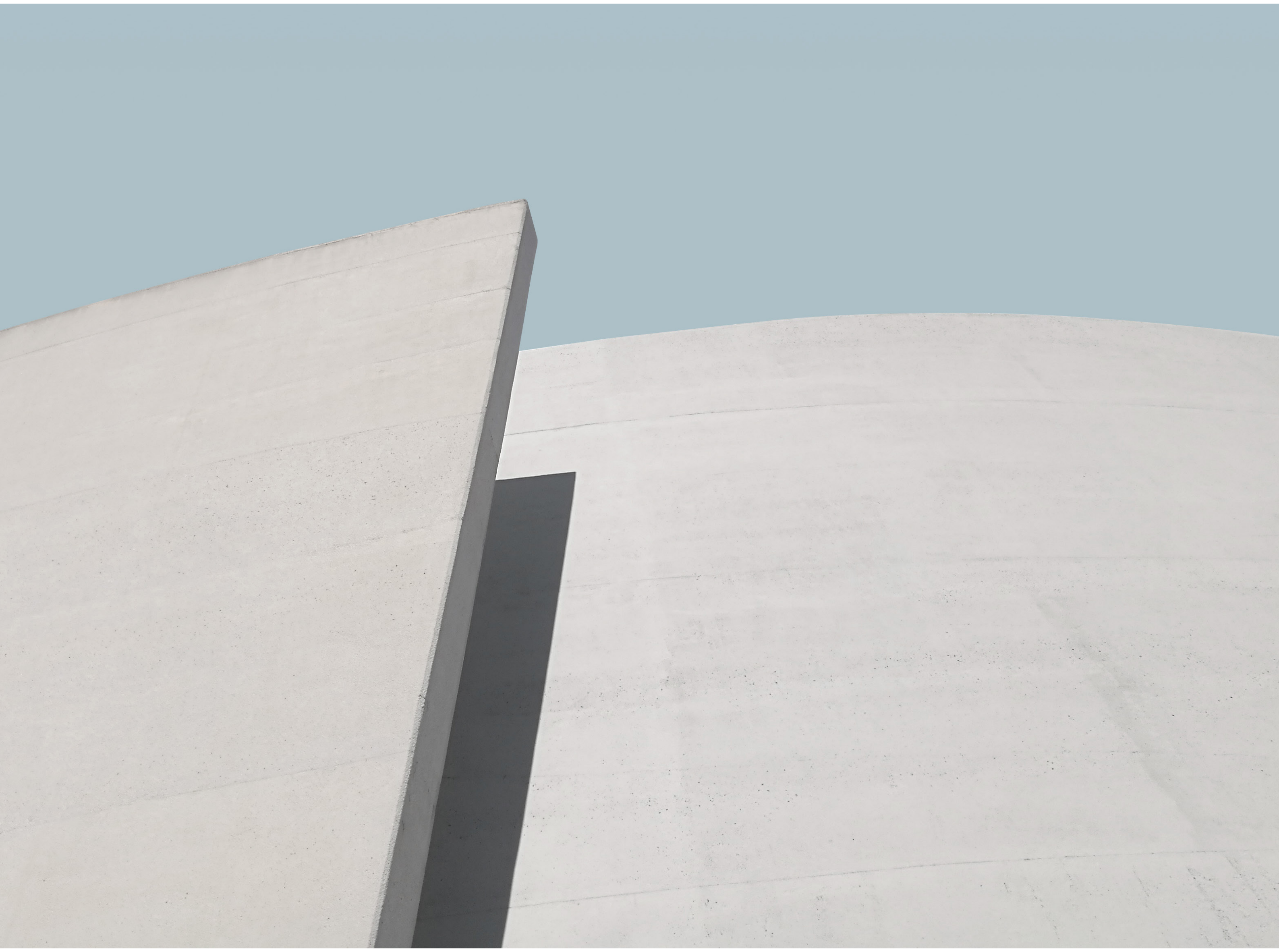


Solvency issues in the face of COVID-19

25 March 2020

Once in a lifetime?

COVID-19 presents the greatest challenge a generation of corporate managers will see in their lifetime.

