Restructuring & insolvency in the UK

The general consensus among turnaround specialists and insolvency practitioners in the UK is that things are a little quieter than they might be, given the depth and intensity of the current recession.

There were 5,055 compulsory liquidations and creditors voluntary liquidations in total across England and Wales in the second quarter of 2009, according to official figures from The Insolvency Service. This was a 2.9% rise on the previous quarter and an increase of 39.1% on the same period last year. Bolstering these statistics, figures for the 12 months ending 30 June 2009, show that one in 120 active companies went into liquidation, which is up slightly on the previous quarter when the figure was around one in 130.

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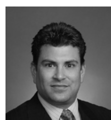

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Despite the slight increase in the number of failing businesses things aren't looking that bad, considering the context of the current economic downturn. There are several possible explanations behind the slightly lower than expected numbers of insolvency cases; the first being that corporates are restructuring operationally and financially in order to cut costs, reduce interest burdens and generally ride out the recession. However, a significant reason behind lower than expected insolvency figures could be the Government's tax deferment scheme. As with all controversial decisions, there is a debate brewing as to whether these agreements are storing up significant debt problems for already weak businesses

The Government has made a strong effort to reduce support SME businesses by, putting pressure on banks to retain existing, and extend new lending, facilities to business customers. The Bank of England has cut the base rate to 0.5% and HM Revenue & Customs (HMRC) has introduced time to pay arrangements for Crown debt. However, the duration of this favourable set of circumstances will not be indefinite and many businesses could find themselves facing the fresh risk of insolvency once they have come to an end

There may be trouble ahead

A recent survey from the Association of Business Recovery Professionals, R3, reveals that 95% of its UK membership fears that the full impact of the recession has yet to be translated into official insolvency figures. This concern is borne out by statistics from the last recession, when corporate insolvency procedures peaked in 1992 - three years after the recession had started.

HMRC's time to pay arrangements have been extended to more than 168,000 businesses and tax are now approximately £30 billion, including corporation tax, VAT, and PAYE. Andrew Duncan, partner at Bridge Business Recovery, believes that distressed businesses are unlikely to feel the pressure of higher interest rates in the near future as the Bank of England will be forced to keep its base interest rate low.,

Mr Duncan said: "In the short term, I don't think interest rates are a major threat to businesses, as I can't see them going up any time soon. Nevertheless, banks have reassessed their price and risk policies and, as a result, the cost of borrowing has increased."

On the subject of deferred tax bills for cash-strapped companies, Mr Duncan predicts that all good things must come to an end and that it is only a matter of time before these arrangements conclude, causing a dramatic rise in corporate insolvencies.

He said: "It wouldn't be an overstatement to say that HMRC has been giving almost everyone who asked time to pay since late last year. HMRC has approximately £30 billion in outstanding taxes due (and has written off around £11 billion). The Treasury's tax take is down significantly and HMRC is going to have to start collecting soon to enable the Government to continue to finance UK Plc."

He added: "There has clearly been a hardening of HMRC's attitude and we are starting to see an end to deferment schemes. This will precipitate a number of business failures, which will subsequently force the hands of the banks, because the last thing they will want to do is to allow HMRC to place companies where they have an exposure into an insolvent liquidation resulting in the destruction of any enterprise value. The High Street banks will be compelled to step in and exercise their debenture security. In my opinion, the Government's actions have allowed companies that are probably insolvent to delay the inevitable, rather than be able to address their financial difficulties. Unless the economic outlook changes fundamentally, which is unlikely, it's difficult to see how these businesses will survive."

Richard Curtin, of law firm Faegre & Benson LLP, says the potential for a Conservative Government next year will only add to the speed with which generous Government schemes are withdrawn, as David Cameron looks to get the public debt burden under control quickly.

He said: "The actions of the Crown will be interesting. We have a general election coming up soon and the new Government will have big bills to pay with depleted revenues because less tax is being paid as companies go bust. They will certainly tighten up soon on the time-to-pay initiative."

These sentiments are supported by Matthew Barker, IP Partner at law firm Clarke Willmott. He believes that lenders have been far more supportive of their customers than in the early nineties recession.

