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The Companies Act
When is a company financially distressed, and what does it mean?

Chapter 6 of the Companies Act, 2008 (the Act) deals with business rescue. Business rescue is largely self-administered by the company, under independent supervision within constraints set out by the Act, and subject to court intervention, at any time, on application by any of the stakeholders.

For purposes of business rescue, it is important to understand the meaning of "financial distress", as the requirements of Chapter 6 of the Act are triggered as soon as a company is in financial distress. Where a company is in financial distress, and the company failed to either adopt a resolution to go into business rescue, or provide written notice to shareholders, employees and creditors that it decided not to adopt business rescue, a reportable irregularity exists.

Financial distress

The Companies Act defines "financially distressed", to mean that it appears to be:

i. 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. reasonably likely that the company will become insolvent within the immediately ensuing six months.

The first part of the test seems clear. A company will be in distress if there is a reasonable likelihood that the company may reach a position within the next six months where it will no longer be able to pay its debt as it becomes due and payable. "Reasonable likelihood" implies that there must be a rational basis for the conclusion that the company may not be able to pay its debt within the next six months. This conclusion amounts to an educated prediction, based on the current financial position of the company, and considering the all relevant factors that may impact the company's liquidity in the foreseeable future.

The second part of the financial distress query deals with insolvency, and here the question often arises as to whether this refers to factual (technical) insolvency or commercial insolvency. There are conflicting views. Some say that because part (i) clearly deals with commercial insolvency, part (ii) must deal with factual insolvency (i.e. a balance sheet test). In terms of this approach, a company is regarded as technically insolvent (and thus financially distressed) if the liabilities of the company exceed the assets. This approach does not take into account subordination agreements, or any other management action. Others say that one must consider the definition in conjunction with the definition of business rescue and the objectives of the Act pertaining to business rescue.

When interpreting these particular provisions one needs to consider the purpose of the Act in this regard i.e. to provide for the efficient rescue and recovery of financially distressed companies, in a manner that balances the rights and interests of all relevant stakeholders. In turn, "rescuing the company" means achieving the goals set out in the definition of "business rescue". Business rescue means proceedings to facilitate the rehabilitation of a company that is financially distressed by providing for:

- The temporary supervision of the company, and of the management of its affairs, business and property;
- A temporary moratorium on the rights of claimants against the company or in respect of property in its possession; and
- The development and implementation, if approved, of a plan to rescue the company by restructuring its affairs, business, property, debt and other liabilities, and equity in a manner that maximizes the likelihood of the company continuing in existence on a solvent basis or, if it is not possible for the company to so continue in existence, results in a better return for the company's creditors or shareholders than would result from the immediate liquidation of the company.

It should be clear from the above that business rescue is meant to be employed only where a company needs 'rehabilitation', and where there is a need to 'rescue' the company. If the purpose of the Act and the purpose of business rescue are considered, it seems unlikely that a company that is factually insolvent, but still able to service its debt, can be regarded as financially distressed.

It is our view (shared informally by the Companies and Intellectual Property Commission, a number of the other Big 4 professional services firms, as well as some prominent law firms) that for purposes of part (ii) of the financial distress test one should consider the complete financial position of the company rather than merely technical insolvency. We belief that, in order to adhere to the purpose of the Act, and in light of the definition of business rescue, one must consider the complete financial position of the company when determining whether there is a "reasonable" likelihood that the company will be insolvent within six months. In terms of this approach a company will only be regarded as in “financial distress” where it is insolvent even after all other circumstances were considered, including any other valuations of the assets and liabilities, reasonably foreseeable assets and liabilities per the solvency and liquidity test in section 4 as well as any other proposed measures taken by management such as subordination agreements, recapitalisation, or letters of support, etc. This approach was confirmed in a recent Supreme Court decision in the UK where the court found that the "balance sheet" test for insolvency must take account of wider the commercial context, and that courts must look beyond the assets and liabilities used to prepare a company's statutory accounts when deciding whether or not a company is balance sheet insolvent.

By employing the narrower definition of “financial distress” (i.e. a balance sheet test for solvency which excludes subordination agreements and other management action) one arrives at an answer that may not serve the best interests of affected parties (shareholders, creditors and employees). There is very little point in writing to affected parties, informing them that the company is financially distressed when it is in fact perfectly able to continue to do business. This approach does not support the purpose of the Act, and may have a detrimental effect on both the company and its stakeholders.

Financial distress requires action

Where a company is in financial distress, the Act determines as follows:

> 129. Company resolution to begin business rescue proceedings.—(1) … the board of a company may resolve that the company voluntarily begin business rescue proceedings and place the company under supervision, if the board has reasonable grounds to believe that—
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> a) the company is financially distressed; and
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> b) there appears to be a reasonable prospect of rescuing the company.
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> (7) If the board of a company has reasonable grounds to believe that the company is financially distressed, but the board has not adopted a resolution contemplated in this section, the board must deliver a written notice to each affected person …. and its reasons for not adopting a resolution contemplated in this section.

Reportable irregularity

If a company is financially distressed, but the directors have taken no further action as required in section 129 of the Act, then a reportable irregularity exists. Non-compliance with this requirement may cause financial loss to many parties, including shareholders, employees and creditors. Furthermore, it may point to a material breach of fiduciary duty, since the directors have a responsibility to deal with the company openly and in good faith.

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