

Distressed companies

Issues and opportunities

The current economic climate creates hazards and opportunities for those involved with or interested in companies in distress. This short booklet will help you plot your way through the challenges that may lie ahead and identify significant opportunities for your business by addressing some of the questions below.

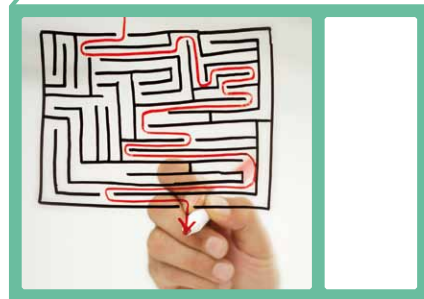
“What are the formal insolvency processes and how do they work?”

“What are your duties as a director of a business in distress?”

“Do you have to enter into a formal insolvency process and what are the risks if you do not?”

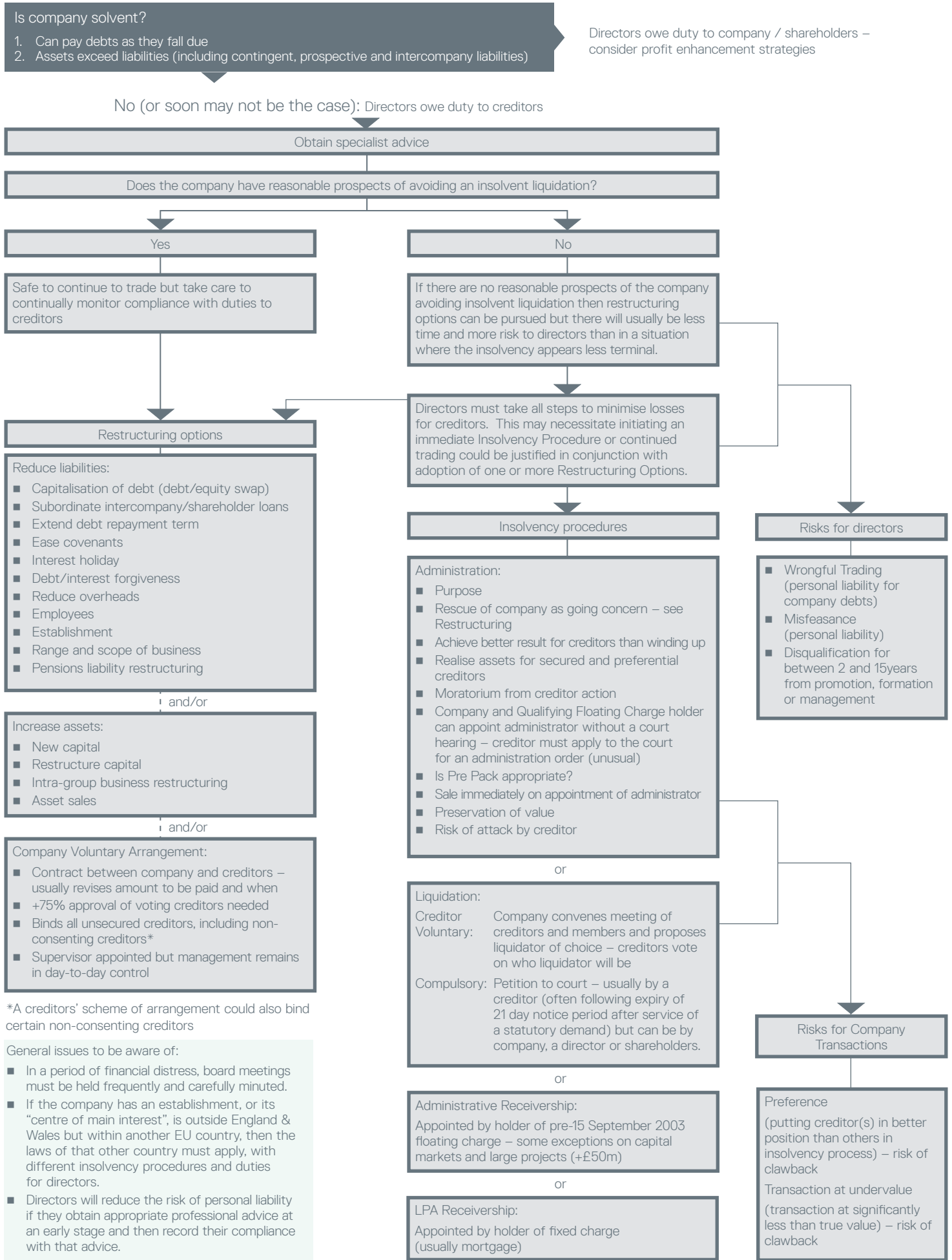
“What is the best way to buy a company in distress?”

