THE APPLICATION OF PREVENTATIVE MEASURES TO FAILING COMPANIES: IS LEGAL CONTROL POSSIBLE?

G. M. Golding*

At a recent seminar held by the College of Law in London and addressed by George Auger[1] the possibility of prediction of company failure was discussed, particularly in the light of work done by Dr. Richard Taffler[2] and Mr. A. W. Houston[3] of Performance Analysis Services Ltd. (henceforth PAS). The coming years are going to produce a rich harvest for company receivers and liquidators. It is not prophetic to suggest that the list of failures will include many large and well known companies.[4] In the PAS files it is indicated that 12% of the 800 largest quoted industrial companies in the U.K. and abroad are at risk.[5] Assuming another recession similar to that of 1974/75, PAS estimates that 18% may not survive, and that 10% are likely to enter into receivership, "piecemeal liquidation",[6] divest themselves of the major parts of their activities, or be acquired at give-away prices as an alternative to liquidation. Even so, in most cases financial privation is not inevitable, provided management does not turn a blind eye to the real situation, and take appropriate action. Should this — could this — be regulated by law? This, in the absence of proof of fraudulent trading, must for the time being remain in the province of speculation.[7] The EEC Company Law harmonisation directives as to the publication of company accounts may give a lead in this direction.[8]

The detailed analysis by PAS of the perceptions of the boards of the 200 worst performing companies indicated in over 70% of cases "an almost blissful unawareness of the true position. Policies that can only compound problems inevitably follow".[9] How can outsiders without access to the informatics of management diagnose a company in distress? A post-dated cheque? One which the drawer has "forgotten" to sign? Possibly, but even the most efficient and solvent of enterprises can also trip, quite innocently, in such respects. Taffler and Houston report that a new technique originally developed across the Atlantic is now being used in the City of London for this purpose. The new diagnostic technique is

*The author is a lecturer in Business Law at University College, Dublin and wishes to express his gratitude to Messrs Deloitte Haskins & Sells, Dublin, for their support of this study.

Journal of Irish Business and Administrative Research, Volume 3, Number 2, October 1981, pp 16-24.

based on what has been called the "Z-model". It measures and analyses a company's solvency by providing the basis for measuring company performance by applying the statistical technique of linear discriminant analysis to such information as may be available concerning the company's financial state of play (ideally, published accounts). The Z-score so derived is compared with the Z-scores for a number of well known failures. The lower the Z-score, the worse the company looks; if below an established norm, the company resembles previous insolvencies and is therefore at risk itself.

The formula for the Z-model for the analysis of quoted manufacturing and construction companies . . . is given by

$$Z = C^0 + C_1 \times \frac{\text{profit before tax}}{\text{current liabilities}}$$

$$+ C_2 \times \frac{\text{current assets}}{\text{total liabilities}}$$

$$+ C_3 \times \frac{\text{current liabilities}}{\text{total assets}}$$

$$+ C_4 \times \text{"no credit" interval}$$

and was derived from samples of 46 [insolvent] and 46 financially sound companies.[10] The four constituent ratios measure profitability, working capital, financial risk and liquidity. C^0 represents a constant term and C_1 to C_4 the co-efficients by which the financial ratios are weighted.

Three years prior warning may thus be obtained in identifying insolvent companies in advance of the boards' decisions to go into liquidation, or in advance of the crucial issues which compel debenture-holders to appoint a receiver.

Houston and Taffler claim that the model has achieved a 100% success rate in the case of over 119 companies, and that the model is so highly effective firstly, on the Hegelian principle that the whole is worth more than the sum of the parts — a number of aspects of a company's performance are measured at once. Next, by attacking on several fronts at the same time it deflects "window dressing" and "creative accounting". Finally, melodramatics on the part of directors' in their reports cannot conceal the truth of the real drama of impending insolvency.

As to previous performances, a "p-score" provides "the basis for the PAS trajectory charts which permit the relative performance of a company over time to be accurately monitored".[11] This measures the performance

of companies suspected to be at risk by charting their trajectories against the base of Z. The failure of Staflex International which went into liquidation in 1979 (though still apparently earning profits up to its last year) was thus predicted; at the end it had 30 bankers. Likewise, Dunbee-Combex-Marx which went into receivership in 1980. So a failing company *can* be identified by an outsider well in advance of any possible fraudulent trading, as legally defined by the present law.

