INSOLVENCY PROCEEDINGS; A DOUBLE EDGED DEBT COLLECTION TOOL

I. Introduction

Whereas it is generally acknowledged that insolvency proceedings are a collective debt collection mechanism through which an insolvent debtor's assets are pooled together for the benefit of all the creditors[1], some creditors have over the years been using insolvency proceedings to collect their individual debts.

This is perhaps because of the historic coincidence that Bankruptcy law began as a debt collection device[2], a view that is incidentally shared by many commentators, especially those inspired by the economics movement[3], who contend that the proper function of insolvency law is to maximize the collective return to creditors[4].

The use of insolvency as an outright debt collection tool is however highly criticized[5]as being unfair, harsh and illegitimate[6], and that if not carefully used, it could adversely affect the petitioning creditor.

This paper, therefore, seeks to discuss the benefits and risks associated with the use of insolvency proceedings as a debt collection tool, with particular reference to the law in the United Kingdom and Uganda[7], but with examples drawn from different jurisdictions.

II. Meaning of Insolvency proceedings

Insolvency proceedings generally include all kinds of proceedings that may be commenced under the Insolvency legal regime by or against a company, including Voluntary Arrangements, Administrations, Receiverships and Winding up or Liquidations[8], as well as Bankruptcy for individuals.

The kind of insolvency procedure that is however used by creditors as a debt collection tool is liquidation and bankruptcy. For purposes of this paper, therefore, I will limit the discussion to liquidation and bankruptcy proceedings.

1Kilborn, Jason J. and Walters, Adrian, Involuntary Bankruptcy as debt collection: Multi-Jurisdictional lessons in Choosing the Right Tool for the Job, 2012, Chicago-Kent College of Law, Research Paper No. 2012-15; available at http://ssrn.com/abstract=2171441

2 Douglas G. Baird, A world without Bankruptcy, 1987, Law and contemporary problem, pp 1-2

3 Jackson, The Logic and limits of Bankruptcy law (1986); Jackson & Scott, 'On the nature of Bankruptcy: An essay on Bankruptcy Sharing and the Creditors' Bargain' 75 Val Rev 155(1989).

4 Vanessa Finch, ' the Measures of Insolvency Law', Oxford University Press, Vol 17, No.2(Summer, 1997) p.231

[5]Op. cit. n.1

[6] Evans Lombe, J in the English case of *Re Javeline Promotions Ltd (2003)* EWHC 1932, stated that a winding up petition is not a legitimate means of collecting debts.

[7]My choice of the UK was guided by the fact that Uganda uses the English common law system, and majority of the laws in Uganda were inherited from the British.

[8]Halsbury's laws of England, Vol 7(3), p. 11

III. Meaning of Liquidation and/or Winding up

In most jurisdictions, the terms winding up and Liquidation are used interchangeably to refer to the collective insolvency process leading to the end of a company's life[9], and this is usually done in two ways; voluntary liquidation and compulsory liquidation. Voluntary liquidation comes into play where the company members or creditors pass a resolution to wind it up, while compulsory liquidation occurs as a result of a court order made upon a petition by the company, the directors, or one or more creditors[10].

It should, however, be noted that in Uganda, the insolvency Act[11], distinguishes liquidation from winding up. Winding up is limited to the process through which the life of a company may be ended for reasons other than inability to pay debts[12], yet liquidation is separately provided for under the insolvency Act[13], and it generally refers to the process through which an insolvent company's assets are distributed to its creditors and/or members as the case may be, with the objective of bringing its life to an end[14].

Liquidation may be done voluntarily through a creditors' voluntary liquidation[15], under supervision of court[16] or by court[17]following a petition by the company, director, shareholder, creditor, contributory or the official receiver upon being satisfied that the company is unable to pay its debts[18]

Hence, in Uganda, whereas a company can only go into liquidation because of inability to pay debts[19], winding up may be caused by many reasons, such as accomplishment of the company objectives, or where, for fear of loss due to foreseeable business risks, the company members resolve to cease operation.

