# COVID-19 AND FINANCIAL DISTRESS

## A Director's Perspective

Prepared by CPA Australia ESG Centre of Excellence

CPA AUSTRALIA

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# FINANCIAL DISTRESS IN CONTEXT

The COVID-19 pandemic has put significant pressure on organisations in a variety of ways. Demand for goods and services have been suppressed, offices and factories have closed for extended periods of time, supply chains have been severely disrupted and the health and safety of team members has been concerning for all.

Ultimately these pressures have impacted greatly on the financial performance of many businesses and may in the worst case give rise to serious solvency concerns which can have dramatic consequences for directors if not managed appropriately.

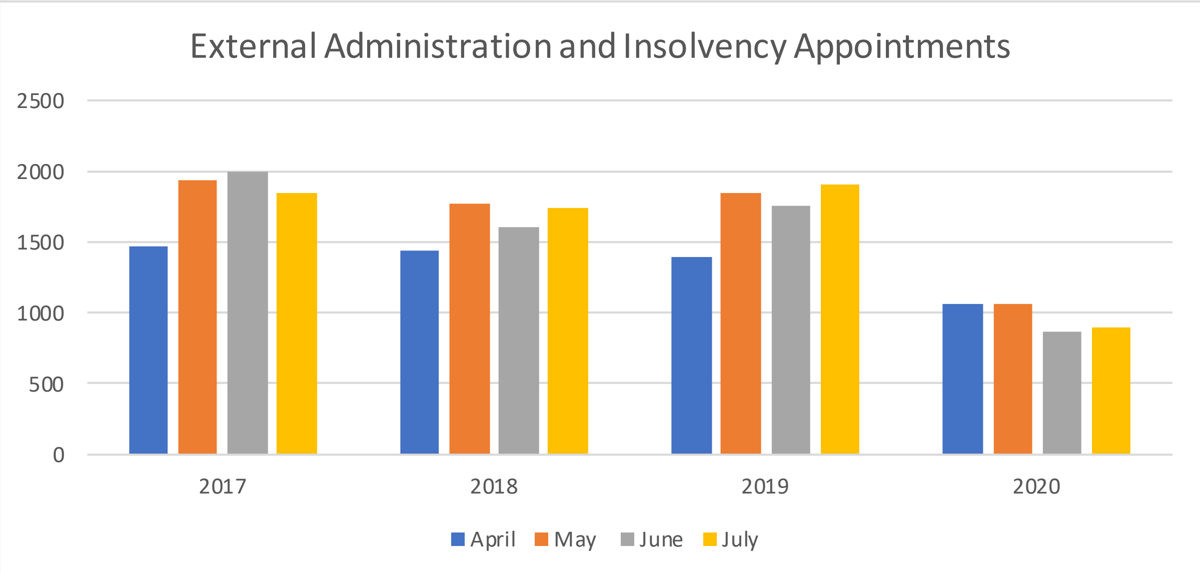
*"Most directors never have to consider the issues of insolvency or face the risk of insolvent trading. COVID 19 has changed all that.*

*Now every director needs to be aware of the potential risks to their organisations.*

*Directors need to be on high alert, ready to make decisions rapidly and they need to be informed. The next 12 months will take courage, vision and strong leadership. Sound information and advice will be critical for success."*

Robyn Erskine, Partner, Brooke Bird-Turnaround, Advisory and Insolvency Specialists and Director, CPA Australia

A time series of recent Australian insolvency statistics[1] for external administrations and insolvency appointments is shown below.




[1] All data was extracted from https://asic.gov.au/regulatory-resources/find-a-document/statistics/insolvency-statistics/

It is apparent that the incidence of external administrations and insolvency appointments for April-July 2020 is considerably less than the comparable months in 2017-2019. While potentially counterintuitive, this is due to two factors — the effect of the Federal Government stimulus and the temporary relief from insolvent trading provisions. It seems likely therefore that there will be a surge in financial distress and insolvency when these government measures end.

This briefing complements other CPA Australia resources[2] in this area and is aimed at members who are directors or advisers to boards who assist organisations in navigating these challenging times. Even where solvency is not an immediate concern, opportunities exist to document strategies for restructuring a business that will reasonably likely lead to a better outcome for business continuity and creditors when performance is poor.

