

When Should A Business Be Placed In Business Rescue?

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Introduction

There seems to be an ill-conceived belief that placing a business in business rescue should be delayed for as long as possible. Some quarters may believe that you should never use business rescue as it will result in the business losing customers and supplier support. The 2022 Deloitte South Africa Restructuring Industry Survey indicated that early identification of financial distress and pre-assessment before business rescue is crucial to improving local restructuring. The impact of delaying a turnaround or restructuring has been a part of a recently published Ph.D. and has far-reaching consequences.

What is “Financially distressed”?

Accountants are very familiar with the tests for solvency and a going concern. Still, many accountants are not aware of the test of “financially distressed” as defined in S128(1)(f) of the Companies Act of 2008 (as amended).

- f) “financially distressed”, in reference to a particular company at any particular time, means that—
 - i) it appears to be reasonably unlikely that the company will be able to pay all of its debts as they fall due and payable within the immediately ensuing six months; or
 - ii) it appears to be reasonably likely that the company will become insolvent within the immediately ensuing six months;

In other words, the company may be solvent, but will it be liquid for the next six months? As most companies in South Africa are thinly capitalised, they may be financially distressed in terms of the provisions of the Companies Act, as the directors live in hope from month to month that things will go better next month. Trading under financially distressed conditions may result in the directors trading recklessly, as contemplated in Section 22. The directors may be personally liable for the losses suffered by third parties in Section 218(2). Delaying the implementation of a turnaround or restructuring, with or without the protection of Chapter 6 of the Act, may have serious legal implications for the directors.

Measuring financial distress

How does one go about measuring “financially distressed”? While there are many indicators that the business is financially distressed or heading in that direction, the quickest and most objective way to measure whether the business is financially distressed is to critically review the cash flow forecast for the next 12 months. This review should not be viewed through rose-coloured glasses but rather based on what is conservatively seen as most likely to occur in the immediate future.

However, most cash flow forecasts are spreadsheet-based. Many studies have shown a high risk of errors in these spreadsheet-based forecasts, such as not normalising the data used, personal bias, and errors in the formulas and calculations, which may result in the directors underestimating the actual severity of the situation.

In a recently published Ph.D. study at the University of Pretoria, the author developed a mathematical model called the Variable Finance Capacity Model (VFC®), enabling a clearer picture of funding requirements when dealing with a turnaround.

Figure 1 shows a solid black line displaying the financial and time consequences based on the assumptions of a proposed turnaround plan. This curve shows that approximately R 2,5 million will be required in period three and that the turnaround duration will last for 6,5 periods. The purple dash line (boundary 1) measures the

impact of a delay of one period in the implementation. It shows that the requirements have changed by approximately R 4,3 million required in period four, and the turnaround duration will last 8,5 periods. It becomes clear that a delay by a single period exacerbates the financial requirements and lengthens the duration. If the delay has been extended to six periods, the requirement to implement the turnaround has grown to R 11,7 million and will take 16,5 periods to complete. This funding requirement must not be confused with working capital requirements or other capital costs -the funding required to fund the losses until the turnaround has been implemented.

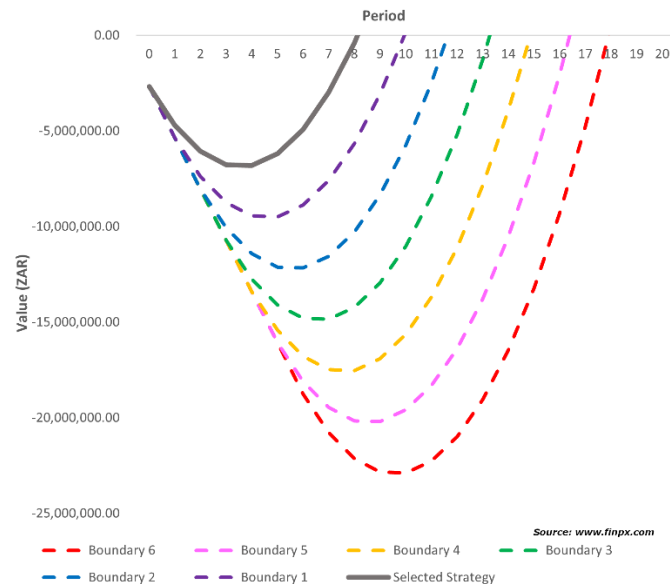


Figure 1: VFC® model showing the impact on the financial and time consequences of delays in the implementation of the turnaround or restructuring plan (Gribnitz,2022)