IV. Inability to pay debts

Inability to pay debts is the primary reason why a creditor may choose to invoke insolvency proceedings against a debtor, and for individual debtors, it is the only ground upon which a debtor may be declared bankrupt[20].

The law provides a broad technical definition of inability to pay debts[21], which can be summarized to include situations where;

---

[9]Roy Goode, Principles Of Corporate Insolvency Law, 2011, p. 30
[10] S.124 of the Insolvency Act, 1986
[11] Act No.14 of 2011
[12] Waiswa Abudu Sallam, A Concise workbook on Fundamentals of Commercial law in Uganda, 2014, Kampala, p.319
[13] Op. cit. n.11
[14]Op. cit. n.12, p.319-324
[15]Op. cit. n.11, s.69provides that voluntary liquidation commences when, on realizing that it is unable to pay its debts, a company passes a special resolution to have its affairs liquidated.
[16]Op. cit. n. 11, s.87 provides that liquidation under supervision of court happens where, after the company resolves to be voluntarily liquidated, one or some creditor(s), contributory or any other interested party applies to court to have the liquidation done under supervision of court.
[17]Op. cit. n.11, s.92 provides that the High court may appoint a liquidator upon an application by the company, director, shareholder, creditors, contributory or the official receiver.
[18] Op. cit. n.11, s.92 (2)
[19] Op. cit. n.12
[20]UK Insolvency Act, 1986, s 267 & 272
[21] S.123 of the Insolvency Act of the UK, stipulates the circumstances when a company may be deemed to be unable to pay debts, and section 267 defines inability to pay debts by individuals.

(a) A creditor, to whom a person is indebted in the sum exceeding 750 pounds, has served on such a person a statutory demand requiring the debtor to pay the debt within 21 days. There is judicial consensus across jurisdictions that for one to qualify to be a creditor for purposes of serving a statutory demand, their debt must not be genuinely disputed by the debtor. A winding up order will not be made on a debt which is disputed in good faith, but the dispute must be based on a substantial ground[22], and as it was stated in *London & Global Ltd v Sahara Petroleum Ltd[23]*, where a company asserts that the debt is in dispute, the court must be satisfied that there is a fair and reasonable probability that the company has a bona fide defence.

(b) Execution or other process issued on judgment, decree or order of any court in favour of a creditor is returned unsatisfied[24].

(c) Where it is proved to the satisfaction of court that the debtor is unable to pay his or her debts as they fall due[25], also known as the cash flow test, and,

(d) If it is proved to the satisfaction of the court that the value of the company assets is less than its liabilities, also referred to as the balance sheet test, which was recently decided upon by the UK supreme court in *BNY Corporate Trustee Services Ltd &Ors v Eurosail-UK2007-3BL plc and others[26]* when court held that a company's solvency is not accurately captured by a 'balance-sheet' test; rather, a company's financial position should be viewed in its entirety. That a company should not be deemed as "unable to pay its debts" simply because, taking into account its contingent and prospective liabilities, its assets are exceeded by its liabilities.

Hence, for as long as one has an outstanding undisputed debt of at least 750 pounds, for the UK, and for Uganda, Uganda shillings 2,000,000 in case of companies, and 1,000,000 for individuals[27](About 555 & 277 USD respectively), he or she can be subjected to insolvency proceedings, and as it was observed in *Cornhill Insurance Plc v Improvement Services Ltd[28]*even if there is evidence showing that a company has a large surplus of assets over liabilities, the Court may infer that it is insolvent if it has failed to pay a debt which has been duly demanded.

V. Does a creditor benefit from petitioning for a debtor's Insolvency?

There is overwhelming consensus amongst both academics[29] and debt collection practitioners[30] that insolvency proceedings can be an effective debt collection device, where, especially, the debtor is solvent but just unwilling to pay his or her debts.

