FORUM CHAMBERS

Corona-Debt: The Impact on Small Businesses

Businesses of all sizes will emerge from the Covid-19 lockdown carrying vast amounts of debt. In another article, I have argued that, paradoxically, now is the opportunity to remove the distortions to company[1] finance caused by the tax subsidy on interest payments for debt.[2] Other measures will also be needed to ensure that economic recovery takes place. Companies which cannot service their debts need to have a fresh start. Entrepreneurs (including those who have learned valuable lessons from previous forays into business) need to be able to raise funds to launch new businesses.

This paper argues that there are three reforms to insolvency law (one of which is already under consideration by the UK government) that could remove the drag on the economy of unpayable debt whilst distributing the costs of accrued debt on as equitable a basis as is possible *ex post*.

Policy Proposals:

- Improve the corporate rescue procedures available to SMEs, through the use of light touch administration, the proposed moratorium, and the new restructuring regime;
- Enlarge the scope of the "Prescribed Part" to make more assets available for distribution to unsecured creditors and other stakeholders;
- Ring-fence some of the business owner's assets so that they can start again.

The imperative for action

A survey by the British Chambers of Commerce showed that by 20 May 2020, 85% of UK firms had received money from the government's job retention scheme.[3] Almost one quarter of London's businesses are on the brink of collapse.[4] A significant number of others are likely to be put under financial strain in the aftermath of lockdown. As

[1] I use the term "company" here because it will be the one most recognized by readers, and because while the principles advocated in this paper are equally applicable to partnerships and sole traders, the insolvency provisions which apply are different.
[2] https://www.jubilee-centre.org/blog/the-taxing-question-of-unsustainable-corporate-debt
[3] Harvey Robertson, 'Coronavirus: Over half of UK firms cannot reopen fully, survey shows', *City AM* 20 May 2020.
[4] Rajesh Agrawal, 'London's businesses still need more help', *City AM* 22 May 2020.

early as 6 May 2020, the Centre for Economic and Business Research was reporting that up to 600,000 British businesses thought there was a high risk that they would enter into insolvency as a result of the recession caused by the coronavirus outbreak.

Businesses fail for all sorts of reasons. Sometimes they fail because they have been mismanaged, sometimes they fail because they need more investment, sometimes they fail because the owner has misjudged the demand for the products or services they are offering. What is unusual about the coronavirus crisis is that whole sectors of the economy have been frozen. As a result, regardless of whether their business was well-run or not, many owners face ruin. An example would the horticultural sector, the bulk of whose profit would have been made during the period where the UK was in lockdown.

The urgent question is how the significant losses should be allocated. The appointment of expensive insolvency practitioners imposes significant costs, reducing the size of the asset pool available for stakeholders. Such costs mean that while administration is often a useful option enabling big businesses to return to profitability, for many small businesses it is another path to closure. The application of insolvency rules which, in practice, only protect the interests of secured creditors leaves all other businesses prey to the knock-on effects of the insolvency of their customers.

The need for small businesses to be protected

Small and medium-sized enterprises ("SMEs") represent around 95% of all businesses in the UK. They are responsible for nearly one-third of all employment.[5] They are usually the businesses which are quickest to start re-employing people following a recession.

But they are more fragile than bigger businesses, their owner-managers are more exposed, and the insolvency system carries a heavier price tag for them than for big business. Smaller firms face more concentration risk than larger businesses. An SME will typically operate in just one sector or will just have a few major customers, so that the business has fewer shock absorbers in the event of an economic downturn.

[5] *RBS v Etridge (No.2)* [2002] 2 AC 773, at §34 per Lord Nicholls.

If nothing is done, many small businesses will close. The Coronavirus Act 2020 provided some temporary protection against enforcement action by creditors but when its provisions come to an end, a tidal wave of insolvencies are likely to occur. There will be many other "zombie" companies, which are engaged in a continual struggle to service their debts, and without the resources to invest in creating new products and services or generating new employment. The combination of waves of business closures and others surviving in a twilight zone of non-productivity will be widespread, severe and long-lasting economic damage.