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[2] An earlier board briefing (CPA Australia (2020): COVID-19 Key implications for boards) prepared by this Centre of Excellence discussed the "respond phase" in a crisis, in which an organisation deals with the immediate situation and manages continuity. Yet another briefing (CPA Australia (2020): COVID-19 Key risks arising from a pandemic) explores some key risks, including financial risk, arising from the pandemic that boards or advisers to boards should consider. Both briefings contain information relevant to responding to potential financial distress and some of the important matters are summarised below.

# KEY RISKS AND OPPORTUNITIES

Increased volatility, uncertainty and complexity ensuing from crises are normally a recipe for disaster. A shock of this scale risks creating major quantum shifts in the post pandemic economic and business landscape. So how can directors and executives ensure survival and potentially take advantage of opportunities as they appear? Some considerations may well include establishing or developing:

| Culture | Risk | Business Continuity | Opportunities | KPIs |
|---|---|---|---|---|
| A strong tone-from-the top and robust ethical culture | A comprehensive risk management framework, linked to scenario analysis and supported by a shared risk appetite | A strong crisis team to manage business continuity, identify shifts in customer preferences and the business landscape and facilitate innovation | Agility to leverage emerging opportunities such as artificial intelligence and robotic process automation | Dashboards and other metrics for keeping track of key performance indicators including financial indicators |

# INDICATORS OF FINANCIAL DISTRESS

Boards and their advisers must be alert to signs of financial distress during this time.

Given the impacts of this pandemic will significantly increase the risk of financial instability and insolvency across the economy, the Board and their advisers need to be acutely aware of the potential penalties of trading while insolvent and must be proactive and diligent in identifying and mitigating these risks.

## Indicators of Financial Distress

While some sectors are likely to be more much more vulnerable to the impact of the pandemic than others, all boards and their advisers must nevertheless be alert to the signs of financial distress during this time.

Indicators of financial stress include:

- A significant fall in turnover or profitability
- Impairment of distribution channels or operations
- Poor cashflow projections
- Deterioration of key liquidity ratios such as the working capital, liquidity and receivables turnover
- Worsening net assets position
- Breaches of debt covenants or debt service defaults
- Irrecoverable loans to related parties
- Inability to produce timely and accurate financial information
- Solicitors' letters, demands, summonses, judgements or warrants against the company
- Overdue commonwealth and state taxes
- Unpaid employee entitlements e.g. superannuation

## Dealing with Potential Financial Distress

The aim for the crisis team should be to preserve the business as a going concern that trades out of distress over the next six to twelve months.

Key actions include:

- Consult qualified and experienced turnaround and insolvency advisors early
- Developing a comprehensive crisis response plan including staff and customer safety
- Modelling alternative business scenarios with varying reductions in revenues and identification of possible cost mitigation strategies for each scenario
- Focussing on liquidity and cashflow as the first priority. Preparation of reliable, short term cashflow forecasts and regularly reviewing and updating them by considering risks and potential mitigations as they evolve
- Exploration of the potential for asset divestitures
- Renegotiation of debt facilities and covenants where possible
- Evaluation of the need for pre-emptive equity raising
- Staying in touch with key stakeholders and having an on-going communication plan to keep them informed

# INSOLVENT TRADING

Insolvent trading leaves a director open to civil penalties or criminal charges as well as personal liability to compensate for losses.

Section 95A of the Corporations Act 2001 (Cth) at subsection 1 states "A person is solvent if, and only if, the person is able to pay all the person's debts as and when they become due and payable." Hence determining solvency is a test of cashflow and often requires considerable judgment on a case-by-case basis. A resource prepared by CPA Australia provides an in-depth discussion of the meaning of insolvency.[3]

The Corporations Act requires a director of a company to cease incurring debt if:

- the company is already insolvent at the time the debt is incurred; or
- by incurring that debt, the company becomes insolvent, and, at the time of incurring the debt, there are reasonable grounds for suspecting that the company is already insolvent or would become insolvent by incurring the debt.

Insolvent trading laws in s 588G of the Corporations Act 2001 stipulate that a director of a company may be personally liable for debts incurred by the company if, at the time the debts were incurred, there were reasonable grounds to suspect that the company was either insolvent or would become insolvent by incurring the debt.

Insolvent trading leaves a director open to civil penalties or, if dishonesty is an issue, potential criminal charges as well as personal liability to compensate for losses occasioned to creditors.

