CHAPTER 5
ALTERNATIVES TO INSOLVENCY

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However bleak things look, there are alternatives to insolvency and to liquidation that can save the underlying business. Well, there are some alternatives that can be reached through using insolvency processes — and these are dealt with in the next chapters. But there are also some that can be arrived at without the destruction of the business: jobs can be saved, creditors can be paid and value can be rescued.

Saving a business depends on whether there is a viable enterprise hiding beneath the present financial difficulties. If the business is no longer viable, the only options are to sell the company or to liquidate it, which involves ceasing to trade and selling whatever assets can be sold. If the heart of the business is still beating, however, investigate the following options.

Company restructuring

It's pretty unusual for a restructuring of the finances of a company to be the sole way of solving its problems but it can at least provide a breathing space for other actions to be taken that can rescue the business.

One way of restructuring is to convert debt to equity so that interest and debt repayments are no longer made but the previous holders of the debt participate in the future potential of the business. This can happen when a business has issued loan notes or some similar form of debt to individuals or to financial institutions. Sometimes the owners of these loan notes can be persuaded that they will be better off swapping them for shares. This may arise if:

- **it is clear that the business will be unable to repay the loan or to pay the interest;**
- **the company balance sheet shows far too much debt in comparison to share capital so that the bank is concerned about the viability of the business. In such cases, even a slight dip in profits can make the company unable to service its loans. That drop into trading losses will very quickly result in a negative balance on shareholders' funds, which is one of the indicators of insolvency.**

By taking shares, the holders of loan notes will strengthen the balance sheet, as well as give the company a welcome break in which to recover and to benefit from that recovery. The shares may be special ones — often called preference shares — that have a right to a dividend, perhaps at a pre-agreed rate, in preference to other shareholders. Those holding the loan notes may be entitled to a percentage of future profits, or maybe the loan notes will be repaid or converted to ordinary shares. The rights involved can get very complicated.

Agreeing to take these shares may be far preferable to an alternative of not having loan notes, or not having interest paid on time. Also, depending on the rights associated with the new shares, the bank may view them as equity and not debt and, seeing a healthier balance sheet, may be willing to increase lending to the business.

Raise new funds

Sounds obvious, doesn't it? But it's worth considering again at these times, particularly if you can find a new angle to explore. This solution presumes the core business is viable and that a cash injection, whether to resolve short-term cash flow problems or to provide investment for new projects, will resolve the difficulties.

If raising money will leave the business with exactly the same problems but merely delay them, it is not a solution but rather a pause on the road to insolvency. Therefore the first step in raising new funds is to produce a recovery strategy.

The second step is to get to the point of implementing that strategy. Do you have enough working capital to cover immediate needs?

New funding can come from existing or new sources. The first port of call will always be to existing investors or banks, not least because this is the easiest route to follow. Existing funders can often block you from going elsewhere. A loan agreement with one financier may limit the total borrowing from all sources but, even if there is no constraint, it may be difficult for a new lender to obtain security without the agreement of pre-existing lenders.

Retailco had bought several properties with the help of loans that it had now almost repaid. It had some financial difficulties but believed these could be resolved by borrowing more and refurbishing its units. However, the existing lender was reluctant to lend more. A new lender was prepared to provide finance but wanted its mortgage to be a first charge on one of the properties. This required the first lender to release its charge. It refused to do this even though the security provided by the other properties was more than sufficient. There was a solution in this case, which was for the second lender to provide enough funding to repay the first lender.

New investors will not want to put their money into a business that is failing. However, there are many instances of businesses that are fundamentally sound but just have a short-term financial problem. These examples normally include businesses that:

- **are profitable but have run out of cash through overtrading;**

- **have run into a single non-recurring problem e.g. a single large bad debt;**
- **can be restructured to create a viable business;**
- **started out with insufficient capital.**

Start by writing a business plan. That concentrates minds on what matters. Every business plan is different and they differ depending upon what their purpose is. This one will have to address:

- **what has gone wrong;**
- **how it will be corrected;**
- **how much investment is needed and for what;**
- **the risks;**
- **what payoff there will be to someone providing new funds.**

Most businesses get into difficulty as a result of management failures. If you have made mistakes you need to persuade a lender or investor that:

- **the existing team has learnt from this;**
- **new management skills have been recruited;**
- **organisational failures have been addressed.**

Relationship failures are often at the heart of other failings. Is the management team working well together? If it is not, what are the issues and what can be done about them? There is no point seeking new funds until underlying problems have been worked out, because lenders and investors will soon discover them.

Sources of new funds

There are many sources of new funding, even for businesses in financial distress and even when there are existing lenders who have charges over the assets.

