

# GUIDANCE NOTES

## FOR DIRECTORS OF COMPANIES WHICH MAY BE MADE SUBJECT TO A FORMAL INSOLVENCY PROCEDURE

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# GUIDANCE NOTES

## FOR DIRECTORS OF COMPANIES WHICH MAY BE MADE SUBJECT TO A FORMAL INSOLVENCY PROCEDURE

### Introduction

These notes have been prepared to give general guidance to company directors whose companies are about to be made subject to a formal insolvency procedure. Such formal procedures include liquidation, administration, administrative receivership and a company voluntary arrangement (“CVA”). A licensed Insolvency Practitioner appointed as a liquidator, administrator, receiver, nominee or supervisor is known as an “office holder”.

*We have not attempted to cover every possible situation and you should seek specific advice if you are unsure about any matters. If you are also concerned about your personal position you should seek independent advice.*

### Insolvency

“Insolvency” is an inability to pay debts as defined in Section 123 of The Insolvency Act 1986. There are a number of definitions, but generally speaking a company is insolvent if:

1. its liabilities are greater than its assets; and
2. it is unable to pay its debts as and when they fall due.

### The period up to the start of the insolvency procedure

1. The period up to the appointment of an office holder is often referred to as the “hiatus period”. The directors’ overriding duty during the hiatus period is to act in the best interests of the company, its creditors and shareholders. If you fail to do so you could find yourself subject to allegations of breach of duty or **misfeasance**. (Misfeasance is the improper performance of a lawful act.)

2. You also have an additional duty to take every step you ought to take to minimise the loss to creditors. If DSi Services (“DSi”) is advising the company during the hiatus period please note that DSi’s client is the **company** and not the directors. DSi will advise the directors only on the matters they should consider and the steps they should take on the company’s behalf.

3. If the company is continuing to trade, stock may be sold in the normal way but you should avoid selling on credit to any company or person who has a claim against the company. We normally recommend that no other assets be sold in the period immediately before the start of the formal insolvency procedure, unless there is some urgent need to do so.

4. There may be some very rare circumstances in which it is in the interests of the company and its creditors for some of the assets to be sold to the directors or to some other person or company associated with one or more of the directors. This should only be done on professional advice. If the asset is worth more than £2,000, a formal company resolution recorded in writing approving the sale must be passed before the sale takes place.

5. If the company sells any of its assets for less than their true value, buys anything for more than its true value or pays any money to a creditor, the transaction or payment **may be set aside** if the company later goes into liquidation or administration. If the company is seeking a voluntary arrangement with its creditors, the nominee will normally have to include any such transaction or payment in his report to the Court or to the creditors.

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## Preservation and protection of the company's position

6. During the hiatus period prior to the appointment of an office holder, the directors must not do anything to worsen the company's financial position. This effectively means ensuring that no assets are reduced in value and no liabilities are increased.

## Further supplies of goods and services

7. The company should not incur further credit in the hiatus period. Any goods which arrive at the company's premises should only be accepted on the basis that they are paid for immediately from cash belonging to the company.

8. Before accepting delivery the directors must consider whether they can sell the items for more than their cost or obtain benefit from them by using them in production. This may be difficult, particularly if the company has ceased trading or the materials cannot be sold with the certainty of payment in full.

9. Any delivered items which remain in stock at the date of the appointment of the office holder may well make a loss on sale and worsen the company's financial position.

10. It is easy for credit to be incurred by the continuing use of facilities and the inevitable cost of, say, electricity and telephone services. The directors must decide whether these and other services are necessary, in which case it may be preferable to lodge a cash deposit as an alternative to credit. Please note that incurring further PAYE/NIC and/or VAT liabilities is regarded as incurring further "credit".

## Position of employees

11. The company must pay any staff who remain on the payroll during the hiatus period in full for that period. The directors must be satisfied that the employees concerned are needed and that the employment costs are justified. Deductions from payments to employees must be made (e.g. PAYE, National Insurance contributions, pension contributions etc) and paid to the appropriate authorities.