“What opportunities are there to restructure the company and its debt?”



A guide for directors and investors

This chart is intended to show the main routes open to the board of an insolvent company, by reference to the law of England and Wales.



Glossary

This table provides more detail on many of the important terms used in reconstruction and insolvency exercises, many of which are used in the chart opposite.

Definition of insolvency		The corporate consequences of insolvency
<p>Section 123 of the Act¹ states that a company is “unable to pay its debts” (ie, it is insolvent) when:</p> <p>a) the company is unable to meet its debts as and when they fall due. This is commonly referred to as a “Cash Flow Insolvency”; or</p> <p>b) the amount of the company’s liabilities (including its actual and contingent liabilities) exceed the value of its assets on a balance sheet basis. This is commonly referred to as a “Balance Sheet Insolvency”.</p> <ul style="list-style-type: none"> ■ In the case of a group with a subsidiary in the UK, the UK company’s cash flow and balance sheet positions have to be considered from its point of view. For example, an insolvent company cannot continue trading on the basis that its parent is solvent unless it is getting the requisite financial support from its parent. ■ Where a UK company is or is about to become insolvent its directors must act in the best interests of the company’s creditors (as opposed to a parent or other shareholders) and there are personal consequences for those directors if they fail to do so. ■ In every insolvent process, either the liquidator, or the official receiver, or the administrator, has various powers to investigate the company’s affairs and directors’ conduct and must report to the government Department for Business Enterprise and Regulatory Reform (BERR). 		<p>a) Preference claims</p> <ul style="list-style-type: none"> ■ A preference is a transaction which has the effect of placing a creditor in a better position if the UK company goes into liquidation than if the transaction had not occurred. ■ If the transaction occurs within six months of the company’s liquidation, the liquidator can apply to have it set aside but he must prove that the directors in entering into the transaction were influenced by a desire to produce the preferential effect. ■ In the case of a transaction with a creditor who is a connected person (for example the company’s parent, or a subsidiary or a director) the period of six months is extended to two years and it is also presumed (unless the contrary can be proved) that there was a desire to prefer the creditor. ■ A classic example of a preference is where the company repays its intra-group debts or its directors’ loan accounts ahead of its other creditors shortly before its liquidation. However paying a creditor who has refused to make further supplies may not be a preference if the primary purpose of the payment was to secure supplies which could not be obtained elsewhere. <p>b) Transactions at an undervalue</p> <ul style="list-style-type: none"> ■ A transaction at an undervalue occurs when a UK company disposes of its assets for significantly less than they are worth. ■ A liquidator can apply to have the transaction set aside if it occurred within two years of the company’s liquidation. ■ A classic example of a transaction at undervalue is where the company transfers its business and/or assets to a creditor, director or another party (ie, a group company) for a nominal amount.
Consequences for a director of an insolvent company		
<h3>Wrongful Trading</h3> <p>Section 214 of the Act states that, if the directors (including any shadow directors - see below) of a UK company allow it to continue trading when they knew or ought to have known that there was “no reasonable prospect” of a UK company avoiding an insolvent liquidation, then the directors can be held personally liable for the debts incurred.</p> <p>A shadow director is a person, or entity, who has effective control over the UK company’s board (ie, the company’s directors are accustomed to act in accordance with that person’s instructions).</p> <p>The only potential defence available to the directors is to show that they took every possible step to minimise the potential loss to the company’s creditors.</p> <p>It is not sufficient to show, for example, that the directors believed that the company’s financial situation might improve because of market forces that are beyond their control.</p> <p>The directors may be able to justify trading for a short period of time if they are:</p> <ul style="list-style-type: none"> ■ trying to sell the whole or part of the UK company’s business and/or assets as a going concern; or ■ awaiting a decision regarding further funding. ■ In these circumstances the directors should: <ul style="list-style-type: none"> ■ investigate whether the company’s overheads and operating costs can be reduced; ■ only pay the creditors that are crucial to the preservation of the business and assets (eg, essential supplies, employees salaries, and judgment creditors who are about to or have taken “key” assets); ■ postpone all other payments; and ■ not incur any new liabilities (except for immediate payment in cash - see below). <p>The directors’ goal should be to ensure that the company’s liabilities do not increase. One way to do this is to “rule off” the account and pay for all further supplies and services on a “cash on delivery basis”.</p>		
<h3>Misfeasance</h3> <p>Any breach of fiduciary duty by a director may result in the liquidator applying to the court for an order that he is liable to the company for any loss suffered by it as a result of the breach.</p>	<h3>Fraudulent trading</h3> <p>Any director or shadow director who knowingly allows a UK company to continue trading with the intent to defraud its creditors or any other person can be held personally liable to pay compensation.</p> <p>Further, if fraudulent trading is established the director and/or shadow director will also be guilty of a criminal offence.</p> <p>It is unusual for a liquidator to pursue a fraudulent trading claim as the onus is on him to show that the director had the requisite fraudulent intent.</p>	<h3>Disqualification as a future director</h3> <p>If the liquidator is able to demonstrate that a preference, a transaction at an undervalue and/or wrongful or fraudulent trading has occurred, then the director and/or shadow director can be disqualified for a minimum period of two years up to a maximum of fifteen years.</p> <p>The disqualification will mean that the director will not be able to be involved in the formation, promotion or management of any company in the UK during the disqualification period.</p> <p>The directors also face disqualification if:</p> <ul style="list-style-type: none"> ■ they breach any fiduciary or other duty they owe to the UK company; and/or ■ they fail to comply with any of the duties imposed by the Companies Acts (for example the obligation to maintain proper books and records).

