

NEWSLETTER

INSOLVENCY, TURNAROUND & FORENSIC SPECIALISTS

DOCA - A Lifeline for Distressed Companies

Put simply a Deed of Company Arrangement (“DOCA”) is a proposal made to creditors of a company in voluntary administration to avoid the company being placed into liquidation. A DOCA is a flexible corporate recovery tool that is often the last frontier to saving a corporate business from a terminal collapse.

This article’s focus is on the matters that need to be considered to make a successful DOCA proposal. There has been lots of narrative in respect to what a DOCA is and its associated benefits, however, little has been written on how to best achieve getting a DOCA into place.

Jirsch Sutherland Newsletter is written by Sule Arnautovic, Partner. All feedback is welcomed.



GENERAL BENEFITS OF A DOCA

The benefits of a DOCA are numerous (and are not the focus of this article) and vary with each individual DOCA proposal.

So as not to totally ignore the benefits of a DOCA (and there are numerous benefits) some of the more common benefits to executing a DOCA as opposed to having the relevant company being placed into liquidation are as follows: -

- A DOCA provides for a greater return (as opposed to liquidation) to ordinary participating unsecured creditors.
- A benefit for directors is that insolvent trading and other insolvent transaction actions against company directors cannot be pursued by a Liquidator under a DOCA.
- A benefit to certain recipient parties is that voidable insolvent transactions such as preference payments and uncommercial transactions cannot be pursued under a DOCA.
- Certain tax advantages (i.e. carried forward losses) can be maintained by the company after the completion of the DOCA.
- All unsecured creditor claims (contingent or otherwise) against the company as at the date of the Voluntary Administrator's appointment are bound by the DOCA.
- If supportive of the DOCA proposal, the company's customers/clients, employees, secured creditors, lease/ landlord creditors, shareholders and other key stakeholders can transition through the Voluntary Administration and DOCA process to ensure the ongoing viability of the business after the completion of the DOCA.
- Suppliers/creditors have the opportunity to provide goods and services to the company during the administration period, DOCA period and beyond on which profits would be generated by those suppliers/creditors.
- Certain asset values (i.e. debtors, work in progress, intellectual property, goodwill and other assets) that are often decimated by the liquidation process can be preserved and maximized through a DOCA.
- Certain liability values can be minimized through a DOCA. For example, leave and retrenchment entitlements to employees may be accrued by the company in the normal course of business after a DOCA is executed and need not be crystallized as is the case in a liquidation scenario.
- In cases where a liquidation appears to look expensive, litigious and uncertain a DOCA can bring more certainty for creditors in terms of costs and possible dividend returns.
- Basically, a DOCA (if approved by the company's creditors or the Court) can achieve any commercial result (including a sale, transfer, release, moratorium, compromise, deferment, assignment, license, other arrangement etc) for the company and its stakeholders i.e. creditors, directors, shareholders and others.



MATTERS TO CONSIDER IN MAKING A SUCCESSFUL DOCA PROPOSAL

As previously mentioned, this article's focus is on the matters that need to be considered to make a successful DOCA proposal, that is, in practical terms what needs to be addressed for the relevant DOCA proposal to succeed.

The following are some of the key matters that need to be addressed or considered in making a successful DOCA proposal: -

Prior relationship/history

The relationship that the company (and its directors) has with its creditors is essential in making a successful DOCA proposal, that is, in the final analysis it is the company's creditors that are entitled to vote on whether the relevant DOCA proposal be accepted and implemented by the company.

Directors should always work to ensure that they keep their relationships intact with key creditors.

Employees

Further to the above point, it is also worthwhile specifically noting that the relationship that directors or business owners have with their employees is critical in making a successful DOCA proposal. Why? Each employee has a vote and one should note the voting mechanics later mentioned in this newsletter. Additionally, unless employee creditors resolve otherwise at a separate meeting of eligible employees prior to the DOCA being proposed at the major meeting of creditors in a Voluntary Administration, or the Court makes a contrary order, all entitlements of priority employee creditors have mandatory protection in a DOCA.

Strategy

Prior to the appointment of a Voluntary Administrator it is essential to agree (in principle) on a strategy for the administration. This strategy needs to be flexible to take into account statutory and commercial obligations, however, if the company's key stakeholders (or proposers of the DOCA) and Voluntary Administrator take divergent paths at the inception of the voluntary administration period, significant damage can be caused to the company's business reducing the potential for a successful restructure.

