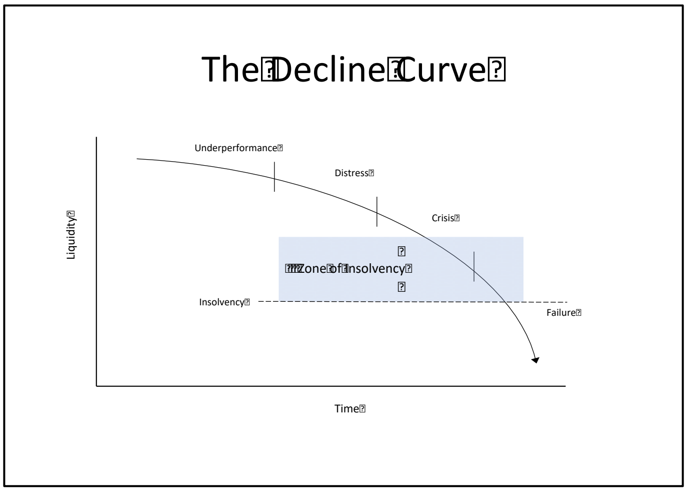
Mini-guide to the Zone of Insolvency

The easiest way to understand the zone of insolvency is by looking at the textbook decline curve:



It is a fairly easy concept to understand as a company's performance declines and liquidity (available cash) comes under pressure. It is important to note that the slope of the curve is getting steeper over time and that reflects reality. These situations spiral downwards ever quicker as one problem triggers another.

Often it is not such a smooth curve either as problematic events cause a step change in the rate of decline. For example, credit insurance may be withdrawn prompting suppliers to insist on cash with order. The effect on cash flow is often catastrophic.

As cash flow deteriorates it becomes increasingly difficult to run the business and management become engaged in constant fire fighting. There is also a subtle change in the legal responsibilities of directors and senior managers. Their duty of care shifts from shareholders to creditors.

A number of legal principles come into play in the zone of insolvency including a duty to treat all creditors fairly, to not make any preferential payments to creditors and not sell assets at an undervalue. There is also the tricky question of deciding when a business has reached the point of no return and not engaging in wrongful trading that makes the creditors' position worse.

This is not the place for formal legal advice but it is necessary. However, directors should ensure they get good quality advice and beware the scaremongers. Lawyers who are not restructuring and insolvency specialists and amateurs at the local pub often don't understand the way the law works and will advise an unnecessarily conservative approach. There is plenty of case law supporting well-managed turnaround efforts and it is just as wrong to file too early as too late.

This danger can be even greater in international groups where the insolvency laws vary with each jurisdiction. It is very easy for a badly advised subsidiary board to drive a group company into premature insolvency and drag the whole group down with it.

The zone of insolvency is a potentially dangerous place. Most boards and senior management have no experience of dealing with the stresses and difficulties of such a situation and wrong decisions can threaten the very survival of the business. If ever there was a situation that needs expert help, finding yourself in the zone of insolvency is it.

Acting early is essential. The longer it is left the deeper the business descends into the zone of insolvency and the fewer the options. There are simply more and more constraints on action.

Turnaround experts spend most of their lives working in the zone of insolvency and can hit the ground running. They know the legal and practical considerations and are used to dealing with all the different stakeholders. They can quickly prioritise actions and help management respond to the multitude of pressures they are being bombarded with.

In many ways, getting help in the zone of insolvency is no different to getting help from any other experts. If you have an IT problem you get expert help, similarly with a tax or legal problem. These days nobody can be an expert at everything. Turnarounds are no different and it is certainly not an admission of failure. There is no doubt that expert help, brought in early, can greatly enhance the chances of survival and lead to the decline curve outcome looking more like this: