Although not usually in the forefront, it is important to consider the possibility that one of your business’ key customers or suppliers might run into financial difficulty at some stage in the future and to put in place measures to protect your business from this risk.

This guide provides a checklist of clauses that you should consider including in your contract at the outset of the relationship, the early warning signs of insolvency, an overview of corporate insolvency processes and practical tips of what to do if your customer or supplier goes insolvent.

1. FIRST THINGS FIRST: TERMS AND CONDITIONS

As soon as there is a hint of trouble, the first thing that people reach for is the contract or terms and conditions. It is therefore essential to protect your business from the risks of counterparty insolvency to have a written contract that is properly signed by all relevant parties or to have at least standard terms and conditions that you are able to evidence were properly incorporated into the contract.

2. WHAT CLAUSES SHOULD BE INCLUDED TO PROTECT AGAINST COUNTERPARTY INSOLVENCY?

- **Termination right:** Make sure you have a right to terminate the contract should your customer or supplier enter an insolvency process. There is no implied termination right for insolvency so this needs to be expressly included. Take care not to use an old precedent or example as insolvency processes have moved on. For example, we often see terms and conditions that provide for termination of the contract on an administration order being made by the court, but they do not refer to the counterparty being placed into administration through the out of court route (which is far more common these days than through the court). Similarly, make sure the termination right extends to analogous proceedings instigated outside the jurisdiction.

- **Right to claim interest and costs:** For contracts with customers, ensure that you have a right to charge interest on late payment and to recover your costs of enforcing payment. If your customer is insolvent, it is likely that you will only recover a certain percentage of your total claim, so it is important to ensure that you maximise your claim.

- **Right of set off:** While the overall commercial arrangement may preclude the inclusion of a right of set off, this right is certainly helpful on a counterparty’s insolvency. If your customer or supplier goes insolvent, the insolvency practitioner will look to collect in any sums that are owed to the insolvent company, which could include sums from your business (such as unpaid invoices or customer rebates). Even if your supplier or customer also owes you money, you are at risk of having to pay what you owe to the customer or supplier, while only ranking as an unsecured creditor in the insolvency of the customer/supplier for the sums that it owes to you. Having an express right of set off in the contract allows you to set off these sums, thus either reducing the claim that the insolvent company has against you or your reducing your claim against the insolvent company (in turn reducing the risk that you will not recover anything).
• **Right to vary payment terms:** In circumstances where you are concerned about customer insolvency, it is always useful to have the right to unilaterally amend payment terms, for example by requiring payment to order. This will ensure that you are not effectively giving free credit to your customer (and thus exposing yourself to risk of non-payment).

• **Reservation of title terms:** A clause that stipulates that title in goods does not pass until payment is made in full is, subject to certain practical limitations (see below), effective to remove those goods from the insolvent estate meaning that you will have a claim for recovery of those goods rather than a claim for payment of the price (which will almost certainly not be paid in full). If the ROT clause is drafted to include the proceeds of sale of the goods, note that it is considered to be more like a charge, and therefore if not registered at Companies House, will be void for non-registration. In addition, it is important to keep a good record of serial numbers (or other identifying characteristics) in order that the goods can be easily identified.

• **Option to purchase licenced asset:** If one of your key assets, such as intellectual property, is licenced and you are worried about what will happen to that asset if the licensor should go insolvent, include an option to purchase the licensed asset for £1 or fair market value (whichever is greater) on the insolvency of the licensor. The inclusion of the words “fair market value” is required to prevent the insolvency practitioner appointed over the licensor from seeking to challenge the option to purchase as infringing public policy.

3. WHAT OTHER DOCUMENTS OR ARRANGEMENTS MIGHT BE HELPFUL?

• **Third party guarantee:** Whether provided by a parent company or an individual director, guarantees are always useful to protect against counterparty insolvency. Make sure they are given by a person or entity with substance and are properly drafted to allow you to pursue the guarantor without first having to pursue the underlying debtor.

