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Risk management and insolvency

STARTER

How can the following be a source of potential risk to a company?



- 1** The business magazine *Fact File* regularly conducts interviews with entrepreneurs from different continents who have successfully set up businesses in Europe. Read the extract from an interview with Piet Forster from South Africa and put the questions in the correct places.

- a And you were happy to rely on your client's assurances?
 b So had you already founded Form and Function, your office and hotel furniture business, in Cape Town?
 c But not everything went to plan, did it?
 d And the headquarters of the company have remained in Cape Town?
 e And what made your products different?
 f What brought you to London?

*Fact File*

PF Yes, we had.

Fact File

PF Well, three things really. Firstly, they were ergonomically designed. Secondly, our furniture was based around a building block principle. All units could be taken apart and reassembled in different shapes to give customers maximum flexibility in their use of resources. Finally, the styling was light and uncomplicated.

Fact File

PF Pure chance really. A lot of our customers in South Africa were subsidiaries and branch offices of European companies and they assured us that our products and design concept would definitely fill a gap in the market in Europe.

Fact File

PF

Not entirely, no. We hired an agency to do some market research. The findings looked promising, so we decided to open a branch office in London – about five years ago.

4

Fact File

PF

Actually, no. Business began to look so promising in Europe that we registered the company in the U.K. as a limited and made our Cape Town office a branch. We also set up a European production facility outside Warsaw and acquired a timber processing company in Finland.

5

Fact File

PF

Not at all. We had a very difficult period a few years back. We could almost have gone under. You see, what happened ...

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- 2 Piet says 'We could almost have *gone under*.'** *Go under* is a phrasal verb. A lot of phrasal verbs are used in the context of insolvency. Have a look at the following newspaper report and match the phrasal verbs with their dictionary definitions below.

Skylark wiped out

by our financial affairs correspondent Hazel Watts

Skylark plc, the low-cost airline founded in the late 1990s, announced yesterday that it had gone into liquidation. This is the second European budget airline to go under in as many months. The announcement followed weeks of speculation that the airline's creditors were unwilling to bail it out with extra cash. "The company will now be wound up as a matter of urgency," said Jonathan Mills, Skylark's CEO. This will be little comfort to Skylark's unsecured creditors, some of whom will have to write off considerable sums.

Skylark had been the big success story of the past decade. It quickly rose to become the leading player in the budget airline market with a spectacular

series of hostile takeovers. Criticism of Skylark's sharp business practices was growing, however, and the decision of the OFT to impose a £50 m fine for price fixing set the company back financially towards the end of last year. In order to make this payment, Skylark was forced to draw on its capital reserves and to borrow as well. When the markets suffered a downturn earlier this year, the airline found itself overstretched. The crunch came when it tried to raise the £20 m it needed to ward off insolvency. So bad was the scale of the problem at this stage, according to inside sources, that the banks refused to put up what, by the standards of the airline industry, is a relatively modest sum.

Example ward off to prevent something from causing harm to someone

1 _____ to rescue

5 _____ to provide money for an enterprise

2 _____ to obtain money from an existing source

6 _____ to cancel the record of a bad debt

3 _____ to delay or impede the progress of something

7 _____ to dissolve a company

4 _____ to become bankrupt

8 _____ to destroy, eliminate

3 Work with a partner to practise phrasal verbs.**PARTNER FILES**

Partner A File 09, p. 73
 Partner B File 09, p. 78

4 The story of Form and Function's difficult period begins a few years ago with an email from the Finance Director, Jana Burzinski, about risk assessment within the company. Read the email and answer the questions below.

From: Jana Burzinski <jana.burzinski@formandfunction.com> **To:** Piet Forster <piet.forster@formandfunction.com>

Subject: Risk Management

Dear Piet

Just a quick email to confirm that I have completed my check on the following:

- Directors' liability insurance
- Company accident and injury liability insurance
- Buildings and contents insurance against fire, flood, theft, accidental damage, etc.
- Compliance with statutory health and safety requirements
- Compliance with statutory requirements regarding dangerous substances

Everything is up to date and in order.

I am increasingly concerned, however, that our risk management procedures are too focused on questions of health and safety, and insurance. With your permission, I'd like to carry out a fuller risk management audit covering commercial, financial and legal risks.

The commercial and financial risks we should look into are e.g. over-reliance on large clients, exchange rate risks (given that we are beginning to export outside of the euro zone) and the fact that the current value of our production facility in Warsaw is possibly lower than the level of the bank loan secured upon it.

In order to assess our legal risks I would need to involve our lawyers. I understand that Fergus Winter specializes in risk management issues.

