What Happens in an Insolvency?

Ever wondered how a company can go bust one day and then be up and running the next? With the same staff and same name, as if nothing had happened?

And how is the same director still allowed to be in charge?

Aren't they personally responsible for the debts of the insolvent company?

These are common questions asked by creditors in an insolvency. Even some of the directors that I interviewed for the book, Hope Won't Pay the Wages, that had been through an insolvency, weren't much clearer on the answers.

What became clear was that there are quite a few people in business that have never been told the basics. How corporations are structured, the role of each party or how the insolvency process works.

This article covers those areas.

The technical elements will be based on the law in England & Wales. However, whilst other jurisdictions may vary in some details, the principal should remain intact.

Basic corporate structure

So to start off with, what actually is a company?

The best way of thinking of a company is as a vessel or a container that is capable of holding various 'things'. It has a unique number, which is registered at Companies House, and it is this number that identifies the company.

You can attribute a name to the vessel and fill it with many different things, but these are transitory elements. Only the number is really important.

Now, this company has to belong to somebody and that body is the Shareholders.

The Shareholders (whether it be one person or a million) have bought a proportion of this vessel and paid a proportionate amount for the privilege. The money paid is thrown into the vessel and a corresponding I.O.U (or share certificate) is produced to show what the shareholders are entitled to recover, if necessary.

At the moment, that money is just sat there not doing anything. The owners, however, are looking to get their money working and provide them with a return.

To that end, the company has to find a business to get involved in that will produce a profit.

So, the money that the owners have put in is used to buy assets and raw materials, convert those materials into finished goods and sell them on for a profit (or whatever is necessary to get the preferred business up and running).

But this doesn't happen of its own accord. So the owners appoint someone to take charge of the company to ensure that this happens and that the business runs smoothly. And that person is a director.

The director's duty is to maximise the return to the shareholders by using the funds, the assets and the business to the best of their ability.

If the owners aren't happy with the job that the director is doing they can replace them.

Similarly, the owners are able to transfer their title to somebody else via a share sale.

This may appear basic, but is essential that we understand the following things:

- A shareholder is not the same as a director (it can be the same person, but they are wearing two hats);
- A business is not the same as a company. The company is just a vehicle in which the business happens.

What happens when things don't work?

The objective of the business is to increase the amount of money in the vessel over time.

If the business isn't working, then the opposite happens. As long as there are enough reserve funds in the pot, then this isn't necessarily an issue. But when the money runs out and debts are still due, then things shift.

Up until now the director has been running things with the intention of returning as much as possible to the shareholders.

However, this can only be the excess cash that exists after any liabilities arising from running the business have been paid out (or profit).

When there isn't enough money left in the pot to pay out the liabilities, then the director's legal focus of responsibility shifts from the shareholders to the creditors.

The relationship between creditor, company and director.

There is a very important point to be made here. The creditors have entered into a contract with the company.

Not the director and not the shareholders. It is the company that owes the money.

The director is there to manage things but, unless the director does something illegal, they are not personally liable for any contract that the company enters into.

However, when you get into these dangerous waters, what is legal and illegal is not so obvious and that is why it is essential, from a directors point of view, that they protect their position and consult with an Insolvency Practitioner or Insolvency Lawyer.

Anyway, the director now must run the business to the best of their ability with the intention of improving the creditor position (and definitely not worsening it).

Only once the creditors have been covered can they turn their attention back to the shareholders.

The concept behind insolvency

Once it is clear that the company cannot recover from its problems, then it has to be placed into insolvency. So what does that mean?

Remember, we are talking about a situation where the value of the assets and the business are not enough to cover the costs.

In the past, when there wasn't any legislation or process, the next step usually involved large people with big sticks taking company assets to cover their losses. The larger the creditor, the more money they were likely to get back, leaving smaller, less violent creditors out of pocket.

This quickly led to anarchy and accelerated violence and not something that is genuinely approved of in a civilised society (the fact that some people still employ such tactics is neither here nor there).

And so, a process was introduced to bring some order to the situation.

The basics of the insolvency process

To start with, the shareholders no longer have any involvement in the process.

They gambled and they lost. Unless they are extremely lucky they won't see any more return on their investment.

The priority is the creditors.