Similar provisions[4] exist for charities and other entities regulated by the Australian Charities and Not-for-Profits Commission which impose a duty on responsible entities to "not allow the registered entity to operate while insolvent."

## Safe Harbour Protections

Safe harbour protections[5] provide that a director may not be liable for insolvent trading if:

- at a particular time after a person starts to suspect a company may become or already be insolvent, he or she starts developing one or more courses of action that are reasonably likely to lead to a better outcome for the company. S588GA (2) lists the steps that need to be followed; and
- the debt is incurred directly or indirectly in connection with that course of action and during a specified time period.

These provisions allow a company to restructure outside of a formal insolvency process and provide directors with an opportunity to remain in control of the company while attempting to resolve financial difficulties. There are strict legal requirements in relation to the Safe Harbour provisions and specialist advice is necessary.[6]

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[3] CPA Australia (2020): The meaning of insolvency. Guidance for public practitioners
[4] Australian Charities and Not-for-profits Commission Regulation (2013) s 45.25(2)(g)
[5] Corporations Act (2001) s 588GA
[6] Australian Restructuring, Insolvency & Turnaround Association: The Safest Harbour

## Recent Changes-Temporary Relief

The Corporations Act 2001 was amended[7] on 24 March 2020 via the Coronavirus Economic Response Package Omnibus Act 2020 (Cth) to implement a COVID 19 temporary safe harbour for directors from personal liability in relation to insolvent trading. The temporary safe harbour is designed to give directors the confidence to continue to trade through the COVID-19 crisis without pressure to enter their organisation into administration if there is a reasonable chance it might be insolvent.

Directors will be able rely on these temporary provisions in relation to a debt incurred by the company if:

- the debt is incurred after 25 March 2020 and is incurred in the 'ordinary course of the company's business';
- the debt is incurred during the six-month period (from the day the new law commences), or a longer period as prescribed by the regulations; and
- the debt is incurred before any appointment of an administrator or liquidator of the company during the temporary safe harbour application period.

Originally the COVID 19 Safe Harbour was to expire on 25 September 2020 however on 7 September 2020 the Australian Government announced that the temporary relief would be extended to 31 December 2020.

As circumstances may vary considerably, the new law is not prescriptive in terms of what debt incurred in the 'ordinary course of the company's business' may be considered eligible for the relief. A director will be deemed to have incurred a debt in the 'ordinary course of the company's business if it is necessary to enable the continuation of the business during the temporary safe harbor period. It is not clear if a company incurring debt as part of recapitalising would qualify for relief. Directors should exercise due care and diligence on a case by case basis to assess whether any debt incurred is necessary for the business to survive in the current crisis.

Any debts incurred by the company are still repayable by the company. Notwithstanding the potential relief from personal liability for insolvent trading, if the company is approaching insolvency, directors must also consider the interests of creditors. Accordingly, directors will need to exercise careful judgment in deciding whether their organisation should incur additional liabilities at a time when the ongoing solvency is in doubt.

## Word of Caution

Once the period for the temporary Safe Harbour period ends, directors will not have the protections available under these temporary measures. Therefore, to continue to trade a company that is insolvent should only be done where the directors believe the company will be able to be returned to a solvent position. Directors in this position should seek professional advice from a qualified insolvency and restructuring specialist in relation to what actions need to be put in place in order to be able to avail themselves of existing Safe Harbour Provisions as set out in Section 588GA.

Moreover, directors should also seek specialist advice from a qualified insolvency and restructuring professional to ascertain the alternatives available. Alternatives range from formal insolvency appointments such as Voluntary Administration, Deeds of Company Arrangement and Liquidation to informal arrangements.

When contemplating a voluntary administration, safe harbour or other restructure, directors should be aware of the illegal phoenix activities[8] which may give rise to significant penalties including fines and imprisonment.

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[7] Corporations Act (2001) s 588GAAA

[8] https://asic.gov.au/for-business/small-business/closing-a-small-business/illegal-phoenix-activity/

### Duties that continue to apply

Directors must continue to carefully oversee solvency and all existing Corporations Act duties will continue to apply, including that directors:

- act with care and diligence;
- act in good faith in the best interests of the company; and
- do not improperly use their position or information received for personal gain.