I appreciate that this audit will take some time and will cost money. Nevertheless, I feel strongly that we need to have a much clearer picture of our exposure to risk.

Let me know what you think.

Best regards

Jana

- 1 Why is Jana unhappy about the company's current risk management procedures?

- 2 In what ways could the three commercial or financial risks mentioned by Jana cause problems for the company in future?

- 3 What would be Fergus Winter's role?

5 Later that day Jana finds a message on her voicemail. Listen and decide which of the statements is correct.

- 1 When Piet says, 'I see where you're coming from', he means
 - a I understand your position on this issue.
 - b I agree with you on this issue.
 - c It is clear to me that you want to discuss this issue.
- 2 a Piet has no problem with Jana's suggestion.
b Piet does not want to carry out this audit.
c Piet has some reservations about this audit.
- 3 a Piet tells Jana to go ahead.
b Piet wants more information before he can decide.
c Piet says that he doesn't want to go into detail at this stage.



6 In the course of carrying out his share of the risk assessment task, Fergus Winter finds that he is particularly concerned by the following contract clauses:

2. Commencement, Duration of Lease, Transfer

- (1) The lease shall commence on the day of transfer in accordance with section 2(2).
- (2) The transfer shall take place on 1st November 2...
- (5) The lease shall end five years after the day on which it commenced.
- (6) The lease shall be automatically extended by a further five years unless the Lessee formally waives its right to this extension. Notification of its intention to waive this right must be made to the Lessor in writing at least twelve months prior to the end of the lease pursuant to section 2(5).

5. Rent price adjustment

- (3) The rent payable shall be adjusted automatically if the Retail Prices Index for the United Kingdom (basis in year 1 = 100), as published by the Office for National Statistics, rises or falls by ten points compared with the value at the start of the lease or at the time of the previous adjustment of the rent payable.

3. Compensation

For the loss of his/her employment the Employer shall pay to the Employee a compensation of three monthly salaries per year of employment. The compensation shall be paid in addition to the salary owed by the Employer until the Termination Date pursuant to sec. 2 para. (1) of this agreement. The claim to the payment of the compensation shall be inheritable.

6. Sale price adjustment

- (1) The base purchase price increases by the amount by which, as of December 31st of the first full calendar year following signature of this agreement, the value of the working capital – as defined in section 4.1 above – is greater than the amount of EUR 750,000. Analogously, the base purchase price is reduced by the amount by which the value of the working capital, as of December 31st of the first full calendar year following this agreement, is lower than the amount of EUR 750,000.

VOCABULARY ASSISTANT

adjust *to change something slightly*
 analogously *in the same way (as the thing discussed earlier)*
 consumer price index (CPI) *a list (published by government) of the prices of some ordinary goods and services which shows how much these prices change each month*
 inheritable *(adj) able to be given to another living person, if the first owner dies*

lessee *the person who pays to use property (usually land or a building) owned by someone else*
 lessor *the person who receives payment for the use of property (usually land or a building)*
 prior to *before*
 working capital *the money needed to run a business from day to day (e.g. to pay employees)*



Discuss the following points.

- 1 What kind of legal agreements do the above clauses come from? Note down your answers.
- 2 In what way might each of these clauses represent a potential risk to Form and Function?

7 Now listen to part of the meeting between Piet Forster, Jana Burzinski, and Fergus Winter. Check you labeled the legal agreements in exercise 6 correctly.

VOCABULARY ASSISTANT

deductions *amounts of money subtracted from wages, for example, tax*
 disadvantageous *(adj) negative, bad (here, for Form and Function)*
 gross *(adj) here, without deductions having been made; gross pay is your pay before tax is taken away*
 lay off (workers) *dismiss, ending someone's employment (usually because of a lack of work)*
 leasehold agreement *rental contract for land or buildings*
 premises *(legal term) building in which a business or trade is carried on*
 price adjustment *change to price for legally agreed reasons*
 redundancy *ending someone's employment because there is no more work for them*

Listen again and complete the table.

