Mini-guide to Insolvency

Whilst we believe that consensual restructurings are better than an insolvency process, we recognise that insolvencies cannot always be avoided. There are occasions where they can be a useful tool. It is therefore worth understanding how such processes work. We touched on the basic principles of insolvency in our mini-guide to Consensual Restructuring but it is worth looking in more detail.

In the UK there are several formal processes available.

Administration is the best known. It is a court sanctioned process where a Licensed Insolvency Practitioner (IP) takes control of the company in place of the directors who usually cease to have any management role. The common outcome is a sale of the goodwill and assets with the "rump" of the company then being liquidated. The proceeds of the sale, after the Administrator's costs, are distributed according to priority with secured creditors paid first, unsecured creditors next and shareholders last. Unsecured creditors rarely get more than a few pence in the pound and shareholders rarely get anything. It is administered by the IP out of court and has the advantage of being relatively quick and predictable.

A pre-pack Administration is a variation of the above. The business is discretely marketed, and a buyer identified, usually a non-connected party. The company is put into Administration and the sale completed almost immediately. Proponents argue that the speed of the process protects the business and prevents the loss of key people. Critics argue that the best price isn't achieved, and creditors know nothing until after the event and can't easily contest it. There are certain processes to attempt to avoid abuse, but these are neither onerous nor effective.

CVA's (Company Voluntary Arrangements) are a process whereby a company negotiates to pay its creditors over time. It must gain the support of at least 75% of the unsecured creditors by value and, if passed, it binds all unsecured creditors. It cannot bind secured creditors. Management remain in control, but the process is supervised by an IP. It has seen increased use in recent years, particularly in the retail sector to reduce onerous leasehold obligations, although this is under challenge by landlords. CVA's have been criticised as a large percentage of cases end up in Administration within the next few years, often quite quickly.

Liquidations come in various forms but as the name suggests it is winding up of a company that has ceased or is about to cease trading. Solvent liquidations involve the payment of all debts. Insolvent liquidations leave almost all creditors out of the money.

Schemes of arrangement are not an insolvency process; they are a Companies Act procedure. They allow a company to negotiate a restructuring of its debts but unlike a CVA allow creditors to be separated into different classes, e.g. financial creditors (lenders) and trade creditors (suppliers) and can include secured creditors. It does require court hearings and tends to be longer and more expensive and is used mainly by larger companies with complex capital structures.

In Europe and the rest of the world, processes vary by jurisdictions. In Europe, most countries have something similar to Administration, but the exact mechanisms may be different. Some have other pre-insolvency processes. If a business has operations in multiple countries, it is important to be aware of insolvency triggers in the different countries. Germany, for example, has very strict rules on when directors must file for insolvency and there can be criminal penalties for breach. Expert advice is essential. It is not unknown for local directors to file without parent company knowledge. This can trigger a domino effect and tip a whole group of companies into insolvency.

The US has the Chapter 11 process. This is based on the directors staying in possession (DIP), managing an operational restructuring and negotiating a financial restructuring which then has to be approved in court. It is a flexible process which gives all creditors a voice. The downside is that it is often time consuming and costly. Many smaller insolvencies in the US now use a form of pre-pack or fast track asset sale Chapter 11 to keep costs down. The EU has a new directive which should result in an early stage consensual restructuring alternative being available across Europe. Progress in introduction varies between jurisdictions.

Most directors will not relish the loss of control in insolvency and the fire-sale of assets which is normally value destructive. Those tempted by the idea of buying a business and assets from insolvency at low prices should also be wary. Adverse publicity may have damaged the business. Trade creditors who have lost money are unlikely to supply on credit and tax authorities may ask for deposits. The working capital requirements are often much more than the purchase price.

If a formal insolvency proposal is unavoidable, the choice of process and how to manage the entry into that process should be planned. It can make the process a lot easier and likely lead to a better result for all stakeholders if it is well planned and executed.

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