He said: "Lenders and HMRC have been very flexible in allowing businesses time to pay outstanding tax, so less corporate failure has occurred than might have been anticipated. Cash has continued to be cheap, which has also enabled more businesses to survive. It may well be that lender and HMRC strategies may harden and inflation may return, which could lead to increased cash pressures on businesses and large numbers of failures."

Avoiding insolvency

Despite the fact that many businesses are teetering on the brink of insolvency, there are ways to bring a business back to health without entering the costly court-driven insolvency process.

As finance is still very difficult to secure, the best and most immediately effective way of doing this is to address cash management.

Matthew Barker says that different businesses face different challenges but that some main principles for management apply to all. He said: "Businesses must devise and stick to a coherent strategy, use real time financial information, focus on cash management and profitability, rather than turnover, address under-performance issues early, whilst they still have breathing space and be realistic, taking early advice and following it."

He added: "Market conditions are tough and most IPs anticipate an increase in failures in 2010. Directors have a very difficult balancing exercise to juggle, when trading a business in distress. They have to act in the best interests of a number of different categories of interested parties, where there may not be a commonality of approach. Hence, the right advice is crucial."

Richard Curtin, from Faegre & Benson, believes that an inventive and practical approach to raising finance will usually work, even in a tough debt environment, since banks are still open to solid propositions.

He said: "Negotiating with banks is always fun and games, they are still cautious and many of them are not the institutions they once were, particularly the one's that received a public bail out. They are still open for business, but you have to be inventive, practical and creative when raising finance. It's out there, but not so easy to find."

The idea of innovative funding is also backed by Alain Le Berre, from Huron Consulting Group. He says there are new routes of funding becoming available as traditional funding sources dry up.

He said: "Innovative funding is the order of the day, at times when traditional financing routes seem to all but dry up. The good news is that new solutions are emerging, that can help solve otherwise tricky situations. They include debt-equity swaps; asset-based lending; accelerated asset disposals; debt buy-backs and/or new money from shareholders or debt restructurings. Innovation is more crucial than ever because the old and tested ways to do things are not working anymore. The international dimension of any funding solution is also becoming ever more important."

Mr Le Berre adds that a successful restructuring has to be holistic and encompass operational, managerial and financial as well as debt issues.

He said: "It is key to understand that a "siloed" approach will not work. Distressed investors with experience of at least one cycle have realised that conducting a debt restructuring alone is not enough. They now realise that a successful restructuring approach has to be "holistic" encompassing operational, managerial, financial as well as debt restructuring issues from an integrated perspective. Ultimately, the successful investor will be the one which has left no stone unturned in his/her quest for value and his/her understanding of all relevant risks in order to put in place appropriate mitigation plans."

Peter Sargent, President of R3, says distressed businesses must return to running their businesses with more prudence if they want to avoid insolvency.

He said: "Cash flow is a problem if you are close to or are bumping into your overdraft limit all the time. Businesses need to take a close look at their aged debtors analysis and ask what they are doing about pulling in outstanding book debts, they also need to step back and look at the order book and work towards turning them around as quickly as possible. Keep an eye out for the build up of your own creditors especially crown debt, make sure you pay over the monies you deduct from people's salaries to the appropriate departments, including PAYE, NIC and pension contributions on time, but if there cash flow problems talk to HMRC and trade creditors, creditors would rather be paid late than not at all.

He added: "Over indebtedness is also a problem, I tend to deal with small to medium sized businesses that are mainly family owned. It can be a good idea to replace bank borrowing with family investment, or put something back in yourself if you really believe in your business. Leaving money in the business so it has some wool on its back to get through the difficult times is crucial."

Andrew Duncan, from Bridge Business Recovery, suggests that many companies that appear to have sound underlying business fundamentals may have a number of issues that will need to be addressed if they are to survive and prosper.

He said: "There may be legacy issues, such as management problems, vendor loans, defined pension schemes or huge revenue debts. If the incumbent funder decides it isn't prepared to extend its lending, as there are concerns regarding its security position, the management team, a VC or another investor, will need to step in, secure new facilities and inject new monies to drive the business forward."