This is not the first time the Australian economy has stared down the barrel of a severe economic downturn, but it is the first time the economic conditions that previously underlined robust business models have evaporated overnight due to a public health crisis. Labour, one of the critical factors of production, is at risk of harm, which in turn has seen demand crushed in many industries which have recently spearheaded growth in our national economy, such as tourism, education and entertainment.

All this has come at the end of a devastating drought and bushfire season and a period of unprecedented growth in household and corporate debt. Flat wage growth and declining household savings have contributed to the 'perfect storm' in consumer confidence.

Recent legislative changes can provide relief, but it is critical to first identify whether there is a problem at all.

Does solvency still matter?

Notwithstanding that insolvent trading laws have been temporarily suspended, insolvency still has serious consequences for directors' duties and certain types of corporate action.

Insolvent companies cannot, for instance, grant security with respect to prior obligations, enter into guarantees, declare dividends, transfer assets unless at full value or make representations as to their status as a going concern.

Directors additionally owe a duty in the zone of insolvency to consider the interests of creditors in discharging their duties to the company.

Accordingly, while insolvent trading is temporarily off the table, boards and corporate groups retain considerable personal exposure to actions taken with respect to insolvent companies.

Illiquidity or insolvency?

Australia's cash flow test for solvency[1] is often criticised for its imprecision, but in these difficult times, corporate Australia should seek to use that imprecision to its advantage.

A company must be able to pay its debts as and when they fall due for payment[2]. This is not a mechanical exercise of comparing bills due today as against cash today.

A common question we are often asked is, what does this actually mean and how far into the future must I look?

The mere prospect a company may be able to pay its debts in the future, is no grounds for comfort that the company is solvent. In our experience, however, notwithstanding the present unprecedented circumstances, companies very rarely become insolvent overnight and directors should not rush to conclude the company is insolvent.

As a general rule, consider your projected cashflow out to the horizon of your ability to produce a reasonable accurate forecast and consider, in particular, the company's ability to meet major financial obligations that may fall due across that period in addition to cash-burn across the forecast period.

Insolvency is prospective in the sense that it will be established at the point it is clear the company has insufficient resources to meet payments that will certainly fall due in the future. A company with a loan for $100m due in six weeks' time, that has $10m in the bank today is not solvent unless it is realistically able to meet the commitment of $100m due in six weeks (by way of surplus cash flow from trading, refinance, selling assets or otherwise) or defer the debts failing due for a sufficient period of time that it might be able to meet those obligations in the future.

The mere fact a company does not have sufficient liquidity (available cash) does not render it insolvent. It has long been recognised[3] that when assessing solvency other sources of funding referrable to the nature of the business and the amount of the debt, including the sale or encumbering of assets within a reasonable time, need to be considered.

Therefore, if you currently have a business that has insufficient cash banked to pay its debts, the company will need to consider whether non-core assets can be sold or used to raise additional cash. If additional cash can be raised with reasonable certainty in a limited period of time, then it less likely that a company is insolvent.

Similarly, the fact that a large surplus of assets exists at a balance sheet will only be of assistance in assessing insolvency where those assets can be converted into short-term cash or used to deal with obligations that fall due in the short-term.

In assessing solvency, boards are entitled to discount contingent liabilities with respect to damages. The mere assertion of a claim will not impact the solvency of the company, but care needs to be taken in making a proper assessment of asserted claims and in relation to any restructuring activities where there are contested liabilities.

Similarly, where there are discussions on foot and making meaningful progress towards dealing with certain obligations, directors may be given the benefit of the doubt so long as they hold a reasonable belief that negotiations will bear sufficient fruit to defer any question of insolvency into the future.

What else can you do to stay solvent?

The simplest way to ensure the company is not insolvent is to extend the time by which the debt will become due for payment. We are now seeing significant negotiations with trade creditors to defer payment of outstanding debts. Parties should not hesitate to approach trade creditors now, to seek discounts for early (on time) payments or extended payment terms.

