Session III
Paper (d)

GOING OUT OF BUSINESS

(GRACEFULLY AND NOT SO GRACEFULLY)

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The first few months of 1988 have seen a wide variety of business failures from small trading enterprises to large public companies such as AIC Securities, Charter Corporation, and Investment Finance Corporation. Anyone keeping an eye on the public notices section of their local newspaper will have noticed a huge increase in the number of receiverships, creditors petitions for winding up, and liquidations. While the increased activity in the insolvency area has made the public more aware of business failures, it is true that the majority of businesses do have a finite life. This paper examines the reasons why businesses finish, and the mechanism through which the termination process happens.

1. Solvent Businesses

There are many and varied reasons why the principals of a solvent business may wish to cease operations. For example, they may wish to retire or to change the nature of their operation. In some fortunate cases they may have been made an offer that they cannot refuse, enabling them to retire with a large capital profit. In other cases the business opportunities may have ceased and the principals find themselves with assets to dispose of.

In the case of a sole trader or partnership the winding up procedure is relatively simple. Normally, the principals will settle all of the business liabilities, and sell the assets either as a going concern or individually for their maximum realisable value. The taxation implications of the sale of assets and/or goodwill must be considered in formulating an acceptable sale price. Where a partnership agreement is in force there may be specific arrangements for the distribution of profits on winding up.

A solvent company may be wound up by the members passing a resolution to wind the company up voluntarily and to appoint a liquidator. This procedure is governed by the Companies Act 1955 and again is relatively straightforward. The article attached to this paper outlines the reasons why you may wish to wind up your company to take advantage of current taxation legislation.

2. Insolvent Businesses

a) Causes of Insolvency

Insolvent businesses are those in which the assets at real value are less than their liabilities or, more commonly, are businesses which are unable to pay their debts as they fall due. Both situations may exist some time before they are recognised and appropriate actions taken by either the principals of the business or its creditors.

In almost all cases businesses fail largely because of ineffective or inadequate management. Occasionally the problem is caused by a trend in a particular industry, changes in the economy or plain bad luck. In the latter cases providing management is still functioning, the companies often have a reasonable chance of recovery. The defects in management may be

characterised as failure to plan the business activities, a failure to execute plans thoroughly, and a failure to respond to the economic environment in which the business operates. There is a strong underlying likelihood of inadequate or over optimistic financial planning. Many insolvent businesses have totally inappropriate capital bases or financial structures.

Basic budgets and cash flow plans, while relatively simple to prepare are a basic ingredient to almost every business. Often they are absent, inadequate or completely out of date. Without proper budgets and cash flow projections, it is very difficult to monitor the achievement of targets and the general performance of the business. Overtrading, whereby volume is achieved at the sacrifice of gross profit margins and perhaps stock control often is a problem. Similarly committing a large portion of the companies resources to the one big project may result in failure if the contract is cancelled without prior knowledge.

b) <u>Insolvent Sole Traders and Partnerships</u>

The procedure governing the failure of companies is contained in the Companies Act 1955. Textbooks have been written on receivership and liquidation law and practice and it is beyond the scope of this paper to cover more than a few facets of each subject. However, it is useful to briefly consider the basic concepts of liquidations and receiverships in order that you may be aware of pitfalls to avoid.

<u>Receivership</u>

In New Zealand receivers of the property and assets of companies can be appointed in one of two ways, either by the High Court of New Zealand or by a debentureholder under powers contained in a debenture deed.

There are only a few instances in which receivers have been appointed by the Court. One the most publicised in recent years was the appointment of receivers to the Security Bank Group. Generally speaking the court will only exercise its discretion to appoint receivers in circumstances where it is satisfied that such an appointment is necessary to ensure the preservation of the property and assets of the company and where required to ensure its proper management pending litigation.

By far the most common method of appointment or receivers is by a debentureholder, such as a bank or lending institution, under the powers contained in a debenture deed. While receivers obtain most of their powers from the debenture, they also has statutory powers and duties contained in the Companies Act. In essence, the task of the receivers is to manage the affairs of the company and to realise its assets to enable the company to repay the monies secured by the debenture.

Debentures securing advances by banks, finance and trading companies and other lenders, usually contain provisions enabling receivers to be appointed immediately after default is made in complying with a demand for repayment of the advance. The debenture deed will generally specify other events on which receivers may be appointed, for example the advertising of a creditors petition to wind up the company. Obviously appointments in terms of a debenture can only be made after the occurrence of one or more of these events. On the appointment of receivers the directors of the company no longer have the power to and must not commit the company in any way without the approval of the receivers. In most cases receivers will elect to continue to trade, at least until the company's financial position has been established and the receivers have decided whether or not it is best to close the business down immediately and realise the assets, or to continue to trade with a view to selling the business as a going concern, or possibly attempting to trade the company out of its difficulties. The receivership process may take anything from a minimum of two to three months to two or more years depending on the nature and complexity of the business.