1 The Insolvency Act 1986 (the "Act").

Options for the Board of Directors of a UK company

Where the directors believe that there is a serious risk that the UK company may not be able to avoid going into insolvent liquidation the directors should consider seeking the advice of an independent licensed insolvency practitioner (the "Insolvency Practitioner"). Most accounting firms have partners, who are Insolvency Practitioners.

The IP would review the UK company's financial position and consider with the directors the options available to the company. These options include:

- continuing trading under the guidance of the IP;
- a sale of the company's business and assets as a going concern outside any formal insolvency procedure;
- requesting further funds from a parent or other shareholders;
- administration, which is a court driven procedure which stops the creditors or any other party from taking adverse action against the company while the IP considers the way forward;
- a company voluntary arrangement whereby the company agrees a payment schedule or some other proposal with its creditors;
- making a request for the appointment of an administrative receiver if the company has granted a fixed and floating charge prior to 15 September 2003;
- a creditors voluntary liquidation whereby the company convenes a meeting of its creditors to appoint a liquidator; or
- compulsory liquidation whereby the company is wound up by the court following the presentation of a petition by its directors, shareholders or any creditor who has an undisputed debt for more than £750.

Administration

- If the company is (or is about to become) insolvent, the company, its directors or an unsecured creditor can all commence an administration through filing documents at Court. However, they must give prior notice to any floating chargeholders who themselves can appoint an administrator.
- Floating chargeholders with security over substantially all of the company's assets may appoint administrators through the same filing process if given notice (as above) or if there is a breach of the borrowing facility.
- The administrator owes duties to all creditors and must seek to rescue the company or, if that isn't practicable, to maximise realisations for creditors (usually through the sale of the business and assets as a going concern) or, if that isn't practicable, to make a distribution to secured creditors.
- The administration procedure provides for a moratorium against enforcement of all claims against the company, including rights of landlords to retake possession of leased property.
- The realisations of fixed charged property are only reduced by the costs and expenses incurred by the administrator on the sale of the property.
- The realisations of property sold by the administrator which is secured by a floating charge will be reduced before being paid to the chargeholder to pay: the costs and expenses of the administrator, preferential creditors and an amount set aside for unsecured creditors (not to exceed £600,000).
- A pre-pack is a sale negotiated before administration with a company administrator appointed immediately before the execution of the sale.