Tax/Industry/Regulatory compliance

The compliance history of a company is important in the company obtaining support from its creditors who are represented by taxation, industry and other regulatory authorities.

These bodies generally view how the company has acted historically in this regard in considering whether they support the company going forward under a DOCA. Bringing the company's tax/industry/regulatory compliance up to date as at the appointment of a Voluntary Administrator may be a key ingredient in obtaining support from these government/industry/regulatory creditors.

Promises/Repayment Plans

Put simply a DOCA is a promise of a repayment plan. So it follows that if a company has previously made promises and entered into repayment plans with its creditors that the success of those historical arrangements are never far from creditors thoughts when considering any DOCA proposal going forward. It is prudent that directors only make promises to creditors they can keep leading up to a voluntary administration period.



Communication

During (and perhaps in some cases prior to) the administration process, the company and its directors should communicate to key creditors what it is trying to achieve and explain at a high-level how its restructure by way of a DOCA is in those key creditors' interests as opposed to placing the company into liquidation. A lack of understanding on the part of key creditors on what directors are trying to achieve can often result in strained relationships that may or may not be saved post DOCA.

Liquidation Comparison

Every DOCA proposal needs to give consideration to what creditors might receive in the form of a dividend from the liquidation of the company so that the DOCA proposal can better this result. The advantages and disadvantages of the DOCA

also need to be highlighted so that creditors who attend the meeting to vote on the DOCA proposal have considered all necessary matters to make an informed decision.

Directors' net asset position

In considering a DOCA proposal, creditors often appreciate disclosure of the net asset position of the proposers (usually directors) of the DOCA. The reasons being that this gives them an insight into whether the directors are able to meet any actions against them that flow from a liquidation and whether they have the resources to meet the DOCA obligations that they may have guaranteed in certain circumstances. In our experience this transparency goes a long way in gaining support for a DOCA, however, we appreciate that there are certain commercially sensitive situations where disclosure of one's

personal net asset position would not be recommended.

Return for Creditors

The return that unsecured creditors are expected to receive from a DOCA proposal should be greater than the forecasted return under a liquidation scenario. The variance or buffer offered as between the return forecasted in a DOCA proposal and liquidation depends on the certainty of the forecasted liquidation return result. If in a liquidation scenario the return result is less certain, the variance or buffer as between the DOCA proposal and the liquidation scenario can be less, however, if in a liquidation scenario the return result is more certain, the variance or buffer as between the DOCA proposal and liquidation scenario should be greater so as to remove doubt in creditors' minds as to which option is in their interests.

Funding

It should be clearly demonstrated by the proposers of any DOCA where the relevant funding for the DOCA is coming from i.e. future cash flows, property, third party sources or other sources. Creditors are less likely to support a DOCA proposal if they are unsure of the origins of funding for the relevant DOCA.

Security

As mentioned above, a DOCA proposal is a promise. A key question that creditors have when considering a DOCA is what security or guarantees are in place to protect their interests if the DOCA fails. The better the security offered the more likely the DOCA proposal will succeed, that is, if the proposal itself is of substance and generates a return greater than the forecasted liquidation result.





Timing of dividend

Creditors look on DOCAs more favorably which generate them a return in a shorter period than in a liquidation scenario. In some cases creditors would prefer a smaller sum certain return in the short term rather than wait for a potentially greater return over a longer period. This is probably due to the time value of money. Other considerations for creditors are the risk that the DOCA will fail over a longer period or that the costs of the Deed Administrator may erode their forecasted returns.

Voting Mechanics

Resolutions at a meeting of creditors to consider a DOCA proposal are carried in situations where the relevant DOCA proposal resolution is supported by 50% in the number of votes and 50% in the value of the debt

of those who vote. Each creditor has one vote and only creditors who are present in person or by proxy can vote. The chairperson of the meeting (incumbent Voluntary Administrator) will have a casting vote in situations of a deadlock as between value and number. Readers should be aware that there is detailed case law and stringent guidelines published by insolvency regulators on the use of casting votes by Administrators. Proposers of a DOCA should consider this in making their DOCA proposal and they should structure their DOCA proposal to suit the company's constitution of voting creditors.