[22]Halsbury's law of England, 4th Edition, 1988 Reissue, Vol 7(2) at paragraph 1451, pages 1101 and 1102
[23] (1998) Times, 3 December, C.A
[24] Insolvency Act, 1986, s.123(1)(c),(d) and (f)
[25] Ibid, s.123(1) (e)
[26][2013] UKSC 28
[27] The 2nd Schedule of the Insolvency Act of Uganda, 2011
[28] (1986)1 WLR 114
[29] Op. cit. n.1
[30] Jonathan Hogg, Insolvency as a collections tool, published in the legal & enforcement magazine, September 2014.

And as any debt collector will agree, many times, debtors don't pay their debts not because they are poor but just because they don't consider settling their debts a priority. Some don't pay merely because they know that they can always exploit the available legal loopholes to delay any enforcement processes.

Indeed, one of the biggest difficulties for credit controllers and debt recovery professionals is getting the debtor to take a payment demand seriously[31], and the success of a debt collector is often determined by how serious debtors take one's demands. If debtors think of you as toothless, they will most probably pay other serious creditors before you.

Using insolvency to collect debts potentially has the following notable benefits;

- It enables the petitioning creditor to quickly determine whether the debtor has the means to pay or is indeed insolvent and unable to pay[32]. This is because if the debtor is capable of paying but only dodging, he will normally pay the debt immediately upon receipt of the statutory demand so as to avert the risks of insolvency proceedings.The few insolvency cases in Uganda show that debtors usually settle their debts even before any court orders are made.[33] In *Re Joash Mayanja Nkangi*[34], the debtor paid a substantial deposit on the due debt immediately he was served with a bankruptcy notice, while in *Re Teddy Seezi Cheeyi*[35]the debtor entered into a settlement with his creditors immediately a receiving order was made against him.

- Insolvency proceedings avert the problems associated with individual creditors separately rushing to recover their individual debts and the concomitant waste caused by such actions against an already distressed debtor, as well as the inequitable distribution of available assets to one or a few aggressive creditor to the detriment of the debtor and other creditors.

- The collective nature of insolvency proceedings present a more efficient and effective means of increasing payment to creditors and in enhancing fair distribution of payments amongst creditors[36], because rather than each creditor engaging in investigations of the debtor's assets and in establishing the genuineness of the creditor's claims for inability to pay debts, during insolvency, this is done by the liquidator for the benefit of all creditors, which not only saves on costs, but also promotes operational efficiency.

- It works as a quasi-regulatory mechanism for extracting payment from unresponsive debtors, and if it turns out that the debtor cannot genuinely pay, it helps in limiting further losses to other creditors who could suffer loss if the debtor continues to operate outside the insolvency system, which benefits even other

[31] ibid
[32] Op. cit.n.1, p.18
[33] A study report on Insolvency law, by the Uganda Law Reform Commission, 2004, p.59
[34] Bankruptcy Cause No. 1 of 2001
[35]Bankruptcy Cause No. 1 of 1997
[36]World Bank Report on the Treatment of the Insolvency of Natural persons, 2013, p. 24, para 56

unsecured creditors who would otherwise suffer loss through extending further credit to the insolvent[37].

- Insolvency enhances the creditor's capacity to negotiate and reach workable compromises with the debtor, since unlike in ordinary enforcement systems where each creditor would have to pursue his interests, during insolvency, all creditors are joined and superintended over by a liquidator, who is usually a professional with better negotiation skills to secure the best position for all the creditors[38].

- It confirms to the debtor that the creditor is absolutely serious about collecting the debt, and that if the debt is not paid, the debtor will suffer the irreparable consequences of liquidation or bankruptcy.

- In terms of court fees, insolvency proceedings are cheaper to commence than ordinary enforcement measures. In Uganda, the filing fees for a petition for liquidation or bankruptcy costs only Uganda shillings 5,000[39], irrespective of the value of the debt, yet for ordinary enforcement procedures, the fees are dependent on the value of the debt, which means that if the debt sought to be recovered is big, the fees can be high, yet as we all agree, no creditor wants to spend any more on a non performing debt.