If only the secured creditors are protected, such insolvencies could have a knock-on effect, causing other businesses to fail. The elimination from the UK economy of many small businesses (which would have been viable but for the pandemic) is likely to prevent the V-shaped recovery which everyone is hoping for. Without those small businesses, unemployment is likely to persist into the medium and long term.

In the case of small businesses, the failure of the business will lead to enforcement of guarantees given by their owners, causing them to lose their homes and the collateral needed to start up a new business. Failing to provide small business owners with the means to get themselves and their businesses back on their feet will make the country as a whole significantly worse off.

The existing types of corporate insolvency procedure under English law

In English law, there are four main types of insolvency procedure when a company cannot pay its debts. In corporate insolvency, one option is that the main creditor can appoint a receiver to enforce the creditor's security. A second option is that a liquidator is appointed, whose job it is to sell all the company's assets and pay off whatever it can to the company's creditors.

A third option is that an administrator is appointed for the benefit of the creditors as a whole, often with a view to continuing to run the business and then selling it to a new owner. This is the UK's closest equivalent to the Chapter XI procedure in the USA, but unlike the USA, it only occurs after a company has crossed an insolvency threshold.

All three of these procedures involve the appointment of a professional called an insolvency practitioner.[6] For small businesses, the fees charged by the insolvency practitioner can be large relative to the company's debts. It is not uncommon that the appointment of the insolvency practitioner in and of itself is enough to ensure that the company cannot be nursed back to life.

The fourth option is called a company voluntary arrangement ("CVA"). This requires 75% of a company's creditors to agree to reduce the amount they will be paid (referred to as "taking a haircut").

English law has a well-established threshold for insolvency. A company is insolvent if (a) its total liabilities are greater than its total assets (balance sheet insolvency) or (b) it is unable to pay its debts as they fall due (cash-flow insolvency). The COVID-19 crisis will have forced companies into both kinds of insolvency. For some companies, the fact that orders have dried up means that they are not able to pay the debts for the time being. Some temporary relief will be sufficient for them to be able to move forward again. For other companies, the COVID-19 crisis will have increased their indebtedness. The continuing effects of this increased indebtedness (sometimes referred to as a "debt overhang") will prevent them from making further investment or returning to profitability.[7] What they will need is a debt reset.

The traditional order of payments from an insolvent company

English insolvency law traditionally orders payments to be made out of the assets of an insolvent company in the following order:

- The expenses and remuneration of the insolvency practitioner;
- The debt due to the creditor holding fixed security, e.g. a mortgage over land owned by a company;

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[6] The fact that insolvency practitioners can expect repeated appointments from secured or major creditors creates a conflict of interest in the system which the status of insolvency practitioners as officers of the court has not fully resolved. A cab rank rule, where insolvency practitioners were nominated by the court on a rota would make insolvency practitioners less susceptible to pressure to keep in favour with financiers.

[7] A survey conducted by Visa found that 56% of small business owners were worried that the coronavirus crisis had caused long term damage to their businesses: Angharad Carrick, 'Small businesses worry they won't bounce back from coronavirus', City AM 15 June 2020.

- If anything is left, then the Preferential Creditors get paid;[8]
- If anything is left, then a creditor holding floating security, e.g. a debenture over a company's assets, gets paid;
- If anything is left, then the Unsecured Creditors are paid;
- Only if anything is left, will the Shareholders receive anything of their money back.

What this means is that the Shareholders almost always get nothing back. In the case of a small business whose owner has guaranteed the Company's debts, if they are able to pay out on the guarantee, the money goes into the pot and is then paid out to the insolvency practitioner and to the Secured Creditor. The owner loses both their Company and the amount they have guaranteed.

Not only does the traditional approach of English insolvency law mean that the Shareholders almost never get anything back, the strict rules on priority used to mean that in many cases that only the insolvency practitioners and the Secured Creditor received significant sums of money.