Asset refinancing

This is ideal for sectors such as manufacturing, engineering, print, construction and transport, which work with a large asset base. Refinancing these can provide a substantial injection of cash. A loan will generally be a percentage, ranging from 50 to 75% of an independent valuation. Assets already subject to finance can be refinanced, with the existing lender paid off as part of the process. Loans will usually be up to five years but can be less where assets are old or have a short economic life.

Mortgage or re-mortgage

Companies often operate from premises that have risen substantially in value and may not be encumbered with a mortgage at all or may have financing that is a relatively small percentage of their value. This presents an opportunity to re-mortgage properties and release cash.

Invoice financing

Banks will often offer invoice financing but there is a wide range of other providers. Factoring hands the entire collections process to the finance company whilst 'invoice discounting' retains control and the company borrows a percentage (often up to 90%) of their receivables based on various criteria, including the credit rating of the customers.

Trade finance

Trade finance companies advance money on the security of confirmed orders. Clearly they will be more cautious when a company is in distressed circumstances and there is a risk of non-completion. Nonetheless, this is a potentially valuable part of the financing portfolio where the pressure on a business arises from difficulty in financing larger orders.

Private investors

There are a number of brokerage firms that will match private investors or private equity firms with businesses that need help.

This action will usually be associated with a direct management involvement in the business and a dilution of the existing owners' equity stake. However, additional expertise may prove an added attraction rather than a penalty.

Sell assets

What about things you can sell? This may be property or equipment. If you can do without something, consider an outright sale but, if the property or piece of equipment is still needed, then what about a sale and leaseback? Instead of owning the asset, you still use it but pay a 'rental'. There are many finance houses that will enter into sale and leaseback transactions. The equipment generally needs to be fairly new so it can be resold if necessary and the length of the leaseback will have to be less than the economic life of the asset.

Sell part of the business

There are often activities carried out by a business that are not really at the core of what it does. For example, businesses that sell equipment will often sell maintenance or insurance alongside; or they may have a property management arm if they operate from many sites; or operate car fleet management if they have many vehicles on the road. They may have a fantastic website and design websites for third parties. Any of these may prove to be a viable business in its own right that can be spun off. Alternatively, one of these may prove to be the future for the business and it is the old business that spawned it that needs to be sold off.

However, do be careful not to react too quickly without careful consideration: sometimes what seems to be a peripheral activity is really critical to the operation of the rest of the business.

I heard an executive of a hotel chain on the radio describe his business as an e-commerce business with a hotel management activity on the side. Now I think he was exaggerating but, still, this is an example of a situation where you wouldn't sell off the website design and management activity, because it sounds like a core activity and not peripheral at all.

Sometimes this secondary activity needs time to build, separate and get ready for sale. Do you have time? Can something else be done to keep the whole business afloat whilst this is done? There may be a potential buyer out there who would be interested in taking the activity as it is and developing it into a significant standalone business. Of course they would offer a price that reflects the work they have to do but if cash is needed quickly is this a practical option?

The practicalities of selling a part of a business are very similar to those involved in selling the whole, which is dealt with in the next section.

Credit card financing

Smaller businesses faced with financial distress may use personal or company credit cards to borrow. This is an act of desperation because the interest rates are very high and the amounts that can be raised are likely to be small. However, there can be circumstances when it should be considered.

Tax benefits for investors

A bad investment remains a bad investment even if it is eligible for a tax break. However, if a rescue proposal is convincing but the prospective financial return is not quite good enough to attract the investor, an increase derived from a tax break may just tilt the balance.

Enterprise Investment Scheme (EIS)

The main UK tax benefit that can be offered to an investor in a struggling business is the Enterprise Investment Scheme. This will not be suitable if finance must be raised within days because it is more likely to take a couple of weeks to put one together. This used to be a simple scheme that a company's finance director could put together but to combat the growth of complex tax avoidance, a host of conditions and regulations have grown up that mean it will now generally be necessary to get professional advice.

EIS offers:

- **a 30% rebate on investment through a personal income tax allowance;**
- **tax-free capital gains after shares have been held for three years;**
- **losses that can be offset against income tax;**
- **capacity for investments of up to £1m.**

What kind of companies are eligible? The conditions change frequently, so it is sensible to check the current position. Broadly they are private, trading companies (not property or investment companies) below a size specified by employee numbers, balance sheet value and turnover.

Sell the business

Clearly it is not that easy to sell a business, particularly not one in difficulty, but it is worth thinking about.

Who might be interested?

- **Suppliers or customers?**
- **Competitors?**
- **Foreign buyer seeking entry into the UK?**
- **Someone to whom the business is worth more than it is to you?**
- **Turnaround investors?**

Either suppliers or customers may be interested in acquisition. The supplier faced with losing a significant channel to market may prefer to assist it through a difficult situation or to buy it outright. The alternative might be that they lose a substantial part of their own turnover either temporarily or permanently. Customers who depend upon the product or service you provide may, similarly, find it difficult to replace you.

