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# Corporate Investors:

## Distressed investments & what to do

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# Insolvency & the Distress Curve

The statutory definition of insolvency is codified by reference to two tests: the cashflow test (a company being unable to pay its debts as and when they fall due) and the balance sheet test (the value of a company's assets being less than the amount of its liabilites). However, the reality of insolvency is that it is measured on a sliding scale, referred to here as the Distress Curve. During this Distress Curve, the duties of directors of a company will transition from acting in the best interests of shareholders (or equity investors) to an overriding duty to act in the best interests of the creditors of the Company. With all insolvencies, the value of the business is likely to 'break in the debt', leaving no return to shareholders. It is therefore particularly important that shareholders are informed and proactive in seeking the tools and advice needed to act appropriately in all circumstances.

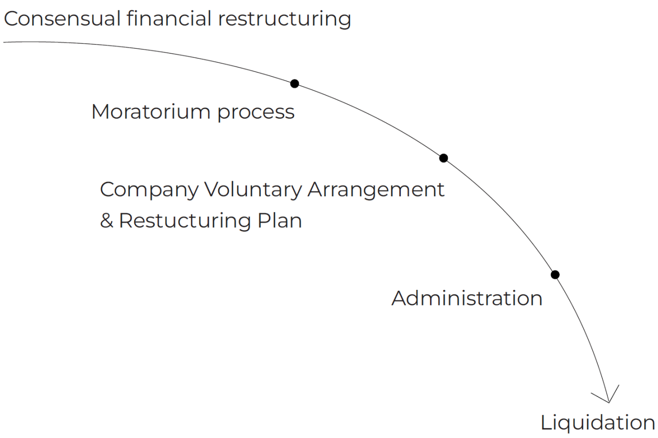
## Insolvency Processes & the Distress Curve

As referenced above, the solvency of a company - and the appropriate corresponding restructuring and insolvency tools – operate on a sliding scale (shown here) dependant on how early shareholders engage and identify liquidity risk.

All processes on the distress curve are rescue processes by nature, save for liquidation which is almost always the winding down of a company.

Crucially for an investor, consensual restructuring, the moratorium process, voluntary arrangements and restructuring plans aim to rescue a company, whereas administration seeks to rescue the business of that company.

Administration is unlikely to result in the company staying whole or returning to solvency, and the effect of this on shareholders (which is fundamentally different to those processes listed above it on the Distress Curve) is set out below.



## Distress Markers: Potential warning signs of financial distress

It follows that the earlier on the Distress Curve that a company seeks to restructure, the better. This is particularly true where seeking to achieve the best possible outcome for an equity investor and/or shareholder because, as a reminder, the further down the Distress Curve a company moves, the more the duties of the board will shift away from the company's shareholders and towards creditors (more on this below).

The following is a non-exhaustive list of examples of markers which may indicate financial distress in a company:

- Late delivery of financial information, reporting requirements, accounts and/or Companies House filings
- Unscheduled or sudden changes in auditors and/or a company struggling to sign off accounts
- Sudden changes in management
- The loss of a key client/customer/supplier
- Unexplained deferrals of planned or regular capital expenditure
- Unusual requests or unmerited complaints about your investment and/or management practices
- Market patterns & events (e.g., reduction in casual dining spend, Silicon Valley Bank collapse)

**If any of the above or any other warning signs arise, advice should be sought as soon as possible.**

## The Payments waterfall & why it matters

Once a company enters administration or liquidation (at the bottom of the Distress Curve), it will be the duty of the appointed insolvency practioner (IP) to realise the assets of that company for the benefit of the company's creditors. In the event that there are sufficient assets to make a distribtion to those creditors, there is a statutory order of payment in these formal insolvency processes. This order is shown below, and critically, once the cash runs out the downwards flow will stop.

1. If there is a fixed charge holder: costs of realising fixed charge assets and payment of that secured debt
2. Costs & Expenses of the insolvency
3. Employee preferential debts
4. Crown preferential debts
5. Payment of floating charge holders' debts
6. Payment of unsecured debt
7. Surplus, if any, to the shareholders of the company

As you will note, a return to shareholders will be the final distribution. By nature of a company's position on the Distress Curve in an administration or liquidation, realisations are very likely to be exhausted before this stage.

# Protecting investments

As set out above, when a company's solvency is in doubt, equity is at risk as protecting creditors and minimising losses will start to take priority. Quick detection, solid advice and decisive action will best protect a company in distress. Remember, the earlier up the Distress Curve action is taken, the better the outcome for shareholders is likely to be.

## Practical Steps you can take

As an active investor, these are some of the steps you may consider, whether or not you have a director on the board.