Company Voluntary Arrangement ("CVA")

- Proposal generally by a company's directors for an Insolvency Practitioner or other authorised person (nominee) to supervise the arrangement.
- Directors produce a statement of affairs to the nominee.
- Nominee reports to Court on whether proposal has a reasonable prospect of being approved and implemented.
- Moratorium for 3 months from date proposal lodged at Court to date of meeting for small companies (as defined) preventing voluntary or compulsory winding-up, administration, receivership, forfeiture by a landlord, enforcement of security and/or execution.
- Notice of meeting sent to all known creditors.
- If approved by a company's members and more than 75% of the value of creditors attending or voting by proxy, the proposal becomes a binding contract between a company and all its unsecured and preferential creditors who had a right to vote at the meeting whether they had notice of it or not.

Receivership

- Administrative Receiver is appointed by debenture holders over company's assets but only in respect of a valid floating charge created before 15 September 2003.
- Receiver can also be appointed under the Law of Property Act 1925, used by fixed chargeholders over property without a debenture.
- Administrative Receiver acts as company's agent for the purposes of realising the Company's charged assets.

Liquidation

Members' Voluntary (Solvent)

- Resolution by company's members to wind company up and appoint a liquidator.
- Statutory declaration sworn by directors that company will be able to pay its debts within 12 months.
- There are criminal sanctions if statutory declaration breached.

Creditors' Voluntary (Insolvent)

- Directors contact Insolvency Practitioner if they are of the opinion the company cannot pay its debts as and when they fall due.
- Insolvency Practitioner calls a meeting of the company's creditors.
- If members resolve to place company into liquidation, they appoint a liquidator.
- Creditors then vote on a choice of liquidator with weight of vote based on the value of their respective claims.

Compulsory (Insolvent)

- Statutory demand served giving 21 days for payment (optional if debt undisputed).
- Petition presented to Court by creditor owed an undisputed amount in excess of £750.
- Petition served and advertised.
- Company wound up by the Court.
- Official Receiver takes control of company.
- Official Receiver calls creditors' meeting to appoint liquidator.
- Automatic stay on proceedings issued against the company.

- The liquidator realises assets of and oversees repayment of company's debts and winding-up of the company's affairs.
- In insolvent liquidation the liquidator has various powers to investigate company's affairs and director's conduct and must report to BERR (government department).

Some key contacts

At Taylor Wessing we have corporate reconstruction expertise across many different disciplines but our core team is shown below.

Please contact one of the individuals listed below or your usual Taylor Wessing contact if you wish to discuss any of the issues raised in this booklet.

Restructuring & Corporate Recovery



Claire Martin-Royle
Partner, London
+44 (0)20 7300 4271
c.martin-royle@taylorwessing.com



Nick Moser
Partner, London
+44 (0)20 7300 4866
n.moser@taylorwessing.com



Neil Smyth
Partner, London
+44 (0)20 7300 4921
n.smyth@taylorwessing.com

Corporate



Will Belcher
Partner, London
+44 (0)20 7300 4221
w.belcher@taylorwessing.com



Robert Fenner
Partner, London
+44 (0)20 7300 4986
r.fenner@taylorwessing.com



Jayne Schneider
Partner, London
+44 (0)20 7300 4711
j.schneider@taylorwessing.com

Finance



Martin Yells
Partner, London
+44 (0)20 7300 4113
m.yells@taylorwessing.com



Marcus Earnshaw
Senior Associate, London
+44 (0)20 7300 4618
m.earnshaw@taylorwessing.com