12. Any other payments to employees should be restricted to arrears of wages and salaries and be necessary to either preserve the company's assets or comply with statutory requirements. Under the provisions of the Employment Rights Act 1996, claims in respect of salaries, wages, holiday pay, damages in lieu of notice and redundancy pay will normally be paid (to certain limits) by the Department of Trade and Industry.

## Position of creditors

13. No goods should be released on credit **to any party** (including carriers) who may:

- have a claim against the company and who will therefore apply set off and refuse to pay for the goods, or
- be unable to pay for the goods.

14. Any creditor claiming the return of goods under retention of title or otherwise should be allowed access to check and record the existence of the goods. The creditor should be asked in advance how they will identify their property. However, **under no circumstances whatsoever** may a creditor be allowed to remove goods. The validity of the creditor's claim will be dealt with by the office holder when appointed.

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15. Any goods identified by a creditor as potentially reclaimable by them should be stored separately and clearly marked. If the directors allow the goods to be sold or used in the hiatus period they may be open to a claim for damages from the supplier.

16. **Under no circumstances may any creditor be paid**, no matter what action they take. Any judgements, writs or other formal demands for payment (including solicitors' letters) should be referred immediately to either the proposed liquidator or DSI. The issue of the notice of the (proposed) appointment of the office holder is usually sufficient to deter even the most aggressive creditor from taking legal action.

17. Any creditor (usually a bank) who has a floating charge over all or practically all of the company's assets can in certain circumstances appoint either an administrative receiver or an administrator. Any such creditor should be advised of the intention to put the company into voluntary liquidation before the creditors' meeting is convened, with **at least 5 days' notice** being given to them of the shareholders' meeting. This will give them the opportunity of considering whether or not to appoint an administrative receiver or administrator before the company is put into liquidation. It may be possible for this 5 day period to be waived in matters of urgency.

## Prospects for going concern sale

18. There may be a prospect of selling the business as a going concern. The additional value which may be received on a sale as a going concern must be balanced against the loss which is likely to be incurred in continuing the business during the hiatus period. Much depends on the levels of operating costs and of sales in the hiatus period and also the possibility that the sale of the business may fall through. Specific advice should be sought regarding continued trading during the hiatus period.

## During the insolvency procedure

### Powers of directors

19. In a company voluntary arrangement, there is no effect on the powers of directors and they remain in control of the activities of the company. However, with some very rare exceptions, **directors' powers cease** on the appointment of a liquidator. In theory their powers do not cease during an administration or an administrative receivership, but they will be severely curtailed.

20. On a practical basis, the appointment of an administrator, liquidator or administrative receiver effectively removes control of the company from its directors. In addition, an administrator can also remove and appoint directors.

### Report on directors' conduct

21. A liquidator, administrator or administrative receiver has a statutory duty to send a report on your conduct as a director to the Department of Trade and Industry ("DTI"). If the DTI consider that your conduct renders you unfit to be concerned in the management of a company, it can ask the Court to disqualify you from acting as a director for anything between two and fifteen years, depending upon the severity of misconduct.

### Co-operation and delivery of records

22. Once the company goes into liquidation, administration or administrative receivership you have a **duty to deliver** any of the company's assets or records under your control to the office holder.

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23. You also have a **duty to co-operate** with the office holder, give him such information about the company's affairs as he may reasonably require and meet him should he ask you to. You should note that the Court can also summon you before it to be examined on the company's affairs, but this will only be done if you do not give the office holder the co-operation and information he needs.

## Reversing transactions

24. A liquidator or administrator can ask the Court to set aside any transaction which took place within the two years (subject to various conditions) preceding the start of the liquidation or administration at a time when the company was insolvent and which:

- resulted in the company receiving less than full value in exchange for what it gave (**transaction at undervalue**); or
- put any creditor connected with the company into a better position than he would have been in on a liquidation (**preference**). If the creditor was not connected with the company such a transaction can only be set aside if it took place within the six months preceding the liquidation or administration.