The director, who has been managing things up until now, clearly is not in the best position to carry on doing so.

Therefore, the director is replaced by a specialist form of director. An individual who is qualified and licensed to deal with companies in such situations. An insolvency practitioner.

In every insolvency there will be a report filed regarding the conduct of the directors. If there is any evidence of wrongdoing, it will be investigated further.

If you have clear evidence of director wrongdoing, then pass that on to the insolvency practitioner. Remember, being owed money is not wrongdoing.

Once the company is placed into insolvency, the accounting position is frozen.

The insolvency practitioner has to take any assets and convert them into cash, less any conversion costs. That net cash is then distributed to the creditors in existence at the date of insolvency.

Different processes lead to differences in process and powers but, in essence, the objective of an insolvency is to maximise the return to creditors.

So the creditors receive an equal share?

Well, yes and no.

The law sets out three categories of creditor and a defined order in which funds are paid out.

I am going to simplify it massively here but, basically, payment is made to employees (preferential creditors) first, then the bank (secured creditor) and the remainder is then shared equally amongst the rest (unsecured creditors).

The employees are put first by law (within prescribed limits) whereas the banks only get special treatment if they have agreed the position with the company in advance. In other words, like a mortgage over a house, a bank gets improved security in return for lending the company money.

This may seem unfair to the unsecured creditors, but basic commerce is based on the balance of risk and reward. Without this extra level of security, banks either wouldn't lend to the level that they do or it would be too expensive to be practical.

Once these specific categories have been satisfied, then funds are distributed equally to the remainder. Though as the secured creditor often has such a large debt, there may not be too much left in the pot.

Maximising asset value

The quickest and easiest way of converting assets into money is shove everything into an auction and flog them off.

But as it's the quickest and easiest way, it also produces the lowest return. Consequently, this is the last option that an insolvency practitioner wants to take.

The ideal situation is to sell the business as a going concern. In other words, as an intact trading entity.

The actual business element, with its employees, processes, contracts and so on, is always going to be worth more than just the bits of machinery contained within. This extra and intangible element is usually referred to as goodwill.

However, another reason why complete sales are of interest to insolvency practitioners is that, due to employment regulations, the employees' contracts transfer across intact.

So, if they had ten years service before the insolvency, they still have ten years service after the sale. Plus all the rights that their contracts attaches to that.

Even with this cost attached to the business, the sale should be more than break up value and, here is the key thing, it means that the employees are no longer a creditor of the insolvency as that debt has been taken on by the purchaser.

So, more money in at the top plus the removal of the highest ranking class of creditor means a greater return to the other creditors.

What about a partial sale of the business?

There are some businesses that have some clearly, separately identifiable areas contained within the whole.

For example, there could be a haulage company with a depot in Newcastle and one in Bristol. Whilst there may be a central admin office and a few central contracts, each depot is essentially standalone. Each employee knows which one they are based at. Costs can be directly attributable to each depot and it would be possible to run either one independently from the other.

A retailer with a chain of stores is another example, as each store will have its own staff, its own costs and its own stock levels.

In these cases, it is possible to sell the different areas separately.

If we use the haulage company example, if the Newcastle depot was very busy and very

profitable but had been dragged down by the loss making Bristol side of things, then it would be possible to carve out that Bristol depot and sell the remainder.

The employees that were attached to the Bristol depot would lose their jobs, but those in Newcastle would transfer across.

Similarly, a purchaser of the retailer could select the profitable stores and leave out the rest.

This may seem quite mercenary and unfair on those that lose their jobs, but remember, the duty of the insolvency practitioner is to maximise the return to creditors and, in general, the more employees that can be transferred across the better.

So, they will aim to get the whole away and only move to a partial break-up if that is not an option.

A partial sale has to be compared to a break up situation where everyone loses their jobs and, therefore, should be a much better solution.

And a pre-pack?

A pre-packed insolvency is where the sales contract is agreed before the formal insolvency takes place and so the sale takes place instantly upon appointment.

For many creditors, they just ring up one day to find that new owners are now in place and, oh, by the way you're not getting your outstanding debt paid.

It is easy to see how this can cause outrage.

However, the bad reaction to this process is usually down to a combination of shock and a lack of instant information regarding the situation. That doesn't automatically mean that a pre-pack is a bad thing.