To establish such behaviour it is necessary to prove that there has been actual dishonesty.[12] It is generally sufficient for this purpose that the company has continued to carry on business and to incur debts at a time when there is to the knowledge of the directors no reasonable prospect of the creditors ever receiving payment.[13] It is worth recalling that apart from any civil liability, the offence of fraudulent trading carries a criminal sanction, punishable with imprisonment for a term not exceeding two years, or for such punishment and a fine not exceeding £500.[14] And, of course, a person has been guilty of such an offence for which he is liable (whether he has been convicted or not) relating to fraudulent trading, or has otherwise been guilty, while an officer of the company, of any fraud in relation to the company, or of any breach of duty to the company, may be made the subject of an order of the High Court that such person shall not, without leave, be a director of or in any way, whether directly or indirectly, be concerned in or take part in the management of any company. The penalty for contravention of this provision is imprisonment for a term not exceeding two years, or on summary conviction, six months, or for such punishment and a fine not exceeding £500.[15] In a receivership, the receiver has control only in compulsory liquidation, and he would therefore not be in a position to take action in a voluntary winding up.[16] Of course, he could always report the matter to the Minister for Industry, Commerce and Tourism and request an investigation of the company's affairs.[17] But the Z-score can only be obtained if there is sufficient disclosure. It is therefore of no application in Ireland to private companies under the present law — they do not have to disclose their accounts. That position will apparently not be affected, in general terms, by the impending implementation of the EEC 4th Directive on company law; but when that is implemented by the Oireachtas[18] disclosure will be much fuller than at present.

Returning to the identification of failing companies before it is too late, mobilisation of the often reluctant banker or other interested party to take steps while there is still time may not be an easy task. Clearly the earlier an impending crisis is diagnosed and action taken the easier it is to cure it. Houston and Taffler report that "[t]here are quite a number of now successful companies where such constructive pressure [to raise additional working capital] applied in time ensured that [insolvency] and its attendant unemployment, loss of skills and waste of resources was avoided". So, given full disclosure, in the interests of the companies at

risk, while exposing them to the avaricious eyes of their competitors, *can* work prophylaxis. Those with vested interests must therefore be made to appreciate that trading-off such apparent drawback as full disclosure may enure to their ultimate benefit, and to the common good. (In any event, competition is a good thing — at least according to the framers of the Restrictive Practices legislation and to the fathers of the Treaty of Rome who sired the EEC competition policy).

So we end on an optimistic note. Prophylactic legal control *is* possible. The question is does the business community want such law? And, how long must we wait for it?

REFERENCES

1. George Auger, F.C.C.A. is a partner in Messrs. Stay Hayward & Partners and has been specialising in insolvency for more than twenty years. He is the author of the 5th edition of Hooper's *Voluntary Liquidation* and a member of the Council of the Insolvency Practitioners' Association.

2. Richard Taffler, B.Sc. (Econ.), M.Sc., Ph.D., studied Economics and operations research at the L.S.E. His Doctorate was obtained in Accounting and Finance at the City University. He is a founder director of PAS.

3. Bill Houston, M.I.Prod.E., A.C.I.S. is Chairman of the Elliott Group of Peterborough and serves on the boards of several other companies, acting also as industrial adviser to the mercantile bank. With Richard Taffler he is a founder director of PAS.

4. E.g., in the recent past, Dubtex (Clothing) Ltd., a long established Dublin public company, has gone into receivership.

5. The PAS files are comprised of course principally of the largest quoted U.K. companies.

6. The writer is indebted to Dr. D. L. Hally, Professor of Accounting at UCD, for this vivid description of the failing company — one which suffers "piecemeal liquidation". In law, of course this is not a technical term of art as legally there can only be total liquidation under the Companies Acts, 1963-1977.

7. Cf. s. 286, Companies Act, 1963: ". . . any conveyance, mortgage, delivery of goods, payment, execution or other act relating to property made or done by or against a company within six months before the commencement of its winding up which, had it been made or done by or against an individual within six months before the presentation of a bankruptcy petition on which he in adjudged a bankrupt, would be deemed in his bankruptcy a fraudulent preference, shall in the event of the company being wound up be deemed a fraudulent preference of its creditors and be invalid accordingly". Also see s. 297 as to the responsibility of persons concerned for fraudulent trading.

8. In particular, the EEC Fourth Directive on the harmonisation of company law — 78/855, OJ 1978, L295 (made pursuant to Article 54(3)(g), Treaty of Rome).

9. Richard Taffler & Bill Houston, "How to identify failing companies before it is too late," Vol. X *Professional Administration* No. 4, 1980, at **p.2.** The present writer's observations on the prediction of insolency which follow are based, in the main, on the views expressed there.

10. Taffler & Houston, *loc. cit.*

11. *Ibid.*, **p.3.**

12. *Re Patrick and Lyon Ltd.* (1933) Ch. 786. Cf. A.C. Hopper, *Voluntary Liquidation* (London, 1949), **p.119.**

13. *Re William C. Leitch Bros. Ltd.* (1932) 2 Ch. 71.

14. Companies Act, 1963, s. 297(3). The fine is obviously now too low in our inflationary age.

15. *Ibid.*, s. 184.

16. J. H. Thompson, *Sales' The Law Relating to Bankruptcy, Liquidiations and Receiverships* 6th ed., London, 1977, **p.277.**

17. Companies Act, 1963, ss. 3(3), 166, 169. Members may also apply for such investigation: s. 165.

18. Hopefully, by way of statute and *not* by way of Ministerial Order: cf. G. M. Golding, "Companies, *Vires* and the First Directive" (1975) 109 Irish Law Times 105 at **p. 119.**