CavanaghKelly

A guide to business rescue & the insolvency process

Contents

Foreword

This guide will be of interest to accountants, solicitors, banks, credit unions and other advisory bodies and professionals who wish to be aware of the options open to their clients who may be in financial difficulty.

Developed by Sean Cavanagh and Michael Drumm of CavanaghKelly, it is prepared in an informal style and provides a general overview of the practical options available to businesses and individuals. It forms part of a suite of guides developed on this topic.

CavanaghKelly is a leading provider of professional advice to help businesses and individuals in financial difficulty and has over 30 years' experience in delivering solutions to help businesses overcome these difficulties and make a fresh start.

Whilst every effort has been made to ensure the contents of this guide are factually correct, we strongly recommend that specific advice and guidance be sought for a more detailed appraisal of each individual case.

The law is stated as at September 2018 in Northern Ireland.

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Financial difficulties – The people test

First and foremost, business rescue is about people. Advising a client in financial difficulty can be daunting both for the advisor and the client. Generally, most people in financial difficulty fall into one of these categories:

- Those who have the strength of character to cope with the demands of debt pressures, are willing to take decisive action and manage the transition back to financial stability
- Those who may be in need of reassurance, who will 'over-worry' if immediately presented with a very negative outlook
- Those who ignore the warning signs and appear unable to take decisive action to weather the storm.

This is the well-known 'Know Your Client' test and often our initial approach is to reassure the client that various rescue options are available.

The key challenge for advisors is to provide a platform and a realistic solution based upon both the financial position and the people involved.

The approach and strategy to be applied will of course be dependent on each individual case. The key challenge for advisors is to provide a platform and a realistic solution whereby clients can, at the end of the process, move forward in a positive manner with renewed hope and energy for the future.

Taking decisive action and responsibilities

If a client is facing the prospect of insolvency, it is vital that the warning signs are spotted so that action is taken to remedy the problem as soon as possible. The earlier advice is sought, the wider the range of options available, increasing the likelihood of a positive resolution for the client.

Initial warning signs

Extending payment terms	Ignoring calls/letters
VAT/PAYE arrears	Bad debts
Loss of turnover/trading losses	Overtrading
Delay in preparing/filing financial accounts	Lack of management information
Poor cash flow	Applying for additional credit

Very often if these issues are only short-term problems they can be managed and normal trading restored. When they continue over a longer term serious issues can arise. Often the client is unaware of these signs and the advisor can provide invaluable assistance in spotting a negative trend and highlighting this to the client.

Serious issues

Legal letters	Legal judgements
Legacy VAT/PAYE arrears	Final demands
Bank overdrawn beyond facility	Extreme creditor pressure
Bounced cheques	Supplier withdrawing supply

These arise when the initial concerns persist and action isn't taken. Contacting a professional advisor is vital at this stage to provide an opportunity to avoid formal insolvency.

Events requiring urgent attention

Statutory demand	Court orders
Winding up petition	HMRC enforcement of debt
Bank calling in overdraft/ Loan facility	Unable to pay wages

In the event of the above, to prevent a formal insolvency procedure, immediate action is required. The client or advisor should seek insolvency advice as soon as possible.

Directors' responsibilities

In recent years there has been increased focus in the courts and within the Insolvency Service on the responsibility of directors when a company or business fails. It is vital to remind directors that failure to take appropriate action can (and often does) result in director disqualification or even personal liability.

Some key actions the client should take include:

- Be aware that in an insolvency scenario, directors have a duty to act in the best interests of creditors
- Prepare realistic financial projections to support ongoing trading and document key decisions
- Review position regularly and document it
- Preserve the value of and safeguard the company's assets
- Keep customer deposits separate from normal trading bank accounts
- Do not prefer individual creditors or connected parties
- Do not worsen the creditor position
- Seek professional advice – this is a key matter considered by the courts. If a director has sought advice early in the process, it can assist in avoiding any personal liability action.

Financial difficulties – The options

When advising clients, the general objective is to avoid the ‘nuclear option’ if at all possible. Business rescue is always the primary aim at CavanaghKelly and there is often a variety of options available to those involved.

The first (and most vital step to appraising options) is to ensure that the current Statement of Affairs (SOA) is accurate. This is the most overlooked aspect of the entire process as, in the attempt to produce a quick solution, extreme pressure is often applied to produce an SOA within a very narrow time-frame.