- Insolvency proceedings are fairly insulated from the very wide judicial discretion that is seen in ordinary enforcement procedures, which often favours debtors. Once an insolvency petition is presented, the presiding court will not have many options, but to grant the petition, except where the debtor genuinely disputes the debt. In Uganda, for instance, ordinary suits can take as long as two years before judgment is granted, and even after judgment, the debtor can still delay actual execution through appeals and interlocutory applications for stay of execution, which are uncommon in insolvency proceedings.

  In *Gitobu Imanyara T/A Gitobu & Co. Advocates*[40], the High Court of Kenya refused a debtor's application to stay bankruptcy proceedings that had been filed against him, because he failed to prove that he had either paid off the debt or that he had any counter claim, set off or cross- demand against the petitioning creditor.

It is thus incumbent upon every debt collection professional to decide whether to collect their debts through the conventional and highly praised but ineffective way or through a means that is legal and highly effective but perceived by some people as illegitimate[41].

In ***Oriental Airlines Ltd v Air Via Ltd***[42] the Court of Appeal of Nigeria held inter alia that the machinery of winding up petitions should not be converted to an engine for debt

[37] Op. cit. n.2
[38] Op. cit. n.37
[39] Insolvency(fees)Regulations, S.I No. 26 of 2013
[40] Bankruptcy Cause No.16 of 2007
[41] Op. cit. n.6
[42] (1998)12 NWLR 271 at 280-281

collection in circumvention of the established legal procedure for instituting action in appropriate courts for collection of debts.

This leaves one to wonder whether the laws allowing the use of insolvency are secondary laws.

In my considered opinion, until the laws on insolvency are changed to provide otherwise, it is improper for courts to stigmatize the use of insolvency as a debt collection devise. Debt collection is not a moral or ethical contest where a creditor's choice of collection procedure should be judged basing on moral or ethical standards. A creditor should have the freedom to freely weigh the risks and choose the most effective and convenient procedure under any law, and no one should be criticized for choosing insolvency over ordinary enforcement procedures, for as Visey. J, stated in *Re a Company*[43], rich man and rich companies which did not pay their debts had only themselves to blame if it were thought that they could not pay them.

VI. Risks posed by the use of insolvency

Effective as it might seem, using insolvency proceedings to collect debts without carrying out a proper cost-benefit analysis can backfire and expose one to some of the following risks;

- Where, after presentation of the petition, the debtor succumbs to pressure and pays the petitioning creditor's debt ahead of other creditors, the court may not sanction withdrawal of the petition, and instead allow the other creditors to continue with the petition. Once this happens, the liquidator appointed by court may avoid the payment made to the original petitioner, and demand that all the funds received by such creditor be refunded to the pool for distribution to all the creditors, which would mean that unless the petitioning creditor is preferential in ranking, he risks losing any gains since he would have to share any proceeds with the rest of the creditors.

- Insolvency proceedings often negatively impact on the debtor's business prospects, which further compromise the debtor's capacity to meet other creditor's obligations, let alone diminishing his or her potential to remain in business.

- Insolvency proceedings should never be invoked to recover genuinely disputed debts, otherwise court could set aside the statutory demand and/or dismiss the petition with orders for costs to the debtor.

- Lastly, insolvency may provide relief to the debtor, since after commencement of insolvency proceedings, all pending actions against the debtor by all creditors are stayed to give way for insolvency processes. This could turn out to benefit the debtor more than the creditor.

[43] 1950(94)SOL J 369

VII. Conclusion

From the above analysis, it is evident that although insolvency proceedings are generally believed to be collective in nature and meant to benefit the entire body of creditors, it is undeniable that there is a growing belief that these proceedings can also be used as a debt collection strategy by individual creditors, and in spite of the risks associated with it, there is every reason for all result-oriented debt collectors to deeply think of insolvency proceedings as the possible weapon against the capable but stubborn defaulters.

In order for insolvency to however work for creditors, it is important that players in the judicial arena change their attitude towards creditors who prefer this mechanism over other possible debt collection measures. Creditors should not be criticized for using insolvency proceedings to collect their debts. The judge's role should remain as that of an umpire; to decide whether or not the petition is lawfully before court, and not to determine the legitimacy of one's choice of procedure.