WEBINAR SERIES:

2021 - INSOLVENCY, RESTRUCTURING & RECOVERY - A LEGAL, ACCOUNTING AND PRACTICAL OVERVIEW

WEBINAR 1 - FINANCIAL DISTRESS: IDENTIFICATION, LIABILITIES AND RELIEF

17 MARCH 2021

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WHAT IS FINANCIAL DISTRESS?

"Financial distress is a condition in which
a company cannot generate sufficient revenues or income,
making it unable to meet its financial obligations."

Is financial distress a sign of potential bankruptcy?

or

Is it a sign for companies to restructure
and re-innovate business and financials?

IDENTIFICATION OF FINANCIAL DISTRESS

Early Indicators of Distress

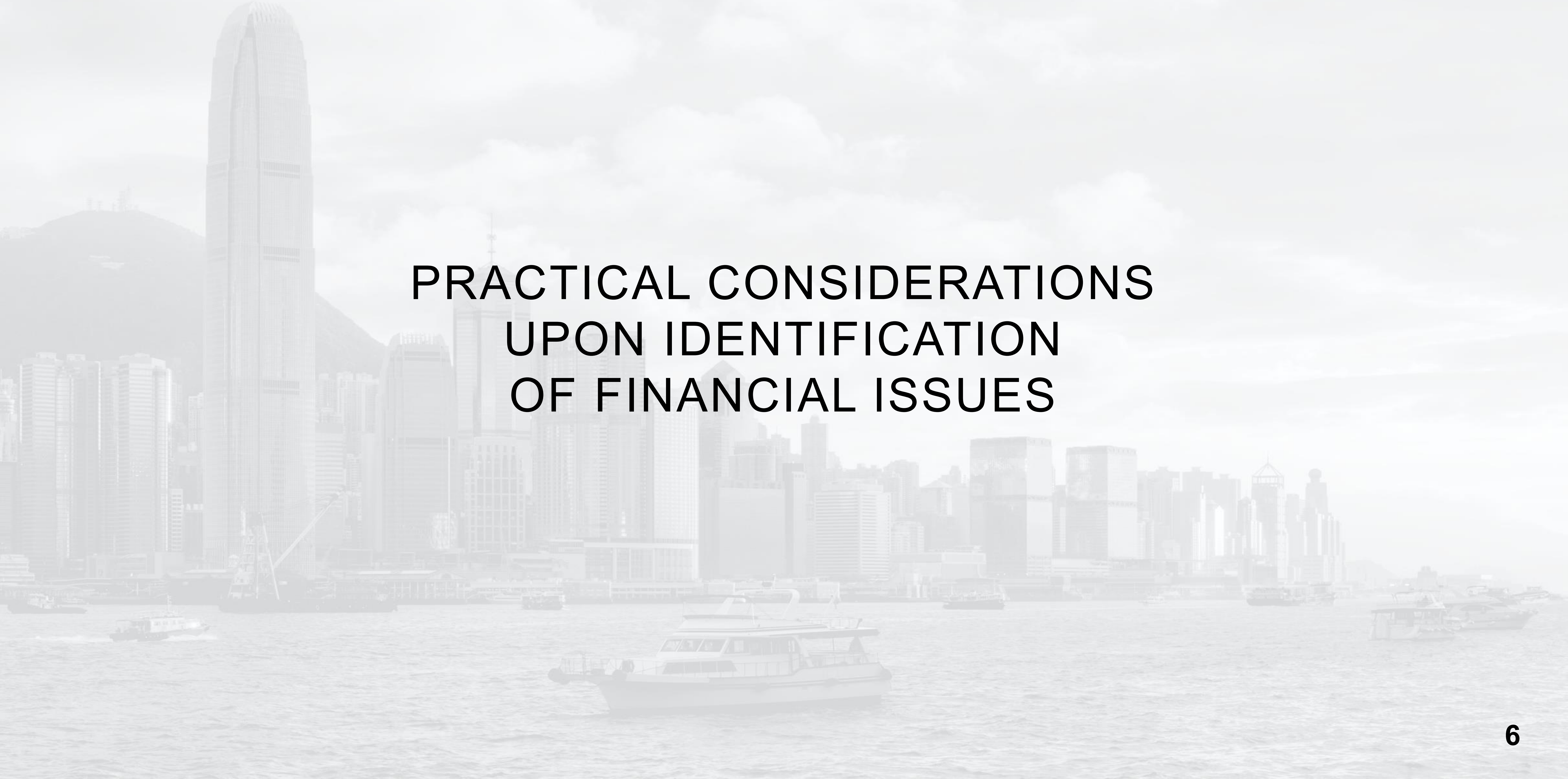
- Shrinking business and industry growth
- Declining profitability and cash flow
- Aging account receivables and suppliers obstructing business
- Adverse regulatory environment
- Management turnover
- Breach of debt covenants or downgrade in debt rating
- Inability to raise funding
- Auditors unwilling to sign on accounts / change of auditor