The receivers have an obligation to obtain the best possible price for the assets of the business. Usually the optimum alternative is to sell the business as a going concern and therefore obtain some consideration for goodwill. However, increasingly this is becoming more difficult to achieve in the current economic climate.

On realisation of the assets the receiver has certain priorities for distribution, governed by the Companies Act 1955. Briefly, any wages and holiday pay owed to employees of the company must be paid up to a total of $2,000 per employee. Next comes PAYE and GST payable to Inland Revenue Department. Any assets secured under hire purchase agreements or instruments by way of security will need to be paid on realisation of the particular asset in priority to the debenture holders fixed or floating charge.

In almost all receiverships it is common to find that the principals of the company have personally guaranteed the advances under the debenture or other liabilities of the company. Should the assets of the company be insufficient to repay these advances, the principals may be called under their guarantee to front up with the balance. In some cases this may lead to personal bankruptcy of the principals. It is becoming more and more common for lenders to require personal guarantees from directors or shareholders and full consideration should be given to the contingent future personal liability before such documents are signed. In effect by obtaining a personal guarantee lenders are extending beyond the scope of the limited liability provisions of a company.

On the appointment of a receiver any debts owed to creditors of the company are frozen as of the date of appointment. Creditors are not entitled to claim any of the companies assets in settlement of its debts, nor can they claim personal property of the principals of the company unless a personal guarantee has been given, and the creditor takes legal action, However, increasingly suppliers to companies are including a Reservation of Title clause in their conditions of supply, to the extent that ownership of the goods does not pass to the company until payments has been made in full. Where such a clause is deemed to be valid a receiver is obliged to return any unpaid goods to the supplier or otherwise be liable for their payment at full cost.

The receivers must take possession of all deeds, books records and documents which in any way relate to the assets pledged under the debenture. The records are the basis upon which a statement of affairs of the company is prepared. While it is the responsibility of the directors and secretary to prepare the statement of affairs, the receivers have a very real interest in ensuring that it is as accurate as possible and completed as soon as possible.

It is very rare that receivers will on appointment elect to endeavour to trade a company out of its difficulties. Usually they will find a combination of the following factors :

- a company with virtually no equity (if any at all)
- evidence of overtrading
- inexperienced or incompetent management
- poor financial records
- no system of effective budgeting or financial control
- inadequate costing information
- reluctant suppliers whose goodwill has been exhausted by repeated failure to pay
- customers whose confidence has been eroded through having been constantly let down
- dispirited or disheartened staff
- a host of unsolved problems

It is into such a difficult position that receivers are often plunged with little or no warning and often in an industry about which they know very little. For this reason receivers will normally continue to trade only for a very limited time in order to sell as a going concern if this is considered possible under the circumstances.

As soon as the receivers are in a position to fully repay the debentureholder they should do so and terminate their appointment as soon as possible. However, they must satisfy themselves that all claims and liabilities outstanding have been satisfied.

Liquidation

The winding up of a company may either be by the Court or voluntary.

The Court procedure is commonly referred to as a "Section 218 winding up". A creditor will normally present a petition to the Court that the company is unable to pay its debts and should therefore be wound up.

In a voluntary winding up the members pass a resolution that the company cannot pay its debts and should therefore be wound up. A meeting of creditors is then called and a liquidator elected by the creditors.

On the appointment of a liquidator all powers of the directors cease except so far as any Committee of Inspection of the creditors permit.

The liquidator is appointed for the purpose of winding up the affairs and distributing the assets of the company. The liquidators statutory powers are conferred by the Companies Act 1955, however one of those powers enables the liquidator "to do all other things as may be necessary for winding up the affairs of the company". Basically the power include :

- bring or defend any legal action
- carry on the business of the company so far as necessary to beneficially wind the company up. Creditors for the liquidators period of trading are entitled to be paid in priority to the creditors at the commencement of the winding up
- Pay any classes or creditors in full
- Make any compromise or arrangement with creditors or persons having any claim against the company
- sell company assets by public auction or private contract either as a whole or separately
- make calls on unpaid shares

The liquidator has a duty to investigate the past affairs of the company and should determine whether

- Proper accounting records have been kept and whether the failure to keep proper accounting records has contributed to the companies inability to pay all its debts, or has resulted in substantial uncertainty as to the assets and liabilities of the company, or impeded the winding up;
- Debts were contracted when the company was unable to pay its debts in full or the company was traded in a reckless or fraudulent manner and an officer of the company knew of this;
- Any person in control of the company has misapplied or retained any money or property of the company or being guilty of any negligence, default or breach of duty or trust in relation to the company;
- Any member or officer of the company has been guilty of any criminal offence in relation to the company.