Our experience as insolvency practitioners (IPs) indicates that critical liabilities are often omitted from the SOA whilst assets can also be overvalued. Therefore, extreme care must be taken in producing this document.

In addition to the above, it is vital that robust financial projections and cash flows are reviewed in conjunction with the SOA. Current creditor pressure should also be reviewed.

When the above documents are prepared, a proper appraisal of the various options can be made. Some of these options are listed on the right.

Business rescue is always our primary aim and there is often a variety of options available to those involved.

Company options

- Trading out of difficulty / Informal arrangement
- Company Voluntary Arrangement (CVA)
- Administration
- Administrative Receivership
- Liquidation (either Creditors Voluntary or Compulsory)

Individual options

- Trading out of difficulty / Informal arrangement
- Individual Voluntary Arrangement (IVA)
- Debt Relief Order (DRO)
- Bankruptcy

Partnership options

- Trading out of difficulty / Informal arrangement
- Partnership Voluntary Arrangement (PVA)
- Separate Interlocking IVAs

Company options

Trading out / Informal arrangements

Where there is a viable core trading business to be saved and there are robust and realistic financial projections going forward, this can provide an appropriate platform for an informal arrangement.

A proposal for such an arrangement can be submitted to creditors and an agreement reached for trading on without the need for a formal insolvency procedure.

The advantages of informal arrangements include their flexibility, less stigma, less publicity, normally less costs and that it can avoid a formal insolvency procedure. In addition, the directors will remain in control of the company.

Options to fund an informal arrangement

Restructure unprofitable areas of the business	Cost-cutting	Director / Shareholders invest funds
Refinance unencumbered assets	Mortgage property	Third party investor
Debt factoring	Time to pay arrangement	Debt / interest forgiveness
Sales of surplus assets	Extension of a loan term	Capital / interest repayment holiday

In this scenario, it is vital that all steps and decisions are properly recorded so that the business owners and the advisors are not exposed to litigation if all does not go according to plan.

Commentary

If relations have historically been good, there can be an opportunity to agree an informal arrangement with creditors.

However, this process is only likely to succeed if there are a small number of key creditors.

In addition, these arrangements are generally not legally-binding and therefore it only takes one creditor to break rank for the whole rescue process to collapse (and formal insolvency procedures normally follow).

In addition, HMRC are often a key creditor and are likely to insist on either a formal procedure or payment of 100% of the debt.

In terms of recording all information this should include:

- A documented external review of the SOA and financial projections. We recommend an external review as all too often the internal assumptions made are too optimistic and lack substance
- Fully recorded board minutes / records agreeing the strategy moving forward and, crucially, noting the key assumptions made in the SOA and financial projections.

Formal Arrangements

If an informal arrangement cannot be progressed, there are a number of formal insolvency options available:

- Company Voluntary Arrangement (CVA)
- Administration
- Administrative Receivership
- Liquidation

Each arrangement is discussed in more detail below.

Company Voluntary Arrangement (CVA)

This is a very popular rescue mechanism for companies with a sound core trading business but with a requirement for some form of formal debt write-off and/or a time to pay arrangement. A CVA requires the approval of 75% of creditors by value and, once approved, is legally binding on all creditors, even those who may have voted against it.

Often if relations with creditors have been good, a write-off of up to 75% of the debt (and more) can be negotiated but there are possible traps:

- Any creditor with over 25% of the debt will be able to exercise major influence over the terms
- HMRC will often insist on imposing its standard terms which can be restrictive (often insisting on monthly contributions over 5 years). Therefore, if HMRC hold over 25% of the total debt, a CVA solution becomes more challenging
- Suppliers with valid Retention of Title (ROT) clauses may also repossess their stock.

Commentary

All too often the financial projections within CVA proposals are unrealistic and aggrieved creditors receive less than the dividend promised.

A 2018 R3 survey of over 550 recent CVAs (of which 93% were small companies) indicated that unsecured creditors were paid, on average, only 26% of the dividend they were originally promised. This survey also indicated that only 19% of CVAs were fully implemented.

There is widespread concern that a CVA of 5 years is too long – 3 years is proposed going forward.

There were 27 CVAs in Northern Ireland in 2017. They usually average c. 30 per year.