25. In a CVA, the directors have a statutory duty to state in the CVA proposals that none of the above transactions apply, or if they do, how they will be remedied.

## Wrongful Trading

26. This will apply where a company has gone into liquidation, but not in administration, receivership or a voluntary arrangement.

27. A director who causes a company to continue trading and incur further credit (which is not paid for) past a point where they **knew or ought to have known** that the company would not be able to avoid liquidation, may be guilty of "wrongful trading". If this is the case a Court may order that the director is personally liable to contribute to the company's assets for the benefit of creditors, unless the director took every step to minimise loss to creditors.

28. It is therefore most important that directors ensure they are aware of the company's financial position in the period prior to the start of a liquidation process.

## The Company Voluntary Arrangement Process

29. A company voluntary arrangement ("CVA") is essentially a deal (the **proposals**) between the company and its creditors to repay all or some of the amounts owed to the creditors over a period of time. The deal may be structured in such a way as to ensure the survival of the company going forward, although this will only be possible with the agreement of creditors to the deal.

30. The directors will normally instruct DSI to review the company's financial position and then draft the proposals for the CVA which are then agreed by the directors. Meetings of the company's creditors and shareholders are held for them to also agree to the proposals. In some cases, the creditors may make modifications to the original proposals before agreeing to them. Once the proposals have been agreed, debts existing at the time of the agreement cannot be enforced against the company by any legal or other action by the creditors.

31. Any debts incurred by the company after the agreement of the CVA proposals must still be paid in full at the correct time.

32. Once the proposals have been agreed, the directors remain in control of the company and the office holder is appointed as the supervisor of the CVA. His job then is to ensure that the terms of the CVA are complied with by the company and make payments to creditors bound into the CVA.

## The Administration Process

33. There are only three statutory purposes for which a company can go into administration:

1. Rescuing the company as a going concern; or
2. 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
3. Realising property in order to make a distribution to one or more secured or preferential creditors

34. As part of the pre-appointment process, DSi will undertake a review of the company and its financial position to ensure that an administration is appropriate and one of these statutory purposes can be achieved. This review may be formal or informal depending upon the size and complexity of the financial position of the company.

34. An administrator may then be appointed by (amongst others) the company, the directors or the holder of a floating charge (usually a bank). On rare occasions, an administrator may be appointed by a creditor of the company. The appointment may be made either inside a Court process or outside of one.

36. Once the administrator is appointed he will act on behalf of creditors generally (not solely on behalf of the appointor). He will take control of the company and carry out his duties and functions with a view to achieving one of the statutory purposes.

37. The administration process may only last for 12 months unless extended by a further six months with the agreement of the creditors or the Court. Once the administration has finished, the exit route may be a voluntary liquidation, a CVA, a compulsory or voluntary liquidation or the company and the control of it may just be handed back to the directors.

## The Administrative Receivership Process

38. An administrative receiver may be appointed by the holder of a floating charge over the whole or substantially the whole of the company's assets. The appointment of an administrative receiver is rare following a change in legislation introduced on 15 September 2003. Only holders of a floating charge which was created prior to this date may appoint an administrative receiver. There are some exceptions to this (e.g. insurance companies) but these are not detailed here.

39. The receiver is appointed by the floating charge holder and acts primarily on behalf of the appointor. He only has a secondary duty to act on behalf of creditors generally. The powers of the receiver are limited to those powers contained in the floating charge document or other document appointing him, but generally speaking they usually allow the continuance of trade and a sale of the business.

## The Voluntary Liquidation Process

40. It may be best for the directors to call a meeting of shareholders, under **short notice**, to appoint a liquidator immediately, rather than waiting for the usual full notice period to expire in respect of holding a shareholders' meeting. The usual reason for the immediate appointment of a liquidator is there are assets that are perishable or likely to diminish in value. However, there

may be other circumstances that mean it is appropriate to appoint a liquidator at short notice and directors should take professional advice in this respect.