After the affairs of the company have been concluded and the assets realised, the liquidator will make a distribution to creditors in accordance with the priorities outlined by the Companies Act. Creditors are required to submit a Proof of Debt to the liquidator in order that the companies indebtedness may be quantified. Proof of Debts include all debts and liabilities present or future certain or contingent to which an obligation has been incurred before the commencement of the winding up. The value of a claim is arrived at by consideration of the position at the commencement of winding up.

Getting Out with some Dignity

In nearly all circumstances management will have early warning signs of impending business failure. Fore example the company may lose a major contract, or competitors may force sale prices down creating unrealistically low margins. Often the problems will culminate in a cash flow crisis and the business will find it difficult to pay its debts as they fall due. This in turn will lead to more pressure from creditors for payment and management

will find that most of their time is spent in dealing with creditors and suppliers to the detriment of normal management functions.

Providing the early warning signs are recognised and acted on many businesses will survive difficult times. It is essential that strategic planning is undertaken immediately. This involves preparation of detailed profit budgets and cash flow forecasts for at least the next 12 months, preferably 2 - 3 years. The causes of the current problems must be identified and resolved. Several problems common to businesses today include :

a) High Interest Rates

If your business is having difficulty with the payment of interest you are probably undercapitalized. Consideration should be given to the introduction of more equity into the business or alternatively finding an equity partner to inject capital. In these competitive times it may be possible to refinance elsewhere at a lower rate.

b) Insufficient Margins

A business will not survive if profit margins are insufficient to cover the costs of operation. Often management will mistakenly believe that increasing production will overcome this problem. While an increase in production will contribute towards fixed costs, variable costs will increase in proportion to the increase in production.

c) Loss of a major customer of contract

If the business depends on supply to a major customer or supply under a contract that may be cancelled with little notice, alternative options will need to be put in place quickly if the business is to survive. This is difficult in any industry and forestry is certainly no exception. The business may in this case need to look at restructuring to enable a different type of operation to be carried out, or alternatively to liquidate the assets and cut its losses.

Should the profit budgets and cash flow forecasts indicate that the business in unlikely to trade out of its difficulties, then the principals should seriously consider (in order of merit) :

1. Restructuring the business to return it to profitability. This may include :
   - disposal of unprofitable divisions or activities
   - liquidation of surplus stock
   - refinancing assets at more competitive rates
   - minimisation of expenses and outgoings.

2. Selling the operation as a going concern in order to obtain some consideration for the goodwill of the business. It may be possible to sell to existing employees under some buy in arrangement.

3. Sell the assets of the business for the maximum achievable price in order to clear all liabilities.

4. Where the company is covered by a debenture, consideration should be given to ceasing to trade and requesting the debentureholder to appoint a receiver.

5. If the company is not covered by a debenture, then it may be necessary to pass a resolution for voluntary winding up.

If your business is experiencing difficulties, then it is essential to consult an experienced financial advisor. Most of the companies that I have seen as a receiver or liquidator could have been saved if advice was sought when the early warning signs appeared. During the past six months the attitude of lending institutions has changed significantly in that corporate rescue units are being set up in order to recognise problem businesses and to appoint advisors to endeavour to restructure the business before complete failure occurs.

WHY YOU SHOULD CONSIDER

WINDING UP YOUR COMPANY

The distribution of capital profits tax free to shareholders has featured on the Government's hit list in recent taxation reform.

The 1985 legislation provided that tax free distributions of capital profits could only be made during the course of a winding up of a company. However, the announcement on 10th February 1988, has limited this advantage to winding ups commenced before 31st march 1989.

Directors of companies with significant capital reserves from the sale of the business or assets of the company should seriously consider commencing winding up proceedings before this deadline. Similarly where a company owns assets with a high capital value, such as property, it may be advantageous to transfer these assets in specie to the shareholders during the course of a winding up. The profits from assets sold by a company after 31st March 1989 will not be able to be distributed to shareholders without attracting tax.

The winding up procedure for a solvent company is relatively simple. A declaration of solvency must be filed at the Companies Office, after which the shareholders pass a special resolution to wind up the company voluntarily and to appoint a liquidator. The resolution may be passed by calling an extraordinary general meeting, or in the case of a private company, by way of entry in the minute book. On appointment the liquidator will finalise the company's affairs and arrange the distribution of assets to shareholders.

For companies that have few assets and liabilities or may have been dormant for a number of years a "fast track" winding up method is available. An application may be made directly to the Registrar of Companies to have the company dissolved after clearance has been obtained from the Commissioner of Inland Revenue.

Now is the time to look carefully at your company's assets and the tax implications of retaining these with your existing company structure. Your contact partner will be able to advise you in this area and suggest the most appropriate form of winding up.