Clause / Legal Document	Risk	Action necessary
2 / _____ _____		
5 / _____ _____		
3 / _____ _____		
6 / _____ _____		

EMPHASIZING A POINT

We can add emphasis to what we say in the following ways:

- 1 by stressing a particular word e.g. **I will try to keep it straightforward.**
- 2 by adding the auxiliary **do** e.g. **I did find ...**
- 3 by restructuring the statement, **Clause 5 is the problem** into **It's clause 5 that is the problem.**
- 4 by changing the statement, **I would recommend that you allocate ...** into **What I would recommend is that you allocate ...**
- 5 by moving certain negative or near negative adverbs or adverbial phrases e.g. **never, under no circumstances, at no time, on no account, seldom** to the beginning of the sentence.
Therefore, **You should not, under any circumstances, just allow the lease to be extended** becomes **Under no circumstances should you just allow the lease to be extended.**
When we use this structure the subject and verb invert i.e. **you should** becomes **should you.**

NB: When the main verb is in the present simple or past simple the following happens:

My client never claimed he was a partner in the company becomes *Never did my client claim he was a ...*

8 Fergus sometimes tries to add emphasis to what he says. Look at the explanations in the language box on page 62. Then rebuild the sentences below to make them more emphatic.

- 1 My client was not at any time made aware of the true financial circumstances of your client's company when he signed the contract. (At no time)
- 2 One seldom comes across an employment contract with as many loopholes as this. (Seldom ...)
- 3 The whole question of misrepresentation interests me in this case. (It)
- 4 The members of this union find it particularly unfair that the company is considering cuts after such a successful year. (What)
- 5 I find it suspicious that the company in this case was registered in the Cayman Islands. (What)
- 6 The rest of the clause is fine. However, the last sentence is open to interpretation. (It ...)

9 About 18 months later the following report appears in the financial press.

Fuller's Construction plc digs itself into a hole

by our financial affairs correspondent Hazel Watts

Mr. Gareth Jenkins, the chairman of Fuller's Construction plc, announced yesterday that the company's board of directors had petitioned Sussex County Court for a winding up order. A liquidator has already been appointed to wind up what is one of the UK's market leaders in the construction of hotels and residential homes for the elderly. "In view of the collapse in orders we have experienced and the insolvency of two of our major clients, we were advised by our lawyers that no other course of action was open to us. All attempts to involve our creditors in a debt restructuring

plan, which would have reduced the monthly cost of the company's loan repayments, had failed," explained Mr. Jenkins.

Not only the financial markets were caught unawares by the news. Brian Harrington, the chairman of British Brick Ltd, expressed concern at the impact of this insolvency on his company. Other key suppliers to Fuller's Construction, who may be affected, are understood to be Thermaglass plc, manufacturers of double glazing, and Form and Function Ltd, the London-based furniture designers. Investment analysts ...

- 1 What two reasons does the chairman give for the company's insolvency?
-

- 2 What role did the company's creditors play in the insolvency?
-

- 3 What does this insolvency have to do with Form and Function?
-



15

10 Now listen to a meeting in which Piet Forster, Jana Burzinski, and Fergus Winter discuss the implications of the insolvency for Form and Function. Are the following statements true or false?

- 1 An administration order and a winding-up order are basically the same.
- 2 The person appointed by the court is going to try to sell Fuller Construction's assets.
- 3 Jana only knew that Fuller's construction was experiencing payment difficulties at the beginning of the month.
- 4 Form and Function would be regarded as an unsecured creditor.
- 5 Fergus is confident that Form and Function can get all its furniture back.
- 6 Jana doesn't think this will be possible.
- 7 It's possible that Form and Function will suffer a loss of 1.5 million.
- 8 Jana thinks that some of Form and Function's non-core activities may not survive this crisis.

VOCABULARY ASSISTANT

administration order *(in U.K.) a court decision which formally starts an administration of an insolvent company (see Did you know? below)*

appoint *put into place, give a duty to*

charge *a form of security for a loan. A bank which takes a charge over a company's machinery can take the machinery if the company does not pay its debt to the bank.*

creditor *someone to whom I owe money*

debtor *someone who owes money to me*

default on payment *to fail to repay part of a loan at a time when it has to be repaid*

knock-down price *very cheap*

off-load *get rid of something that you do not need*

petition a court *ask a court formally to do something /take action*

preferential creditors *people who have a legal right to have money which is owed to them repaid before any other debts are repaid (see exercise 12 on page 65)*

realize assets *(legal) sell things that you own in order to get cash*

service debts *to pay interest on debts that you owe*

PARTNER FILES

Partner A File 10, p. 74
Partner B File 10, p. 79

DID YOU KNOW?

In the U.K., as in many other jurisdictions, it is illegal for a company to continue trading once it has become **insolvent**. In both jurisdictions, however, there is now a greater emphasis on **rescuing** than on **liquidating** the company or **winding it up**. Accordingly, there is a distinction drawn between a company being in **administration** and in **liquidation**. These two procedures are carried out by an **administrator** or a **liquidator** accordingly. The administrator has the task of keeping the company going; the liquidator has the job of winding the company up and **realizing its assets** in order to satisfy its **creditors** as far as possible. This work is often done by **Insolvency Practitioners**, who are usually specially qualified accountants. If the liquidator is appointed directly by the court, he / she is called the **Official Receiver (OR)**.

