Debunking Five Fallacies About Financial Distress

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From the outside looking in, the world of corporate restructuring may appear daunting and complex. However, there are many misconceptions about the process and what it entails. Nerina Jahja dispels some common restructuring myths and helps business owners learn their options and gain peace of mind.

While most businesses have weathered varying levels of economic uncertainty, the last few years have introduced unprecedented volatility. Combined, the impact of the pandemic, geopolitical tensions, inflationary pressure, and mounting competitive forces have pushed many companies into financial distress—raising the spectre of insolvency.

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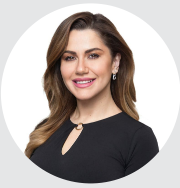

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If your company has been experiencing cash flow problems, struggling to raise capital, taken on material COVID related debts, or exploring cost-cutting measures, you may be concerned about ongoing viability. The same is true if you've lost a key customer or are in an industry that has been disproportionately hit by recent downturns.

There's no question that financial difficulty conjures up worst case scenarios. However, in truth, many companies face short-term financial challenges only to emerge stronger on the other end.

To help clear up some common misunderstandings about financial distress, we explore—and debunk—five common myths about the world of insolvency and restructuring.

Myth #1: Insolvency means liquidating your business

Companies are considered insolvent when they lack sufficient assets to cover their liabilities. If your company is facing this scenario, you may not understand some of the solutions available or might be under the impression that your only option is to shut down your business, liquidate your assets or declare bankruptcy. In reality, your business may be viable however—due to its current debt or reduced liquidity —it cannot currently meet its obligations. A well thought out restructuring may be able to turn the tides into a strong and viable business.

In Canada, the *Companies' Creditors Arrangement Act* (CCAA), the *Bankruptcy and Insolvency Act* (BIA) and other applicable statues are legislations that govern the formal restructuring process. The CCAA, for the most part, applies to larger companies or a group of companies that have a complex corporate structure and with liabilities exceeding $5 million. Insolvent companies that owe less than the threshold amount, can often file a proposal under the BIA.

To file a proposal under the BIA or a plan of arrangement under the CCAA, a company must demonstrate to its creditors and the court, that it can recover once the arrangement is settled. Businesses undergoing this process must work with a Licensed Insolvency Trustee (LIT) who will assist your company in preparing and presenting the arrangement to the creditors and subsequently seek court approval, and more.

Typically, while the experience can be emotionally arduous, it does have the advantage of giving companies some breathing room to negotiate with its creditors so that the business can get back on the path towards recovery.

Myth #2: A formal restructuring means losing control of your business

When facing insolvency, many business owners fear that they will lose control of their business as soon as they initiate a formal proceeding. In this scenario, they incorrectly assume that the Trustee under the BIA or the Monitor under the CCAA, will take over the business and start making day-to-day management decisions. Although management may lose decision-making authority in the event of a bankruptcy or receivership, this is not the case during a debtor-in-possession (DIP) restructuring.

When the LIT is brought in to manage a formal restructuring, their role is confined to effectuating the terms of the proposal or plan of compromise. Both Trustee and Monitor are officers of the court and not the agent or representative of either the company or the creditors. Their role is to supervise the business and financial affairs of the company while it formulates a plan of compromise or arrangement, and to report to court.

A company in a debtor in possession restructuring remains in control of its assets as it seeks to compromise its debts all the while being protected from its creditors.

Myth #3: A formal restructuring means

you must continue to deal with creditor and demands for re-payment

The stay of proceedings provided under the BIA is a legal mandate that applies automatically as soon as proceedings are commenced. Under the CCCA, this stay of proceedings does not apply automatically but rather is at the discretion of the court.

When a company files for a formal proceeding, the LIT will notify all creditors about the filing and that a stay of proceeding is in place. The stay of proceedings protects the company from paying these outstanding debts for a period of time, it stops any ongoing legal proceedings against the company, and prevents any creditor from commencing an action against the company. The company is given a temporary reprieve from its creditors to allow it to restructure its affairs.

There are some caveats to this rule. For instance, if a secured creditor gave notice of its intention to enforce its security, more than 10 days before the restructuring proceedings commenced, you cannot pause that creditor's actions retroactively. Therefore, timing is of the essence when you're facing financial difficulty. By responding expeditiously, you can give yourself the runway you need to get a proposal filed before your creditors start knocking at the doors.

Myth #4: A formal restructuring means a business can't borrow additional funds

It may seem logical to assume that, when facing a formal restructuring, a company can't borrow additional funds to finance its ongoing operations. In truth, companies undergoing a formal restructuring process still can borrow funds while the restructuring plan is being developed.

One way to borrow more funds is through interim financing or DIP financing which is an increasingly important instrument in restructuring proceedings. An interim lender can possibly obtain security over both encumbered and unencumbered assets with approval of the court.

Admittedly, certain rules apply, but neither the creditors nor the court want to put companies on such a tightrope that they are restricted from earning the revenue required to regain their footing. By working with an experienced LIT, you may be able to obtain the additional funding you need to continue operating without interruption.

Myth #5: Restructuring can be achieved only through formal

proceedings

If your company must reorganize its affairs to survive, another option could be an informal restructuring which could be achieved by entering direct negotiations and private arrangements with your creditors and stakeholders.

An informal restructuring can usually be efficient when there are non-complex situations or when you have small group of creditors with similar interests, whether secured or unsecured. An informal restructuring can provide you with a discreet and quick way to negotiate new terms with your creditors and perhaps identify a new lender who can help cover your restructuring costs.

Keep in mind, that there are disadvantages to restructuring informally. The main downfall is that there is no stay against creditors that prohibits them from starting or continuing actions against the company. It also could place an unmanageable burden on management. The key is to partner with a LIT who has proven experience not simply helping companies through formal proceedings, but also working with businesses to manage stakeholder negotiations.

Understand your options

Although navigating financial distress can be harrowing, it's important to remember that businesses stumble and recover all the time. The key is to be realistic as soon as the signs of trouble appear. Financial difficulty won't go away and its usually difficult to tread out of on your own. To up the odds of business survival, it's essential to understand your circumstances, be proactive, and act quickly.

Financial distress may seem like the end of the world, but once you know the realities, it becomes a lot easier to confront and fix. By working with an experienced LIT, you can explore your options and put together a plan to keep your lenders and creditors onside.

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Is your company insolvent? There can be positive outcomes if you act quickly and decisively. Learn your options.

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