Of course there is a risk in approaching a competitor. They may just contact all your customers or your staff and tell them you are in difficulty. They then try to win your business away and recruit your staff. Even inadvertently they may let slip that they are in discussions with you. Further, you will have to give them information and they may just talk to you to find out what they can but with no real intention of doing a deal. What can you do to protect yourself? The first step is to get them to sign a confidentiality agreement; and your accountants or solicitors should be able to supply one. This will prevent them from approaching your customers or staff and oblige them to keep any information you give them secret. But be aware that it is pretty hard to enforce these agreements in practice and this is particularly the case if you are short of time and money. The second step is to try to work out if they have money to conclude a deal. Thirdly, you try to limit what information you give and what access you allow to your staff, while you build up confidence in their intentions. Finally you require a quick answer. If they can't make an offer within a few days, maybe you move to plan B, or try to negotiate a deposit. However, if you need to do a deal you may have little choice but to take whatever risk is involved.

You need to judge whether it is likely to be worthwhile approaching a competitor. Is your business big enough to provide them with economies of scale or do you have a regional presence that would complete their network? Do you have a product that they would like to add to their range? An approach to a competitor may be worthwhile even for quite small businesses where that business wants a presence just where you are based or in the small market niche you occupy or even, in some instances, partly to acquire the team or even an individual who is part of your team.

Searching out a foreign buyer, or someone else who wants entry into your market, is a likely option for larger businesses. However, there are cases of large companies buying many smaller companies and combining them to achieve economies of scale.

A company I worked for called Staveley Industries bought up relatively small businesses involved in manufacturing non-destructive testing equipment. These small businesses were spread around the world and had sales of only two or three million pounds each but, combined, produced a substantial company. This achieved economies of scale by selling through one sales force and covering most of the important niches in the industry.

Why would your business be worth more to someone else than it is to you? A company that is buying up small businesses may achieve economies of scale; they might get better volume discounts from suppliers or be able to trade with lower percentage overheads. On the other hand your business might be worth more to a competitor just because they could shut it down and put all the sales through their business. Or it may occupy a property that may be suitable for profitable redevelopment in a few years — if you can't wait, maybe someone else can.

Turnaround investors may appear in the form of brokers who assemble an investor group or they may be private equity houses that have already raised funds to invest in interesting situations. The only real difference between a private equity firm that specialises in turnaround investments, and the rest, is the understanding that businesses in financial distress may need to act very quickly and need very rapid assessment and action from investors. This is seldom an option for a really small business because only private investors are likely to be interested in investments below a couple of million pounds. However, even here it may be possible to find one or more private investors who are interested in smaller investments.

Analyse again what you have to sell. For example, is there:

- **a significant property?**
- **a good customer list?**
- **supply contracts?**
- **any unusual expertise?**
- **a well recognised brand name?**
- **volume or locations to add to someone else's business?**

How should you approach people?

- **Contact specialists in selling businesses?**
- **Direct approach to existing business partners — perhaps through an intermediary?**
- **Advertise?**

The instant risk in putting a business up for sale is that customers, suppliers and employees get spooked. This is not just true for approaches to competitors, but to anyone. As discussed above, it is possible to insist that a potential buyer signs a confidentiality agreement but you probably don't have the resources to pursue them through the courts if they fail to comply with their undertakings.

Working for a public company that had suddenly lost the confidence of its bankers, we decided to sell various assets. One retail business had a division that sold computers from relatively small premises. The division was not profitable because it was being overtaken by big 'shed' operators. However, its premises themselves were of great value to a mobile telephone company that wanted to build its customer base. It was the early days of mobile telephones and this company was eager to build sales very quickly and then to sell their business to one of the bigger companies.

They knew we were in difficulties: we knew they were in a hurry, and so a suitable compromise emerged.

Lessons

Think creatively about who might be interested in the business, its people or its assets — it might not be someone obvious.

Compound with creditors

Compounding simply means reaching an agreement with creditors. There are two approaches: a formal or an informal deal.

The informal approach

If you have one or two major suppliers, they may agree to help you through your difficulties rather than lose your business. For them to help you, they must believe that your business will survive and prosper, so it's essential that you produce a business plan to discuss with them. They already know you and so you probably don't need a full-blown business plan that details the usual contents (history, markets, management, competitors, strategy etc.). The occasion may call for just a quick summary of that but it *will* require four critical components (adding in anything else you feel may be persuasive):

- **An explanation of why there is a problem.**
- **A strategy for recovery.**
- **The current financial position.**
- **A financial forecast.**

The statement of current financial position needs to summarise:

- **Creditors. How much is owed to each and how overdue they are? Virtually any computer accounts system will produce**

this schedule of 'aged creditors'.

