



Validation Orders

The recent decision in R C Brewery Limited v HMRC [2013] EWHC 1184 (Ch) highlights some of the pitfalls in applying for a validation order in response to a winding up petition.

What is a validation order?

A validation order is an order made by the Court in response to an application by, or on behalf of, a company in the process of being wound up. Such an order is necessary in these circumstances where the company wishes to avoid the effect of Section 127 of the Insolvency Act 1986 which provides:

“In a winding up by the Court any disposition of the company’s property... made after the commencement of the winding up is, unless the Court otherwise orders void”.

The winding up of a company by the Court is deemed to commence at the date of presentation of the winding up petition (Section 129).

This means that in the period immediately following the issue of the petition up to and including the date on which a winding up order is subsequently made any disposition of property by the company is void. The definition of property is wide but most commonly includes payments out of the company’s bank account. It may also include the sale of an asset i.e. a property or the granting of security over a property in order to secure funding to discharge the petition debt.

Why is there a need for a validation order?

Any disposition of the company’s property post-petition and prior to the making of a winding up order will be void. Such payments or dispositions of property may be recovered from the recipient by the liquidator who is subsequently appointed.

The need to act?

In many cases following a winding up petition, the focus turns to negotiations with the petitioning creditor, often HMRC, to try and reach an agreement with regard to the outstanding debt, usually by payment of instalments. Often, presentation of the petition will be preceded by lengthy negotiations with the petitioning creditor, in an attempt to agree payment plans or to reduce the outstanding liability.

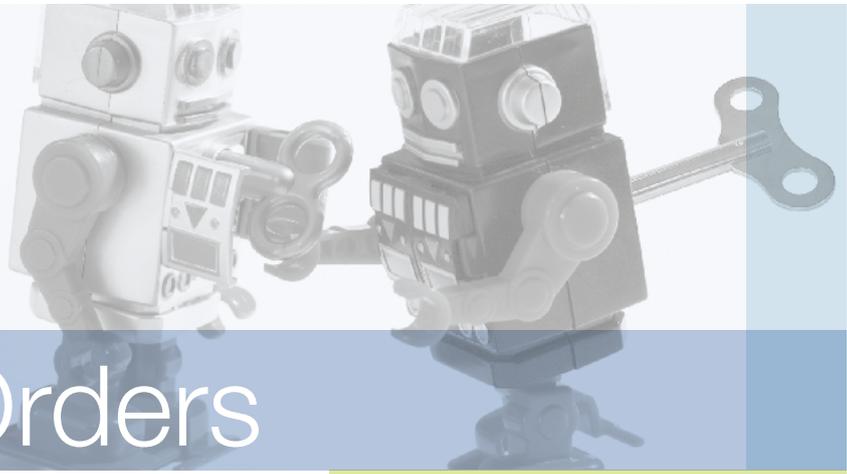
The temptation on the part of the company and its advisors is often to continue those negotiations even after the petition has been presented.

In many cases, the first indication of any need to obtain a validation order will arise following the freezing of the company’s bank accounts after advertisement of the petition. Faced with an angry customer, the bank’s stock response is to suggest that they “simply apply for a validation order”. The impact on the company’s business where the accounts are frozen, will have serious consequences for the company’s continued trading.

What is involved in making an application for a validation order?

The application can be made at any time after a petition has been presented and must comply with the **Practice Direction: Insolvency Proceedings [2012] BCC 265**. This sets out both the procedure and requirements for an application for a validation order. It is detailed and the extent of the information required will often come as a surprise to the company and its advisors. Set out below are some of the matters that must be covered by the application:-

1. It must be supported by a witness statement from a person “intimately acquainted” with the company’s affairs i.e. a director.
2. A witness statement from the company’s accountant may also be required.
3. If disputed, the basis of any dispute in respect of the petition debt should be outlined.
4. Full details of the company’s financial position.
5. A copy of the company’s latest filed accounts, management accounts or an estimated statement of affairs.



Validation Orders

6. A cash flow forecast for the period of validation sought.
7. Details of the disposition/payments to be made.
8. An independent valuation of any property or assets to be sold.

The extent and contents of the evidence that will be required will vary depending on the circumstances of each case. One of the most important factors is that the evidence must demonstrate that the company is solvent and that it is able to pay its debts as they fall due or that a particular transaction for which validation is sought will be beneficial to and will not prejudice the interests of unsecured creditors.

