

Insolvency

Companies or individuals with debts they are unable to pay are said to be insolvent. By the time a business starts thinking about insolvency, things are already going badly. Simply allowing yourself to run out of money is the worst possible way of handling it. If you understand your options, you can take steps to improve the situation.

This briefing covers ways to:

- Reduce the risk of insolvency.
- Manage company insolvency.
- Deal with personal insolvency.

1 Reducing the risks

1.1 Choose an appropriate **business structure**.

- A limited company offers the most protection against personal bankruptcy. But giving a personal guarantee removes the protection of limited liability (see **1.4**).
- A limited liability partnership (LLP) offers some protection against bankruptcy.
- If you trade in a normal partnership, you can be liable for all the partnership's debts.

1.2 Use realistic, up-to-date **cashflow** forecasts to plan your financing needs. Many businesses fail because of unrealistic cashflow assumptions, or because the problem is not noticed until it is too late.

- Your accountant will advise you and be a key ally if your business runs into trouble.

If you identify a potential problem, act immediately (see **2**).

1.3 Protect yourself against customer failures

with good **credit control**.

- Limit the amount of credit you offer and ensure customers are financially sound.

1.4 If possible, avoid personal **guarantees**.

- When you must give a guarantee, limit the amount it covers and how long it lasts.
- If several people are giving guarantees, avoid joint and several liability. In the worst case, you could be liable for all of the debt, not just your share.

1.5 Protect your **family** and friends.

- Do not borrow more from them than they can afford to lose.
- Give them security to help them get their money back if things go wrong (see box).

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- Ensure your spouse or civil partner has a separate bank account in case you go bankrupt (see 5).
- Do not ask your spouse or civil partner to give a charge over your home to secure a business loan.

2 Take early action

2.1 Can you improve your **cashflow**?

If long-term prospects are good, there are several possibilities to consider:

- Approach your bank for more finance.
- Use factoring to minimise the effects of slow payment by your customers.
- Recover debts which you are owed.
- Sell assets which are not essential, (you may be able to lease them back).

2.2 Can you negotiate with **creditors**?

The pecking order

Different creditors have different rights. They are paid off in the following fixed order.

A Secured creditors with a **fixed charge**.

- Typical fixed charges are over a property or plant and machinery.
- If you fail to make payments a creditor can sell the asset to cover the debt.

B **Preferential** creditors, whose categories have been reduced.

- Employees are now the main preferential creditors for holiday pay, up to four months' wage arrears (subject to a set maximum) and contributions to occupational pension schemes.
- HM Revenue & Customs etc no longer have preference.

C Secured creditors with a **floating charge** — normally the banks.

- Assets such as work in progress are normally covered by a floating charge.

D **Unsecured** creditors.

- Trade credit is usually unsecured.
- Under new legislation, unsecured creditors may be entitled to part of what has previously have gone to HM Revenue & Customs, where there is a floating charge — only where it was created on or after 15 September 2003.

Communicating with creditors is vital if you want to agree a compromise.

- You can offer revised payment terms. Those most at risk if you become insolvent are more likely to co-operate (see box).

2.3 Can you **cover your debts**?

- If prospects are poor, paying your creditors and ceasing trading is usually the best option.
- If you cannot cover your debts, consult an adviser immediately (see 2.4).
- If you allow a limited company or LLP to continue trading with no reasonable prospect of avoiding insolvency, you may be held liable for wrongful trading. You could become personally liable and be disqualified from acting as a director.

2.4 Do you need **help**?

- A licensed insolvency practitioner (IP) can advise on the best course of action. An initial consultation is usually free.
- Avoid unlicensed advisers.
- The Government's Insolvency Service website (www.insolvency.gov.uk) provides information for debtors and creditors.
- All the bodies that authorise and regulate IPs have adopted an 'Insolvency Ethical Code', published by the Insolvency Service. It has been designed to help IPs to work to high professional and ethical standards.

2.5 Avoid creating **preferences** when you are already insolvent.

A preference is anything which gives an advantage to a particular creditor (or to someone who has guaranteed your debts).

- Preferences can be set aside if your company becomes insolvent (or you become bankrupt) within set time limits.
- If unsecured creditors think you are creating preferences, they are more likely to press for liquidation or bankruptcy.

2.6 Do not try to **protect your assets** from creditors.

- Putting your assets into your spouse's or civil partner's name will not work. Your trustee in bankruptcy (see 5.3) can get them back again.

If you cannot avoid insolvency, choose the best way of dealing with it. For companies the alternatives are outlined in 3 and 4. Personal bankruptcy and possible alternatives are covered in 5 and 6.

3 Aiming for a rescue

If there is some prospect of rescuing your company, you and your creditors are now encouraged to use administration.

3.1 An **administrator** is appointed to run the business and deal with the creditors.

- The administrator will be a licensed IP.
- He or she arranges for the rescue of the company as a going concern, if possible.
- If it is not possible, or if it would achieve a better result for the creditors than rescue, he or she can take some other course with a view to achieving a better result than liquidation (eg selling the business).
- If there is no way of producing a better result for the creditors than liquidation, the administrator will sell assets to raise money for the secured or preferential creditors.

3.2 Anyone who holds a **floating charge** over all the assets of the company can put it into administration.

When directors decide

Businesses in trouble are encouraged to go into administration as soon as possible to maximise the chances of rescue. If you are considering this, take professional advice.