Each period (usually measured in months) of delay in placing the business in business rescue pushes the break-even point out. Still, and more importantly, the business will require increasingly more funding to implement the rescue.

Options for financially distressed businesses

In most cases, where the company's directors are closely involved in the day-to-day running, they will be acutely aware that the business is struggling to meet its payment obligations. They may be making ad hoc and emergency plans to continue trading.

They are undertaking these actions, fully aware that they are incurring debt with suppliers and funders while there is a substantial risk that the debt cannot be repaid. As discussed, there are potential personal legal consequences for the directors who may be held personally liable for conducting the company's affairs in this manner, so what should the directors do?

The directors should obtain professional advice from their accountants and or lawyers and have several options available to them while also being bound by a number of obligations:

- they should immediately perform a test if the company is able to pay its debts in the next six months and take the necessary corrective actions to ensure that the company is able to do so.; or
- upon recognising that the business is financially distressed, the directors may pass a resolution to commence with business rescue in terms of S129(1); or
- If they fail to take either of the above two actions, then in terms of S129(7), the board must inform all affected parties and CIPC why they have not resolved to commence with business rescue, that is, they must inform the parties of their continued reckless trading.

There is also the possibility that an affected person may apply to the court in terms of S131(1) to commence business rescue proceedings and place the company under supervision. Such action is a clear indication that the directors did not take the necessary steps to as prescribed in the Act, which may result in the directors being held liable.

If the directors should pass the resolution to place the business in business rescue, where they will have control over the appointment of a competent business rescue practitioner rather than the court appointing the business rescue practitioner through the S131(2) process.

Why do so many businesses delay the decision?

While the provisions of the Act are clear, it fails to recognise the difficult decision that the directors and owners of a business face is when to stop the "hope tomorrow will be a better day game." Commencing business rescue is a daunting option as it requires handing over total control to a third party, being the business rescue practitioner. The best chance that the directors have to save the business is to appoint a competent business rescue practitioner. Delaying the decision to take the right actions has, among other things, the following consequences:

- the probability of funding the turnaround becomes increasingly smaller with every day that passes; and
- the ability to appoint a competent practitioner reduces as the third parties may bring an application for business rescue or even a liquidation application.

Delaying the commencement of business rescue is a mistake, as the longer one waits to take the decision, the more difficult it becomes to rescue the business. Delays may result in the business rescue practitioner concluding that the business cannot be rescued and must be liquidated instead.

According to a 2022 Companies and Intellectual Property Commission (CIPC) report, 4 370 companies entered business rescue between 2011 and June 2022, with 19% reaching substantial implementation of the business rescue plans. However, 546 ended up in liquidation.

The sooner, the better

If placed in business rescue early enough, the company can be rescued and returned to the shareholders and directors within a relatively short period (3 to 6 months).

Most business rescues require some form of restructuring of the balance sheet of the business, which may include a capital injection or raising of post-commencement funding. Here the *VFC* model can play an essential role in indicating the quantum of finance required and the timing to affect the turnaround. It can be of great assistance in convincing investors or funders that it is worth their while to invest in the business or to fund the business rescue.

Conclusion

The South African economy had only started to recover from the negative effects of Covid-19 and the resultant disruptions to the global supply chains when the war in Ukraine started. Furthermore, with the present specter of global inflation, it is essential that businesses facing financial distress take the necessary actions sooner rather than later. Don't wait to get help.

References

KJ Gribnitz (2022). *Proposing the variable finance capacity model for fundamental moments in turnaround*. The University of Pretoria.