Again, the major banks have already announced a number of measures to assist customers manage their cashflows, including deferral of principal and interest payments for up to six months on business loans and deferred payments on business credit cards. Similarly, the ATO has announced measures to allow eligible businesses to defer payments of GST and PAYG installments. State taxing authorities are expected to unveil similar measures.

Beyond those measures, there are a range of large financial investors with substantial capacity that remain liquid and potentially willing to transact with viable businesses.

Duties of directors in times of crisis

Directors play a crucial role in the management and control of the businesses to which they are appointed and as such are regularly easy targets when a company fails. It will often be in the interests of all stakeholders - shareholders, employees, creditors and government - that otherwise profitable and viable businesses can be supported in times of global crisis.

Central to this role, are the legal obligations which hold directors accountable for the decisions that they make. In times of financial difficulty fraught with uncertainty, where there may be no right or wrong decision, it is critical that directors are armed with all the necessary information about the nature of their duties and the impact of insolvency.

The GFC and the chaos that ensued was the last time we experienced a proliferation of litigation involving breaches of directors' duties. Back then, ASIC was not as focused on commencing proceedings against offending directors. As a result, enforcement of directors' duties was by and large

1 Occasionally the balance sheet position of the company may be relevant to the question of solvency

2 S95A *Corporations Act* 2001

3 Barwick CJ in *Sandell v Porter* (1966) 115 CLR 666

the domain of insolvency practitioners. This time round the regulator is emboldened and better resourced.

Varying degrees of egregious behaviour in recent regulatory inquiries and royal commissions, has prompted a revamp of the penalties under the *Corporations Act*, including for breaches of directors' duties. As such, going forward directors will be exposed to increased risk. Putting to one side the cost of any reputational damage and the expense involved in defending litigation, under the revised penalty regime, directors can now face 15 years in prison or a fine of up to $945,000 for criminal contraventions. Alternatively, for civil penalties, directors can be liable for up to $1,050,000 per breach.

What duties are owed?

The duties themselves are an overlapping and interrelated web of common law and statutory obligations.

For directors worried about insolvent trading, the Federal Government will provide temporary relief to directors from personal liability for a maximum of six months in respect of debts incurred in the ordinary course of the company's business.

As to whether this relief will provide directors with the level of comfort they need to continue trading will remain to be seen. However, a cursory review indicates that directors must remain cautious. As a start, egregious cases involving any dishonesty and fraud will continue to be subject to criminal penalties. Further, in extraordinary times such as these, it will not always be clear what "the ordinary course of business" means. By restricting relief in this way, it may prevent directors from undertaking the innovative solutions needed to survive. Lastly, given that secured creditors are not preventing from enforcing, directors may have little control as to when the company goes into external administration.

In addition to insolvent trading, there are a number of other duties which directors should be mindful of if they have solvency concerns. These duties can be broadly divided into two groups, namely those arising at common law derived from the director's role as fiduciary and a number of analogous duties set out in the *Corporations Act*.

While traversing similar ground, the duties enshrined in the *Corporations Act* are in addition to, not in substitution for, the duties owed at common law. An understanding of these key provisions is critical for directors concerned about the solvency of their businesses. For example under section 181(1)(a) of the *Corporations Act*, a director must exercise their powers and discharge their duties in good faith in the best interest of the company – this will involve a consideration of creditors where the company is, or likely to be, insolvent.

Similarly, under s180 of the *Corporations Act*, a director must exercise their powers and discharge their duties with a degree of care and diligence that a reasonable person would if they were a director of a corporation in the company's circumstances and had the same role and responsibilities. For example, allowing a company to enter into transactions that produce no benefit for the company will be sufficient to constitute a breach of duty.

Directors concerned with their ability to discharge their duties in times of questionable solvency, should familiarise themselves with the defence known as the business judgment rule (s180(2)). Critically, the business judgement rule will not be available to a director who has a material personal interest in the decision, the subject of the proceedings.

In the past Courts were reluctant to judge the commercial decisions of directors, however this is no longer the case. Directors exhibiting mere passive participation or demonstrating a failure to check and challenge management decisions may still breach the provisions of the *Corporations Act*.

Is relief available?