Potential Impacts on Daily Operations

- Operational Impact
  - Suppliers seek advance deposits or cash on delivery
  - Decline in production levels because purchasing cycle has been disrupted
  - Confused business strategy due to lack of senior management
  - Retrenchment of staff

- Financial Impact
  - Negative cash flows and increase in working capital cycles
  - Short term debt (e.g., bank overdrafts) used to fund interest or debt repayments
  - Freeze on CapEx plans
  - Breach of covenants potentially trigger cross default on loans

- Regulatory Impact
  - Regulatory enquiries due to employees' grievances or layoff
  - Disclosures to stock exchanges/shareholders/strategic investors
  - Corporate governance issues may arise



PRACTICAL CONSIDERATIONS UPON IDENTIFICATION OF FINANCIAL ISSUES

Working Capital Management – 13-week cashflow forecast

ABC Ltd – Short-term cash flow forecast

Week ending	12-Mar	19-Mar	26-Mar	2-Apr	9-Apr	16-Apr	23-Apr	30-Apr	7-May	14-May	21-May	28-May	4-Jun	Total
Cash inflows														
Debtor Receipts	2,000	1,600	2,000	2,000	1,600	2,000	2,000	2,000	2,000	2,000	1,600	2,000	2,000	24,800
Bulk Payments	250			500						300				1,050
Overpayment Refund		(750)												(750)
Vehicle Sales Proceeds	145			1,250	1,072				1,429			1,100		4,996
Sales Tax Refund									279					279
	2,395	850	2,000	3,750	2,672	2,000	2,000	2,000	3,708	2,300	1,600	3,100	2,000	30,375
Cash Outflows														
Vehicle Settlements		1,197	1,026				1,368	1,197				1,026	1,197	7,011
Trade Credits and Accrued Invoices	821	455	813	441	635	653	355	345	785	554	633	721	522	7,733
Commission Creditors	100	513	100	547	100	507	100	534	100	507	100	534	100	3,842
Rent	29							384						413
Fleet Insurance	91			95				95				95		376
Credit Repair Payments	749	343	751	978	863	625	625	625	625	610	560	550	640	8,544
HP Repayments and Contract Hire	403	358	637	875	794	593	601	854	933	566	446	521	665	8,246
HP 10% Deposits	197	131	131	131	393	131	131	131	393	131	131	131	393	2,555
Salaries	938				953				953				953	3,797
Payroll Taxes				537				546				546		1,629
Pensions				52				54				54		160
Sales Tax Payments	761				263					460				1,484
Other	65	65	65	81	124	65	65	121	65	65	65	96	65	1,007
Interest on Loans	72	68	4		347	72		81			94	114		852
	4,226	3,130	3,527	3,737	4,472	2,646	3,245	4,967	3,854	2,893	2,029	4,388	4,535	47,649
Net Cash Flow	(1,831)	(2,280)	(1,527)	13	(1,800)	(646)	(1,245)	(2,967)	(146)	(593)	(429)	(1,288)	(2,535)	(17,274)
Opening Cash	7,386	5,555	3,275	1,748	1,761	(39)	(685)	(1,930)	(4,897)	(5,043)	(5,636)	(6,065)	(7,353)	7,386
Closing Cash	5,555	3,275	1,748	1,761	(39)	(685)	(1,930)	(4,897)	(5,043)	(5,636)	(6,065)	(7,353)	(9,888)	(9,888)

Example Initiatives:

Accelerate with discount?