41. In a Creditors Voluntary Liquidation (“CVL”), the directors authorise the calling of a meeting of the members (otherwise known as shareholders) for the purpose of placing the company into voluntary liquidation and the appointment of a licensed Insolvency Practitioner as liquidator of the company. The directors must also convene a meeting of the company’s creditors to be held within 14 days of the members’ meeting when the appointment of the members’ liquidator will be confirmed, or creditors may appoint a liquidator of their own choice.

42. **The company will not be in liquidation until the members' meeting has been held.** It is therefore important for the directors to remember that, until the members' meeting has been held, the proposed liquidator and/or DSI can only act in an advisory capacity and the directors remain entirely responsible for the running of the company and all actions and decisions taken.

43. A statement of affairs must be presented at the creditors’ meeting. This is a list of the company’s assets and liabilities in a statutory format. If the statement of affairs is to be made up to a date before the meeting of creditors, the directors must report any material changes prior to the meeting.

44. You should note that if the terms of engagement for DSI provide that DSI will assist in the preparation of the statement of affairs on behalf of the directors, the content of the statement of affairs still remains the sole responsibility of the directors. The directors will be required to swear an affidavit confirming that the contents of the statement of affairs are true. As such the final document is a legal document. If directors have any doubt as to their personal position in this respect, they should seek independent legal advice.

## **Restrictions on re-use of Company Name**

45. Your attention is drawn to the provisions of Section 216 and 217 of the Insolvency Act 1986 which are briefly explained below.

46. As you are acting as a director of or taking part in the management of a company that is likely to go into **liquidation**, at any time in the period of 12 months ending with the day before the company goes into liquidation you are prohibited from using any name by which the company was known, **including any trading names**, or a name which is so similar as to suggest an association with that company.

47. The restriction from using a prohibited name applies for the period of **5 years** beginning with the day on which the company went into liquidation and except with the permission of the court you cannot:

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

48. Your attention is also drawn to Rules 4.226 to 4.230 of the Insolvency Rules 1986 which provide three exceptions to the restriction imposed by Section 216 of the Insolvency Act 1986.

49. From 6 August 2007 Rule 4.228 specifically requires that a person who is or intends to be a director of, or involved in the promotion, formation or management of, a company or unincorporated business with a prohibited name must give notice under the Rule using Form 4.73, **before** he acts in such capacity.

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50. You should note that it is a **criminal offence** to contravene Section 216 of the Insolvency Act 1986 and if you act in contravention of this section you are **liable on conviction to imprisonment and/or a fine**.

51. Your attention is also drawn to Section 217 of the Insolvency Act 1986, which provides, amongst other things, that a person who is involved in the management of a company in contravention of Section 216 of the Insolvency Act 1986 is **personally liable** for any debts of the company incurred during the period of that involvement.

52. A copy of Sections 216 and 217 of the Insolvency Act 1986 is attached together with a copy of Rules 4.226 to 4.230 of the Insolvency Rules 1986.

*If you have any doubts about the contents of these guidance notes, please discuss them with us directly. Alternatively, you may wish to seek independent legal advice. If you do not know the name of a solicitor to contact, you may find that your local Citizens' Advice office will be able to offer you some assistance.*

### **Personal liability**

53. None of the above insolvency processes will affect the personal liability of any person who has given a personal guarantee to any creditor or other party in respect of any liability of the company. Any party who holds a personal guarantee (e.g. from a director) will be able to take steps to enforce that personal guarantee against the individual.

54. If you have any doubts regarding your personal position in respect of any personal guarantees, you should seek immediate independent legal advice regarding your position.

## **YOU ARE REQUIRED TO SIGN HERE TO ACKNOWLEDGE RECEIPT OF THESE GUIDANCE NOTES.**

I confirm receipt of these guidance notes.