- Keep up open dialogue with boards & companies
- Consider an investor appointee to the Board if there isn't already one
- Consider an investor director being required for quorum for extra security and control
- Keep a close eye on management and accounts – request monthly updates and reports including cash flow forecasts, management accounts, projections
- Consider independent accounting reviews/monitoring/ cashflow forecasts
- Follow companies at Companies House Beta for immediate notifications of filings
- Keep a track on value of assets, fixed security and secured and unsecured debts
- Consider any cash injection as debt, with or without security
- Keep open dialogue with boards, shareholders, lenders, and other stakeholders (nb. check confidentiality).
- Seek advice early – be proactive rather than re-active.

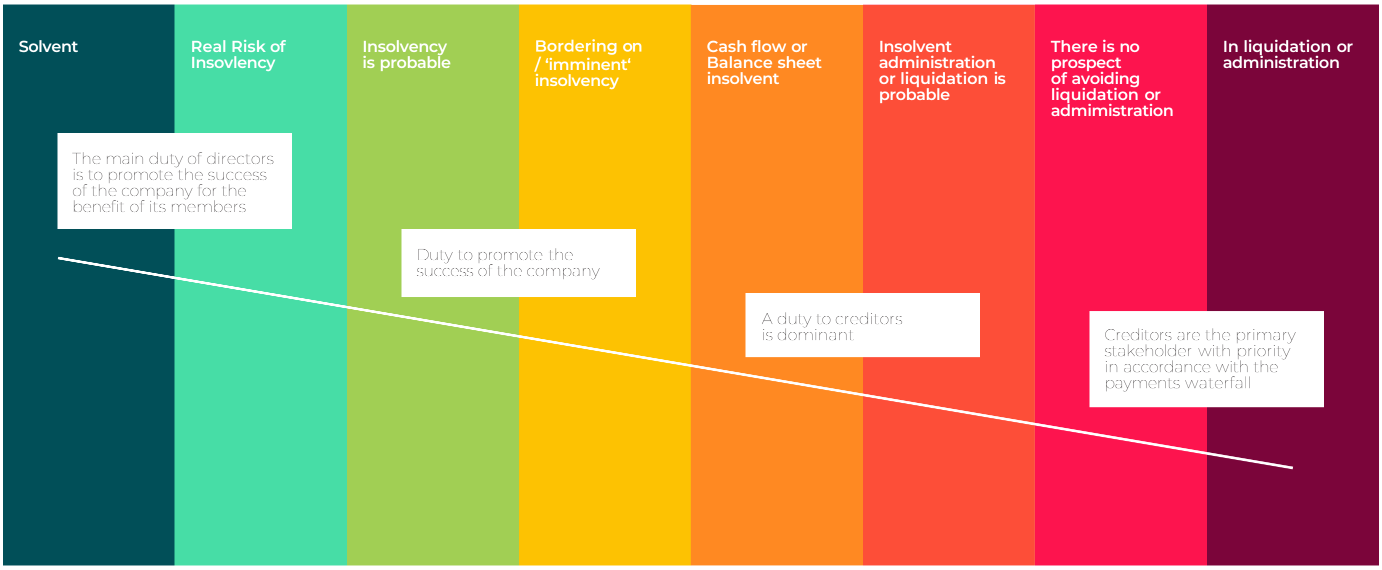
An independent accountant with an insolvency and restructuring specialism will be able to assist in a number of ways, be it with financial monitoring, forecasting and early intervention through to contingency planning. We would be very happy to put you in touch with such specialists with the expertise for each job.

# Protecting Investor Directors and the Board

**It is vital that a board considers its duties in light of the sliding duties to creditors when operating within the Distress Curve.**

## The sliding scale of solvency & directors' duties

In the ordinary course of business, a board of directors' primary duties are to promote the success of the company for the benefit of its members. As set out above, as a company's solvency passes through the Distress Curve, those duties will start to tip in favour of the company's creditors until they reach a point where the sole overriding duty of a director is to that company's creditors. This sliding duty is represented below:




## Navigating this changing landscape

When a company is operating on the Distress Curve, the directors face a challenging situation. The board must continuously review the company's position and, when the company passes the tipping point, ensure that decisions are made for the benefit of the company's creditors as a whole.

These obligations and decisions may move quickly as events develop and, from the point that a company shows any sign of distress, it is important that the directors of that company seek advice in relation to the extent of their duties to the company's creditors body as a whole. Following any subsequent appointment of an Insolvency Practitioner, the conduct of each director may be subject to scrutiny as to the steps taken by the company under the direction of the board in such circumstances. The risks of and sanctions for failing to act appropriately can be far reaching.

Directors should record their decisions and the factors that affect their decision-making. The relevant test applied to directors' duties in the Distress Curve is both subjective and objective, and liability is judged with the benefit of hindsight. It important that decisions are made with forethought and advice, and that the relevant insolvency practitioner has all the relevant information to hand (usually recorded in a board minute).

An insolvency lawyer will be able to assist in navigating and appropriately recording the decisions of the board.

## Get in touch

If you would like one of our team to present the options available to you in more depth please do reach out.

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