Net off against receivable?

Deferral?

Reduce monthly advance?

Payment holiday?

Deferral?

Deferral/offset receivable?

Payment holiday?

Working Capital Management

Operational

- Improving the speed of collections
- Cutting payroll (i.e. reducing headcount)
- Delaying supplier payments
- Liquidating inventory
- Selling assets

Financial

- Seek additional funding sources
- Negotiate with creditors
- Delay debt related payments

Strategic

- Attempt a turnaround out of court
- M&A: Seek a buyer or strategic investor
- File for bankruptcy

Negotiation With Key Stakeholders (Start Communications Early)

1. Who are the key stakeholders and what are their attitudes like?

2. How much time do you have?
   - Any key dates or milestones imposed by stakeholders?
   - Any cash shortages? Is new money required?
   - Is there chaos and crisis, or business as usual?
   - What bargaining power does each stakeholder have?
   - What are their BATNAs?

3. Can you prioritize keeping your stakeholders informed to avoid miscommunication?

4. Can you prioritize keeping your management team/wider employees informed as well?

Cost Cutting Measures

Loss making Operations and Business

- Segregate business divisions by revenue and profit contribution
- Identify and evaluate performance on key financial metrics (e.g., return on capital, return on assets)
- Is the business productive for future growth or is it underperforming and impacting value?
- Can these assets add value to new owners?
- Prioritize the hires of turnaround consultants and restructuring advisors to lead the process
- Consider a win-win situation to cut losses, improve valuation and generate cash through a strategic sale

Selling underperforming assets is better than allowing those assets to be unproductive

Legal Considerations for Laying Off Staff

Termination notice or payment in lieu

- within probationary period:
  - *first month*: without notice
  - *thereafter*: 7-days notice
- after probationary period:
  - depends on contract, but not less than 7 days
  - if not specified in contract, not less than one month notice
- terminate without notice:
  - need to pay for the wages that would have accrued during notice period
  - calculation: the daily average or monthly average of the employee in the preceding 12 months before the date of notification
  - “wages” include sums payable for maternity, holiday or annual leave, statutory benefits etc.

Legal Considerations for Laying Off Staff

Termination payments

- outstanding salaries and benefits that has accrued
- severance payment (where employee under continuous contract of employment > 24 months):
  - *maximum*: not exceeding the lesser of (I) the total amount of wages earned during the period of 12 months immediately preceding the date of dismissal; and (II) HK$390,000
  - *calculation*: year of employment x (the lesser of (I) two-thirds of the last full month's wage; and (II) HK$15,000 (being two-thirds of a month's wage of HK$22,500))
- severance payment reduced by amount of gratuity or MPF payments in years of services when severance payment is payable