Insolvency practitioners need to be able to justify why they went down a pre-pack route instead of the traditional trade and sell approach.

This may be due to lack of funds needed to allow trading to take place or the actual act of appointment will cause the collapse of the business, e.g. the termination of certain licenses or contracts.

There is still an obligation to get the best price for the assets. In addition, the insolvency practitioner must inform creditors as quickly as possible why this route was followed and what steps were taken to ensure best value e.g. a confidential sales process.

If handled properly, a pre-pack is a very efficient way of maximising value, reducing costs of the insolvency (trading in an insolvency is very expensive) and saving employee jobs.

As in all things, there are people who will abuse the process and the regulatory control is not currently strong or efficient enough to fully stamp that out but, as it is such a sensitive area, most of the major insolvency firms have very good internal policies. If they oversee a pre-pack it will be for the right reasons.

If you are a creditor of a pre-packed insolvency and you have not received any information regarding the whys and wherefores within a week or so of the sale, then you are entitled to chase up the practitioner.

If you are still dissatisfied with the information provided, then speak to the Insolvency Service to see if you should lodge a complaint.

But, if you receive a statement telling you what was done and why, then 'not being happy about losing money' is not a reason in itself to criticise the process.

It is not uncommon for there to be bad press and complaints from creditors when the business survives but isn't liable for the outstanding debt. Especially when the previous director is still involved or if a pre-pack option has been pursued.

But the business is just another asset of the company. Not the company itself.

Consequently, the business can be sold and integrated into a different company without taking on the previous liabilities.

Buying a business from an insolvency practitioner

It doesn't matter if you are an independent third party, an existing competitor, customer or supplier or the director of the insolvent company. Anyone can put in a bid to buy the business out of an insolvency.

The price that the business goes for is usually higher than break up but lower than what you would expect to pay in other circumstances.

It is lower for a number of reasons.

First of all, the previous company went bust, which tends to suggest that the business is not perfect in its current format. Even if the profitable elements can be lifted out, there may be a lot of restructuring work required to get it back to where it should be.

Secondly, the insolvency practitioner will be keen to sell the business as quickly as possible. Continued trading is costly, a drain on resources and usually causes the goodwill to erode, so a quick sale is always better.

This means that the buyer will only be able to spend limited time reviewing the books of the

business that they are buying (called the due diligence process). This increases their risk and, therefore, reduces the price.

Thirdly, there are the employee costs that we referred to before. These may not be an actual cost, as are only realised if they make someone redundant. But it is certainly a potential cost and, with the limited due diligence, will be taken into consideration.

Finally, in the majority of cases, transactions will have to be made in cash. No deferred payments, no part payment with shares. If it isn't a single transfer made at the point of sale, it probably won't happen. Remember, the point of the insolvency is to convert assets to cash, distribute the funds and get out.

This means that the buyer is probably going to have to raise finance, which has an extra level of cost and will be another factor in reducing costs.

So, buying a business out of insolvency can be a very good deal for the purchaser and provide a better return for the creditors.

Now, if you think about it, many of the points that reduced the price were down to lack of knowledge of the company. That is something that the existing director doesn't lack. So, subject to funding, they may be in a very good position to put in a better offer than a totally independent third party.

Consequently, it is not at all unusual for the director's offer to be the best return for creditors and the offer that is accepted.

Summary

The insolvency process exists because the alternative leads to anarchy, violence and bloodshed.

Pretty much by definition, there will be losers out of the process. They won't be happy, but that doesn't mean anything illegal has happened.

A business is an asset to be sold and, provided a fair process has been followed, there are no restrictions as to who can buy it.

Outstanding liabilities attach to the insolvent company, not the business, the director or the shareholders.

Consequently, there is nothing inherently wrong with a director taking on the business post-insolvency. In fact, it will be a much better option than the alternative that would see the business shut down, all the employees lose their jobs and pretty much guarantee no return to creditors.

Naturally, dodgy directors do exist and there are even insolvency practitioners who act outside the regulations. So, if you do have clear evidence of wrongdoing (you may want to have a chat with an insolvency lawyer first) then report it.

But, just because you don't like something, doesn't mean that it's wrong.

And that, in brief, is what happens in an insolvency.