- **Secured lenders. Spell out the amount owed, any repayments overdue, security, and covenants, whether they have been breached or not.**
- **Statement of affairs. This usually sets out assets and liabilities of a business on the assumption that it is not a going concern. However, in this situation it is more appropriate to assume the business will be saved but to exercise an extra degree of conservatism when considering issues such as the realisable value of property and likely recoverability of overdue debts.**

The statement should also include a financial forecast, which needs to be realistic and persuasive. It needs to show how, with some help from the suppliers, the business will be profitable and will pay-off overdue creditors within a reasonable time. What a 'reasonable time' means will depend upon the circumstances. It is likely to be months or, at the extreme, a year or two. It will not, however, be as long as five years.

An essential part of the financial case is a cash-flow forecast. Be realistic and be conservative. If debtors usually pay in 30 days, allow a little extra time. If the result shows that you are able to pay creditors in 90 days, ask for 120. If things do go wrong, get in touch with creditors as soon as you can to keep them up to speed: clearly they won't be thrilled, but if you don't keep them informed, trust breaks down. This forecast is likely to show units of weeks but when in difficulties, a business should produce a daily forecast for its own use.

The help required from creditors is likely to mean paying off a part of the outstanding debt over an extended period. In some cases, a deal may be possible that entails the creditors writing-off part of their debt. In such circumstances they will invariably want to see a comparable sacrifice from the owners of the business and possibly from other suppliers. The wider the circle of creditors who have to take part in such a rescue the more difficult it is to arrange.

Another approach may be to consider asking a wide circle of suppliers to accept delayed or reduced payment. This inevitably raises a problem for future supplies and must be considered very carefully. Options include asking for:

- **deferred payment;**
- **payment of a reduced amount over a period;**
- **payment of a reduced amount immediately.**

In every case the creditor should be asked to acknowledge in writing that the agreement is in full and final settlement, which means it cannot be reopened once the company is past its difficulties. The creditor should also be asked to confirm their continuing willingness to supply on the same terms (or different terms you may agree).

The advantages of this informal approach are:

- **That it can be carried out within just a few days and without incurring heavy fees from professional advisers.**
- **An informal approach may allow a different deal to be struck with different creditors.**
- **It can be a way of avoiding adverse publicity.**

There are, however, risks too.

- **Creditors may react by stopping further supplies or by ratcheting up their debt recovery proceedings.**
- **Creditors may not keep the approach confidential.**
- **Many property leases include a clause that permits termination if the tenant compounds with its creditors...**

This is a typical clause:

"... or if the Tenant shall compound or make arrangements with the Tenant's creditors or shall suffer any of the effects of the Tenant or the Surety to be taken in execution or if the Tenant (being a corporation) shall enter into liquidation whether compulsory or voluntary (except for a reconstruction or amalgamation of a solvent company forthwith carried into effect) or if a receiver shall be appointed in respect of any part of the Tenant's undertaking or if an application shall be made or a petition shall be presented to the court for the grant of any administration order under the Insolvency Act 1986 or for any order of similar effect under any law relating to companies or if an administrator or administrative receiver or provisional liquidator shall be appointed or if the Tenant or the Surety (not being a corporation) shall become bankrupt or make any assignment for the benefit of his creditors or make any arrangement with his creditors for the liquidation of his debts by composition or otherwise..."

It essentially provides for the landlord to regain possession of a property in the event of any insolvency process or any informal deal with creditors. These clauses are not always enforceable but legal advice should be taken.

However, landlords may prefer to have a tenant in place rather than risk incurring a void period and losing some of the rent that is owed. The key to assessing this risk is to take a view of the property market and whether the landlord would be able to re-let quickly and, even, at a higher rent.

- **A deal may be harder to reach the more creditors that are involved.**
- **Reaching a deal may take a lot of management time.**
- **If it does not work it might then be harder to go the formal route.**

Company Voluntary Arrangement (CVA)

The CVA is the formal approach to creditors. Its key features and main differences from an informal arrangement are as follows:

- **All unsecured creditors are approached and, if an agreement can be reached with those whose claims amount to at least 75%, by value, of all the unsecured debts of the business, it is binding on all of them, including those who voted against or refused to participate.**
- **Whilst attempting to reach an agreement, there can be a moratorium on legal proceedings to recover debts — usually for 28 days.**
- **The arrangement is dealt with through the courts.**
- **A supervisor, who is usually a licensed insolvency practitioner, is appointed to work alongside the management.**

The directors of a company can apply for a CVA unless it is in administration or liquidation, in which case the administrator or liquidator may still do so. Even if the administration or liquidation process has been started it can still be worthwhile to pursue a CVA for all or part of a business. So, for example, an administrator can disclaim uneconomic contracts and leases or close parts of a business and then start a CVA process in the hope that creditors will get a higher return than from a piecemeal sale of assets.

