The winner takes it all: how forward planning can minimise a bad debt position

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IT IS A SAD TRUTH THAT THE COLLAPSE OF ONE company in a supply chain can have severe consequences on the rest of the chain. While a solvent company may be able to cope with one insolvent trading partner, the collapse of several, as may well be the case over the next few months, could really rock an otherwise steady company. The other problem is that as companies head towards insolvency, they become more reluctant to deal with their creditors and more likely to generally bury their heads in the sand.

This article provides some practical guidance by which, hopefully, businesses can limit their exposure to companies in financial distress, or else increase the chances of maximising their recoveries from debtors.

BEFORE DEBT ARISES

Taking security

The most powerful way to protect yourself against future non-payment is to take some form of security from the borrower. Depending on the form of the security (mortgage, fixed or floating charge) and whether there are any prior-ranking security holders, this can strengthen your hand in any negotiation with the debtor. However, in many cases this will either be impossible or overkill in the circumstances. A more realistic option would be to take some form of 'quasi-security'. In the case of a landlord, that might mean asking for a rent deposit deed, or an equipment supplier might use a hire-purchase or conditional sale agreement; in such cases, title will not pass until all the payments have been made.

Retention of title

However, the most common form of quasi-security is a retention of title (ROT) provision in the sale or supply contract. At its most straightforward, an ROT clause allows the supplier to provide goods to a buyer, but provides that title to the goods does not pass until the goods have been paid for. The supplier can therefore reclaim the goods in the event that the full price is not paid. As title has not passed, the goods will not be part of any security given by the buyer to anyone else and business sale agreements (whether inside or outside of administration) usually contain a clause specifically protecting any goods where title has been retained by a third party.

The supplier may also seek to include rights such as:

- reservation of title until the buyer has not only paid for those goods but also all/any other goods supplied (an all-monies clause);
- extension of its rights to the proceeds of sale of the goods if they have been sold on by the buyer before being paid for (proceeds-of-sale clause); and
- retention of its rights over the goods, even when they have been incorporated into other goods (mixed-goods clause).

However, great care must be taken, especially with the proceeds-of-sale clause, that the reservation is not deemed to be a charge over book debts, which would be invalid against an officeholder, if not registered.

Further, the supplier needs to ensure that it also takes auxiliary rights to allow the ROT clause to function. For example, the supplier needs to be able to enter the buyer's premises to reclaim the goods and the buyer must be required to store the items separately and identifiably. My colleague, Kay Morley, wrote in more detail about ROT clauses and recent changes to case law in the December 2007/January 2008 issue, and I refer you to her article for further information (see *IHL*156, p84).

On a practical note, now might be a good time to review your existing standard ROT clause to ensure that it is as strong as possible, especially in light of the new case law. It would also be a good idea to visit those customers with whom you have ROT arrangements to ensure that they are storing and using your items in accordance with the contract, and in a manner that will assist you should you need to reclaim your items.

Credit terms and creditworthiness

An obvious way to protect yourself is to tighten your credit terms. Methods include: reducing the number of days' credit offered, refusing to supply more goods until all outstanding invoices have been paid, or even demanding cash on delivery. If these measures seem too draconian, or there are fears that they might prompt rumours about your own company's financial position, at the very least getting your credit control department to chase late-payers shows your debtors that you mean business. This 'stick' approach could be used with the 'carrot' of incentives for early payment.

Your business probably already investigates the creditworthiness of new or potential customers, but you could increase the thoroughness of these checks or maybe take the time to re-assess all of your existing customers. This would allow you to focus your recovery efforts on those who seem most at risk of financial distress and prevent you upsetting your more solvent customers.

Jaw-jaw not war-war

Regular communication with your debtors is key. Whether it is amicable discussions that allow you both to identify a problem in its early stages and

negotiate a workable solution, or a more hardline approach, there is no doubt that the squeaky wheel gets the oil.

EXISTING DEBT

Once you have an existing customer who is not paying, what are the options available? First, keep talking. The tone of communication may change, but they may be willing to pay up, just to make you go away. Decide whether you are prepared to reschedule the debt or even compromise it. Is receiving 80% of the debt next week better than not receiving any of it at all?

As companies tip over into the zone of insolvency directors become increasingly unhappy to make payments, particularly where they think that an officeholder might later deem it a preference payment under the Insolvency Act 1986 (as amended). There is not room in this article to examine reviewable transactions under the 1986 Act, but in summary, a payment is a preference payment under s239 only if:

- the company is insolvent at the time the payment is made or becomes insolvent because of it (s240(2));
- the payment is made to an unconnected person within six months, or a connected person within two years of the onset of insolvency (ss240(1)(a) and (b)); and
- the company *desires* to put the recipient in a better position than it would be in a liquidation (s239(5)) (emphasis added).

It is important to note that a company is not deemed to desire all the necessary consequences of its actions; a transaction will not be set aside as a preference unless the company positively wished to improve the position of the creditor (see Millett J in *Re MC Bacon Ltd* [1990] at 87). The six-month look-back period for unconnected creditors and the automatic dismissal of a challenge if the paying company was solvent are further reasons for creditors to push sooner rather than later for their debts to be paid.