Whilst CVAs have been in the spotlight recently with so many high-profile Retail Rescue Schemes, they do have an important role in business rescue in Northern Ireland. If proposals and financial projections are realistic they will often have a good chance to succeed. If, however, after a full assessment, the risk is too high, an alternative procedure such as administration via a prepack (discussed in more detail in on page 7) might be more suitable.

Administration

Administration is a formal procedure which can be entered into by the directors or the company with the aim of rescuing either the whole or part of a business, or for the purposes of securing a better return to the company's creditors by preserving the value of certain assets.

Administration can be a beneficial business rescue procedure to assist a company in difficulties to receive breathing space so that it can assess how best to deal with its financial problems. A key advantage is that it is fast – an administrator can be appointed by the directors through a simple out-of-court procedure (provided certain conditions are met such as consent from any qualifying floating charge-holder). In addition following the appointment, a moratorium commences which suspends the power of creditors to take actions.

Once appointed, the administrator takes control and the directors' powers cease. This is an important distinction between an administration and a CVA – in a CVA the directors remain in control. The administrator will prepare proposals within 8 weeks and if a meeting is held, acceptance or rejection of the administrator's proposals is normally decided by a voting majority.

Commentary

There were 13 administrations in Northern Ireland in 2017, compared to 31 in 2016.

This is a reflection of the improvement in the economic climate as well as the banks being more prepared to work through distressed cases without the requirement for a formal insolvency procedure.

Prepacks

A 'prepack' is a deal for the sale of an insolvent company's business and assets which is agreed before the company goes into a formal insolvency process, usually administration.

In today's world, once a company's potential difficulties become public knowledge, it becomes much harder to retain the value and goodwill in that business with key suppliers, customers and employees often leaving.

In a 'prepack' scenario, a deal can be completed quickly with the IP negotiating the best price for the business with the aim of securing a better return for creditors.

Commentary

Prepacks have been the subject of much criticism in recent years and the Government and the insolvency profession have introduced very strict rules and parameters which now apply to prepacks, particularly where the business is sold to connected parties.

These procedures include guidance in the form of Statement of Insolvency Practice 16 (SIP16) and the requirement of IPs to use where possible the 'Prepack Pool' (an independent body) to review prepack proposals.

The Government has also announced a full review of prepacks to connected parties and this is expected in 2019. We expect that this review will make it mandatory for all connected party prepacks to be referred to the 'Prepack Pool'.

Administrative Receivership

It is no longer possible to appoint an administrative receiver in Northern Ireland under any security instrument created after 27 March 2006 and therefore they are becoming extremely rare. There was only 1 administrative receivership in 2017 – until then there were only 3-4 per annum.

Liquidation

Creditors Voluntary Liquidation (CVL)

This is by far the most common form of insolvent liquidation and is often the last resort after the directors have considered and exhausted every option of rescuing the company.

Once the directors of the company have decided it can't trade on and that it is technically insolvent, they must call a meeting of the shareholders and pass a resolution to appoint a liquidator.

Creditors are then notified and invited to meet to vote on the liquidator's appointment (which is why the process is called a Creditors Voluntary Liquidation) and they can, if they wish, appoint a different liquidator from that proposed by the directors. In addition to the liquidator's normal duties of realising the assets and making distributions to creditors, a report on the directors' conduct also has to be submitted to the DDU (Directors Disqualification Unit) of the Insolvency Service in Belfast. This also applies in an Administration.

Commentary

The directors' reasons for winding up the business are very often not properly documented and this leads to problems when the DDU report is being prepared. In addition, if directors are found guilty of 'wrongful trading', they can be personally liable to pay funds back into the company.

Proper care and advice at an early stage can prevent these problems arising. Advisors are also strongly recommended to review the directors' current accounts and all their transactions with the company to ensure there is no balance owing to the company – if there is a debt due the liquidator will seek for it to be repaid.

The DDU decides on the sanctions to apply to directors where improper conduct has been identified. This normally results in disqualification from being a director or being involved in any company for a period of between 2-15 years. In the year to 31 March 2018, 42 directors' disqualifications were obtained in Northern Ireland.

There are, on average, 70-80 CVLs per year in Northern Ireland.

Court winding up

This is often called a Compulsory Liquidation and usually occurs on the application of a creditor, following the presentation of a statutory demand and subsequent winding up petition.

In this scenario, the Official Receiver will take control of the company, interview the directors and require them to submit an SOA. If there are sufficient assets an IP is likely to be appointed to conduct the liquidation. If there are insufficient assets the liquidation is handled directly by the Insolvency Service. The liquidation procedure is the same as for a CVL and includes a report on the conduct of directors.

