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# **Companies in Difficulty A Guide for Directors**

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**David Bridge**

With a contribution from Michael Griffiths



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# Introduction

The latter half of 2008 saw the world economy move steeply into decline and current predictions are that it may be the deepest and most dramatic downturn for a long time. Even in times of economic boom, business insolvencies occur in large numbers every year. The directors and officers of a company may find themselves dealing with the issues that arise from financial difficulties, be it those of their own company or others they deal with, at any point in the economic cycle.

The difference in a severe downturn is the larger scale of businesses that find themselves in financial difficulty and therefore the number of other parties affected. When a large concern ceases to trade the ripples reach out over a very wide pool of businesses. Suppliers may be left with unpaid invoices for goods already delivered or the loss of a key customer, related companies and individual officers may find guarantees called upon by banks, while businesses who were customers may find themselves without goods or services that are critical for their own trading.

Late 2008 and early 2009 have already seen a string of companies in the UK that were household names enter into some form of formal insolvency procedure. Some have emerged already, following a restructuring or sale of part of their business, while others appear unlikely to survive in any form. After canvassing the views of its members in November 2008, R3, the Association of Business Recovery Professionals, predicted an increase of 41% in business insolvencies between 2007 and 2009.<sup>1</sup> If anything this currently looks conservative. The government's figures for England and Wales, provided by the Insolvency Service, an executive agency within the Department of Business, Enterprise and Regulatory Reform (BERR),

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<sup>1</sup> R3 article: "*Insolvency Practitioners predict dramatic rises in personal and business insolvencies will not hit UK until end of 2009*" 03 November 2008

show 2,018 companies entered administration in the fourth quarter of 2008.<sup>2</sup> This represents a 251% increase in the number of administrations year on year.

The purpose of this book is not simply to act as guidance for directors of companies that are struggling financially. It is to offer a brief and digestible guide to the framework within which companies in financial difficulty are dealt with in England and Wales.

Understanding this is as relevant to the management of a company dealing with the insolvency of a supplier or customer as it is to directors concerned about the financial health of their own company. To this end the first part of this book briefly summarises the main types of insolvency procedures in England and Wales, the steps involved and the roles of the company's management, its creditors and the insolvency practitioners appointed.

Many businesses go through serious financial difficulties without ever entering a formal insolvency procedure. Instead they enter into restructurings of their obligations with key creditors behind closed doors. The range of possible restructuring arrangements a company can enter into are practically endless and entirely determined by the particular circumstances of the company involved. Those companies that restructure their debts are the "invisible majority" of companies in difficulties. In order to prevent a loss of confidence among their suppliers, customers and staff, they are likely to say as little about their difficulties in public as is allowed according to their regulatory status. The announcement by a company that it has entered into revised loan agreements with its banks and bondholders may generate some coverage in the Business sections, but is far less dramatic than an announcement that it has entered into a formal insolvency procedure, such as administration.

However, many commentators have suggested that in the current economic cycle there may be fewer restructurings and more formal insolvency procedures. This is partly due to the ever increasing flexibility of formal insolvency procedures in the drive towards a "corporate rescue culture" in the UK. Successive legislation has aimed to enable companies to be restructured under the protection of a formal

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<sup>2</sup> [www.insolvency.gov.uk](http://www.insolvency.gov.uk)

insolvency process, moving the default position away from merely liquidating the failed company's assets and distributing them to creditors. It is now widely accepted that the best outcome is for a company to survive in some form, not just for its employees and suppliers, but also its creditors in the longer term. A second factor pointing to fewer restructurings, more specific to the situation that developed in 2008, is that whereas in the past the banks were often the rescuers for companies in difficulties, the lack of available credit from banks is now one of the biggest problems. Indeed, it is likely to be companies that were reliant on readily available financing at low cost that will now be the first to struggle.

Even where a formal insolvency procedure can be avoided by restructuring, it would be wrong to assume that the rules of formal insolvency procedures have no relevance. Restructuring negotiations are always conducted with one eye on the possibility of no agreement being reached. The negotiation lines in this context will always be drawn by reference to a party's position under the back-stop option: formal insolvency in some form. No-one will agree to a deal that puts them in a worse position than they would be under in an insolvency procedure that they have the power to commence. Indeed, it is quite common for companies to draw up draft documentation for a Company Voluntary Arrangement or Scheme of Arrangement to represent "Plan B" when restructuring negotiations appear likely to stall. If certain creditors in the negotiations know that they will be worse off under such an arrangement and that it can be implemented in the face of their objections, their leverage is greatly reduced. Likewise the threat of placing the company into administration, with its moratorium on creditors' rights, may undermine the position of certain creditors in negotiations. For this reason an understanding of the insolvency procedures is relevant in far more situations than might be apparent.

The second part of the book focuses on the position of the directors of a company that finds itself in financial difficulty. It considers the duties of company directors in this situation, the decisions they face and the traps they need to avoid. Directors of companies that start to experience a decline in their finances are in an unenviable position and face an intensely stressful time. They are expected to be bold in order to turn things around, without being so reckless as to

diminish what is left if ultimately any attempted turnaround fails. There are new considerations that they must take into account in their decision-taking and new risks to themselves personally. Whatever they do, it is certain that someone, be it a creditor, shareholder or analyst, will suggest that there was a better course of action.