Legal Considerations for Laying Off Staff

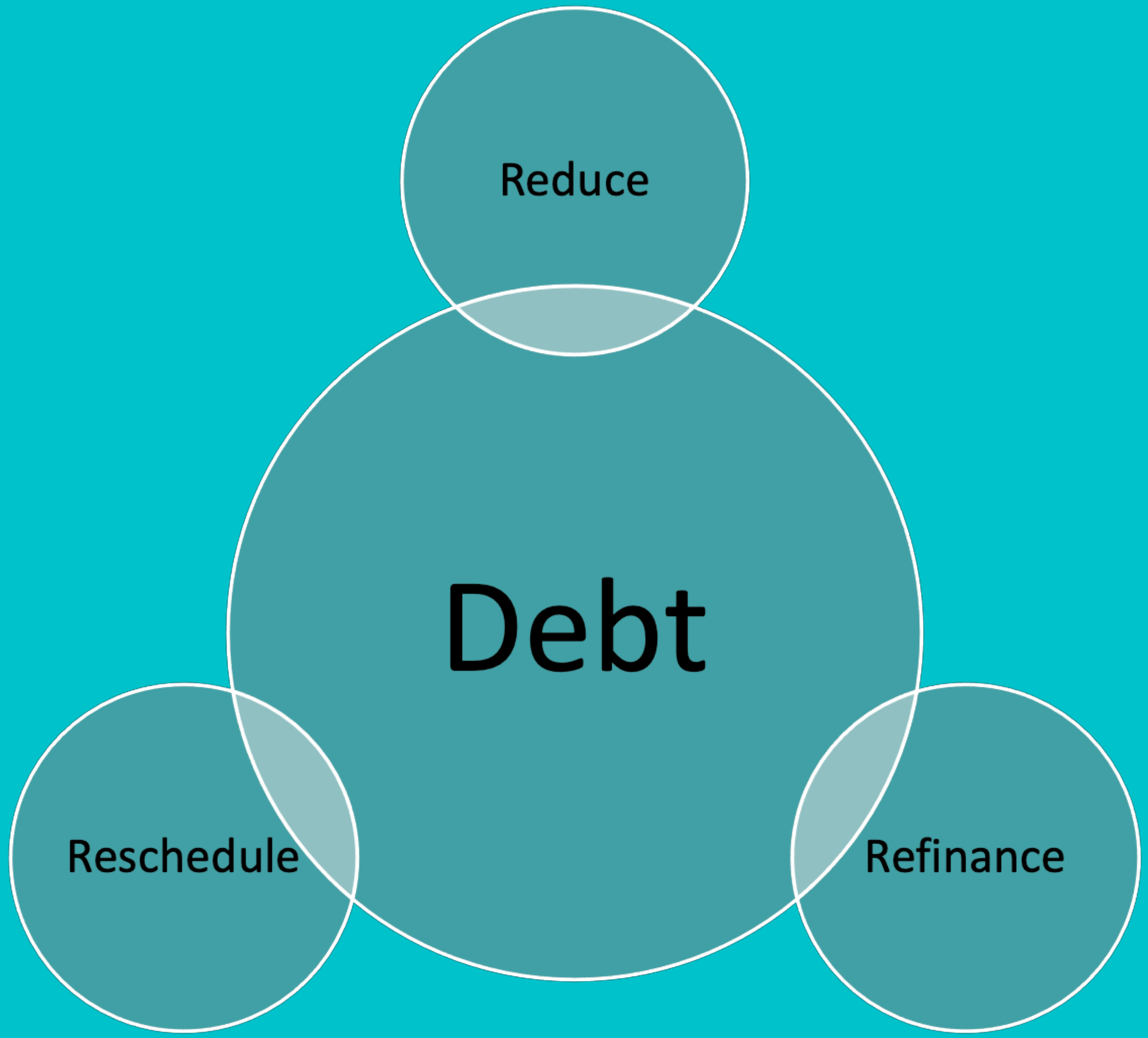
Selection criteria of staff to be dismissed

- *“last-hired-first-fired” rule* – objective but without consideration of skill set/ merits
- *merit-based selection criteria* – based on performance, but can be subjective
- *skills-based selection criteria* - based on required skill-set of employees, possibly objective
- *other factors* – loyalty, customer relationship, consistent with strategy
- key for any criteria – fair, non-discriminatory, properly managed

CASH-FLOW INFUSION

Options for Reducing the Debt Burden

- Principal and interest payment holidays
- Margin reduction
- Term extensions
- Payment profile alterations



- Replace current debt with alternative debt facilities with the existing providers or a new lender
- Change of terms
- Consider syndications

Non-Core Asset Sale/Potential Factoring of Receivables

Review Business Plan

- Identify growth business and segregate non-core assets
- Examples of non-core assets - real estate, investments in subsidiaries, financial investments, etc.
- Including non-core assets in core business might impact business valuation and equity funding
- Exit strategy based on liquidity requirements of business, marketability of non-core assets and proposed restructuring plan

Factoring of Receivables

- Utilize upfront cash to pay suppliers for assured supply or available discounts
- Especially beneficial on government contracts
- Reduce collection costs and overheads
- Factoring may be expensive but avoids negative working capital cycles