Commentary

Whilst the vast majority of court windings up are initiated from a creditor's petition, the court can also order a company to be wound up on the petition of the company itself, the company's director(s) or member(s).

It is often better to avoid a court winding up if at all possible as the Insolvency Services resources are limited and the process is likely to take longer than would be the case in a CVL.

Dissolution

Whilst this is not a formal insolvency procedure, it is becoming increasingly common in Northern Ireland. When the company fails to file Returns with Companies House, after the standard statutory warnings, Companies House will automatically begin the process for dissolution. After the required advertisement period, the company is dissolved.

The directors of a company can also apply for it to be dissolved. The procedure and documentation is fairly simple but, for directors to make the application, it must be accompanied by a statement confirming that the company has no assets or liabilities. If any asset is later discovered (e.g. an insurance claim or strip of property) this asset automatically becomes 'bona vacantia', in other words it becomes an asset of the Crown.

After a company is dissolved it effectively no longer exists but, if any person/creditor wishes to make a claim against it, it can be resurrected subject to certain time limits.

Commentary

The Government has recently noted alleged abuse of the dissolution process by directors and is intending to introduce new powers to investigate the conduct of individuals/directors of dissolved companies. This could include an order for monetary compensation.

Liquidation (Cont.)

Members Voluntary Liquidation (MVL)

This is a solvent liquidation procedure and is very widely used for successful companies which have come to the end of their useful life and/or where the owners wish to retire and receive cash from the company in a tax efficient manner. The legal procedure is relatively simple:

- Directors' meeting and resolution to wind-up the company and sign a declaration of solvency
- Shareholders' meeting to pass the resolution (both meetings are usually held together)
- Appoint a liquidator who takes control of all assets and after paying any remaining creditors and expenses of the liquidation, distributes the assets to the shareholders.

The accuracy of the declaration of solvency is crucial as occasionally the company is found to have liabilities which directors have overlooked. If the liabilities are greater than the assets, the MVL converts into a CVL (an insolvent liquidation).

If a false or inaccurate declaration of solvency is made, then the director(s) can face fines and penalties and even imprisonment in serious cases.

The tax advantages of MVL are that, providing the shareholders qualify for entrepreneur's relief, the shareholders can extract the cash and/or assets at a 10% tax rate. This is in contrast to an income tax rate of up to 38.1% if HMRC decide that the distribution was a dividend instead of a capital distribution.

It is therefore critical to get all the preparations right and there are two important matters to highlight:

- HMRC recently announced a Targeted Anti-Avoidance Rule (TAAR) which might apply to MVLs if there is any possibility of phoenixism. Very broadly, if the shareholders were only winding-up their company so as to trigger the 10% tax charge and then re-start a similar business in a new company, this could trigger the TAAR and leave the shareholders with a large tax bill.
- If there is an overdrawn Directors Current Account and a liquidator includes this as a distribution in specie i.e. by a paper transaction in a non-monetary format, HMRC are threatening to reclassify this loan distribution as income rather than capital and so the tax applied would be up to 38.1% rather than the expected 10%. To avoid any problems with this we strongly recommend shareholders to repay the overdrawn current account before the liquidation process commences.

Personal options

Trading out / Informal arrangements

If cash flow problems arise for individuals in business, the same principles apply as for companies but generally in a more informal way. Therefore, by taking early decisive action and by negotiating with trade creditors, HMRC and/or the bank, the client often has the potential to get their business back on track.

Individual Voluntary Arrangement (IVA)

An IVA is a popular way for a sole trader/partnership business in financial difficulty to enter into a formal arrangement with its creditors and get the business back on track (and also avoid bankruptcy). The agreement will typically involve a write-off of some of the debt and/or a time to pay arrangement.

There is no 'one size fits all', so each case is determined by its own particular circumstances. The debtor's proposal requires the agreement of 75% by value of the creditors voting, so larger creditors will have huge influence over the proposal.

The advantage of an IVA is that it is a formal legal solution and is approved by the court and, when approved, all creditors, even those who voted against it, have to abide by it. Another advantage is that it is not advertised, although a Register of IVAs is maintained at the Insolvency Service in Belfast and is available online.

IVAs in Northern Ireland normally average 1200-1300 per year (there were 1537 in 2017), but a vast number of these are consumer or personal, non-trading IVA cases.