A The **procedure** (for directors) is as follows:

- Directors file a notice of intention to appoint an administrator with the court. An interim moratorium on debt applies for the next 10 business days.
- A copy of the notice must be sent to every holder of a floating charge, seeking their written consent.
- If consent is forthcoming, or there is no reply after five business days, the appointment can be made.

B In taking responsibility for the business, **the administrator:**

- Can remove directors.
- Can appoint directors.
- Is required to report to the Department for Business, Enterprise & Regulatory Reform on the conduct of the directors.
- Can make payments to particular creditors if it will help achieve the purpose of administration.
- Can make distributions to creditors though only to unsecured creditors with the court's permission.

- Other prior floating charge holders must agree. Whoever holds the first floating charge can choose the administrator.
- Directors themselves can usually put the company into administration (see box).
- Other categories of creditor have to obtain a court order to do so.

3.3 Administration should end **within a year**.

The time limit can be extended, if the creditors agree or the court orders it.

- If it has not been possible to rescue the company, but there are assets available for the unsecured creditors, the administrator can arrange for a creditors' voluntary liquidation (see 4), or ask the court's permission to pay creditors.
- If no assets are available for the unsecured creditors, the company will be dissolved.

4 Other options

In particular circumstances one of the following alternatives may apply.

4.1 Winding up or liquidation is the death of a company. The company ceases trading and the assets are sold to pay creditors.

- Any creditor or group of creditors owed more than £750 (or, in certain situations, less) can ask the court to wind up your company (compulsory winding up).
- Members can put the company into liquidation. Then creditors can appoint a liquidator (creditors' voluntary liquidation).

4.2 You can reach a **company voluntary arrangement** with your creditors. This sets out a schedule of repayments to creditors.

- You use a licensed IP to prepare and negotiate the proposal. Fees to set up the arrangement will depend on the complexity and length of the negotiations.
- At least 75 per cent by value of the creditors at a meeting must agree it.

It can be difficult to reach agreement with secured creditors, who will often prefer to put you into administration or receivership.

4.3 A creditor with a floating charge over all the assets can sometimes appoint an **administrative receiver**.

A company can be moved from receivership into administration, but only if the creditor who appointed the receiver agrees.

5 Bankruptcy

Bankruptcy is the formal procedure for individuals who are declared insolvent by the court. It could happen to you if you are a sole trader or in partnership, or give a personal guarantee for the debts of a limited company.

5.1 A creditor may force you into bankruptcy.

- Any creditor or group of creditors owed £750 or more can ask the court to bankrupt you. The creditor must first have served a demand for payment (unless a court judgment is already outstanding).
- If you can show you can raise the money quickly, you may ask for time to arrange it.

5.2 You can ask to be declared bankrupt.

- You pay a deposit of £345 and court fees.
- You complete a form detailing your assets, debts and so on.
- The court will usually declare you bankrupt immediately.

If your assets are over £4,000 and debts less than £40,000 the court may tell you to see an IP (see 6).

5.3 Once you are bankrupt, your **assets** are controlled by the official receiver or by an IP acting as your trustee in bankruptcy.

- Valuable assets will be sold. This could include your house, if it is worth more than the mortgage.
- You will be allowed to keep assets that are necessary for your business or employment and basic domestic needs, provided they are not particularly valuable.

5.4 Repayments to your creditors will be made by the official receiver, or by your trustee.

- In addition to the money from selling your assets, you may have to commit part of your income (by an income payments order or agreement) for up to three years. You will be allowed to keep enough money to finance a modest lifestyle.

5.5 While you are bankrupt, you will have to live with certain **restrictions**.

- You will not be able to borrow more than £500 without disclosing that you are bankrupt.
- You cannot act as a company director. Many of the other restrictions on what you can do, however, are being abolished.

5.6 In most cases, people made bankrupt after 1 April 2004 will be **discharged** within 12 months.

- You will not get back the assets you had at the date of bankruptcy.
- Apart from any outstanding amounts secured on your house and any income payment orders or agreements, you are not compelled to make any further payments on your debts at the date of bankruptcy, except for certain debts which are excluded (eg fines and matrimonial orders).

5.7 'Culpable' bankrupts may be subject to **Bankruptcy Restrictions Orders (BROs)** or undertakings, for up to 15 years.

- These are people who have been dishonest or irresponsible. For example, someone who traded knowing the business was insolvent.

6 Alternatives to bankruptcy

You have two main alternatives to personal bankruptcy.

6.1 You can reach an **individual voluntary arrangement (IVA)** with your creditors.

- A licensed IP can help prepare and negotiate the proposal.
- At least 75 per cent by value of the creditors at a meeting must agree it.
- If you break the arrangement, the IP can apply to court to make you bankrupt.

6.2 For debts up to £5,000, if you already have at least one county court judgement against you, you can ask your local county court for an **administration order**. You are protected from your creditors and make payments to the court.

Partnership insolvency

- A** The **methods** of dealing with an insolvent partnership are: winding up, partnership voluntary arrangements, and administration orders.
- B** If you are a partner in an insolvent partnership, you can be made **personally bankrupt** (see 5).
- C** If you are, or have been a member of a **limited liability partnership** you may be obliged to contribute funds to it under the partnership agreement. This can continue after you stop being a member.

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