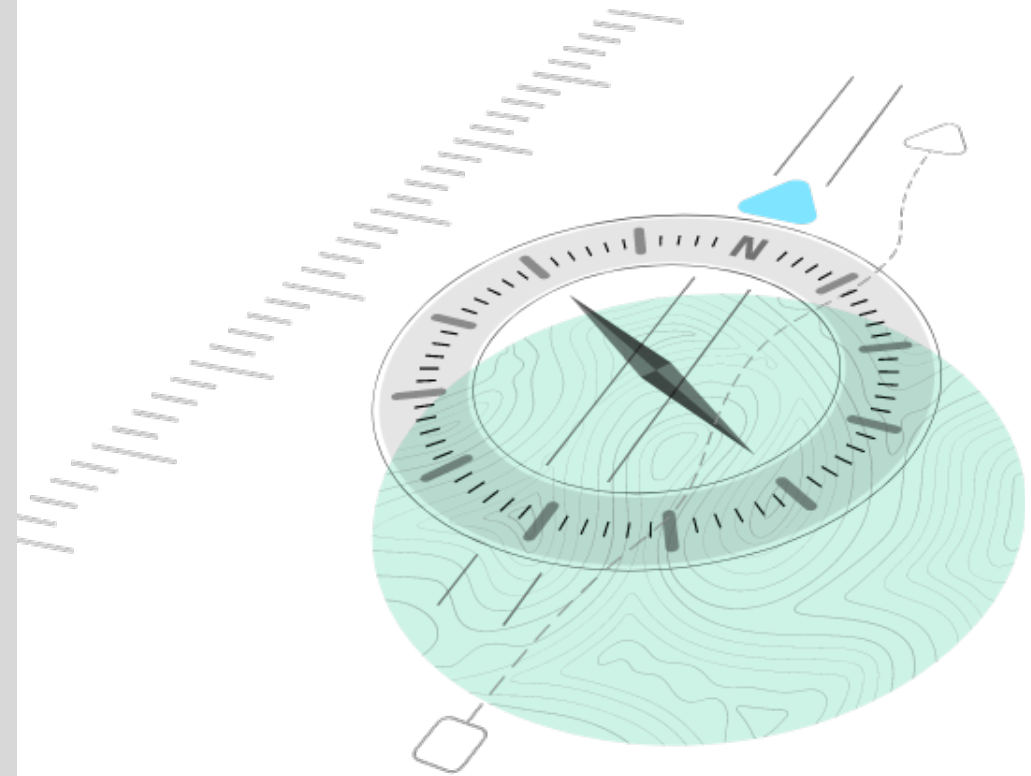


Advising Zombie Companies in 2023

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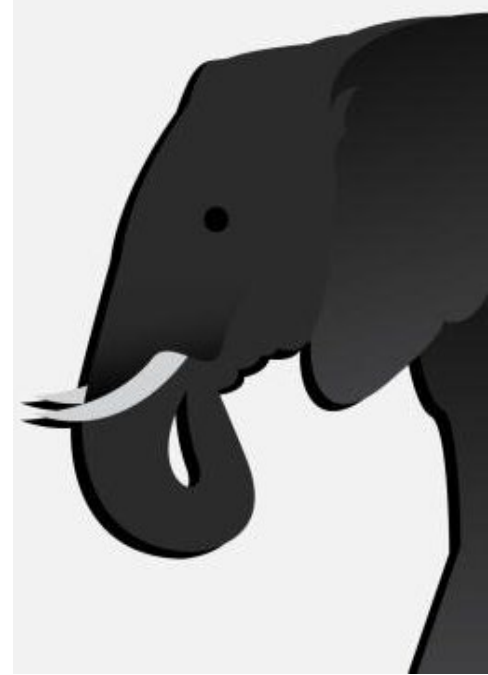
A Zombie company may not be insolvent