Improving the outcomes for viable companies in financial distress

In these exceptional economic circumstances, far more viable SMEs will be saved if they are able to access light touch administration and the proposed moratorium; fewer will fail because of the collapse of their customers if the Prescribed Part is increased; and more new businesses will be launched if owners of companies brought down by the coronavirus lockdown are able to retain some of their capital in order to start again.

(1) Light Touch Administration

One approach which was much discussed during the early weeks of the crisis was so-called "light touch" administration. Light touch is an administration where, using

[8] "Crown Preference" under which HMRC was paid ahead of all a company's other unsecured creditors, was abolished by the Enterprise Act 2002. It was due to be reintroduced with effect from 6 April 2020 (for VAT, PAYE and Employee NI contributions) but in his budget delivered on 11 March 2020 (before the full effects of the coronavirus were known), the Chancellor of the Exchequer announced that its reintroduction will be delayed until 1 December 2020.

powers under existing insolvency law,[9] although administrators were appointed, the existing management continued to run the business. The significant reduction in the costs charged by the administrators would therefore increase the likelihood of the business being able to continue as a going concern.

(2) The new Moratorium process

However, (with the exception of CVAs), one problem with the UK's insolvency procedures is that they often give a company protection from its creditors only once the company has already passed the point of no return.[10]

Recognising this fact, the UK government has brought forward legislation (the Corporate Insolvency and Governance Bill) proposing that companies could enter into a moratorium process even before they have crossed the insolvency threshold.[11] A moratorium allows the directors of a company, by filing specified documents at court, to obtain 20 business days (4 weeks) protection from the company's creditors. If the company is able to pay or discharge all its due debts other than those covered by the payment holiday, the directors can obtain an extension for another 20 business days and then, with the consent of the company's creditors, the moratorium can be continued for a total period of up to a year. The running of the company during the period of the moratorium is supervised by an insolvency practitioner acting as monitor who has to provide statements confirming that the moratorium is likely to result in the rescue of the company as a going concern.

(3) The new Restructuring regime

Another change proposed by the UK government is a new restructuring regime, similar to a CVA, but again not requiring the company to have crossed the insolvency threshold,[12] and unlike a CVA, potentially affecting the rights of creditors in different

[9] Paragraph 64 Schedule B1 Insolvency Act 1986. The Insolvency Lawyers Association and the City of London Law Society prepared a Consent Protocol to facilitate use of the light touch administration process.

[10] In practice, the appointment of a receiver by a secured creditor will take a company beyond the point of no return.

[11] A more detailed analysis of the provisions of the Corporate Insolvency and Governance Bill 2020 by Nathan Webb can be found at http://www.forumchambers.com/corporate-insolvency-governance-bill-2020-permanent-changes/

[12] It is sufficient that the company has encountered, or is likely to encounter, financial difficulties that are affecting, or will or may affect, its ability to carry on business as a going concern.

classes (including secured creditors) even if they have not voted for it, under a new 'cross-class cram down' procedure[13].

Conclusion

These new approaches to maximising the chances of viable companies recovering from temporary financial distress are to be welcomed. It is to be hoped that insolvency practitioners will engage pro-actively with creditors and directors of companies in distress to make them work successfully.

The Prescribed Part: An Established Exception to the Secured Creditor first principle

English law contains two exceptions to the rule that the Secured Creditor gets paid first. One, contained in the Insolvency Act 1986, provides that a very limited category of debts count as preferential debts. This includes salaries owed to the employees of an insolvent company, but only up to a limit of £800 fixed by statutory instrument at £800 in 1986[14] and not increased since.

The other exception was introduced by the Enterprise Act 2002. This Act introduced the idea of a "Prescribed Part"; that part of a Company's assets should be paid out to the Company's ordinary unsecured creditors rather than to the bank holding floating charge security.