• **Letter of credit:** Particularly useful in international trade, a letter of credit can provide a mechanism for ensuring payment on shipment.

4. WARNING SIGNS OF COUNTERPARTY INSOLVENCY

Every business functions differently and will have different warning signs, some of which will be more readily evident to you than others. However, the most common warning signs of counterparty insolvency are:

• the customer or supplier is paying or performing late (if at all);
• the customer is seeking extended payment terms or the supplier is seeking shorter payment terms;
• the customer or supplier operates in a contracting market;
• the customer or supplier is late in filing its statutory accounts;
• the management team or your key contact at the supplier or customer is changing or you sense that there is a high turnover of staff; and/or
• you read in the press or hear from competitors or other people operating in the same market that the supplier or customer is in financial difficulty.
5. BRIEF OVERVIEW OF CORPORATE INSOLVENCY PROCESSES

<table>
<thead>
<tr>
<th>Insolvent?</th>
<th>Appointed over all assets?</th>
<th>Automatic stay?</th>
<th>When is the process used?</th>
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6. MY CUSTOMER OR SUPPLIER HAS GONE BUST – WHAT NEXT?

- **Find out what insolvency process it is in:** Your rights as a creditor will very much depend on what insolvency process the customer or supplier has entered so this should always be the first step (see above for the different implications).

- **Consider terminating the contract:**
  - Where you have an express right, you may consider terminating the contract (see 2 above, ‘Termination right’).
  - This will not be the right course of action in all cases. If it is a customer that has gone insolvent, the insolvency practitioner may wish to continue trading the business and your business’ continued supply may be required. If this is the case, negotiate! You may be able to negotiate payment in advance or increased prices, although it is unlikely that you will be able to negotiate payment of unpaid invoices that relate to the period prior to the customer entering insolvency. It may be worth asking though!
  - Note that there are special rules around the supply of point of sales terminals, computer hardware and software, information advice and technical assistance in connection with the use of information technology, data storage and processing and website hosting. If your business supplies any of these goods/services to a customer that has gone into an insolvency process, you may be prevented from terminating the contract or withholding future supply. We would be happy to advise further if you find yourself in a situation where this applies.
• **Consider asserting a right of set off:** Even if you do not have an express right of set off in your contract, consider whether you can nonetheless assert one. If the customer or supplier enters liquidation, statutory set off rules apply. In any other type of insolvency process, provided there is no express contractual exclusion of set off, you may be able to argue that equitable set off principles apply. This is a technical area of law and we would be happy to assist you where this situation arises.

• **Consider repossessing goods supplied subject to reservation of title terms:** If your customer has entered administration or compulsory liquidation, there is an automatic stay or moratorium against creditor action, which prevents creditors repossessing goods supplied subject to ROT terms without the consent of the insolvency practitioner or permission of the court. This does not mean that you no longer own the goods; the rule is there to ensure that, say, competing claims are properly administered and there is not a free for all run on the company. There is no such stay/moratorium in the case of receivership or voluntary liquidation. Either way, in practice, the best way to proceed is to contact the insolvency practitioner with details (including serial numbers or defining characteristics) of the goods supplied and to state that you wish to repossess the goods or be paid for them in full. Inevitably a period of negotiation will then ensue, the outcome being dependent on whether the goods remain in the possession of the insolvent company or whether they have been on-sold, and whether the goods can be easily identified and/or located.

• **Submit a proof of debt:** If, after utilising all of the above measures to reduce or extinguish your claim against your insolvent customer/supplier, you are still owed money, the insolvency practitioner will ask you to fill in a one-page form providing details of your claim (known as a proof of debt). Make sure you add interest and costs to your claim (provided the contract entitles you to do so) and mention if you have any security in respect of the debt (otherwise you may be deemed to have waived it!). It is also helpful if you can attach evidence of your claim (the contract/terms and conditions, invoices etc).