Company name: \_\_\_\_\_

Signed: \_\_\_\_\_

Name: \_\_\_\_\_

Date: \_\_\_\_\_

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#### SECTION 216 INSOLVENCY ACT 1986

- (1) This section applies to a person where a company ("the liquidating company") has gone into insolvent liquidation on or after the appointed day and he was a director or shadow director of the company at any time in the period of 12 months ending with the day before it went into liquidation.
- (2) For the purposes of this section, a name is a prohibited name in relation to such a person if -
- (a) it is a name by which the liquidating company was known at any time in that period of 12 months, or
  - (b) it is a name which is so similar to a name falling within paragraph (a) as to suggest an association with that company
- (3) Except with leave of the court or in such circumstances as may be prescribed, a person to whom this section applies shall not at any time in the period of 5 years beginning with the day on which the liquidating company went into liquidation -
- (a) be a director of any other company that is known by a prohibited name, or
  - (b) in any way, whether directly or indirectly, be concerned or take part in the promotion, formation or management of any such company, or
  - (c) 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.
- (4) If a person acts in contravention of this section, he is liable to imprisonment or a fine, or both.
- (5) In subsection (3) "the court" means any court having jurisdiction to wind up companies; and on an application for leave under that subsection, the Secretary of State or the official receiver may appear and call the attention of the court to any matters which seem to him to be relevant.
- (6) References in this section, in relation to any time, to a name by which a company is known are to the name of the company at that time or to any name under which the company carries on business at that time.
- (7) For the purposes of this section a company goes into insolvent liquidation if it goes into liquidation at a time when its assets are insufficient for the payment of its debts and other liabilities and the expenses of the winding up.
- (8) In this section "company" includes a company which may be wound up under Part V of this Act.

#### SECTION 217 INSOLVENCY ACT 1986

- (1) A person is personally responsible for all the relevant debts of a company if at any time -
- (a) in contravention of section 216, he is involved in the management of the company, or
  - (b) as a person who is involved in the management of the company, he 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 the company of section 216.
- (2) Where a person is personally responsible under this section for the relevant debts of a company, he is jointly and severally liable in respect of those debts with the company and any other person who, whether under this section or otherwise, is so liable.
- (3) For the purposes of this section the relevant debts of a company are -
- (a) in relation to a person who is personally responsible under paragraph (a) of subsection (1), such debts and other liabilities of the company as are incurred at a time when that person was involved in the management of the company, and
  - (b) in relation to a person who is personally responsible under paragraph (b) of that subsection, such debts and other liabilities of the company as are incurred at a time when that person was acting or was willing to act on instructions given as mentioned in that paragraph.
- (4) For the purposes of this section, a person is involved in the management of a company if he is a director of the company or if he is concerned, whether directly or indirectly, or takes part, in the management of the company.
- (5) For the purposes of this section a person who, as a person involved in the management of a company, has at any time acted on instructions given (without the leave of the court) by a person whom he knew at that time to be in contravention in relation to the company of section 216 is presumed, unless the contrary is shown, to have been willing at any time thereafter to act on any instructions given by that person.
- (6) In this section "company" includes a company which may be wound up under Part V.

**CHAPTER 22 of the Insolvency Rules 1986 as amended****LEAVE TO ACT AS DIRECTOR, ETC, OF COMPANY WITH PROHIBITED NAME (SECTION 216 OF THE ACT)****Rule 4.226 - Preliminary**

The Rules in this Chapter –

- (a) relate to the leave required under section 216 (restriction on re-use of name of company in insolvent liquidation) for a person to act as mentioned in section 216(3) in relation to a company with a prohibited name,
- (b) prescribe the cases excepted from that provision, that is to say, those in which a person to whom the section applies may so act without that leave, and
- (c) apply to all windings up to which section 216 applies, whether or not the winding up commenced before the coming into force of the Rules.

