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BUSINESS RESCUE, RESTRUCTURING & INSOLVENCY

NEWSLETTER

CLIFFE DEKKER HOFMEYR

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DISPUTE RESOLUTION

IN THIS ISSUE

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As the first quarter of 2022 has already passed us by, one cannot help but reflect on the importance of timing, whilst hearing the introduction to the soap opera, Days of Our Lives, "*Like sands through the hourglass, so are the days of our lives*." While we all sat in anticipation for what we thought would be an inevitable exponential increase in company business rescues and restructurings at the start of the COVID-19 pandemic, we soon came to realise that the ostrich necking mentality amongst boards of directors was far stronger than we had first anticipated. While trying to avoid commenting on the short-sightedness of directors opting to rather risk their companies' existence, than let their reputation be ostensibly stained by placing it under business rescue, we must reiterate that time passes faster than we realise, and the continued future of a financially distressed company often hinges on whether relief interventions are timeously resorted to. While the health and social impacts of the pandemic may have seemingly come to pass, the economic impacts are guaranteed to remain for a long time to come. The risk to stakeholders and companies alike will only increase for as long as the management of companies ignore this reality. Before you know it, the sands of the hourglass will have flown right through; and both the company and its stakeholders will find themselves in a lose-lose outcome.

Our intention in highlighting this message is not to criticise boards' decision-making inertia, but instead to contribute to debunking the stigma attached to the business rescue process, in the effort to achieve better outcomes for all stakeholders. With South Africa's unemployment rate having reportedly reached the highest in the world, and liquidations on the rise, we believe that the economic landscape is quite blatantly communicating a need to readjust our approach towards the governance of companies, to one which is more sustainable in nature. This form of governance includes asking for the help that is on offer when it is needed. After all, the history books will look more favourably on those who were able to put their egos aside for a greater good for all, than those who ignored the writing on the wall to the detriment of all stakeholders.

Feeding into the above point, we recently had the privilege of attending the 2022 Deloitte Restructuring Survey results presentation and thought to unpack some of our key takeaways and observations. Notably, themes such as a lack of trust in the business rescue process, and the obstacles posed to the success of a business rescue by board of directors' psychological inability to let their companies go into the process, were very much at the forefront of the conversation.

What we find most interesting is that even after the events which shook the economic core of the entire globe over the last two years, the outdated perceptions of restructuring processes seem to have largely survived. From our discussions with other business rescue and restructuring professionals, there seems to be agreement that this can partly attributed to the media's glass-half-empty approach towards reporting on business rescues. It is understandable that the businesspeople would be suspicious of the business rescue process when media reports are, for example, more focussed on the number of jobs that were lost as opposed to those preserved due to a business rescue. In this regard, while many rescues do entail majority job losses, it must not be overlooked that in the context of our current unemployment rate the preservation of even just a minority of jobs is an admirable achievement in and of itself. One must also not forget the long-term vision which constitutes the method to the madness of business rescue; being that although a rescue may entail large scale job losses at first, its further purpose is to subsequently allow the company to fully get back on its feet and again start creating additional job opportunities in the future. It essentially boils down to the adage that 'things must sometimes get worse before they get better'. Once boards start reconciling themselves to this understanding, and ignoring the social stigmas imposed on business rescue by way of media reports and the like, we think we would be able to see a move towards the effective use of our restructuring mechanisms.

In an attempt to avoid flogging a dead horse, we want to comment on the likely imminent change in economic and business conditions which may place companies in the precarious financial position we originally thought COVID-19 would result in. To ameliorate and weather through the negative economic impacts of COVID-19, lenders and borrowers banded together by implementing many reasonable accommodations. As reported in the Deloitte Restructuring Survey results, we saw the reversal of 2020 credit impairment positions, Covid-light covenants, and greater accommodation by lenders and other financial stakeholders in extending tenor and repayment profiles. However, with the 'return to normal', precipitated by the soon total abandonment of the State of Disaster regulations, it seems likely that these accommodations will start to wane. Lenders and other financial stakeholders will consequently start taking a more discerning stance in extending and calling on credit lines.

In this context it is important that companies remain cognisant of the need to monitor indicators of financial distress, to ensure that they maintain sufficient liquidity to have a sufficient cash runway to be resilient in the face of adverse financial circumstances - such as a pandemic, or the consequences of geo-political tensions on inflation and supply chains. While it is self-evident as necessary to put sufficient safeguards in place well-prior to the company finding itself in a financially distressed position, the survey results highlighted the importance of companies further remaining alive to the need to take proactive steps to ensure a sufficient cash runway to allow for a successful rescue scenario even once the company has undergone financial distress.

Unsurprisingly, in the Deloitte Restructuring Survey results showed that companies remain inclined to still first (and exclusively) resort to their in-house advisors in the face of serious financial distress indicators.