An increasing role for CVAs

The Company Voluntary Arrangement (CVA) is available to small and medium businesses in the UK as a way of avoiding the costly process of a formal insolvency. It is a process, overseen by an insolvency practitioner, which aims

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agreement to write-off and repay debts.

This process is becoming increasingly popular with creditors, particularly junior, or unsecured creditors, as they see that keeping the company as a going concern is the best way of getting paid, better than to risk getting little or nothing from a liquidation process.

The Insolvency Service has even recently issued a consultancy paper looking to extend the CVA model to larger businesses, as a possible move towards a more American Debtor in Possession model for the UK insolvency system. It is designed to find ways to help businesses remain as going concerns, in the light of recent court cases where schemes of arrangement were implemented (ie IMO Car Wash and McCarthy & Stone). Junior and subordinated creditors received little or nothing of their investment back, since the business, as a going concern in administration, was deemed to be worth less than the senior debt it had amassed.

Sue Staunton, head of insolvency at accountancy firm James Cowper, says the CVA is a viable alternative to administration.

She said: "The CVA allows a business space to bring in slightly different strategies. It can buy time to open up a different market place for the product or service, cut costs and overheads, or negotiate with creditors and landlords. Some landlords are open to forgiving rent for a period in return for equity which is quite an innovative solution.

She added: "CVAs have become less popular over the years, probably because administration has become a much better process and cheaper to go into. In the last recession it was expensive and CVAs were an alternative, but we are beginning to see more of them again, particularly in the not for profit sector. CVAs still need to be supervised by an IP, but they are not involved to the extent of an administrator so it keeps cost down."

Andrew Duncan, from Bridge Business Recovery, says CVAs are becoming more popular in certain sectors in that they allow directors to retain control and turnaround an insolvent business without the need for an insolvency process.

He said: "CVAs have been used extensively in the retail sector as you can often get landlords on-board by explaining that they will get a better outcome from a CVA than a liquidation or an administration sale."

The case for pre-packs

Pre-packs are used extensively by UK administrators as a tool to preserve value in businesses by facilitating a quick sale while customers, staff and revenue streams are still in place.

Despite the, apparently positive, nature of pre-packs there are some negative perceptions surrounding the way in which existing directors can often buy the failed company's assets back, while leaving liabilities behind.

This criticism culminated in the Joint Insolvency Committee issuing a new Statement of Insolvency Practice (SIP 16) in January 2009 setting out the procedures for implementing the pre-pack sale of an insolvent business.

Insolvency practitioners believe the pre-pack, when used appropriately is a very useful and positive tool.

Sue Staunton, from James Cowper, says that pre-packs can safeguard jobs while also achieving the purpose of the administration.

She said: "A pre-pack is useful if the business is particularly vulnerable or if the finance isn't there for the administration to trade it as a going concern, or if customers will disappear if it is traded in administration. Pre-packs keep the value in the business, which is often held within the staff as businesses are increasingly knowledge intensive. Pre-packs have become quite a dirty word in the market, with connotations of ditching creditors, but sometimes directors are the only ones offering anything for a business because of their emotional attachment. Administrations have to get the best value for the business, so if the highest offer is being offered by the directors, then that is the offer that has to be taken."

She added: "Following the guidelines of SIP16, there are certain times where a pre-pack is appropriate and others where it's not. For example, we have just run a large administration in Wales which we traded for three to four weeks and actually added four people to the headcount, before selling it as a going concern, with the whole business and 104 jobs preserved in a very deprived area of Wales. In this case a pre-pack was not the answer."

Cross Border Restructuring - Understanding Chapter 15

The use of chapter 15 of the U.S. Bankruptcy Code (the "Bankruptcy Code") by foreign representatives has increased during the past year, but given chapter 15's potential, the statute is still underutilised in cross-border corporate restructurings and liquidations. Although chapter 15 was implemented under revisions to the Bankruptcy Code in 2005, many districts outside of New York and Delaware still have not experienced a chapter 15 case. This reality has led to a dearth of case law to guide the proceedings and general unfamiliarity with the process among the courts. Professionals representing clients in cross-border matters also have demonstrated a propensity to rely on chapter 11, even though chapter 15 often presents a more efficient and less cumbersome process in cross-border case administration.