Finance disputes



Shane Gleghorn
Partner, London
+44 (0)20 7300 4242
s.gleghorn@taylorwessing.com



Richard Marsh
Partner, London
+44 (0)20 7300 4895
r.marsh@taylorwessing.com

Tax



Nikol Davies
Partner, London
+44 (0)20 7300 4779
n.davies@taylorwessing.com



Peter Jackson
Partner, London
+44 (0)20 7300 4721
p.jackson@taylorwessing.com

Employment & Pensions



Sean Nesbitt
Partner, London
+44 (0)20 7300 4294
s.nesbitt@taylorwessing.com



Mark Smith
Partner, London
+44 (0)20 7300 4090
m.smith@taylorwessing.com

Property



Saleem Fazal
Partner, London
+44 (0)20 7300 4261
s.fazal@taylorwessing.com



Raman Sharma
Partner, London
+44 (0)20 7300 4633
r.sharma@taylorwessing.com

What we do

- Advice to boards of directors of insolvent or near insolvent companies on their obligations, duties and potential liabilities in the UK, Germany, France and Belgium.
- Insolvency-related disposals and acquisitions of companies and businesses from distressed corporate groups.
- Debt and equity refinancings and restructurings, debt for equity swaps and debt sales.
- Insolvency procedures, including pre-packaged administrations and voluntary arrangements.
- Assisting private equity funds, venture capital houses and other institutions with existing investments and new opportunities.
- Advising private equity investors on “loan to own” strategies, and related security enforcement and intercreditor issues.
- Advising banks on loan structures and recovery.
- Assisting general partners in claims from limited partners.
- Dealing with regulators.
- Issues of shadow directorship, and wrongful trading for investor directors.
- Directors’ duties and D&O insurance claims.
- Wrongful trading and antecedent transaction disputes.
- Fraud litigation and asset tracing.
- CMBS loan structures, and advising lenders on inter-creditor and loan servicing issues.
- Mortgage and portfolio sales.
- Reconstruction and refinancing of property groups and property portfolios.
- Restructuring and insolvencies of commercial and residential real estate and construction projects.
- Landlord-tenant issues in the case of insolvency.
- Terminating employment, running a redundancy exercise.
- Managing the impact on employers and the business of TUPE transfer to a purchaser.
- Reducing or removing final salary pensions liabilities.
- Advising on tax efficient structures for insolvency related disposals and restructurings including maintenance of tax groupings, preservation of losses and consideration of tax issues arising from debt refinancing.
- Advising on mitigation of stamp duty land tax and other tax costs arising out of real estate insolvencies.
- Advising on the employment tax implications of the transfer or termination of employees.

Credentials

- > Advising a major UK private equity fund in relation to the disposal of its investment in a household name retailer in Europe, involving the restructuring and ultimate sale of the group. The exercise involved the sale and lease back of over 100 high street stores, the collapsing of the partnership ownership structure and the separation of operating and property assets.
- > Acting for a group of banks as holders of different tranches of debt in a £1.2 billion CMBS loan, restructuring the loan and advising on, negotiating and protecting the position of those lenders as against lenders of other tranches in accordance with intercreditor arrangements.
- > Acting for the private equity owner of a pan-European manufacturing group on its purchase and subsequent restructuring, using various insolvency procedures and debt structuring techniques.
- > Acting for Peter Saville and Stuart MacKellar of Zolfo Cooper as joint administrators of Hardy Amies Limited and other members of the Hardy Amies Group, selling parts of the Hardy Amies business and assets and advising on group structural issues.
- > Acting for the Independent Trustee Services Limited as newly appointed independent trustee of a group of schemes advising on fraud issues and the recovery of assets from those schemes from various jurisdictions.
- > Advising a major bank on the restructuring of part of its structured property portfolio.
- > Advising a turnaround private equity fund on the acquisition from receivers and the refinancing and subsequent sale of a major UK power station.
- > Advising Gartmore in connection with the debt restructuring and debt purchase relating to an AIM listed borrower, DCD Media plc.
- > Advising the directors of solvent companies in the Lehman Brothers group of companies following the appointment of administrators to Lehman Brothers International Europe, on their duties with regard to continued trading and issues arising, and the preservation of value in those companies.