# FORMAL AND INFORMAL ARRANGEMENTS

Boards and their advisers may also have to consider formal and informal arrangements to try and ensure the long-term viability of their business. This table summarises a range of these arrangements:

| Level of Financial Distress | Potential Actions |
|---|---|
| Uncertain<br>– actions outlined above not entirely successful | • Negotiate informal arrangement with creditors<br>• Restructuring plan with safe harbour protection |
| Insolvent<br>– with some potential for all or part of business to be viable | • Voluntary administration with a deed of company arrangement<br>• Liquidation involving the sale of part of the business |
| Insolvent<br>– with no part of the business viable | • Liquidation |

Early intervention and engagement are critical to success in both formal and informal arrangements. Boards and advisors of distressed companies should consider concurrent planning of both formal and informal restructuring.

A more detailed discussion of the options for formal arrangements as well as the need for seeking expert advice in matters of corporate insolvency is outlined in a resource prepared for CPA Australia by the Australian Restructuring, Insolvency & Turnaround Association (ARITA).[9]

[9] Australian Restructuring, Insolvency & Turnaround Association (2020): Helping clients with companies in financial distress

# IPSO FACTO REGIME

An *ipso facto* clause is a contractual stipulation that allows one party to terminate or modify the contract upon the occurrence of an identified insolvency related event. A common example is an event of default under a loan contract triggered by a receiver being appointed is an *ipso facto* clause.

Following reforms [10] to the Corporations Act (Cth), a new *ipso facto* regime is now in effect in for a range of contracts dated on or after 1 July 2018. It stays the enforcement of *ipso facto* clauses that may be triggered on entry into certain restructuring and insolvency processes such as creditors' scheme of arrangement (including certain steps leading up to the scheme), a voluntary administration, or a receivership over all or substantially all of the assets of the company.

This regime is designed to restrict an insolvent company's counterparties' ability to terminate or modify contracts as a result of a company's entry into a specified insolvency or restructuring procedure. Hence, it aims to enhance the prospects of a company continuing to trade to facilitate recovery from an insolvency event.

Certain contracts, including a number of financing arrangements such as syndicated loans, are excluded from the new regime.

Most importantly given the legal complexities in this area it is strongly recommended that organisations seek their own individual legal advice in order to position themselves to take advantage of these *ipso facto* reforms should they experience financial distress.

[10] Treasury Laws Amendment (2017 Enterprise Incentives No. 2) Act 2017

# A NEW INSOLVENCY REGIME FOR SME's

Australian law does not currently distinguish the treatment of financial distress between different sizes of companies. On 24 September 2020, the Federal Treasurer announced the planned introduction of the Small Business Restructuring Arrangement and a Simplified Liquidation Pathway.

The Small Business Restructuring Arrangement will allow small companies owing less than $1million to creditors to trade their way out of insolvency and avoid being wound up.[11] Whilst the detail has yet to be provided, key features are expected to include:

- Shifting from a one-size-fits-all "creditor in possession" model to a less rigid "debtor in possession" model which will allow eligible small businesses to restructure their debts while retaining control of their business
- A rapid twenty business day period for the development of a restructuring plan in consultation with a Small Business Restructuring Professional followed by creditors to then vote on the plan within a further fifteen business days

For companies with less than $1million in debt, where a restructure is not viable a new, simplified liquidation pathway is to be introduced to allow a faster and cheaper liquidation process.

The new processes are expected to be available for small companies from 1 January 2021 subject to the passage of the legislation through Parliament.

[11] https://ministers.treasury.gov.au/sites/ministers.treasury.gov.au/files/2020-09/Insolvency-Reforms-fact-sheet.pdf

# CONCLUSION

Organisations often face crises but the scale and the global health, financial and operational impacts of COVID-19 are clearly likely to significantly increase the risk of financial instability and ultimately survival of many businesses.

A brief analysis of ASIC insolvency data suggests there may well be a surge in financial distress and formal arrangements when the current Government stimulus and temporary relief from insolvent trading provisions end.

Boards and their advisers should be aware of the indicators of potential financial distress, their duties regarding trading while insolvent, as well as the safe harbour provisions and the temporary relief available in relation to debt incurred while continuing to trade through the COVID-19 pandemic. They should also be aware of the relatively new ipso facto regime that potentially stays the enforcement of *ipso facto* clauses that may be triggered on entry into certain restructuring and insolvency processes and the opportunity to position themselves to be protected by these provisions. It should also be noted that from 1 January 2021, it is expected there will be new “debtor in possession” processes that will allow eligible small businesses to restructure their debts while retaining in control of their business.

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