The absolute condition for taking this route is that the business can be viable and can return to profitability. There are two scenarios where the CVA may work:

1. **The business has a short-term cash shortage but is otherwise profitable. This is where the economic model is viable but, perhaps through an issue such as overtrading, the failure of a large customer or a cost overrun on a single project, there is insufficient immediate cash.**
2. **The business has a faulty economic model but, given time to adjust, it has good prospects for future viability.**

In both cases, the forecasts will show that if the immediate gap can be filled, that future trading will produce sufficient surplus cash for the business to continue.

The CVA provides key components that can help this to happen. In the first place there is the all-important moratorium when creditors such as banks, landlords and suppliers are prevented from pursuing their legal remedies such as seizing goods. This breathing space can then be used to try to reach an agreement with creditors. The moratorium is only available to smaller companies, as defined by the Companies Act S382[5] and some companies may choose not to take it. The procedure without one may be quicker and less onerous, with fewer reporting requirements.

The business will probably need additional working capital to see it through to recovery. This may come from:

1. **existing or new investors;**
2. **the company's bankers;**
3. **cash generated from trading.**

In the first two cases, the investors or the bank will have to be convinced that the capital structure is viable, which will probably mean that creditors agree to write-off part of their debts. If the business can generate sufficient cash from trading to ensure it prospers, this will still probably entail at least a deferral of debts owed to creditors and probably some write-off. In most cases, unless there is a write-off of some of the debts, there will be insufficient incentive left for the management team, who may feel they are working for their suppliers with their own potential reward extended too far into the future. In some cases, the suppliers may convert some of their debt into shares in the company. These may have restricted or deferred rights to capital and dividends — it being important not to remove the

5 Turnover less than £6.5m, gross assets not more than £3.26m and no more than 50 employees.

incentive for management to work hard to make the business successful.

The second key aspect of the process is therefore that creditors agree to either write off part of the value of their debts or to defer their repayment. It may also be important to get their agreement to continue supplying the company as before. Whilst the 75% vote by creditors may bind the other 25% to the agreement to accept reduced or deferred payment, there is no way of forcing them to continue supplies.

As well as having a breathing space the business may need to make other adjustments, which could include changes to:

- **strategy;**
- **management;**
- **underlying cost structure.**

It may, for example, be necessary to shed staff, abandon or renegotiate leases on premises etc.

CVA process

There are three stages to entering a CVA. The first is informal and occurs when the company directors decide to investigate this course of action. It is therefore an appraisal stage and will normally involve discussions with a professional adviser. It culminates in the directors deciding to proceed and formally appointing an adviser with experience of CVAs, who is usually also a licensed insolvency practitioner.

The second stage leads up to the formal papers that will be filed at court and sent to creditors. It involves assessing the situation, determining that a CVA is both viable and the best option and drawing up the plans and forecasts to support the proposal. There will be:

- **a business plan and cash forecast;**
- **a statement of affairs;**
- **a proposal for creditors as to how the CVA will work;**
- **formal documentation.**

Since a formal proposal will result there will inevitably be discussions with key suppliers to get their support — there is no point in sending out a proposal unless you know in advance that it is likely to be passed. Of course this can be a difficult time because the company is probably under pressure from creditors with the possibility of suppliers refusing to supply, applications for county court judgements and winding-up petitions. Bailiffs may enter premises and bankers may decline to provide further finance.

The attitude of banks is critical because a CVA does not affect the rights of secured creditors. They can still withdraw lending or exercise their security. And the very act of reaching a deal with creditors is an act of default under most finance agreements. So persuading them that the proposal is viable and winning agreement to support the CVA, or finding another bank to take over, is a top priority.

Administration followed by CVA

Once it becomes known that a company is in difficulties and considering a CVA, might this spur one or more creditors to petition for a winding-up? The company can be protected by the court, using an administration order, while its directors and the administrator put together a plan for the Company Voluntary Arrangement.

If there is a risk of a creditor winding the company up or a landlord taking aggressive action then this is a powerful (but expensive) way of controlling them. Usually nobody will feel it is in their interests to do this while alternatives are being investigated but, nonetheless, it can be a risk. If it happens, the company can ask the courts for a delay in granting a winding-up order in order for the CVA to be agreed — the courts have some discretion. An alternative is to put the company into administration, or just to start the process, in order to give time for agreement.