By looking at each area of conduct for which directors may face criticism or even sanction, this section of the book provides the officers of a company with the knowledge to guide them through a period of financial difficulty. There is practical guidance that seeks to prevent a board finding itself on the wrong side of England's voluminous and complex company and insolvency law. Whenever the board of directors realises that the company is in danger of being unable to meet its obligations due to the state of its finances, they should of course seek immediate professional advice. However, many directors are slow to face up to the reality of a deteriorating position. The later it is left to consider the worst case scenario, the fewer options may be left to turn things around and the more likely it is that the directors will be criticised for their conduct. The focus of this section of the book is therefore on what is sometimes called the "twilight period": the period when a company's fortunes hang in the balance and when the most difficult decisions have to be taken.

The third part of this book looks at how a company can protect itself against the insolvency of a third party, be it a customer or supplier. These chapters look at warning signs that can point towards impending insolvency, how to check a counterparty's credit rating and how contracts can be drafted to put your company in the best possible position should the counterparty enter a formal insolvency procedure. In particular it looks at ways in which companies can ensure that goods that have been supplied but not paid for do not end up as the property of an insolvent company. It also assesses the position of a company as a creditor in a formal insolvency procedure, what its rights are under the various regimes and whether it may be entitled to exercise security or seize back goods provided on credit to the insolvent company.

Finally, it is necessary to sound a note of caution. The insolvency of a company affects every part of its operations and all of its relationships. It therefore involves every area of the law that covers

companies, including topics far beyond the remit of this book. Areas of law that may become relevant include employee rights in the context of possible redundancies, the treatment of pension schemes and the sale and purchase of businesses, with all that that entails, such as competition considerations.

The subject matter of this book covers elements of the Insolvency Acts 1986 and 2000, the Insolvency Rules, the Company Directors Disqualification Act 1986, the Enterprise Act 2002, the law of property Act 1925, the Pensions Act 2004, the Financial Services and Markets Act 2000, the Disclosure and Transparency Rules, the Listing Rules and the Companies Act 2006. The last of these alone runs to more than 700 pages. It will be obvious from this that the slim volume you are holding cannot be an exhaustive analysis of every possible situation that may arise. Nor is it intended to be. The aim in writing this book has been to provide an accessible guide to the issues of which directors and company secretaries need to be aware and to explain the application of the most relevant law from a practical standpoint. It is a statement of the obvious, but this book does not constitute definitive advice and is no substitute for proper legal and financial advice based on the specific circumstances involved.

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## **PART ONE**

# Insolvency procedures

*David Bridge*

- When is a company insolvent?
- Formal insolvency procedures
- Administration
- Receivership
- Company voluntary arrangements and schemes of arrangement
- Liquidation
- The 'prescribed part'

# 1 When is a company insolvent?

## **The tests for insolvency**

Everyone is aware of what insolvency means in the most general sense. In the context of the rights and obligations of a company or its directors, however, the term needs to be defined more carefully, particularly as to *when* a company becomes insolvent. To determine this, it is necessary to look at how the courts decide whether a company is insolvent at any given point in time. The key definition of insolvency is set out in s. 122 of the Insolvency Act 1986 ('IA 1986') as a ground for the court to order the liquidation of the company:

'the company is unable to pay its debts'

This is commonly divided into two separate tests, though it is not always necessary for both to be satisfied for a company to be considered insolvent. The two tests are the cash-flow test and the balance sheet test.

### **The cash-flow test**

A company is cash-flow insolvent if it is unable to pay its debts as they fall due. This test is set out in s. 123 of IA 1986 and is reasonably self-explanatory. The only question that sometimes arises is how far into the future directors should look when seeking to ascertain whether the company will be unable to pay its debts as they fall due. Construing this test to involve looking far into the future blurs the line between this and the balance sheet test, but to interpret it in a way that would not include a large debt due in a few weeks' time

would clearly be unrealistic. The court has recently considered this question in the context of a contract that defined an ‘Insolvency Event’ as a determination by a receiver that the company was, or was about to become, unable to pay its debts: effectively the cash-flow test. The court held that when assessing whether a company is unable to pay debts as they fall due, it is possible to take into account known future events, even where these would not occur for more than a year.<sup>1</sup> The nature of future events that can be taken into account and how far into the future will be highly fact-sensitive and the circumstances in which a company will be held to be cash-flow insolvent because of future events as far as a year away are likely to be very rare. In this case the company was an investment vehicle that had future liabilities and a pool of assets both of which were fixed. As the company had no ability to trade and improve its position, it was possible to say with certainty that it would not be able to pay its debts beyond a certain point. In most cases no such certainty will exist and a trading company is entitled to make reasonable assumptions as to its ability to improve its financial position over a longer period.<sup>2</sup>

### **The balance sheet test**

A company is balance sheet insolvent if its liabilities exceed the value of its assets. While the value of the company’s assets and liabilities shown in its accounts will be the starting point for applying this test, if there are reasonable grounds to look at other evidence it may not be determinative and the court will consider all the evidence. In the case of a company dealing in assets whose value is very volatile, such as financial instruments, the court may take the view that any valuation of the company’s assets needed to be made with a wider view than the value on any particular day.

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1 *Cheyne Finance plc (in receivership)* [2007] EWHC 2116.

2 See, for example, *Highberry Ltd v. Colt Telecom* [2003] BPIR 324 where the applicant’s attempt to rely on future events to show insolvency on the cash-flow basis was rejected by the court when considering an ordinary trading company as ‘tentative and shaky peering into the middle distance’.

In the context of wrongful and fraudulent trading (see **page 68**) the test applied as to whether a company was insolvent at its liquidation includes the costs of the liquidation as a liability of the company, though this is rarely likely to be determinative.