On the question of insolvency, the mere existence of an outstanding petition debt which is not disputed will indicate that the company is unable to pay its debts as they fall due. Unless it can be shown that the transaction for which validation is sought will be beneficial to the interests of the creditors, validation is unlikely to be granted. In certain cases however, the Court may be willing to take a purposive approach and grant a validation order based on the fact that the company is balance-sheet solvent. This is only likely to be the case where it is clear that creditors would in the event of liquidation and the sale of the company's assets be likely to receive payment in full. It is the requirement to establish that the company is solvent or that the transaction is for the benefit of creditors where most applications falter.

Types of Order

Where a validation order is successful, the type of order that will be granted will vary from case to case. The most common application is for validation to enable the company to continue trading in the ordinary course of business, usually for a specified period. This will specify a bank account from which payments will be permitted to be made in the ordinary course of business, to pay wages and other items essential to continued trading. Alternatively, validation orders may be sought for the sale of property. In such circumstances where the Court permits the sale to proceed, on the basis of the valuation evidence, it will usually specify a minimum price at which the property is to be sold, in order to ensure creditors' interests are protected. Other forms of validation include the granting of a charge over the company's assets to secure funding which may be used to discharge the petition debt and/or other creditors' claims.

Costs

Usually as part of any application for a validation order, the application will include the validation of payments by the company to its professional advisors to cover the costs of the application. Sometimes, as in the case of R C Brewery Limited, the validation application will concern only the payment of costs in connection with the validation application.

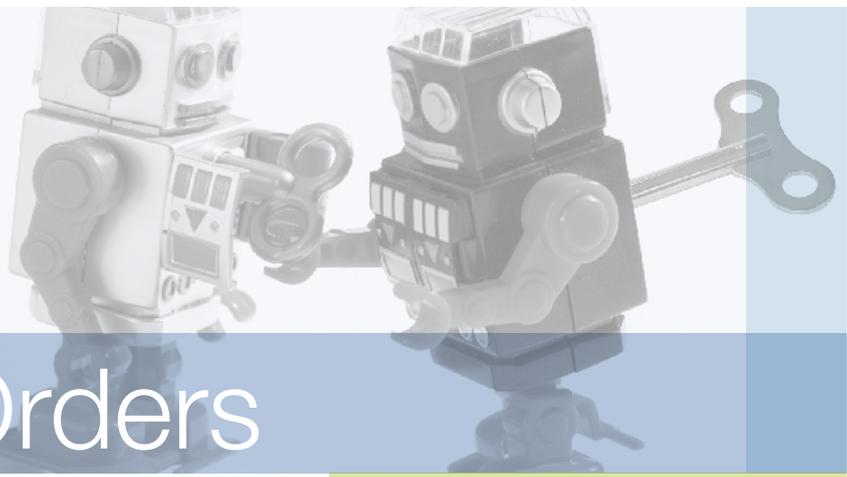
R C Brewery Limited v HMRC [2013]

Following presentation of a petition by HMRC, the company sought to restrain advertisement of the petition. The debt was not disputed but the company complained that HMRC had rejected proposals for payment by instalments. The Court rejected the company's application to restrain advertisement. The company sought a validation order in respect of the fees paid to solicitors including Counsel which amounted to £22,500. The company also sought validation in respect of future payments for legal costs of a further £27,750 i.e. a total of £50,000. If validated this would have reduced the amount available to creditors.

The general rule

The Court noted the general rule that a validation order will only be made where there is no serious risk to creditors or where the Court is satisfied that the company is likely to improve the position of creditors by trading at a profit only.

The Court continued that if there was no dispute as to the petition debt the incurring of such legal fees would not be in the ordinary course of business. The Court therefore refused to validate any of the payments for legal costs in connection with the application.



Validation Orders

The decision gives a clear warning to companies and their lawyers that applications for validation orders in respect of legal costs where there is no genuine dispute as to the petition debt and there will be no benefit to creditors, are unlikely to be successful. Fortunately for the lawyers concerned a director of the company agreed to discharge the company's legal costs separately.

Conclusion

The information required in order to obtain a validation order is substantial. In order to stand a reasonable prospect of success the application and evidence in support must comply with the Practice Direction. Failure to obtain a validation order in respect of the disposition of property may also render the directors liable for misfeasance which ultimately will mean that they may have to pay back personally the value of the property disposed of in breach of Section 127.

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