Related parties

It is not unusual that a company in financial distress will have large outstanding related party debts payable, that is, business owners often inject large sums of

working capital to keep businesses operational before they realize that the expected turnaround will not eventuate. In light of the already mentioned "voting mechanics", quantification and proof of related party claims can be useful in resolving to accept a DOCA proposal. It should be noted that it is preferable for proposers of a DOCA that a DOCA proposal resolution is carried by unrelated creditors so as to avoid any application to set aside the relevant DOCA under Section 600A of the *Corporations Act 2001*.

Another worthwhile consideration is whether related parties will merely defer (as opposed to compromise) their claims behind other creditors to improve the return to those creditors participating in the DOCA as an alternative to

making commensurate cash (or other asset) contributions to the DOCA. This deferral of claims may also result in significant tax advantages for the business post DOCA.

Cashflow forecasts

The ongoing financial viability of a company post the voluntary administration period is of key interest to creditors in considering whether to support a DOCA proposal. This is particularly important where the relevant DOCA contributions are being funded from future cash flows. In our experience providing transparency on cash flow forecasts to creditors goes a long way in gaining support for a DOCA, however, there are certain commercially sensitive situations where disclosure of forecasted cash flows would not be recommended.





Working capital - Transition from VA to DOCA

The transition from a Voluntary Administration to a DOCA can sometimes be perilous if there has been a lack of planning on how the transition will be effected. Too often proposers of a DOCA forget to provide sufficient working capital to fund business operations after a voluntary administration period. Working capital in the form of cash/loan facilities or retaining certain company assets such as debtors and stock under the DOCA is required to ensure that the company is not immediately insolvent upon handover to the Board when the DOCA is executed.

Personal Guarantees

During the voluntary administration period, guarantors who are directors (and their relatives) are afforded

a moratorium on debts that they have guaranteed for a company prior to the commencement of the Voluntary Administration. As soon as the voluntary administration period expires and the company is either placed into liquidation, executes a DOCA or is returned to the control of its directors those creditors who hold valid personal guarantees are entitled to call on those guarantees. Significant thought needs to be given by DOCA proposers about how these guarantees will be settled, refinanced or continued in the normal course of business. Clear communication of one's intentions with these guarantee holding creditors is strongly recommended.

Secured creditor

If there are secured creditors that hold fixed and floating charges over the whole or

substantially the whole of the company's assets, these creditors need to be fully informed and protected in any DOCA proposal. Why? Secured creditors are not automatically bound by a DOCA and they have the power to appoint Receivers & Managers over company assets which may be detrimental to the company's business going forward and will in most cases result in the DOCA failing. It is of great benefit to DOCA proposers when a secured creditor is supportive of a DOCA proposal and if they are not it may be essential for proposers of a DOCA to refinance out that secured creditor with another lender who might be interested in the company's business plan and forecast post Voluntary Administration and DOCA.

Restructure opportunity

Although an intense period of time for business owners,

creditors and other stakeholders, a Voluntary Administration is the right forum to prune under-performing divisions, premises, staff, contracts or other loss-creation areas of a company. If these sorts of matters aren't attended to the question must be asked whether any DOCA proposal (if accepted) is merely one of debt relief and whether the company may end up in the same insolvent position at some stage in the future. Proposers of the DOCA and/or directors of the company need to take advantage of the moratorium and circumstances created by the voluntary administration period.

Go forward changes

In addition to the restructure changes mentioned above that could be made by a company during the voluntary administration period, a clear business and action plan are



required to ensure that the relevant company prospers once the DOCA is effectuated and that it avoids becoming insolvent in the future. These plans may even extend to changes to management, shareholding structures or the Board. Proposers of the DOCA and/or directors of the company need to do all they can to meet their business and action plan (which should also afford some flexibility given the variance in business goals and results).

If the above matters were successfully attended to (planned for) it would give a DOCA proposal the best opportunity of being approved by creditors of the company (and of succeeding). This is not to say that there are no other matters that need to be addressed or considered in addition to the above, that is, the form of the DOCA proposal would largely dictate what further matters need to be addressed.

Jirsch Sutherland has been successful in implementing numerous DOCAs and if you have any particular questions in this regard please do not hesitate to contact the writer at sule@jirschsutherland.com.au

Congratulations to our newly appointed partners:

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Bradd Morelli Insolvency & Turnaround Management, Sydney & Newcastle

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Readers should feel free, with no obligation, to contact the writer to discuss any matter raised herein.

Disclaimer: This newsletter should not be construed as legal advice or relied upon in anyway to make any type of investment, commercial or other decision.

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