

Following on from his first article in this three part series studying insolvency (see *In Practice* 69), Peter Windatt looks at John Doe and his ABC Company Ltd.

# insolvency – the formal and informal ways forward

■ **“Just when it looks like things can't get any worse... they take a turn for the worse.”**

On the basis that many companies are SMEs and most of us work in this sector, I have based this article on a typical smaller company. As with all great movies, the likeness, actual or perceived, between the 'facts' which follow and any partnership, company or person(s) living or dead, solvent or insolvent, are entirely unintentional. However, I hope all readers recognise something in what follows and can learn some lessons from it.

#### the background

John's company, in which he is a 50% shareholder, is run with his business partner and finance director, Paul. Until three years earlier it had been trading quite successfully for a number of years as a partnership. Their accountant had for some time been recommending that they incorporate and, in 2002, the newly formed company continued the former partnership's business.

In its short life the company has taken some knocks. Their bad debts were on the increase and their market was being eroded by people making available 'off the shelf' widgets which had always been their bread and butter products. All that was now being required of them were the technically complex widgets which brought production problems with them. The company's ability to quote accurately was undoubtedly a major issue. Also they didn't value their own worth – their pricing of changes to a quoted specification once work had begun was woeful. Such changes were rarely charged and even more rarely paid for.

Just over six months before I met John, essentially the company's one and only technical guru, Paul had moved to Spain with his new wife. Paul had convinced John that all would be as it ever had been. Computer links were created which would enable Paul to work from his Spanish villa just as effectively as he did whilst resident in the UK. Documents would be scanned and e-mailed

to Paul at least daily and he would come over to the UK as and when required, but at least once a month.

Following Paul's departure, John found he quickly became more involved in the day to day management issues previously dealt with by Paul. Whilst John was willing he found himself unable to cope. He had no financial or management skills and he would try to take on everything to keep all customers and suppliers happy. John was working 24/7 and it was too much.

As soon as I met John it was obvious that he was a man on the edge. The first hour of our 'initial free hour' was spent trying to talk him in off the ledge – he was more than ready to jump. A list of assets and liabilities including an aged debtors and creditors schedule was produced in response to our questions. Customers were taking longer to pay. Suppliers were putting the company on stop as the creditor days went through the roof. No one was talking to anyone and the

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## insolvency – the formal and informal ways forward (continued)

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financial controls were non-existent. No one had seen Paul for some time though the company credit card statements still showed that the work on his villa was continuing at a pace.

Looking further into the change from partnership to limited company, some three years earlier, it became clear that the partnership, just prior to incorporation, had ordered a significant quantity of quality stationery. This stock was only now being exhausted. Some of the company's customers and suppliers were unaware that a limited liability company even existed. As far as they were concerned they were dealing, and had always dealt, with the former partnership.

So what? The directors had omitted to detail the company name, registered office and other essential information. What was the problem with that? This was not destined to be a straightforward case.

Investigations into how and when the employees and directors were paid showed that there were modest arrears to employees. They all remained very loyal to John but had no good words about Paul. Both directors had been paid by way of dividend and lump-sum drawings throughout – notwithstanding the absence of any profits from which to make dividend payments and no accounting for PAYE/NIC in respect of the lump sum withdrawals. Added to this there were massively overdrawn directors loan accounts about which John knew nothing and understood less – Paul had always said "not to worry, it would all come out in the wash when the accounts were finalised".

A couple of days later, whilst further and better particulars were being compiled, the director called to ask what was meant by a winding-up petition. One had been received while he was out on site the previous week and he had only just been made aware of it.

The landlord had also called regarding the arrears of rent and was threatening distraint if payment or, at the very least, contact were not made immediately (from a brief telephone conversation with the landlord's agent the company had been good tenants for many years occupying a small office block and larger production premises. The landlords were reluctant to be the ones who might pull the plug – again a lot of sympathy for John, none for the absent Paul!)

While it looked like there was a business to be salvaged, and trading and cash-flow forecasts were being produced, the matter was taken out of our hands when, over a bank holiday weekend, the landlord's agents took over the production premises and cleared them.

### creditors voluntary liquidation

John admitted defeat; he was a man at the end of his tether and, whilst continuation looked impossible, it looked like there would be just about enough assets available to cover the costs of the petitioning creditor and then the costs of convening a Creditors Voluntary Liquidation and provide something for the liquidator to work with.

Given that Paul was a 50% stake-holder the directors' meeting was agreed by exchange of faxes and the members' resolution (an EGM is required to be held with 75% of members' resolving to wind up the company voluntarily) agreed to hold the members' meeting immediately prior to the creditors' meeting in two weeks time.