In the U.S., companies file with the **bankruptcy court**. The two procedures that are broadly analogous to administration and liquidation are called **Chapter 11** (administration) and **Chapter 7** (liquidation) of the U.S. **Bankruptcy Code**. For example, a company 'goes Chapter 11' or it 'goes Chapter 7'.

12 Read this excerpt from the booklet *A Guide for Creditors*, published by the Insolvency Service at The Department of Trade and Industry in the U.K. and fill in the gaps.

asset • creditor • distribute • preferential • repayment • secured • unsecured

Creditors – Order of priority

The rights of a creditor who holds a fixed charge, or security, on assets (such as a mortgage) to sell the asset to recover their debt are not affected by insolvency. The chargeholder (¹ creditor) is the first to get paid when the ² is sold. Any surplus will be handed over to the trustee / liquidator.

When all the assets available to unsecured creditors have been realized, the trustee / liquidator will ³ the proceeds in a strict order of priority as follows:

1. The fees and charges of the liquidation / bankruptcy.
2. Debts due to ⁴ creditors. These debts are set out in the Insolvency Act 1986 and include wages owed in the four months before the date of the insolvency order and contributions to occupational pension schemes.
3. All unsecured creditors.
4. Any interest payable on debts.
5. In company cases, the shareholders.

Therefore, ⁵ creditors will usually only be paid when the fees and charges of the insolvency procedures and the claims of secured and preferential creditors have been paid. If full ⁶ of claims is not possible, payments are made to creditors by way of a dividend in proportion to the value of each claim.

(abridged)

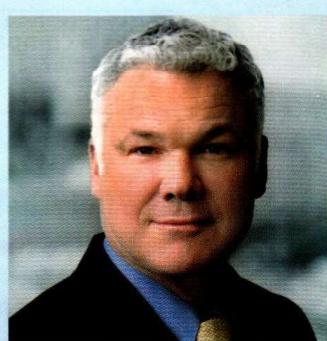
13 Read the end of Piet Forster's interview with Fact File. Complete the interview using words from the box.

acquisition • debts • insolvent • lease • loss • severance

Fact File So how close were you to becoming ¹ at that time?

PF Well, not nearly as close as we would have been. You see, we implemented most of the risk management measures suggested at the time and I'm glad we did. If we hadn't renegotiated the ² on our business premises and our staff ³ arrangements, and if we hadn't put aside capital to cover for the additional sums that arose due to our

 ⁴ of Finnwood, our financial situation would have been much tighter. It wouldn't have been as easy to finance the necessary redundancies and to restructure our ⁵. As it was, we were able to absorb the ⁶ of 1.5 million euros and we haven't looked back since.



HYPOTHESIZING ABOUT PAST ACTIONS

In his interview with *Fact File*, Piet Forster looks back at the past and considers scenarios that were a possibility at the time, but that didn't happen. We often do this when we talk about mistakes we made or mistakes we avoided making. The structure works as follows:

*If we **hadn't implemented** those risk management measures, we **would have gone** under.*

The logic of the statement is that they **did** implement the risk management measures and as a result they **didn't** go under.

14 Rewrite the following statements.

Examples Our client withheld vital evidence so we lost the case.

*If our client **hadn't withheld** vital evidence, we **wouldn't have lost** the case.*

The core business was healthy, so the Insolvency Practitioner didn't wind the company up.

*If the core business **hadn't been healthy**, the Insolvency Practitioner **would have wound** the company up.*

1 The new machine in the company's warehouse was paid for, so it was part of the insolvency estate.

2 The bank secured its loan against assets of the company, so it got its money back.

3 The creditors had no confidence in the company's ability to pay, so they petitioned the court to make a winding-up order.

4 The directors took the correct action quickly when the company became insolvent, so they weren't guilty of an offence.

5 The company got into a lot of speculative ventures, so its core business was exposed to risk.

6 It was a company with limited liability, so the members' personal assets were not at risk.

15 Choose from the topics in the list and tell your partner what happened. Try to finish with a sentence like the ones you practised above.

- a case that went badly because the judge made a strange ruling
- a difficult client or difficult board of management decision
- a failure to negotiate an out-of-court settlement
- a course in your studies which, contrary to your expectations, turned out to be useful
- something important that you noticed in a contract but nearly missed
- a case in which your client didn't tell you something important