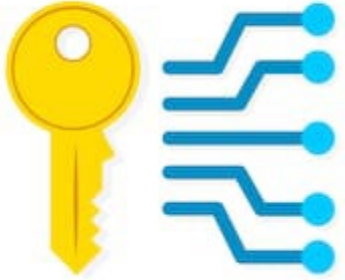


- Zombie company – doesn't make an economic profit, origin of term is from the Japanese asset bubble from 1990s (as well as the term “too big to fail”)
- There is a lot of Zombie companies in Australia now (my hypothesis)
- Voluntary administration and SBRP require actual insolvency to qualify
- Insolvency is not temporary illiquidity, but endemic shortage of working capital in a business

SME insolvency – what is the biggest informal process for company closure?

- ASIC strike offs 12: liquidations 1 – ratio shows hidden growth in abandoned companies versus external administrations (both solvent and insolvent)
- Deregistration by ASIC for non-payment of ASIC annual fees – backdoor way to close a company without paying for a liquidation process





What are the key options for restructuring distressed SMEs?

- Turnaround – cost cutting may be enough when not insolvent
- Rescue finance – may be linked to safe harbour if insolvency
- Informal workouts – may be linked to safe harbour if insolvency
- Pre-pack insolvency arrangements and liquidation (beware line with phoenix activity)
- Voluntary administration or small business restructuring

How does a company work out if it is insolvent?



- Cash-flow test – unable to pay its debts as and when they fall due and payable
- Accounting analysis – current ratio (current assets/current liabilities)
- If not insolvent, less onerous to undertake a solvent restructure
- General rule in insolvency law is if company is insolvent, any restructure transactions would be subject to review during a future liquidation



Typical Liquidation and Voluntary Administration (Source: Prof Jason Harris seminar)

- **Company size** (by employees): 78% of co had less than 20 employees; 62% had 5 or less
- **Asset levels** (at appointment): 78% had \$50k or less; 85% had \$100k or less (estimated assets)
- **Estimated liabilities:**
 - 38% owed \$250k or less
 - 62% owed less than \$250k to unsecured creditors
 - 20% of reports showed related parties were owed 50% or more of the debts
- **Estimated asset deficiency:** 62% had \$500k or less; 41% had \$250k or less
- **Books and records:** found in 82% of cases, and of those only 45% were adequate
- **Estimated returns:** 96% of reports was 11c or less, but in 92% it was 0c, and only 4% was between 0-11c
- **IP Remuneration:** in 10% of VA no remuneration; in liquidation that was 17% (and for liquidation 67% was \$50k or less)



What is the root cause of SME insolvency?

- Most writing about causes of SME insolvency are really symptoms: Poor controls, failure to keep records and inadequate cashflow
- What is the typical archetype in Australia? Males 45 - 55, worked in industry 20 years, overworked and rarely take vacations, construction industry
- Construction and transport industries – weak bargaining position, subcontracting relationships, low margins, large overheads and capital investment required
- Sensible responses to zombification: downsizing and expense reduction, terminating unprofitable customers, terminating unproductive staff, managing by objectives, focusing on profitable product and service lines (80/20 rule), terminate vanity marketing (2 recent clients have sponsored racing teams)

What is the size of the debt?



- Psychology of debt – Maynard Keynes “You owe the banks \$10,000 they own you, you owe the banks \$10m and you own them”
- SBRP – overall debts must be < \$1 million (total liabilities test)
- No minimum limits on voluntary administration or safe harbour from insolvent trading – but not cost effective for small businesses
- VA has become too expensive for most SME insolvencies



How angry are the creditors?

- Voting differences in formal restructuring options: SBRP easier than a VA
- Angry creditors can replace VAs but not SBRP appointee
- Pre-packs do not require a vote and the review process is slow through liquidator
- Landlords, trade unions and equipment financiers can be ornery (ornery means bad-tempered or difficult to deal with)

Are employee entitlements up-to-date?