Commentary

Our experience with IVAs, just as with CVAs, is that the dividend promised to creditors is often unrealistic and in too many cases aggrieved creditors have to be subsequently advised of a much-reduced figure payable to them. The crucial significance of this is that a failed IVA can often result in the IVA Supervisor (the appointed IP) having to make the debtor bankrupt.

As with CVAs, we believe that 5-year IVA's are too long and look forward to recommendations that they will be capped at 3 years going forward.

Debt Relief Order (DRO)

A Debt Relief Order (DRO) is a similar mechanism as bankruptcy for those with personal debt of £20,000 or less. There are other conditions, the main ones being:

- You don't own your home
- You don't own a car worth £1000 or more
- You have less than £50 per month after paying household expenses

The fee to apply for a DRO is currently £90 and must be applied for via a DRO advisor, also called an approved intermediary. You can find a DRO advisor at most local Citizens Advice. A DRO usually lasts for 1 year after which the debtor, with some exceptions (such as student loans), will be released from all of their debts. In 2017/18 year there were 427 DROs in NI, up from 330 in 2016.

Bankruptcy

Bankruptcy is a legal procedure whereby a debtor can have a total write-off of their debts (with some exceptions such as student loans and certain fines). It is a well-established legal procedure and can be triggered either by a debtor personally (it's now even possible to do it online), or by a creditor if the amount owing is £5,000 or more.

The advantage of bankruptcy is that a definite line is drawn on debts and the debtor can make a fresh start after 1 year (if providing no problems arise and the debtor is discharged from their bankruptcy). It is also now possible for the debtor to continue trading during their bankruptcy. There are however some downsides such as:

- The family home can be at risk. If a bankrupt owns their home, either with a mortgage or outright, this will be considered an asset and could be used to repay their debts, depending on how much they owe. However, a trustee in bankruptcy cannot force a sale within one year (they have 3 years in which to do so) and if that deadline is missed, the house reverts to the bankrupt. Special rules also apply where a house is in joint names.
- Excess income – if the bankrupt has surplus income or profits above their needs, they may be required to make contributions into the bankruptcy. This is called an Income Payments Agreement / Order.
- Investigations – a trustee will also conduct investigations into the conduct of the bankrupt.
- Other assets, such as vehicles, equipment, savings etc. are liable to be realised by the trustee but the bankrupt is allowed to retain certain tools, equipment, etc. required to carry on their work.
- Directorships – a bankrupt will have to resign as a director in a company until discharge occurs.

Commentary

In bankruptcy, pensions are protected.
In Horton vs Henry (2016) the Court held that the statutory position is that all property vests in a trustee, subject to explicit exceptions. Rights accumulated under pension schemes were ruled to be one such exception and are therefore protected in bankruptcy. However, income which stems from a pension arrangement is not.

Bankruptcies in Northern Ireland are administered by the Insolvency Service in Belfast and have averaged around 1,000-1,200 per annum in recent years. However, the year to 31 March 2018 saw an all-time low figure of 812 bankruptcies – this is probably due to the recent increase in the debt limit for filing for bankruptcy from £750 to £5,000.

There has been a considerable increase in trading bankruptcies over the last two years which we believe is reflective of the difficulties facing small retailers and hospitality businesses.

Partnership options

Trading out / Informal arrangements

In an informal arrangement, the principles and actions to be taken by partners are often the same for individuals and companies. A critical issue is that one or two partners may make decisions for the partnership as a whole and, if things go wrong, all of the partners can be personally affected. It is therefore critical for all partners to be made aware of these key decisions and the financial position of the partnership business. You should also be aware that former partners could be at risk if the debts incurred arose whilst they were partners.

Partnership Voluntary Arrangement (PVA)

A PVA largely follows the same procedures as a CVA for companies. However, it is crucial to note that a PVA alone will not bind the creditors of partners with any personal individual debts (i.e. individual debts need to be dealt with via a separate voluntary arrangement).

Separate Interlocking IVAs

Where there are individual debts, as well as debts of the partnerships, it might be advisable to consider interlocking IVAs for each partner – in this way both partnership and individual debts will be covered.

Partnership administration

A partnership administration closely follows that of a company administration. It should be noted that in a partnership administration, the IP takes control of the business.

Insolvency of LLPs

The options in respect of LLPs closely follow that of company options.

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