

Solvency addiction

Though the financial crisis didn't deliver the expected swathe of insolvencies, **Henry Harington** discovers that business recovery itself could still swell the number of victims

IT'S SAID that an ill wind that blows no body any good, though while insolvency practitioners don't break out the bunting at the first sign of an economic downturn, they can't be blamed for the fact that another man's bust has the potential to be their boom.

The downturn that began with the banking crisis in 2008, however, feels different. According to Christopher Harlowe, Partner at Speechly Bircham LLP and Head of the Insolvency and Recovery Department: "This recession has been a little strange, as recessions go. In the last recession, businesses closed down, there were regular updates on unemployment, it was all doom and gloom. This time it has been a bit subdued. Some insolvency practices and lawyers say they are not as busy as they expected to be in a market like this."

There have been high-profile failures – Woolworths probably being the most notable – and there has been a mix of anything and everything that depends on discretionary spending, from retailers and holiday firms to restaurants and advertising companies.

It is worth noting, however, that reports from The Royal Courts of Justice Viscount's Department on the appropriately named *désastres* (bankruptcies) indicate Jersey does not mirror the despondency in the UK economy. This is somewhat reassuring when you consider the scale of the problem on the mainland.

The UK's Department of Business Enterprise and Regulatory Reform (BERR) paints a sombre picture. There were 4,716 compulsory liquidations and creditors' voluntary liquidations in total in England and Wales in 2009's third quarter: a decrease of 4.7 per cent on the previous quarter but an increase of 14.6 per cent on the same period in 2008. Figures comprised 1,301 compulsory liquidations and 3,415 creditors' voluntary liquidations.

Before the flood

According to Alan Roberts, a Partner at Begbies Traynor, a business rescue, recovery and restructuring specialist, worse is yet to come. Towards the end of last year they recorded 134,000 UK companies showing "material signs" of financial distress. Their experience is that a significant number of troubled companies fail within a year, auguring a deluge of business failures in 2010.

Despite this apocalyptic view, things are not as bad as they could be. In the first instance, illiquid firms are getting help from unexpected sources – the taxman, the banks and the law. The UK taxman has had a bad reputation in past recessions for pulling the rug from under firms that are viable but struggling to pay their tax. This time though Her Majesty's Revenue and Customs (HMRC) is allowing firms to reschedule tax obligations.

Begbies Traynor say the number of companies in difficulty has fallen because HMRC's Business Payment Support Service has allowed more than 215,000 companies to defer payment of £3.79bn in tax.

Of perhaps more concern is Roberts' view that banks are keeping a finger in the dyke ahead of the anticipated flood of insolvencies. He says banks are taking a less aggressive view to debt recovery because of the instability a high rate of business failures and closures would cause in the run up to a UK general election.

Administration or not?

Harlowe, on the other hand, says, "The banks are far more reluctant to use insolvency than in previous recessions. Then, banks used 'administrative receivership' to enforce their security. But a change in the law allows UK companies to go into administration".

Robert Gardner, Senior Litigation and Insolvency Specialist with Bedell Cristin says: "The purpose of





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administration is similar to that of Chapter 11 in the US, which gives a company the breathing space to reorganise its liabilities – and possibly sell its business – without the process being jeopardised by creditors seeking to place the company into winding up.”

Roberts says administration has brought about an improvement in the way companies in difficulty are dealt with. “In the last recession, an administrative receiver would come in, sell off and hand proceeds to the bank. But the bank lost a customer. Now banks think, ‘We can keep this customer if we’re not too trigger-happy’”.

Jersey, unlike the UK and Guernsey, doesn’t offer administration. Gillian Robinson, a Partner in the Litigation and Insolvency Department at Appleby, says that Jersey’s proportionally lower insolvency rate has meant the island has not previously felt the need.

As a result, she says: “The insolvency framework in Jersey is creaking somewhat.” She concludes that the lack of an administration law leaves Jersey exposed “because it limits insolvency options and may deter certain companies from setting up here.”

Robert Gardner adds: “Jersey continues to monitor the English administration process and is currently giving consideration to bringing in its own regime, which could operate both domestically and internationally. I am unsure whether it will be introduced

here, and no formal proposals have been advanced to date. The priority is on having a regime which is both efficient and cost effective. The insolvency laws in Jersey are generally applied with flexibility by the courts here, and have stood up well in the context of some large international collapses.”

Risks of recovery

A rustic reflection is that if the graveyard is green in January (as a result of mild weather) it will be full by spring. Acting on green shoots can spell the death knell for firms.

Begbies Traynor statistics from recessions over the past 40 years confirm that insolvencies peak between one and two years after GDP stops shrinking. They warn that scarce credit after this recession may intensify this effect, causing a substantial rise in insolvencies during 2010 and into 2011.

Mark Hooton, Manager at PwC, and Nick Vermeulen, Director PwC Business Recovery Services, put this down to what they call ‘working capital drag’. They say: “If you don’t have working capital in place as you come out of a recession and you need to finance an increase in business, you can end up with a working capital issue. You have all the purchases lined up, but you can’t finance them and you may trip over a loan covenant.”

But banks are also faced with a structural change of businesses. In the past, businesses

held reserves on their balance sheets and owned assets like factories, raw materials and stock.

The modern firm now leases back property, its machinery is on finance, debts are factored and cars are leased. Creditors have little against which to secure debts, and little to realise in the event of insolvency. But it is not only a problem for creditors – a firm’s ability to refinance with this lean management regimen is limited by the lack of security it can pledge.

Administration can be said to be akin to putting a patient in intensive care, while insolvency is the equivalent of giving them a decent burial. There is evidence that despite the severity of this recession, creditors have not been hell-bent on winding up companies to recover what they can from the corpse.

Changes in how business assets are owned and changes in the law providing for rehabilitation through administration, restructuring and agreements with creditors have meant not a painless recession, but one that can curb the loss of jobs and businesses.

That said, even if the financial crisis is effectively over, the aftershocks may still take a number of companies down. We shall have to wait and see. ●

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