The opposite approach, however, was applied in CPI Plastics Group Ltd., et al. ("CPI Plastics"), which was filed earlier this year as the first chapter 15 proceeding ever filed in the state of Wisconsin. In this matter, the debtors' Canadian interim receiver successfully utilised chapter 15 to liquidate the debtors' U.S. assets as a going concern on an expedited timeline and without the associated cost or administrative difficulties associated with a plenary chapter 11 case.

CPI Plastics was a North American leader in designing, engineering and manufacturing thermoplastics. After CPI Plastics failed to meet certain loan covenants at the end of 2008, the companies' senior secured creditor placed CPI Plastics in receivership in Canada under the Bankruptcy and Insolvency Act (the "Canadian Proceeding"). The liquidation process was complicated because CPI Plastics had operations and significant assets in both Canada and the U.S.

The receiver of CPI Plastics (the "Receiver") ultimately chose to commence a chapter 15 proceeding in the U.S. (the "Chapter 15 Proceeding") rather than commence a chapter 11 case. By using chapter 15, the Receiver essentially conducted the sale process in the Canadian Proceeding, and subsequently sought approval of the process in the Chapter 15 Proceeding. This process allowed the Receiver to gain all the protections afforded for a sale process under the Bankruptcy Code (such as good faith purchaser status and a court approved sale) while avoiding the cost and delay that is often associated with running independent sales processes in the U.S. and Canada. Additionally, performing the sale under chapter 15 allowed the Receiver to easily sell the estate assets as a single package, thereby maximising the sale price.

The use of chapter 15 further enabled the Receiver to obtain a court order recognising the Canadian Proceeding as a foreign main proceeding, which gives significant protections to the Receiver); enjoin all creditors from taking any action against CPI Plastics during the Chapter 15 Proceeding; make a final distribution to CPI Plastics' creditors; and close the Chapter 15 Proceeding. The Receiver's utilisation of chapter 15 allowed the entire matter to be completed in just over six months' time and represents ground-breaking precedent to the efficient liquidation of U.S. assets of foreign debtors.

Contributed by Aaron L. Hammer, Partner and Bankruptcy, Reorganization and Creditors' Rights Practice Group Chair, Freeborn & Peters LLP.

Richard Curtin, from Faegre & Benson, agrees that pre-packs can help to save jobs.

He said: "I recently saved a whole workforce using a pre-pack and, these days, that's an important issue. What has to be remembered is that directors don't want to shed liabilities, they are desperate to save the business. Critics say it's a way of shedding debt, I can see that point of view, but it's not the reality."

He added: "Pre-packs are a legitimate tool if used by proper hands and in a proper fashion. SIP 16 is a checklist for insolvency practitioners to make the pre-pack more acceptable in the market place."

Matthew Barker, from Clarke Willmott, says it enables continuity of trade, employment and relationships with customers and suppliers.

He said: "It also takes away the IP's concerns about trading a business, without funding to do so. Frequently, it is the only realistic option, where the alternative is to simply close down and break up a business, which would show no return to creditors and result in all staff losing their jobs. Many commentators do not appreciate the extreme time and cash constraints in which IPs frequently have to operate and much of the concern about pre-packs is that creditors are unaware that the process is being mooted and undertaken. An IP is under a statutory obligation to maximise the return from assets and often, a pre-pack is the only realistic way to achieve this, even though some creditors find the whole principle of a pre-pack as distasteful."

He added: "SIP 16 has been introduced to address some concerns and to ensure greater transparency to creditors and regulators. SIP 16 is not a perfect solution, but what it ought to achieve is that the analysis undertaken by an IP in deciding to enter into a pre-pack is visible. The IP's decision should be objectively justifiable and as part of the new process can be reviewed by the Insolvency Service and creditors."

The way forward for the UK economy

The general consensus is that the UK economy has further to fall and that the current signs of improvement are an illusion. This is based on the assumption that, when the artificial props are removed from the economy by the Government, we will see more struggling businesses fail.