It is important to note that directors faced with possible contraventions of their duties should not assume relief will be available under section 1317S or 1318 of the *Corporations Act*. A review of the case law indicates that judges are on the whole reluctant to exercise those powers without a special reason. This has been particularly so given the shift in general sentiment to holding directors to a higher standard of care. Having said that, given that the tipping point into insolvency is often unclear, it is possible that a judge could be persuaded that the crippling impact of COVID-19 constitutes a 'special reason' in the absence of fraud or dishonesty.

The best advice for a director concerned about their position is to take advice. Many of the duties require an assessment of reasonableness and accordingly there is a clear need to act objectively and impartially with respect to financial decisions about the company's survival. It may be critical to have evidence that demonstrates that due consideration was given to the risks at the time and that the decision reflects that which a reasonable person acting in a similar role with similar responsibilities would have taken.

Will safe harbour help me?

In light of the announcement by the Federal Government to insulate directors from insolvent trading claims for six months, directors may form the view that they do not need to avail themselves of the safe harbour protections. For the reason outlined above we consider that this would be a mistake.

In these unprecedented times, directors should arm themselves with as many safeguards as possible to ensure they have the flexibility and freedom to make critical decisions.

Parliament originally introduced the safe harbour regime to allow companies to continue to trade during periods of insolvency without the directors being liable for criminal penalties or debts incurred subject to meeting certain criteria. The safe harbour allows directors time to attempt to implement a solvent turnaround in circumstances where it is reasonably likely the plan will lead to a better outcome for the company. This regime goes much further than that the temporary changes announced by the Federal Government.

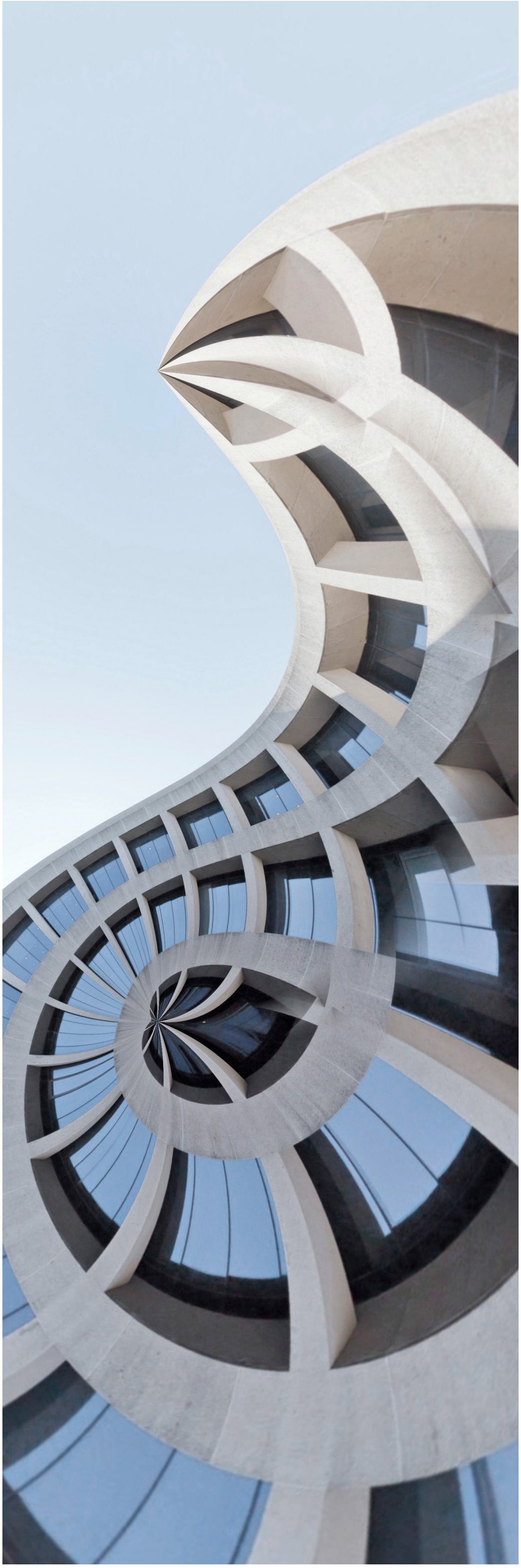
Safe harbour does not require listed companies to make market disclosure of the appointment.

