may be liable for the charity's debts (unless the trustees have limited their liability to the trust assets).

8. COVID-19

- Under the Coronavirus Act 2020, which became law in the UK on 25 March 2020, landlords are prevented from taking action to forfeit for non-payment of rent, or other sums such as service charges and insurance rent, from 26 March 2020 until 30 September 2020. The Act also provides that for any existing proceedings, there can be no order for possession before 30 September 2020.
- On 26 June 2020 the Corporate Insolvency and Governance Act came into force with a mix of emergency temporary measures with the objective of helping UK companies and similar entities to continue to trade during the pandemic, and permanent new processes introducing greater flexibility into the insolvency regime.

- A new company moratorium procedure is introduced to give companies in difficulty, including as a direct result of COVID-19, formal breathing space to pursue a rescue plan. During the moratorium, legal action cannot be taken against a company without court approval. The moratorium lasts up to 20 days with a possible extension to 40 days. It is monitored by an Insolvency Practitioner and there are super-priority provisions regarding the payment of moratorium debt. This is an out-of-court process unless there is an existing winding up petition, in which case court approval is required.
    - Government guidance states that, alongside the main incorporated forms, further regulations will provide for the application of the moratorium to both CIOs & Co-operative and Community Benefit Societies.
- The promised 'suspension of wrongful trading' legislation and thus the threat of directors' personal liability is, on review of the detailed proposed legislation, of less assistance to directors than may otherwise have been the case. The legislation provides that while this suspension is in place (currently between 1 March 2020 and 30 September 2020) a director will not be liable for losses attributable as a result of continued trading during that period. As the wrongful trading rules apply to charity trustees of CIOs, we understand that they will also benefit from the suspension. At best the legislation gives comfort to those directors who are currently questioning whether insolvent liquidation is inevitable and thus whether they should cease trading and commence an insolvency process. For the individual director it should be remembered that all other legislation and duties remain in place and as a result misfeasance/wrongdoing during this period of suspension would be caught in any event.
- Other temporary measures also have been proposed in regards to statutory demands and winding up petitions issued between 27 April and 30 September 2020. During this period a creditor can only proceed if there are reasonable grounds to believe that COVID-19 had no financial effect on the company and/or the company would have been insolvent & unable to pay its debts, irrespective of COVID-19. Coronavirus has a 'financial effect' on a debtor if the debtor's financial position worsens in consequence of, or for reasons relating to, coronavirus. There are likely to be accompanying rules setting out a threshold test and how/when this will be assessed.
- Time periods within the Act may be extended by the Secretary of State without further legislation for a period of up to 12 months. As a result, temporary measures may well be extended if the economic conditions do not improve, as the restrictions are gradually lifted.

9. Final Thoughts

Entering insolvency is ultimately a commercial decision for the not-for-profit, dependent on its financial reserves, the current law and any further guidance that is announced by the government over the next weeks and months. Before any formal insolvency procedure is

entered into, the directors/ trustees should engage with the not-for-profit's creditors as soon as possible to pragmatically consider whether they can continue to operate. For example, the government expects landlords and tenants to work collaboratively, with landlords giving tenants the breathing space that they need, while making it clear that tenants should continue to pay rent where they can afford to.

The Charity Commission has published guidance, particularly aimed at smaller charities, aimed at managing financial difficulties during COVID-19. This suggests that charity trustees take the following key steps:

1. Obtain as accurate a picture as possible of the charity's current financial situation, focussing on cash flow management.
2. Consider options for minimising costs and protecting and increasing income.
3. Regularly monitor and review the charity's operations and finances

For further information on the Commission's COVID-19 guidance, including their views on accessing and releasing restricted funds, please visit the following link:

https://www.gov.uk/guidance/coronavirus-covid-19-guidance-for-the-charity-sector