While this may be a logical first step by default, the issue is that the financial runway necessary for a successful business rescue becomes shorter for as long as the company delays seeking external input. The need for steps to bake financial resilience into the company's trajectory is accordingly not limited to the time prior to the company finding itself in a financially distressed position. If anything, it then becomes more amplified. At a practical level, for example, the length of the financial and time runway given to a business rescue practitioner would be determinative of whether an acquisition, that is necessary for the successful rescue of the company, can be successfully implemented. From experience, we have learnt that these sorts of transactions require the fulfilment of various conditions precedent, such as regulatory approvals that are incapable of being expedited. Should the transaction not be given a enough time to obtain such approvals, it could result in it having to fall through and the company having to resort to an orderly wind-down. As another example, lenders would be far more inclined to extend emergency credit lines if the company is able to show an actual prospect of rescue and returns – which is only possible when a practitioner has been given enough time to devise a plan for the achievement of such prospect. So as we return to the new normal, with economic conditions not really showing any promise of getting better, we implore companies to bear these practicalities in mind when considering the courses of action during periods of financial instability in the future.

Lastly, we want to touch on a relatively novel concept of 'discussion covenants'. Although lenders may again start becoming more discerning in extending credit lines, it seems that the pandemic has still stimulated a newfound synergy and trust in lender-borrower relations. What we found very promising during the Deloitte Restructuring Survey results presentation is that lenders communicated that they are starting to include what they call 'discussion covenants' in their facility agreements. Essentially, to overcome information asymmetry between lenders and borrowers, and thereby facilitate a greater relationship of trust, lenders are asking borrowers to commit to periodical sit-down discussions regarding the company's current financial position and future trajectory in the context of their facilities with the lenders. We find this to be quite a brilliant innovation, as it will assist in these stakeholders working together in more effectively and timeously identifying financial distress indicators and taking the appropriate steps to address them. We can only hope that these sorts of discussions will in turn generate the sort of proactivity needed from companies and their financial stakeholders.

In this month's newsletter, in a two-part series, we join forces with our CDH Kenya colleagues to discuss what Kenyan and South African courts consider in deciding whether to grant liquidation applications or not.

Unfortunately, this will likely not be the last time we harp on about the need for expeditious action by financially distressed companies, but we do hope that the holistic views derived from the above discussed results may have driven the point a bit closer to home.

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To liquidate or not to liquidate: Kenyan and South African courts' views on liquidation applications (Part 1)

In addition to the Indian Ocean coastline, Kenya and South Africa also share similar insolvency law principles in relation to the liquidation of companies. In a two-part series of articles, we consider the two countries' courts' views in liquidation applications or, as Kenyan lawyers refer to them, "*liquidation petitions*". In short, there is evidence that Kenyan and South African courts are not so quick to grant liquidation petitions. This first article looks at the Kenyan position.

Kenyan courts have on numerous occasions held that liquidation amounts to a "*death warrant*" for a company. The Kenyan Insolvency Act of 2015 imposes an obligation on courts to keep in mind the objectives of the act when dealing with companies whose financial position is redeemable. The courts are obligated to supervise insolvency proceedings to enable a company to continue as a going concern so that it can ultimately meet its financial obligations to its creditors in full or, at least, to the satisfaction of those creditors.

This was the position taken by the Kenyan High Court in *Synergy Industrial Credit Limited v Multiple Hauliers (EA) Limited* [2020] eKLR. The court postponed the hearing of a liquidation petition for a period of 12 months on the grounds that even where the debt was admitted by the insolvent company, the court

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had to consider the views of all the insolvent company's creditors and the company's business prospects. The court did not limit itself to the arguments of the petitioning creditor and the insolvent company. The court did not grant or dismiss the liquidation petition – it postponed the liquidation petition so that other creditors could be heard.

While declining to dismiss the liquidation petition, the court held that it was in the best interests of the whole body of creditors for the hearing of the liquidation petition to be postponed. The court stressed the importance of considering the best interests of the insolvent company and the whole body of creditors. It held that this would give creditors time to consider restructuring proposals and explore the possibility of reviving the insolvent company.

The court noted that the insolvent company was a large employer performing large contracts within East Africa and its collapse would affect more than just the creditors. On this basis, the court postponed the hearing of the liquidation petition for 12 months to allow for the formulation of a comprehensive restructuring plan for the turnaround of the insolvent company's business and payment of its secured and unsecured creditors.

This judgment clearly demonstrates that Kenyan courts are cognisant of the importance of protecting insolvent companies attempting to recover and make a complete financial turnaround. Kenyan courts will not be quick to grant a liquidation petition where there is a chance that an insolvent company can recover. This does not, at all, mean that the tide of the Indian Ocean will always turn in favour of insolvent companies in liquidation applications – a court will consider each case on its own merits.

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