Further, in getting to safe harbour there are some difficult issues to navigate that are set out below.

Criteria for entering the safe harbour

If a director suspects that a company may become, or is in fact insolvent, then safe harbour will provide protection from insolvent trading liability subject to meeting the following criteria:

- the director must properly inform themselves of the financial position of the company and keep adequate books and records;
- the director must obtain advice from an appropriately qualified person who is given sufficient information to provide appropriate advice (this person is sometimes called a 'harbour master' but is more properly understood to be an qualified specialist accountant or restructuring consultant);
- the director must make appropriate steps to prevent any misconduct by officers or employees that could adversely affect the company's ability to pay all its debts;
- all employee entitlements are continued to be met as and when they fall due and lodging all tax returns as and when they fall due; and
- the director, must develop or implement a plan for restructuring the company to improve its financial position.



Reasonably likely to lead to a better outcome?

Assuming that a business is able to pay its employees (including the costs of restructuring its workforce), and reach suitable arrangements with the ATO in relation to the payment of taxation obligations following lodgement, the most pressing question becomes whether there is a plan that is reasonably likely to lead to a better outcome than an immediate insolvency filing.

Ordinarily, against a steady state or relatively orderly economic backdrop, it is possible to identify a restructuring plan which contains reasonable revenue and expense projections. This enables a reasonable financial model to be built to compare whether the restructuring plan is reasonably likely to lead to a better outcome for the company than an immediate insolvency filing.

With many industries facing an unprecedented challenge caused by a potentially prolonged shut-down or precipitously decreased revenue, the concept of "reasonably likely to lead to a better outcome" is potentially a very difficult one. It is not clear how long the current period of dislocation may continue or what the effect of particular public health measures will have on the broader economy.

As a starting point, many business currently have cash reserves and receivables. In the event of an immediate cessation of business it might be that the return to creditors would be relatively higher than in a scenario where a shutdown occurs after six months, with a corresponding exhaustion of cash reserves and an increase in overall creditors. However, an immediate shutdown in current market conditions may result in the value of some businesses being basically unrealisable (for instance, it is unlikely there is thriving market for aviation assets). Any safe harbour plan must be reasonably likely to beat the outcome of an immediate shutdown (whatever that might be) and it is necessary to reach a reasonable baseline scenario.

Next, while we expect that in some instances emergency credit facilities may be made available to provide short-term support, if that short-term support is insufficient to put the corporation in a position where it can realistically meet its commitments through an interim period of disruption, difficult issues emerge as to whether the plan is reasonably likely to lead to a better outcome. Accordingly, any additional working capital has to be sufficient to meet the expected shortfall during the current crisis.

The ability to service any additional borrowing feeds into an assessment of the reasonableness of the plan. If a board simply decides to hope for the best without regard to how certain financial commitments can be met (because the capital available is simply never sufficient for the size of the hole in revenue) there is considerable doubt as to whether a safe harbour defence is established to insolvent trading liability. There would also, given the requirements to act with care and in the best interests of the company, be substantial difficulties with this course from a directors' duties perspective.

We would expect, as a minimum requirement for any safe harbour plan, that a director might be able to show that in normal trading conditions the business will be able to meet its debts as and when they fall due, including in relation to repaying or servicing any borrowings that are incurred to survive the immediate crisis. However, it may not be reasonable to assume against the backdrop of current circumstances that business will return to normal or that there will necessarily be the same opportunities for growth.

If under normalised conditions, a business will have difficulty in trading out of the financial hole then a more fundamental restructuring is required at a financial and/or operational level. It may be that counter-parties will be willing to agree to compromise their position such that the restructuring can be achieved informally. However, in a variety of situations, a formal restructuring may be required.

In the interim, directors face a series of difficult business judgments in navigating a pathway through the immediate crisis.

Capital raising in distress

Generally, a company in financial distress is entitled to raise capital, subject to the normal requirements for capital raising transactions.

