

INSOLVENCY: KEY ISSUES FOR BUSINESS PEOPLE

As we enter uncertain times business people will need to be aware of the risks and opportunities that the insolvency regime poses to them. This is the first of a series of briefing notes prepared by Forsters to introduce some of the issues for our clients.

IN BRIEF...

- *On the insolvency of a business, creditors and debtors have a number of options.*
- *The choices they make can transform the outcome for them.*
- *Early planning, monitoring and prompt action is essential to optimise the position.*
- *Specialist advice should be sought.*

INITIAL QUESTIONS

When should I worry about insolvency issues?

Now! You should **monitor your exposure** to high risk creditors and **review leases, loans and major contracts**.

As a creditor, do you have sufficient rights to **information** about your debtors? Do you have all appropriate **remedies** and necessary **triggers** to act? Can you obtain **security** or third party **guarantees** to mitigate the risks?

As a debtor, the law requires you to **act responsibly** in managing your debt. Failure to do so could have significant financial and legal implications.

What should I regard as a problem?

Don't wait until you receive notice of a creditor's meeting or insolvency appointment. By that stage someone else has taken the initiative and your escape routes may have been closed off.

Look for the early signs. Is a debtor repeatedly late on payment? Has a cheque bounced? Has more than one legal action been issued? Have assets been repossessed by hire purchase companies or lenders? Is there enforcement action from tax authorities or utilities?

What should I do if there is a problem?

Once you know there is a problem, the facts need to be analysed carefully and quickly. Is this a short term problem which the debtor can trade through? Can the situation be salvaged by an orderly asset disposal, refinancing, company sale or other informal rescue arrangement? (See future Forsters briefing note "Rescue and the Entrepreneurial Business"). Creditors will need to consider whether immediate litigation or other pressure tactics would improve their position. In many cases, thought will turn to formal insolvency procedures.

Forsters acted for administrators of the developer of an innovative system for replenishing ATMs. The founders exhausted their budget and had failed to find a buyer or appropriate funding partner. We helped the business in obtaining funding from a major customer to continue trading, pursued potential business buyers and took action to boost recoveries through litigation.

SECURED LENDERS

How will the bank react?

Most troubled businesses will have borrowings secured by a mortgage, debenture or charge. **Secured creditors have special privileges in insolvency.** They are generally paid ahead of ordinary unsecured creditors and have additional remedies. Any insolvency strategy must take their position into account.

Start with a careful reading of the loan and security documents. Is the facility enforceable? What assets are secured? Is there more than one secured creditor and, if so, what are their relative rankings? Is the security limited to a fixed charge over specific assets or does it also contain a floating charge over all or a class of the borrower's assets?

If they want to enforce, what can a secured creditor do?

In the simplest cases, it may decide to exercise the lender's **power of sale** and sell the property to a third party in order to realise the secured debt.

In more complex cases it may wish to rely on the professional judgment and advice of a **receiver** to deal with the asset.

By comparison with other procedures, receivership is quick and inexpensive. However, it may achieve little for unsecured creditors. A receiver's principal duties are owed to the secured creditor and in a receivership it will be unusual for there to be substantial realisations available for unsecured creditors.

Where the secured creditor's strategy is to sell an ongoing business or stocks or to realise debts they will usually require access to floating charge assets, and the usual preferred route will now be **administration**.

RESCUE PROCEDURES

Administration (Companies only)

This offers a breathing space allowing preservation of a company's business, or at least better realisation of its assets. The administrator must be a qualified **insolvency practitioner** (usually a specialist accountant) and is given broad powers by statute to take control and realise the company's assets. The administrator's appointment (or even certain steps towards it) will impose a **moratorium**, freezing litigation and many creditors' remedies against the company.

Administration can be started by:

- floating charge holders, directors or shareholders using a simple out of court procedure; or,
- creditors, or others by a court application.

An administrator will generally be the person nominated on the application and has wide discretion in strategy. So a party who starts this ball rolling can have a big influence on where it rolls to!

Voluntary arrangements (individuals and companies)

A voluntary arrangement is a deal struck between the debtor and its creditors. If approved by 75% of creditors (by value) and for companies also by 50% of shareholders, it binds all creditors and shareholders.

Care and skill is needed to negotiate optimal terms. For individuals and smaller companies a court imposed **moratorium** can be obtained to help orderly negotiation.

Once approved, all creditors (and shareholders) are bound and the main routes to court challenge are only available for 28 days. So concerns should be raised early and immediate action taken if a challenge is intended.

Our client, a major property investor owned property tenanted by a hotel group which went into administration. To keep the businesses trading and thereby preserve the value of the property the landlord bought the hotel businesses from the administrators and appointed skilled hotel managers to run the businesses on our client's behalf.

AND FOR THOSE BEYOND RESCUE?

Liquidation (Companies)

Liquidation can be started by court order (**compulsory liquidation**) or shareholders' resolution (**voluntary liquidation**).

Compulsory liquidation petitions will often be based on the company's inability to pay its debts, although there are other grounds.

There will usually be a hiatus after issue of a petition during which any business is paralysed. In bigger cases an insolvency practitioner may be appointed months later (by which time any business is often dead). In other cases the company is left to languish with the **official receiver** (a government department).

Fear of these dire results (and the broad liquidator's powers to challenge directors' actions in the pre-liquidation period) makes a liquidation petition an effective tool in an aggressive debt collection strategy- but not without risk, asset values can be decimated.

Voluntary liquidations, however, are quick to start. With smaller companies, the shareholders' resolution can be passed on short notice or in writing – almost immediately. Creditors (voting by value) effectively choose the liquidator. Standards and approaches vary, so use your vote to secure the right appointee.

Bankruptcy (Individuals)

This is similar to compulsory liquidation - but for individuals. It is started by court petition and the official receiver will generally be appointed as trustee, subject to displacement by an insolvency practitioner in private practice in appropriate cases.

WHAT IF I DO NOTHING?

For a creditor, the consequences are obvious. Delay could mean that others get to the limited assets first or a procedure is invoked which is far from optimal.

Inactive but insolvent debtors, also expose themselves to financial and legal liability. A company director who trades for too long may render himself liable to make up the resulting shortfall (**wrongful trading**); irresponsible decisions (or inactivity) may be challenged as a breach of general **directors' duties**; and action may be taken to **disqualify** him from acting as a director. Gifts and concluded deals (particularly with those who are "connected") may be re-opened as transactions at an undervalue, **transactions defrauding creditors** or **preferences**.

For debtors and creditors, inaction is not an option!

THE NEXT STEPS

If we face a major financial down turn there will be casualties. Insolvency can look like a battle field with the foot soldiers exposed to risks at every step. But the risks can be greatly mitigated. Review your major agreements and exposures with the benefit of expert advice and take prompt action to protect yourself. This is the time to act.

Jeremy Whiteson heads our Insolvency Team. After qualification at CMS Cameron McKenna, Jeremy worked as a dedicated insolvency specialist and was involved in many of the largest insolvencies of the recession in the early 1990s. Since then he has remained involved with insolvency practice, has published numerous articles on insolvency topics and is author of the Creditors' Meetings chapter of Tolleys Insolvency Law. He now focuses on insolvency for the property sector and entrepreneurial businesses.

This briefing offers general guidance on insolvency issues. It reflects the law as at November 2008. The circumstances of each case vary and this note should not be relied upon in place of specific legal advice.

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