The first £10,000 of the Company's assets is shared equally between the bank and all the unsecured creditors (producing a pot of £5,000 to be shared among all a company's unsecured creditors). Above that threshold, the percentage reserved for the company's unsecured creditors is only £20,000 out of every £100,000. The maximum amount of the Prescribed Part is £600,000.[15] Insolvency Support Services report that the average prescribed part is between £50,000 to £60,000.[16]

The Prescribed Part is an important mechanism for ensuring that, when a company fails, the knock-on effects of its failure to do not destroy other businesses. This is

[13] Section 901G of the Companies Act 2006, introduced via Schedule 9 of the Corporate Governance and Insolvency Act 2020, introduces this procedure whereby a court can, in specified circumstances, sanction a compromise or arrangement notwithstanding a dissenting class of creditor.

[14] Article 4 Insolvency Proceedings (Monetary Limits) Order 1986.

[15] In the unlikely event that the floating charge was created on or after 6 April 2020, the maximum Prescribed Part is £800,000.

[16] https://insolvencysupportservices.com/iss-outsourcing/prescribed-part-distributions/

particularly important where the shock to the economy caused by the lockdown could otherwise lead to a domino effect of business failures.

Two modifications to the operation of the Prescribed Part would make it an effective tool for reducing the domino effect and sharing risk more equitably in response to the lockdown. The first change would be an increase in the percentage of assets included in the Prescribed Part. The second change would be to include the business owners as beneficiaries from the Prescribed Part.

If the Prescribed Part were 35% of a company's assets, the percentage returned to its unsecured creditors could be increased from 20% to 25%. The business owners would receive 10% where, under the current rules, they receive nothing.

Help for entrepreneurs

The Global Financial Crisis of 2007-2009 showed that the managers of large businesses (such as Fred Goodwin of RBS) could destroy the companies they ran but walk off into the sunset having banked their enormous pay packets, having vested their share options, and having locked their pension funds out of reach of the company's creditors.

By contrast, the owner-manager of a small business will typically have given a guarantee of their company's debts, and is likely to have put their house (often including their spouse's share in the house) up as security for those debts. Even if the house has not been put as security, if the guarantee is enforced and the owner-manager cannot pay, the trustee in bankruptcy appointed is likely to seek the sale of the house.

Addressing this situation raises two difficulties. First, if banks are unable to enforce against a home, then banks will no longer lend against the security of a home, thereby reducing the funding available to small businesses. Second, a general amnesty would reward those businesses that had loaded themselves up with debt before the crisis rather than targeting those businesses whose debt burden has exploded because of the Covid-19 crisis.

To get round those difficulties, banks should be allowed to enforce against an owner's home up to the level of the pre-coronavirus debt but to cap the security at that level. A company could then go through administration, light touch administration, a CVA, a

restructuring regime or a moratorium and emerge from other side with all excess debt (i.e. debt accumulated because of the coronavirus crisis) unsecured and not covered by any guarantee.

The losers

The big losers from these proposals will be banks and other secured creditors. They, even more than other big businesses, have financed themselves with money they have borrowed.

As in 2009, the UK once again faces a choice between what is in the narrow interests of the banks and what is in the broader interests of society. However, government investment into banks because of the effects of legislation which has reduced the value of the security held by banks is wholly different from government investment into banks necessitated by reckless speculation by banks. In the present circumstances, government action to shore up the capital position of banks would be the short term price to pay for the longer term benefits of a recovering economy.

Conclusion

The global economy in general, and the British economy in particular, is going to go through a very nasty recession as a result of the coronavirus lockdown. Businesses will fail and unemployment will rise. But the choice of measures now will determine whether the debt overhang persists or is reduced, whether corporate failures are orderly or disorderly, and whether a vibrant, successful and entrepreneurial SME sector emerges from the ashes or is crushed by the weight of insolvency procedures which prioritise the narrow interests of secured creditors over the need to re-start the national economy.

The increased use of light touch administration and the new moratorium and restructuring regimes are to be welcomed; an increase in the Prescribed Part is urgently required to reduce the domino effect of small business collapse, and measured help to protect small business owners from losing all the value in their homes as a result of coronavirus debt would significantly improve the prospects of a healthy recovery in the UK.

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