Equity Financing to Raise Capital

‘Funding is available for companies with a turnaround story’

New Equity (Issuing new equity shares in exchange for cash, even at a discount)

- Corrects capital structure but dilutes existing shareholders
- Ensures sufficient cushion in authorized capital available
- Option is preference shares – via sponsors, no dilution of existing shareholders

Private Placement (A single cornerstone investor – financial or strategic)

- Private equity – may increase balance sheet leverage if funded through an LBO
- Strategic investor – operating synergies but subject to takeover or anti-monopoly laws

Right Issue (New shares to existing shareholders in ratio of current shareholding)

- New shares issued at a discount
- Existing investors need to believe in equity story or share price may fall further if issue fails

Mandatory Convertibles (Hybrid instrument of debt with equity conversion at end of tenor)

- No immediate dilution of equity and lower interest rate than regular debt
- Ensures management control and maintains leverage as may be treated as equity

Legal issues and liabilities of directors

Fiduciary and common law duties

I. Common law

II. Statutory provisions
- Companies Ordinance (Cap. 62 of the Laws of Hong Kong)
- Companies (Winding Up and Miscellaneous Provisions) (Cap. 32 of the Laws of Hong Kong) ("**CWUMPO**")

III. Non-statutory guidelines
- *Guide on Directors' Duties* published by the Hong Kong Companies Registry
- *Guidelines for Directors* and *Guide for independent Non-executive Directors* published by the Hong Kong Institute of Directors

IV. Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited
- *Applicable to listed issuers (a standard at least commensurate with standards established by Hong Kong law)*

I. Fiduciary duty

Directors, acting collectively as a board, are agents of the company. As agents of the company, directors stand in a *fiduciary relationship* to the company which requires them to act honestly, in good faith and in the best interests of the company as a whole.

Re Smith and Fawcett Limited [1942] 1 All ER 542.

II. Duty of care, skill and diligence

In discharging duties owed to the company, a director must exercise reasonable *care and diligence* and exhibit a degree of *skill* which may reasonably be expected from a person of his knowledge and experience.

In Re City Equitable Fire Insurance Co Ltd [1925] Ch 407 at 427, CA.

Fiduciary duties

Duty to act in good faith *bona fide* in the interests of the company

- the duty is a subjective one, and except in exception circumstances, the court will not typically second-guess exercise of directors powers

- when company is in distress and insolvency is a realistic outcome/ financial troubles not fixable, shareholders interest would no longer be paramount and <u>interests of creditors "as a whole" should be considered prior to shareholders</u>

- real risk of insolvency means:
  - cash flow test (inability to pay debts)
  - balance sheet test (liabilities > realizable profits)

- Interests of creditors "as a whole" means no preference is given to any or any particular class of creditors

Kinsela v Russell Kinsela (1986) 4 ACLC 215, Street CJ at 730A-C states:

"where a company is insolvent, the interests of the creditors intrude. They become prospectively entitled, through the mechanism of liquidation, to displace the power of the shareholders and directors to deal with the company's assets. It is in a practical sense their assets and not the shareholders' assets that, through the medium of the company, are under the management of the directors pending either liquidation, return to solvency, or the imposition of some alternative administration." [emphasis added]

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Fiduciary duties

Duty to exercise powers only for proper corporate purposes

- not for collateral or ulterior purposes, or cause substantial detriment to the company

Duty to avoid actual or possible conflicts between duty to company and personal interests

- common law test: whether a reasonable person looking at the facts would think that there was a real sensible possibility of conflict
- mitigate risk by proper disclosure of conflict

Duty not to make secret profits

Directors’ duty of care

Duty of care, skill and diligence to the company

- prior to 2008, “*to be measured by the care an ordinary man might be expected to take in the circumstances on his own behalf*”

- section 465 of the Companies Ordinance:

  “(1) A director of a company must exercise reasonable care, skill and diligence.

  (2) Reasonable care, skill and diligence mean the care, skill and diligence that would be exercised by a reasonably diligent person with –

  (a) the general knowledge, skill and experience that may reasonably be expected of a person carrying out the functions carried out by the director in relation to the company; and

  (b) the general knowledge, skill and experience that the director has.”

