



Strategies for Companies in Insolvency

The need to deal with creditors

The number one priority for companies with viable businesses that are unable to meet their debts is to deal with their creditors.

Options for doing so are:

- a. A debt moratorium using the Government's recently announced debt hibernation scheme;
- b. A compromise with creditors;
- c. Voluntary administration;
- d. Restructuring operations into a new company.

I discuss these options below but emphasise at the outset that whichever option is chosen, it must be coupled with a plan to restore the viability of the business. For example, a debt moratorium that merely buys time and is not coupled with other steps will not ultimately achieve anything nor will it gain creditor approval.

Debt Moratoriums

The debt hibernation scheme introduced by the Government as part of its Covid 19 insolvency laws re-write (a 6 month freeze on existing debts with 50% creditor approval, by value and by number), has already proved popular. Undoubtedly that is because of its simplicity and automatic stay on creditor action for the one month period from notice of the proposal being given to creditors.

The burning issue is how to encourage creditors to approve the moratorium. Plainly, creditors will only give their approval if they believe their prospects of recovering amounts presently owed to them are heightened by waiting. Secured creditors will need to be persuaded that they will recover a greater amount by allowing the company to continue rather than putting it into liquidation, whereupon they stand first in line to recover amounts realised in liquidation. Unsecured creditors need to be similarly persuaded.

To persuade secured and unsecured creditors alike, the moratorium proposal will need to be accompanied by a plan to:

- a. raise new capital; or
- b. remodel the business into a smaller state to match revenues to the scale of the business and to restore it to profitability; or
- c. sell the business as a going concern.

Creditor support will be dictated by the viability and preparedness of steps to effect one of these plans. If a capital raising is intended, creditors will undoubtedly require information to apprise them of the likelihood of the capital being successfully raised (ie the amount, on what terms and from whom, preferably

underwritten). Above all, the capital raising will need to be shown to be sufficient to restore the company's balance sheet and working capital to viable levels to allow the business to operate.

If possible, companies should include a term sheet for the capital raise with the notice to creditors.

If either a remodelling of the business or a proposed sale of it is intended, again details should be included in the notice given to creditors. That detail should:

- a. in the case of a remodelling of the business, include financial projections once the remodelling has been completed. Central amongst these projections will be the assumptions around leased premises and other long term commitments as these may not be so easy to "remodel";
- b. in the case of a proposed sale of the business, it would be advisable to be able to point to a business broker agreement or appointment of a financial advisor and an appraisal for the business and of the market for it.

What is the plan if the moratorium is not approved? It would be helpful in the notice to be given to creditors to answer this. It might be as simple as saying that the company will fail and only secured creditors are likely to see any recovery. Whatever the plan is or the result of creditors not approving the moratorium should be spelt out.

Compromises with Creditors

This entails asking creditors to take a haircut (although it is also possible to restrict the compromise to a moratorium on debt for a period that extends beyond the 6 month availability under the debt hibernation scheme; one year perhaps). Asking creditors to take a hair cut will be appropriate when a capital raising and/or a remodelling of the business is, on its own, insufficient leg up for the company.

In like fashion to a proposal made under the debt hibernation scheme, the success of a compromise proposal lies in your ability to persuade creditors to approve it. The approval threshold is 75% by value and by number of the creditors affected. Approval won't be possible without the support of your secured creditors. Equally, approval will not be possible without the support of small creditors, as these will form the majority of creditors by number. This mix usually means offering the small creditors a greater amount per dollar of debt than is offered to large creditors. Alternatively, you might pay out the small creditors in full in which case they will not be included in the compromise proposal and their support is not required.

Where do shareholder loans and other related party debts fit in?

It is best to treat them as a separate class of creditor. Should you elect to roll them in with other unsecured creditors, perhaps with the design of achieving the 75% threshold, you will be in peril of an unfair prejudice claim.

In any event, most compromise proposals involve shareholders committing to inject additional capital on the condition that creditors agree to the compromise proposal.

I anticipate many companies following a two-step approach that entails a debt moratorium under the debt hibernation scheme, followed by a compromise proposal. The moratorium will gain the company time to determine the extent of compromise that is needed of creditors and to put together any proposed injection of capital. Such two-step approach is perfectly permissible and indeed wise.

Voluntary Administration

I recommend this option only where all other alternatives have failed. It entails appointment by the board of an external administrator, and hand over of control of the company to the administrator.

By going into voluntary administration, all company debts are immediately frozen. Unlike the debt hibernation scheme or creditor compromises, no approval of creditors is needed and therein lies the

attraction of voluntary administration. The purpose is to buy time to allow the company to continue as before. Creditors are given the opportunity to vote on the arrangement at a watershed meeting. The fate of the company will turn on the outcome of that vote.

Restructuring into a New Company

It is feasible to carry on your business in a new company, leaving the debts behind in the existing company. For example, say you operate 5 stores and you wish to close 3 of them, and continue to operate the other 2. Is that possible? Yes it is, but it requires the existing company to be placed into liquidation, receivership or voluntary administration. It also requires the new company to pay fair value to the old (failed) company for the assets to be employed by the new company.

Restructuring of this type requires considerable planning and agreement of the liquidator, receiver or administrator. Nevertheless, this is a viable means of remodelling your business to suit smaller scale operations in circumstances where the company's long term commitments (leases for example) do not make this possible by other means.

Tax Loss Carry Back

This week the Government announced a relief package for businesses in the form of a tax refund. Businesses that produce a loss:

- a. in the 2020 income year (for businesses with a 31 March balance date, this year has just completed) to carry that loss back to the 2019 income year and offset the loss against income in the 2019 year. Tax paid for that year will be refunded to the extent the loss reduces taxable profit for that year;
- b. in the 2021 income year, to carry that a loss back to the 2020 year with the same effect.

For businesses with a 31 March balance date , the 2021 income year has of course only just begun. The Government's tax loss carry back relief measure allows businesses to estimate their 2021 results and offset losses on the basis of that estimate (use of money interest will apply where the businesses are subsequently found to have over estimated their 2020 or 2021 year losses).

For the 2020 income year, businesses will have a final provisional tax payment due on 7 May. This relief measure will relieve many businesses from the obligation to pay tax on 7 May. For others, relief may be slightly less immediate.

If you forecast a loss this year (or in the 2020 year) , I strongly urge you to take advantage of the tax loss carry back relief.

Please don't hesitate to contact me if I can assist in any of these areas.