Upon conclusion of the directors' meeting held at my office (Paul present by telephone and fax), I then attended the company office premises with John and addressed the employees. They knew what was coming but were saddened that John, despite his best efforts, had been left in the lurch by his

former partner, worked himself to a frazzle and, it now appeared, left himself open to a whole load of problems by virtue of not properly tying up the conversion from partnership to limited company. I gave the employees their forms for claiming what could be paid to them under the Employment Rights Act scheme operated by the DTI.

As with most cases, I suggested that employees take any personal possessions with them (as agents would be in later to start preparing the assets for sale and sort out third party/reservation of title items) and make sure that the company had their most recent addresses recorded correctly. In addition I advised them to sign on as soon as possible in order to mitigate their claims to pay in lieu of notice – the Government will assume that they have signed on if they have not gained other paid employment, and reduce their claim accordingly, regardless of whether they did claim.

John gave everyone his home address in case they wanted references in the future and wished them an emotional 'all the best for the future' whilst thanking them profusely for their help over the years. Those employees with company cars were required to leave them with my agent, who had by then arrived; some, living further afield and having a number of personal items to take home, were allowed to use the cars to transport themselves and others home, having first spoken at length with my agent regarding arrangements for their collection. A check as to the car tax and insurance position was first carried out.

At the creditors' meeting John was, as predicted, the only director to attend. Only one creditor turned up, though my colleagues had spoken with many others in the meantime. The rest of those who were represented at the meeting were only there by virtue of a 'proxy'



vote. The creditor who attended clearly had every sympathy for John and was really only there to ask Paul questions. He had a long list of questions for Paul and was clearly 'gunning' for him.

Following the meeting and the signing of all the requisite forms, we had retained the appointment (it is the creditors' choice of liquidator that prevails over the members' choice). In this case the creditors were largely apathetic and left their vote to 'the chairman' for him to decide how to vote. After the meeting John asked if he could talk about his own, somewhat straitened, circumstances.

#### John's liability

John had discovered that some of the suppliers the company had been dealing with for some years were, as I had feared, wholly unaware of the existence of a limited company. They believed, and the paper trail supported their belief, that they were still dealing with a partnership. As far as they were concerned John and Paul remained personally liable for the 'company' debts and they would make demand shortly if payment were not received.

John had also used his personal credit card to fund certain purchases required whilst out on site doing various jobs – in the absence of the ABC Company Limited paying him any wages/dividends he had nothing to offer from

income. He was also aware that the company's bank, whom he had personally guaranteed (and who, not uncommonly, had no debenture giving them a first claim over the company assets), would shortly be added to claims in respect of the directors' overdrawn loan account and HM Revenue and Customs for his PAYE (under regulations 42/49). His wife was far from happy with the situation – they had only recently paid off their mortgage and had been looking towards an early, peaceful, retirement.

At John's age, and with so many years working effectively for himself, long term payments from income appeared unlikely. With an un-mortgaged house it would be necessary to look at what equity might be forthcoming from that and then to compare the outcome for himself and for his creditors in putting forward an Individual Voluntary Arrangement (IVA) instead of bankruptcy.

Paul, needless to say, was not returning to the UK anytime soon and, as liquidator, I had insufficient funds to mount any action against him. The sums involved, whilst large enough if you don't have them, were not of sufficient size to interest my litigation insurers who could have funded pursuing Paul on a contingency fee basis. Creditors, having already lost money, were disinclined to fund us taking any action against him.

In the end, John's creditors, only seven in all, mostly arising from the company but including two credit card companies, accepted an informal arrangement rather than a full blown IVA, in full and final satisfaction of their claims against him whilst reserving their positions against Paul, who they went on to make bankrupt in the UK notwithstanding his Spanish residency. His return from Spain seems more remote than ever now, especially as his discharge from bankruptcy has been suspended pending his surrendering to the proceedings.

A year on, John is now working for one of his former suppliers and servicing his new mortgage quite comfortably. He is going to be working a few more years than planned, though he now starts at a sensible time in the morning and leaves most nights at 5pm. He has not heard from Paul for some time, and has no plans to holiday in Spain.

#### form a relationship

Lest I didn't convince you with my earlier article, I would again urge all accountants who have not yet done so to form a relationship with an IP – get to know and trust someone before you need them. What you are seeking is the survival of your own client base – not another job for the insolvency professionals.

For an unbiased, comprehensive, technically written, summary of the principal forms of insolvency I recommend you look at the Association of Business Recovery Professionals' website at [www.R3.org.uk](http://www.R3.org.uk) (R3 stands for the 3 Rs – Rescue, Recovery and Renewal). ■

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