**Rule 4.227 – Application for leave under s 216(3)**

When considering an application for leave under section 216, the court may call on the liquidator, or any former liquidator, of the liquidating company for a report of the circumstances in which that company became insolvent, and the extent (if any) of the applicant's responsibility for its doing so.

**Rule 4.228 - First excepted case**

- (1) This Rule applies where—
- (a) a person ("the person") was within the period mentioned in section 216(1) a director, or shadow director, of an insolvent company that has gone into insolvent liquidation
  - (b) the person acts in all or any of the ways specified in section 216(3) in connection with, or for the purposes of, the carrying on (or proposed carrying on) of the whole or substantially the whole of the business of the insolvent company where that business (or substantially the whole of it) is (or is to be) acquired from the insolvent company under arrangements—
    - (i) made by its liquidator; or
    - (ii) made before the insolvent company entered into insolvent liquidation by an office-holder acting in relation to it as administrator, administrative receiver or supervisor of a voluntary arrangement under Part 1 of the Act.
- (2) The person, will not be taken to have contravened section 216 if prior to his acting in the circumstances set out in paragraph (1) a notice is, in accordance with the requirements of paragraph (3),—
- (a) given by the person, to every creditor of the insolvent company whose name and address—
    - (i) is known by him; or
    - (ii) is ascertainable by him on the making of such enquiries as are reasonable in the circumstances; and
  - (b) published in the Gazette.
- (3) The notice referred to in paragraph (2)—
- (a) may, subject to compliance with sub-paragraph (a), be given and published before the completion of the arrangements referred to in paragraph (1)(b) but must be given and published no later than 28 days after that completion;
  - (b) must state—
    - (i) the name and registered number of the insolvent company;
    - (ii) the name of the person;
    - (iii) that it is his intention to act (or, where the insolvent company has not entered insolvent liquidation, to act or continue to act) in all or any of the ways specified in section 216(3) in connection with, or for the purposes of, the carrying on of the whole or substantially the whole of the business of the insolvent company; and
    - (iv) the prohibited name or, where the company has not entered insolvent liquidation, the name under which the business is being, or is to be, carried on which would be a prohibited name in respect of the person in the event of the insolvent company entering insolvent liquidation; and
  - (c) must in the case of notice given to each creditor of the company be given using Form 4.73.
- (4) Notice may in particular be given under this Rule—
- (a) prior to the insolvent company entering insolvent liquidation where the business (or substantially the whole of the business) is, or is to be, acquired by another company under arrangements made by an office-holder acting in relation to the insolvent company as administrator, administrative receiver or supervisor of a voluntary arrangement (whether or not at the time of the giving of the notice the director is a director of that other company); or
  - (b) at a time where the person is a director of another company where—
    - (i) the other company has acquired, or is to acquire, the whole, or substantially the whole, of the business of the insolvent company under arrangements made by its liquidator; and
    - (ii) it is proposed that after the giving of the notice a prohibited name should be adopted by the other company."

**Rule 4.229 – Second excepted case**

(1) Where a person to whom section 216 applies as having been a director or shadow director of the liquidating company applies for leave of the court under that section not later than 7 days from the date on which the company went into liquidation, he may, during the period specified in paragraph (2) below, act in any of the ways mentioned in section 216(3), notwithstanding that he has not the leave of the court under that section.

(2) The period referred to in paragraph (1) begins with the day on which the company goes into liquidation and ends either on the day falling six weeks after that date or on the day on which the court disposes of the application for leave under section 216, whichever of those days occurs first.

**Rule 4.230 – Third excepted case**

The court's leave under section 216(3) is not required where the company there referred to, though known by a prohibited name within the meaning of the section -

- (a) has been known by that name for the whole period of 12 months ending with the day before the liquidating company went into liquidation, and
- (b) has not at any time in those 12 months been dormant within the meaning of section 252(5) of the Companies Act.

[Note: the Companies Act 2006 redefines a "dormant company" slightly under section 1169 CA06, effective from October 2008]

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