- Director cannot rely on inexperience, inadequacies or ignorance

Statutory provisions applicable to company with prospects of being wound up

Unfair preference (section 266 of CWUMPO)

- starting point: creditors to be entitled to *pari passu* (equal) distribution of assets/properties

- court may reverse payments where unfair preference is evidence – i.e. if company conducted to put a creditor in better position if company goes into liquidation during which its assets are insufficient to pay debts/ other liabilities

- must be shown that company was influenced by *a desire to prefer* a particular creditor ("associates" of company are presumed to be so influenced)

- relevant time period is 6 months prior to commencement of winding up (and for transactions involving connected persons, 2 years)

- directors may be asked to restore money to the company (the state of mind of director is relevant when attributing liability)

Transactions at an undervalue (section 265D of CWUMPO)

- gift or transfer of property with no payment of consideration, or consideration paid at undervalue
- relevant period: 5 years prior to commencement of winding up
- court may order restoration of position but for the transaction
- possible situations giving rise to concern: guarantees, indemnities, compromising of debt
- directors of financially distressed companies should be particularly careful:
- the company giving guarantee or indemnity for benefit significantly less than the value of the benefit that the guarantee of indemnity conferred; or
- the company accepting, in satisfaction of debts, sums significantly less than the recoverable value with the debts being written off.
- a defence if there were reasonable grounds to believe that the company entered into the transaction in good faith reasonably believing that it would benefit the company

Possible consequences for breach of directors duties

- civil and criminal liabilities
- unfair prejudice petitions
- derivative actions from minority shareholders
- adverse orders from courts or regulators which may affect the director's reputation and ability to act in the company or other entities

Remedies under statute

Fraudulent trading (section 275 of CWUMPO)

- director may be held personally liable if knowingly involved in any dealings with intent to defraud creditors or for fraudulent purpose
- subject test as to whether director was fraudulent in some circumstances, but high threshold means limited precedent cases

Misfeasance (section 276 of CWUMPO)

- director may be liable to repay or restore company's money or property with interest if misapplied, retained or become liable or accountable for money or property, or for breach of trust/duty

Disqualification order (section 168H of CWUMPO)

- director may be barred from serving as director for up to 15 years if conduct makes him unfit to be concerned with management of a company
- for listed issuers, SFC may have similar powers under the Securities and Futures Ordinance (Cap. 571 of the Laws of Hong Kong)

Common law remedies

- damages or equitable compensation
- account of profits
- restoration of company's property

Further liabilities for directors of listed issuers

- standard commensurate with that under Hong Kong law
- possible consequences include:
  - private reprimand
  - public censures
  - statements involving criticism
  - reports to be made to SFC or other regulators
  - injunction or other orders ("cold shoulder" or "cease and delist" orders)

SME Financing Guarantee Scheme: Government-guaranteed loans

- Launched on 1 January 2011 by The Hong Kong Mortgage Corporation Limited

- Provides loan guarantee to SMEs to help them secure loans from certain participating lending institutions for meeting their business needs (such as acquiring business installations and equipment) to enhance their productivity and competitiveness

- under the scheme, a SME could receive guarantee coverage of 50%, 60% or 70% to the credit facilities as approved by the lending institutions

SME Financing Guarantee Scheme: Government-guaranteed loans (COVID-19)

Last year, with the rapid deterioration of the business environment following the COVID-19 pandemic, the government has introduced special **100%** loan guarantee under the SME Financing Guarantee Scheme to provide the SME with much needed financial support to ease their cash flow problem.

- Aims to help relieving the burden of paying employee wages and rents by the SME which are suffering from reduced income, thereby help minimise enterprises shutting down and laying off staff

- The maximum of the loan would be the lower of HK$2 million and the total amount of employees wages and rents for six months

- No guarantee fee but there will be an interest rate of the Prime Rate minus 2.5% chargeable per annum (i.e. current interest rate at 2.75%)

- Maximum repayment period is 36 months, with an optional principal moratorium