As explained above, directors of Australian companies are required to act with care and in the best interests of the company in exercising their duties and powers. Simply adding debt or equity without a detailed analysis of whether this capital injection will be sufficient, or strikes a reasonable balance for all stakeholders in the company, is a dangerous pathway. Accordingly, ahead of any capital raising it is important to have a detailed plan.

Noting the general comments above, equity capital raises less complex issues than debt capital. If a company, making full disclosure and in compliance with the *Corporations Act* and any applicable listing rules, raises equity capital, then it is entitled to do so whether or not its solvency or future prospects are uncertain.

Turning to debt:

- If a company is merely distressed, then provided full disclosure is made to the incoming financier of the company's material circumstances and the decision is made with appropriate care and skill, it is unlikely to have any adverse impact upon the directors. A company that is insolvent and not subject to insolvent trading laws or in safe harbour can again raise debt capital subject to the general comments above.
- A company that is insolvent cannot raise debt capital unless it does so during the period of the suspension of insolvent trading laws and without unduly prejudicing the interests of creditors. One observation is therefore critical in relation to debt capital – timing is important. It is important to move early before the situation devolves to a point where it is impossible to formulate a plan it is important to have in place a strategy around further capital raising (if required).

We set out below a series of high level options for capital raising:

Potential sources of capital

Source of capital	Pros	Cons
Existing shareholders, in particular existing strategic investors.	Know business well, most obvious way to raise capital quickly	Listing rules and Corporation Act restraints for related parties and large shareholders. Shareholders may be capital constrained or unable to move quickly.
Equity funding from new shareholders, e.g. PE and hedge funds, high net worth investors	May have access to capital not available to existing shareholders, can move quickly.	Likely to demand high returns, potential dilution of existing shareholders and loss of control.
Banks, existing financiers	Generally reliable source of capital	Unable to move quickly given resource constraints and overwhelming demand from borrower clients. Unable to approve funding outside of usual credit requirements
Non-bank financiers	Accelerated credit approval process, flexible and less risk adverse capital.	Cost of funding, potential dilution of capital if equity participation part of funding terms.

Types of capital raising

Type of raising	Pros	Cons
Equity		
Pro-rata rights issue	Available to all shareholders, non-dilutive. No shareholder approval required. Can have strategic investor underwrite the issue.	Lack of appetite from existing shareholders, timing. Need to issue a cleansing notice to support a rights issue
Placement direct to strategic investor	Most streamlined form of equity raising.	Need consider compliance with Listing Rules, takeover laws and *Corporations Act*. Restrictions on total amount that can be raised. Not practical to hold general meetings to approve raisings.
Re-capitalisation via Deed of Company Arrangement	Allows for large scale re-organisation of capital base with creditor support.	Requires filing for voluntary administration which is uncertain and expensive. Still requires compliance
Debt		
Extension of funding from existing lenders	Relatively simple process, can be done quickly. Existing lenders well placed to undertake credit analysis	Lack of appetite from existing lenders, unable to obtain approval if outside conservative credit requirements.
New 'super senior' debt funding from new lenders or sub-set of existing lenders.	Favourable priority position and pricing will be attractive to new capital.	Will need consent of existing lenders, priority and consent terms potentially complex and time consuming to resolve.
Hybrid debt / equity issues (e.g. debt with warrants granted to lenders, preference shares)	Potential upside returns can be attractive to new capital.	Cost of funding, potential dilution of existing shareholders, loss of priority to preference equity holders
Super priority loans for wages	Provides 'super priority' over circulating assets (debtors, inventory etc) for loans. Provides some measure of coverage for stretched loans otherwise unavailable.	Super priority is limited to amounts used to pay wages and employee entitlements. Will not work in a situation where there are insufficient circulating assets. Often only related parties or special situation investors will be in a position to make these type of loans.
Receivables financing	Potentially brings forward debtor payments, thereby injecting extra working capital into the business.	Likely to be prohibited by existing financing arrangements. Often very expensive. Availability depends on counter party risk profile.