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As part of active debt management, a company might be tempted to threaten legal action. It is crucial if a creditor intends to make more than just vague warnings that they seek proper legal advice. If you intend to sue for non-payment or breach of contract there are certain pre-action protocols that need to be complied with and failure to do so will hamper an otherwise good case. Likewise, it is an abuse of process to issue an administration or winding-up petition or make a statutory demand (see box, opposite) purely as a method of debt collection. You also need to be wary of making empty threats. If you threaten action, and fail to follow up, you quickly lose all power you might have had.

I wrote in March (see *IHL*158, p82) that the common perception that it was not possible to petition for administration or winding-up where a debt was disputed had been altered a little by recent case law (*Hammonds (a firm) v Pro-Fit USA Ltd* [2007]). In *Hammonds*, an unsecured creditor's debt was subject to a cross-claim by the debtor, but the judge heard the administration petition and was prepared to grant the administration order if the debtor did not obtain the surrender of a licence for certain intellectual property that it had previously granted. Even aside from the order, it was an unusual case. The judge was clear that he was heavily swayed by Hammonds' contention that assets were being dissipated and that a neutral officeholder should be appointed to investigate. Perhaps *Hammonds* should be treated cautiously, but it still seems to offer a new option for creditors to pursue, especially where there is concern over the management of the estate. In light of these issues, companies should seek up-to-date advice before proceeding down these routes, even if they have previously gone it alone.

Nonetheless, a statutory demand can be a cheap and quick way of finding out whether a debtor will pay a debt. You may consider it better to find out earlier that a customer cannot pay, than embark upon legal action only to discover that it is unable to pay any judgment debt. The threat of an administration or winding-up petition based on genuine grounds from a creditor who is willing to follow through on their words has a remarkable way of focusing a debtor's attention.

ONCE IN ADMINISTRATION OR LIQUIDATION

There are differences between administration and liquidation, and indeed between the various types of liquidation, but in general the following applies. Despite all of the above, sometimes it is not possible to be paid before the debtor goes into an insolvency process. If you are a floating-charge holder or have sufficient leverage through other means, you may be able to control the appointment process and choice of administrator or liquidator. Even if you do not, this is not vital, since once appointed the officeholder must act in the interest of all of the creditors and in accordance with their professional and fiduciary duties.

Creditors can choose how active a role they play in an administration or liquidation. You may always contact an officeholder to discuss their progress or ask

Hammonds (a firm) v Pro-Fit USA Ltd [2007] EWHC 1998 (Ch)

Re MC Bacon Ltd [1990] BCC 78

questions. Except in unusual circumstances, meetings of creditors will be called to discuss and vote on proposals produced by the officeholder. It is important that creditors submit a proof of debt in advance of the meeting in order to be entitled to speak and vote. Even if an administrator determines that a meeting need not be held, a creditor (or creditors) whose debts exceed 10% of the total debt of the company can require the administrator to call a creditors' meeting. If you are a known creditor of the company, the officeholder should contact you, but again, there is no downside in you making contact first.

In certain cases, a creditors' committee may also be formed. These can be quite time-consuming to sit on, but if your debt is large enough you may decide that it is worth it. The creditors' committee acts in a semi-supervisory capacity of the officeholder's decisions.

Lastly, creditors can decide how and if they want to deal with an administrator or liquidator. As a matter of statute neither administration nor liquidation automatically terminates contracts, although a well-drafted contract will provide for optional termination upon a range of insolvency events. Where you deal on standard terms, it may well be worth reviewing these clauses in anticipation of the financial distress of your customers. Any money which is owed to you before insolvency will be an unsecured claim in the estate. However, assuming that your contract has an appropriate termination clause, you can choose to re-negotiate the terms upon which you deal with the company now that it is in administration. It is very common, and pragmatic, to demand cash on delivery, however some creditors also seek to renegotiate the price. Such ransom demands are a double-edged sword. They can be useful to help a company make up some of the money due, but if the price is too high this can affect the attractiveness of the business for a going-concern sale, and so a business might realise less value than anticipated or even fail to be sold at all. This has a direct impact on the amount of money available to creditors for distribution. Occasionally, where there is a specialised supply chain or one with a long lead time, a business that felt aggrieved by a particularly rapacious creditor in administration will, once out of administration, take advantage of the creditor's inability to move to another supplier to raise its prices in return.

STATUTORY DEMAND

A statutory demand is a formal demand for the payment of debt made by a creditor to a debtor in a manner prescribed in the Insolvency Act 1986. The debt needs to be for at least £750 and the debtor has 21 days in which to pay. If it does not pay it is deemed unable to pay its debts. A statutory demand is a useful piece of evidence in a creditor's armoury, but it is not mandatory in proving a debtor's inability to meet its debts.

CONCLUSION

Inevitably, in debt management, along with many other things, prevention is better than cure. Keeping an eye on the financial health of your customers and suppliers, and maintaining regular discussions with them, particularly when payments start to become late or sporadic, and generally minimising the levels of outstanding debt can all assist a company in weathering whatever the credit crunch storm throws at it. A company that makes a big play of chasing its debts may risk rumours about its own financial health. Instead, perhaps now is the time for companies to speak softly with their creditors, but also carry a big stick.

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