> Towards the end of March 2011, Oddbins, a retail wine seller, started the administration process, which automatically gives it a period of protection from its creditors. This period extends over the quarter day when its rents are due and prevents landlords from reclaiming properties when rent is not paid. The court hearing is set for some 10 days after the quarter day. In the meantime negotiations continue to agree a CVA. If these are successful, the administration hearing can be set aside.

As soon as a plan is approved by a nominee and filed with the court there is the possibility of a moratorium to protect the company (see below). The final stage is a creditors' meeting at which a vote is taken to approve the CVA.

The lead-up to producing formal papers could take anything from a few days to a month or two. The period between filing papers and holding the creditors' meeting is a minimum of 17 days (legal minimum notice to creditors is 14 days) but is usually around 21 days.

The company continues trading during the time the CVA is being considered — but only as long as the creditors' interests are being optimised and not prejudiced. If, for example, the company had to take on significant new debts in order to keep trading then this would probably constitute wrongful trading and directors could be personally liable. If, as is usually the case, new debts can be kept to a minimum and are with existing suppliers, then it can be argued that the position of individual creditors and creditors as a group is not made materially worse and the proposal will be to their advantage. As soon as this appears not to be the case, the company directors would have to cease trading.

The moratorium

The original legislation did not provide for a moratorium, which was added by subsequent amendments. So there remains an option to file for a CVA without the protection of a moratorium.

The moratorium is also only available for small companies, as defined in the Companies Act which specifies that a company meet two out of three of the following criteria:

- **less than £6.5m turnover;**
- **balance sheet total less than £3.26m;**
- **not more than 50 employees.**

It lasts only for a maximum of 28 days unless the court grants an extension and exists from the point documents are filed until the creditors' meeting.

During this period, the most important protections are a block on winding-up petitions or resolutions, appointment of an administrator or administrative receiver by a secured lender; enforcement of repossession; entry of bailiffs or entry by landlords. This gives the company time to try to get support for the CVA from creditors without anyone taking steps that would result in the company ceasing to trade.

However, the company will still be under pressure because it will not have additional bank cash and must make do with what it can get from trading. Suppliers may also refuse to supply further goods on credit, though options remain of cash on delivery, a very short credit period or some form of security.

Restrictions are placed on directors to protect creditors. Any invoices issued must contain the nominee's name and a statement that a moratorium is in force. The company cannot obtain more than £250 credit without declaring there is a moratorium. Property can only be disposed of with the nominee's consent and in the reasonable expectation that it will benefit the company. If the property is subject to security from a lender then the proceeds must be used to repay that security. The nominee must approve payment of any pre-existing debts, which must be for the benefit of the company.

The actions of directors can be challenged in the courts by creditors, which can result in a wide range of action including sanction against the directors.

The nominee monitors the company's affairs during the moratorium to protect creditors, and must withdraw consent to act if it becomes clear that the CVA will not be approved or if the company runs out of funds to trade. Notice must be given to the company, creditors and the court, and the moratorium ends.

As court cases have multiplied, the law has become more complex and the moratorium is sometimes seen as too cumbersome now. It is therefore used less frequently, pushing the onus back on the company to either reach agreement with all key creditors in advance, or to use the dual mechanism of an administration followed by a CVA.

The CVA proposal

The CVA proposal that can be put forward to creditors is not defined by the legislation so it can be very wide-ranging — it is basically just a private agreement with creditors that is given support by the law. This allows maximum flexibility to do a deal that can save the business and optimise the interests of creditors. The offer to creditors will usually be a percentage of their debt that may be as little as 30 or 40% and this will be paid over an agreed period that may be as long as five years — there is no limit in the legislation. At the end of the agreed period, any debts not repaid will usually be written off. The amount paid may be a proportion agreed at the outset, it can be a minimum plus a percentage of profits, and it can include some shareholding for creditors. Often existing or new shareholders will invest additional money. Sometimes the bank or other secured lenders may write off part of what is owed to them.

Note that the forecast must be persuasive, which means the scheme is probably not appropriate for businesses with irregular or uncertain income, since that makes it difficult to make a convincing case and hard to set clear targets with a fixed timeframe.

There have been cases where an initial CVA was established on the understanding that a review of progress would be necessary after a period, followed by a further creditors' meeting to revise the CVA or to abandon it and petition to liquidate the company.

The proposal must provide for a nominee who will supervise the implementation of the CVA. This person must either be an authorised insolvency practitioner or a member of a designated professional body that authorises their members for this purpose [see page 208].

The CVA creditors' meeting

The proposal for the CVA will be presented at the creditors' meeting but creditors may propose amendments. The final outcome must be approved by 75%, by value, of those voting on the day. Votes may be cast by proxy.[6] It must also be approved by 50% by value of non-associated creditors, those other than directors and associated companies.

