

## A Cautionary Tale

The lowest bank interest rate in history supporting a stagnant housing market, increased taxation, rising inflation and unemployment, under investment, restricted availability of credit, rocketing fuel prices, neutral growth, declining disposable income, the public sector pension deficit, an ageing population – welcome to the twenty tens and be afraid.

Very afraid indeed.

But amid all this gloom corporate insolvencies are at unprecedented low levels. Surely that is a ray of sunshine. Or is it?

The following example is hypothetical but is based on the realities that we in the insolvency profession are encountering on a daily basis.

Trevor and his wife, Elizabeth, run a logistics business. They have been doing so for 15 years and are the sole shareholders and directors, ie a typical owner managed business.

Until 2008/9 annual turnover was approximately £7m and profits were steady. Subsequently, however, turnover and profits slumped and Trevor and Elizabeth had no choice but to make redundancies, eventually more than halving the company's workforce. They have continued to make economies, for example by not updating the fleet as finance agreements expire.

Unfortunately, the company's premises are subject to a 15 year lease entered into in 2006. The landlord has been approached but has refused to reduce the rent, even temporarily, although he has informally allowed the company to pay its rent monthly rather than quarterly. The bank facility of £400,000, which now comprises a mixture of loan, overdraft and invoice discounting, has been guaranteed by Trevor and Elizabeth.

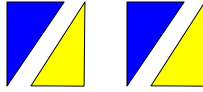
The overdue sums owed to HM Revenue & Customs are approaching £250,000 despite a time to pay arrangement successfully completed in 2010. The company has requested a further arrangement and is waiting to hear back from HM Revenue & Customs in this regard.

Trade creditors are putting pressure on Elizabeth, who is the book keeper, but the company is not yet, despite numerous threats, on stop with any of its suppliers and no legal proceedings have been commenced.

Trevor and Elizabeth have sought angel or equity investment but all potential investors have demanded more equity than Trevor and Elizabeth are willing to release.

Following an announcement by the company's major customer (responsible for 65% of turnover) that they will be reducing their spend on logistics by 50% in the coming year Elizabeth and Trevor are concerned for the future of their business and have discussed their concerns with their auditors who have recommended that Elizabeth and Trevor get advice from an insolvency practitioner.

The insolvency practitioner quickly determines that the company is insolvent on both a balance sheet basis and as a result of its inability to pay its debts as they fall due.



He quickly identifies three issues which will shape the options available to Trevor and Elizabeth:

1. In view of the historic debts to HM Revenue & Customs and trade creditors, the company has absolutely no prospect of avoiding an insolvency process.
2. The company will not make sufficient profits to enable the promotion of a Company Voluntary Arrangement unless fixed costs are significantly reduced.
3. No investment will be made without the company entering into an insolvency process.

Effectively, if the company or its business is to survive, costs will need to be reduced which means that the lease will have to be exited. In view of the landlord's attitude, this makes an insolvency process inevitable. Such a process will, however, make investment more likely.

The insolvency practitioner outlines to Trevor and Elizabeth the various options available to them which comprise:

- Company Voluntary Arrangement
- Administration, or
- Liquidation

Trevor and Elizabeth are left to think over the options. After a few days the insolvency practitioner advises Trevor and Elizabeth that he knows someone in the logistics industry who is acquisitive and who he is willing to put in touch with the company.

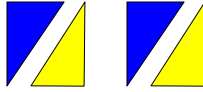
Perplexingly for the insolvency practitioner, after a few initial requests for clarification, Trevor and Elizabeth ignore the offer to put them in touch with the competitor and make no attempt to progress any of the suggested insolvency options.

The auditor who introduced the insolvency practitioner to the company is similarly marginalised but eventually, over a period of weeks, the reasons for Trevor and Elizabeth's apathy are revealed.

As interest rates are low, they are under no pressure from the company's bankers and have heard nothing from HM Revenue & Customs. While trade creditors continue to press for payment of their accounts there is no desire to issue proceedings which cost money and might lead to the loss of a customer as well as the writing off of the debt. Most importantly, Trevor and Elizabeth have concluded that they have no prospect of obtaining employment at a similar salary if the company fails, in addition to which their personal guarantees might also be called upon which would necessitate the sale of the family home.

Under no real pressure therefore, Trevor and Elizabeth continue to struggle on. The company's debts continue to increase, cash management remains crucial and every day could bring a winding up petition, but so far this has not happened.

This is a scenario which the profession is encountering again and again. In the long run the company has little or no chance of survival and its demise is inevitable. The directors run the very real risk of a subsequently appointed liquidator initiating a wrongful trading action against them, but if they have no free personal assets this is probably the least of their worries.



This Zombie economy is therefore propping up huge numbers of insolvent companies. At some stage, possibly once interest rates rise and borrowing becomes more expensive, they will finally enter into an insolvency process but in the meantime the danger for directors is that they are leaving themselves open to actions in the future in respect of their conduct. Such actions are very straightforward for a liquidator to instigate, the burden of proof generally being on the directors to demonstrate that they have acted correctly rather than on the insolvency practitioner to prove their case.

If you have clients in a similar position they should be made aware of the risk of being attacked by a liquidator for wrongful trading (see summary below).

Your clients should always take a realistic view and realise that they cannot expect to trade on and worsen the position of creditors without there being repercussions in the longer term. It may need you to alert them to the consequences of not doing so.

### **Wrongful trading**

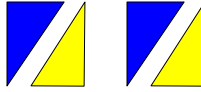
Under section 214 of the Insolvency Act 1986, personal liability for wrongful trading may arise for directors of a company which has gone into insolvent liquidation. Liability for wrongful trading is established if, on an application to court by a liquidator, it can be shown that at some time before the company went into insolvent liquidation (note: but not any other insolvency process) the person concerned who was a director at the time knew or ought to have concluded there was no reasonable prospect that the company would avoid insolvent liquidation. However, such liability can be avoided if it can be shown to the court's satisfaction that the director thereafter took every step they ought to have taken with a view to minimising the potential loss to the company's creditors.

The directors should never allow the Company to accept credit if in their view there is no reasonable expectation of the creditor being paid, since this may render any persons who were knowingly party to a transaction in such circumstances liable to make such contributions to the Company's assets as the court deems proper.

The test applied to a director is that they should have known or concluded facts which ought to have been known or ascertained by a reasonably diligent person having the general knowledge, skill and experience that can be reasonably expected of a person carrying out the functions of a director (i.e. "the reasonable company director"); and the general knowledge, skill and experience that they in fact possess.

The same "knowledge" test applies to the conclusions that the director ought to have reached as to the impending insolvency and, in the context of their defence, the steps they ought to have taken to minimise the loss to creditors.

There is no requirement to prove intent, dishonesty or fraud. The standard of proof is the civil standard of a balance of probabilities only. There is no requirement for positive misconduct; mere inadvertence can give rise to liability if the liquidator can show that the director knew or ought to have known of the impending insolvency.



*Geoffrey Martin & Co was formed in 1983 by Geoffrey Martin, who was until then a partner with Arthur Andersen. It now operates from offices in Leeds and London which collectively employ 5 partners and 30 staff.*

*We are business recovery professionals (the new term for what used to be called insolvency practitioners). We have no audit or corporate finance arms or associations and are solely dedicated to assisting companies, partnerships or individuals with financial or cash flow difficulties.*

*We would welcome the opportunity of working alongside you to provide bespoke solutions to the needs of your clients. These would not necessarily be formal insolvency procedures.*

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