Restructure via voluntary administration and deed of company arrangement

For many companies in financial distress, particularly those with some prospect of long-term viability once the crisis passes, short to medium-term survival will only be possible if the company can quickly restructure its affairs with its creditors, including its financiers, trade suppliers, employees and the tax office.

Most restructures fundamentally boil down to a deal between a company and its creditors by which creditors agree to accept less than they are owed, in return for keeping the company's business alive in some way. As a general observation, a restructure will be appropriate if on balance it provides, or has a realistic prospect of providing, a better outcome for creditors than the liquidation of the company.

Distressed restructures are typically achieved by a deed of company arrangement. But in order to achieve a restructure by a deed of company arrangement, the company must first enter voluntary administration.

Under the *Corporations Act*, it is open to the directors of a company to initiate voluntary administration only in circumstances where the company is insolvent or is likely to become insolvent at some future time. As such, deeds of company arrangement are not available to otherwise solvent businesses, even if the profitability of those businesses has been substantially impacted by the COVID-19 shut-down.

Upon their appointment, voluntary administrators take over management of the company and its business. While the directors of the company remain in office, their powers in respect of the company are largely suspended. The administrators' fundamental role is to take control of the company while restructure options are identified and explained to creditors. The administrators are required to assess independently whether restructure options are likely to provide a better outcome for creditors than liquidation of the company.

Ultimately, however, the creditors of the company determine whether to implement a restructure proposal. This occurs by way of a vote of creditors. In order for a deed of company arrangement to be implemented, a majority of the creditors by value and in number must vote in favour. Administrators can use a casting vote to resolve deadlocks.

Throughout the administration process, which in many cases can be completed in a matter of weeks, the company is largely immune from creditor claims. This means that trade creditors can't take enforcement action, third parties can't commence or continue with litigation, and landlords can't re-take possession of property from the company in administration. The idea behind this moratorium is to provide the company, its creditors and the administrators enough breathing space to prepare for a restructure, if one is possible. That said, any creditors with security over substantially the whole of the company's property are not affected by the moratorium. For this reason, it is often appropriate for companies wishing to restructure their affairs in this way to engage with their secured lenders before appointing administrators.

If the creditors vote in favour of a restructure proposal, generally speaking all creditors of the company, regardless of whether they voted in favour of the restructure, will be bound by the deed of company arrangement. When the deed of company arrangement takes effect, and subject to the terms of restructure, creditors' claims against the company are extinguished, and instead creditors receive the dividend provided for in the deed of company arrangement.

It is not uncommon for unsecured creditors to give up their claims and receive very little out of a deed of company arrangement. But every restructure is different, and deeds of company arrangement can provide different outcomes for different creditors – not everyone must be treated equally. Further, deeds of company arrangement affect owners and lessors of property, and secured creditors, differently to regular unsecured creditors.

Ultimately however, a restructure via a deed of company arrangement provides a company with an opportunity to recalibrate its balance sheet so that its prospects of continuing operation as a going concern are maximised. The restructure mechanism is very flexible, making it appropriate for restructuring debt and equity in highly complex businesses and less complicated ones alike. Further, the restructure can be implemented without the involvement of the Court, and relatively quickly.

Importantly for the creditors of a company, a restructure via a deed of company arrangement provides the opportunity to achieve a better outcome than liquidation. Historically, creditors on average recover less than 10% of their claims when a company enters liquidation. It's hard to believe, but given what lies ahead, returns of that kind in a liquidation might one day be considered remarkably good.

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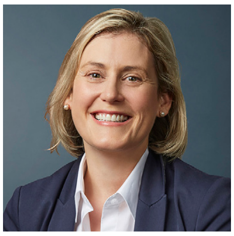

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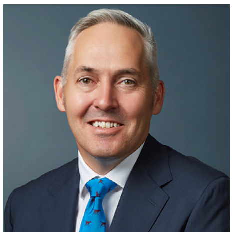

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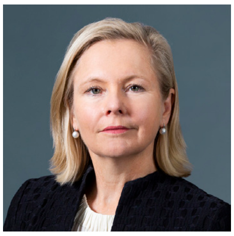

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