It is quite common for creditors to propose and pass modifications to the CVA. Whilst they may see this as imposing discipline on the directors, it may have the disadvantage of reducing their incentive to make it work.

Secured creditors can vote only in respect of their debts that are not covered by the value of their security, except in relation to a proposal to adjourn the meeting, in which case they can vote the entire value of their debt. This is because they may be stopped from enforcing their security by a moratorium on the one hand, but on the other hand they do have security.

After these votes, there will be a shareholders' meeting to confirm the CVA. However, even if this vote goes against the proposal, the directors are still empowered to proceed because their duty, once the company is insolvent, is to the creditors and not the shareholders. To avoid the CVA, the shareholders would have to remove the directors, replace them with opponents and also demonstrate that the company is not insolvent. Members (shareholders) can apply to the court within 28 days if they feel

6 A proxy is someone authorised to vote on behalf of the person entitled to vote. This may be covered by an instruction to vote in a particular way or to use their discretion. Normally the organisers of the meeting must be informed in writing of the proxy arrangement at least 48 hours prior to the meeting. Often the organisers will provide a proxy service rather than creditors being obliged to send their own appointee.

the result of the CVA proposal and vote is unfair to them.

The chairman must report the outcome of the meeting to everyone who was sent notice of it within four days and, if the CVA is approved, notify the Registrar of Companies.

Challenging a CVA

Once a CVA is agreed, a disgruntled shareholder or creditor can still challenge it but only on one of two grounds:

1. **That it unfairly prejudices them — they have been treated differently from others or the effects are to damage their interests more than other shareholders or creditors.**
2. **That there was some material irregularity at the shareholders' or creditors' meeting or insufficient notice was given.**

The challenge must be registered within 28 days of filing the results of the creditors' and shareholders' meetings with the court. If the challenge is successful, the court has wide discretion as to the order it can make. For example, it can declare the CVA to be invalid or direct the holding of new meetings and another vote.

Disadvantages of a CVA

There are sometimes reasons why a CVA will not work and expert advice will be needed. Although intended to be simple, the law has become very complicated and the original provisions of the Insolvency Act 1986 have been changed by numerous amendments.

There are also potential disadvantages:

1. **If the CVA fails it is possible that the outcome could be worse than if the directors opted for a solution such as administration immediately. The indebtedness could be greater and therefore the claim on guarantors could be larger.**

2. The company's credit rating will be adversely affected by a CVA, which could affect decisions by suppliers and customers. Though, of course, not as adversely affected as by an administration.
3. As noted above, creditors may modify the details of a proposed CVA at a creditors' meeting and this action, if not well judged, may make the scheme less likely to succeed. This emphasises the importance of winning support from creditors before the meeting.

What happens during the CVA

Once the CVA is approved, the nominee usually is appointed supervisor of the scheme and the directors and officers of the company must hand over any assets included in it. This means that assets that are charged to secured creditors (such as banks) are not passed over to the supervisor. All creditors who were entitled to vote at the meeting as well as any unknown creditors are bound by the scheme.

The supervisor must:

- Keep records and accounts and report at least once every twelve months to the company, its members, creditors included in the scheme, the court and the Registrar of Companies;
- Report any directors they suspect of criminal offences in relation to the moratorium or CVA.

New debts incurred after the CVA commences can still be the subject of enforcement proceedings up to and including a petition to wind up the company. It is then a matter of the wording of the CVA whether the assets contained in it are available for these later creditors or are held by the supervisor on trust for the CVA creditors.

Reducing directors' liabilities

A CVA can be used to reduce director's liabilities for, say, rent by having the lease as part of the CVA. If the lessor accepts a programme of lower future rents and the directors have given personal guarantees, their liability may be reduced too. Although the lessor may prefer to call on the guarantee there can be circumstances where, depending on its terms, they will be better off accepting the CVA.

Complaints

Any interested party may apply to the court if they are dissatisfied with acts or omissions of the nominee or the supervisor. The nominee or supervisor may also apply to the court for directions in case of uncertainty.

CVA problems

A CVA is not the same as administration and, once agreed, the company is not insolvent. One of its key features is that it is far less public. There does not have to be a public announcement nor do invoices and correspondence reveal that the company is in a CVA. (Companies House will have to be informed and will have a public note of it, however).

Nonetheless it is undeniable that there is some stigma attached, even though the fact that creditors and the bank are supporting the company has to be a vote of confidence. How might key stakeholders react?

Staff

There is always a risk that key staff will leave and that it will be hard to recruit replacements. However, going into a CVA does imply a vote of confidence in the business by some important and impressive constituencies — namely the bank, suppliers and probably the tax authorities. It is important to communicate honestly and openly with staff in order to win their support too. If they are kept in the dark or misled, their confidence will fall and they will look for alternative employment.