Michael Geoghegan, chief executive of HSBC, recently warned of a global double-dip recession, as Governments exit stimulus packages too early.

Alain Le Berre, from Huron Consulting, agrees, suggesting that the current rally is not based on solid ground.

He said: "The banks are still not lending for a good reason – which is that they still haven't solved their problems and will need many more years to solve them fully. Unemployment is bound to rise sharply this autumn and in early 2010, which will weigh on sentiment and consumer disposable income. Thousands of companies that have survived the past leg of this downturn are now standing on significantly weaker balance sheets and are more prone to "accidents" going forward. The number of corporate defaults is expected to rise sharply in Q4, 2009 and Q1, 2010 – which will in turn impact the banks negatively (and also helps explain their current caution).

He added: "Governments and central banks can't do much more than what they have already done, and will at some point need to raise taxes or let inflation go in order to repay their debt (assuming they don't choose to default on them). All this does not sound like an improved outlook at all – but it does however underline the importance as well as the urgency for corporations to address their issues (excessive debt or need for improved performance) very early on – rather than wait for the problems to become unavoidable, because then it may be too late given the difficulty to find new funding in the current market."

Andrew Duncan, from Bridge Business Recovery, says that this recession is proving to be different from the last one.

He said: "I believe it will take a number of years for the underlying structural problems in the economy and the banks to work themselves through, and in the mean time there will be companies that won't be able to survive during this period."

Finding finance in a downturn

If, as predicted, distressed situations rise as economic stimuli are removed then there should be an increase in demand for distressed finance. With traditional cash flow lending still in short supply, the spotlight will fall on others, such as asset-based lenders, to provide options.

Steve Websdale, managing director of independent asset-based lender Venture Stuctured Finance, says that demand hasn't yet reached the level anticipated at the start of the year, but he expects that to rise significantly into 2010.

He said: "We continue to see funding requirements for the automotive sector from challenged suppliers. That demand has continued, which means there are still many automotive suppliers looking for alternative funding options. Aside from automotive we are seeing a general overall increase in new funding requests, but nothing sector specific"

He added: "The banks appear to be holding onto their revenue streams for as long as possible, so there has been a tendency to not bring situations to market for alternative funding. With problems increasing within the economy, we are finding many of those funding requests that do eventually come to market being quite heavily distressed. Unless there is a clear forward plan, often involving decisive restructuring, it is difficult for us to help"

Mr Websdale says that the withdrawal of support from bodies such as HMRC will generate additional demand for asset-based lending. He said: "HMRC has been very supportive to lots of businesses in recent months, but there is a real sense that the tide has turned. We are now seeing HMRC more actively pursuing outstanding debt. To make payments may bring forward a need to identify other forms of liquidity- asset based lending is well positioned for that. During recent weeks we have seen a very significant increase in organisations with arrears to HMRC seeking funding. If the business has a viable business model we can help."

Mr Websdale says that the assets are now easier to value, with valuations settling down from the vicious fluctuations seen during the past 18 months. This produces greater scope for lending.

He said: "Valuations have been more stable since the deep difficulties of Q4 last year and Q1 this year. The quantum of fixed asset value reductions has thankfully slowed. We are no longer suffering that phase of high fixed asset values devaluations- Venture is happy to provide finance against a range of fixed assets, including plant & machinery and property."

Venture works closely with a handful of private equity houses and is actively supporting them with liquidity for the financing of transactions.

Mr Websdale said: "We work with a number of regional private equity houses in London, Birmingham and Manchester. Typically the private equity firm will be looking at an opportunity, where we can come in alongside. This works very well and can move quickly"

He added: "There have been some harsh learnings during recent months concerning the asset mix involved in proposed transactions. Certain valuations of receivables and inventory, as part of our due diligence process, have caused the private equity house to go back and renegotiate the proposed deal. We still find asset profiles are not fully understood. For example, the blend of inventory and estimated stock turn can significantly affect a transaction valuation- depending on the business model and the estimated trading going forward. EBITDA multiples have to be calculated more realistically these days. The time of valuations at 10 x EBITDA has gone, and may be down to very low single figures"