- SBRP requires all employee entitlements to be paid up-to-date
- In the Corporations Act 2001 (Cth), after the liquidator is paid, employees are next in the order of priority for returns
- There is a statutory scheme (the Fair Entitlements Guarantee or ‘FEG’ Scheme) in Australia which may step in for a liquidated company and pay out employees, unless there is a successor company

Is action being pushed by suppliers?



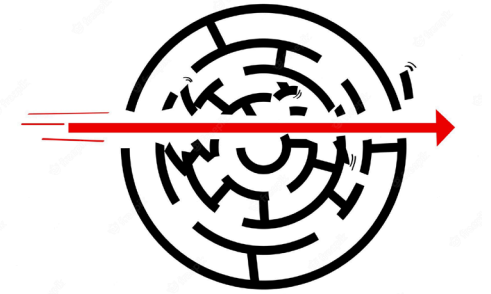
- **An SBRP might be the most seamless process.** For a small business, this process is quick, and directors remain in control (debtor-in-possession). A compromise may be able to be quickly worked out without a major break in trading.
- **Personal guarantees may come into play.** Suppliers have been burnt ones too many times and regularly obtain these from the directors of debtor companies. As generally unsecured creditors in any liquidation, their return is likely to be small, so they may be better off focusing on enforcing directors' personal guarantees.
- **Suppliers of goods may have PMSIs.** Sometimes suppliers will be secured creditors, and will register and perfect a particular type of security, a PMSI, through the Personal Property Securities register. This gives them a security that potentially extends to receivables and cash at bank. In practice, they often miss out because their interest can be difficult to trace.



How hard is it to finalise a compromise with creditors?

- **SBRP processes are relatively easy.** No instrument is required for registering creditor agreement, and vote is by majority by value only. As this framework has just started up, there is no rule of thumb about what creditors would accept.
- **Deed of Company Arrangements (DOCAs) are harder.** The DOCA — the ideal outcome of the voluntary administration — is a more formal process. It requires agreement from creditors by majority in value AND number, and requires an instrument to be implemented and overseen by a deed administrator.
- **Liquidation is no compromise**, with creditors receiving whatever miniscule amount they are entitled to *pari passu*.
- **Pre-packs do not require consent or compromise from anyone.** A pre-pack can be implemented without a single creditor agreeing. Though, as noted before, any pre-pack will be investigated by a voluntary administrator or liquidator with any uncommercial transactions being voidable.

Which process is the quickest?



- **Pre-packs can be very quick.** There is no need for creditor agreement slowing down the process. Note, however, that the subsequent liquidation of the original company could go on for a couple of years.
- **The SBRP process is quick.** It is to be completed within 20 business days plus voting period.
- **Voluntary administration can be quick.** It can be done within 25 business days plus time to draft and sign DOCA.

Which turnaround process gives the best return to creditors?



- **Practical issue – creditors don't get much from insolvency anywhere in the world.** Modern objectives aren't moral but economic – getting capital back to work and efficient asset allocation
- **Voluntary administration is most expensive.** High hourly VA fees chew up the asset pool before the (likely) eventual liquidation and dispersal or remaining assets to creditors
- **Liquidation is often better.** But it involves stopping business and a firesale.
- **The SBRP process is an unknown.** One potential issue will be the smaller creditors being forced into restructuring plans that are not to their benefit
- **Pre-pack is the worst for creditors.** A pre-pack is designed to empower the directors of the debtor company and enable them to continue the business without prior debt hanging over them. Generally, unsecured creditors are left in the dust because the liquidated company is deprived of assets.
- **Informal workouts/private treaties rarely occur.** It is extremely difficult to get agreement from creditors to a private treaty.



Capstone comment

- Lack of an accepted business turnaround profession in Australia means that directors often seek advice from the wrong people (such as phoenix operators)
- There is no restructuring option in Australia that both provides significant returns to creditors and also enables directors to smoothly turnaround an insolvent company
- The new SBRP process could be useful for these purposes, but will only be available for small businesses. If you have an insolvent client with less than \$1 million in debts it could be a cost effective option with a decent chance of success.