Bank

Directors often fear that the bank will react badly to a planned

CVA, particularly if it has good security, perhaps with personal guarantees. However, if their security is preserved and the proposal is persuasive, they have no reason to 'pull the plug'. If they do so, they will lose a customer and their security may turn out not be as good as it appears. They know very well that in a receivership or liquidation, much of the value of assets evaporates. They are worth far more in a business that is continuing to trade.

It is generally best to present the bank with a proposal and one that has, at least, been discussed with creditors and seems viable. Informing them at an earlier stage has the disadvantage of uncertainty. They may be concerned that their security will be compromised if too much time elapses and will be reluctant to allow long before they exercise their rights. The case will be transferred from the company's normal relationship manager to the bank's recoveries team as soon as it becomes clear that there is a problem and knowledge of the business or a good previous relationship will have limited effect on decisions after a very short time.

Customers

As with staff, there is always a risk that customers will confuse a CVA with administration, will fear the business is just about to cease trading and that they'll take their business elsewhere. Again, if the business managers are open, honest and timely in their communication, the risk of losing customers is greatly reduced. Customers will abandon ship if they fear that the company's ability to supply good quality products and services will be impaired: if they are persuaded that business will continue as usual, there is no reason to take their custom elsewhere.

HM Revenue

The tax authorities are often the largest constituency who must agree, alongside others, to write-off part of their debt. They too have an interest in the continuation of the company because it is better for them to receive part of what is owed than none of it. They too are acutely aware that the bank usually has security and is paid first, that employees' rights come next and that there is often little left for the tax liabilities. They also know that the value of assets evaporates in a liquidation. It is therefore not a surprise that they support some 70% of proposed CVAs.

Common reasons for rejection include:

- **failure to give full disclosure;**
- **failure to treat all creditors in a class equally;**
- **no provision to pay all future taxes as they fall due;**
- **failure to meet obligations under a previous CVA;**
- **previous lack of compliance.**

Although the HMRC's Voluntary Arrangements Service aims to respond to proposals within seven days, more time should be allowed for potential negotiation over their response.

Problems with suppliers

Suppliers can agree to a CVA but still refuse future supplies on credit, which would leave the business in serious trading difficulties. An approach to win them around is to propose making payments for future goods a condition of the CVA which, if breached, would require the supervisor to wind up the company. Try offering accelerated payment or, if necessary to secure supply, cash on delivery together with measures to ensure retention of title can be successfully applied. Another approach is for the supplier to hold stocks and supply when they are needed, limiting their risk.

Failed CVA

The CVA will sometimes fail because the business is unable to meet the debt repayments that it promised. Even if the forecasts were very cautious and the proposal only called for a part of the cash generated to be used to repay debts, nonetheless things can still go wrong. Some may be associated with the CVA itself; customers, staff or suppliers may be lost. The same range of risks that affect any business still applies to the CVA.

There is still the option of going back to creditors and revising the CVA, though some credibility may have been lost. Nonetheless, if the business still looks viable in the long term, a revised deal may still look more attractive than the alternatives. This revision may involve amendments to the terms of a CVA or even a new CVA that covers new debts that were not previously included, perhaps because new suppliers have been brought in.

The alternatives are some form of winding up. The ability of a secured lender such as a bank to appoint a receiver is unaffected by a CVA. If covenants have been breached or repayments are in arrears, a lender still has the right to appoint a receiver. Indeed the lender will often have the right to ask for their money back at any time, particularly from a company in CVA. If it is clear, therefore, that the company is failing to reach its targets, the bank can lose confidence, which can result in foreclosure. The supervisor who is looking after the interests of creditors can apply to the court for a termination of the CVA if agreed repayments are not kept up. And new debts, incurred after the CVA was agreed are not covered by it so, if they are overdue, action can be taken by creditors to recover them.

The end of the CVA

There is no duration for a CVA prescribed in the legislation, although a CVA will usually run for several years. The duration will usually be part of the CVA agreement. At the end of the agreed period, or when the agreed debts have been paid, the supervisor issues a completion certificate and the business emerges from CVA status. The unsecured debts that were frozen in the CVA and were not repaid during it are written-off at this point and the directors revert to running the business in the interests of its shareholders.

CVA costs

The total costs of a successful CVA are generally less than a receivership or administration, not least because the business continues to be managed by its directors rather than by an administrator.

In addition to lower fees, the company continues to trade and therefore avoids the evaporation of asset values that occurs during insolvency processes. The costs of a CVA comprise court fees, the expenses of the supervisor who looks after creditors' interests during the process and the expenses of the adviser, who helps to put the deal together.