Diamonds in the rough: Using Deeds of Company Arrangement

Diamonds can be found in the most obscure and hard to find places. Failing businesses, whilst often raising a myriad of red flags, can also on occasion be a gem worth investing in.

We continue our ‘Diamonds in the rough’ series with our second article that looks at some of the key challenges to be aware of when considering the deed of company arrangement, or DOCA, process. When understood and used appropriately, the DOCA process can provide an innovative mechanism for the acquisition of distressed businesses.

What is it?

Buyers can use the DOCA process to prise out the valuable pieces of a business embedded in an insolvency process. Several iconic, but financially challenged Australian businesses have recently been saved using a DOCA.

In practical terms, a DOCA is a contract between a company in administration, the administrator and an interested party which allows the business, and the company’s assets, to be extracted by the interested party, normally in return for a sum of money which should at least, in part, meet creditor claims. DOCAs also:

- Require creditor approval and are formally voted upon by creditors at a meeting convened by the administrator.
- Are only available in circumstances where an insolvent company has been placed into voluntary administration.
- Are one of three main outcomes of the voluntary administration process, with the other being returning the company to the directors or winding up the company through the appointment of a liquidator.

Why use a DOCA?

There are many reasons why interested parties would elect to use the DOCA mechanism over a standard sale of a business. These include:

- Normally, the outcome of a DOCA is that the recapitalised business will remain in the existing corporate structure. This is often important from the buyer’s perspective as it provides an opportunity for maximising the preservation of the business. It also avoids a formal transfer of business and contracts that would otherwise terminate or require the counterparty’s consent to transfer the business.
- All parties who have claims over assets held by the insolvent business will be bound by the DOCA, save for secured creditors.

- The funds used to contribute to the DOCA can be introduced over time, (often through trading profits from the entity in administration), providing almost a degree of 'vendor finance' for the buyer. A word of caution here – if deferred terms are proposed, the administrator will be required to consider the future viability of the business. Robust forecasts will be required in order to support any such proposal. The DOCA also has the benefit of maintaining existing tax structures and potentially carry forward tax losses for future benefit (although, the extent of tax debt can impact the potential benefit – be sure to get appropriate advice on this point).

For related parties, however, the real motivation behind proposing a DOCA is to avoid the alternative – liquidation. This means that claims uniquely available to a liquidator – for example claims of trading whilst insolvent are no longer a risk factor.

It all comes down to the dollar

Creditors hold the power when it comes to deciding if a DOCA proposal should be accepted for a company in voluntary administration. The administrator is required by law to provide creditors with a comparison of the alternatives (DOCA vs liquidation) and the financial return associated with each. The administrator also delivers its recommendation as to the future of the company. The administrator's opinion will often largely be based upon the financial return available to creditors in both scenarios, after factoring in any risk associated with the DOCA proposals.

When determining the level of funding to support a DOCA proposal, investors need to appreciate the likely returns under an alternative recovery scenario, such as liquidation. That means taking into account individual asset recovery values for plant and equipment and other assets, likely recoveries from debtors and other potential recoveries that are uniquely available to a liquidator, such as unfair preferences, uncommercial transactions and trading whilst insolvent, to name a few.

That means, if you are a director and are using a DOCA to avoid insolvent trading litigation risk, you need to offer something in return, beyond what would be available in a liquidation.

Given that a DOCA is usually a more cost-effective option for all parties, consideration needs to be given to the cost of a DOCA process, ensuring the costs don't exceed those of a liquidation and thereby diluting the return to creditors.

Remain grounded

The DOCA process provides a flexible alternative for parties wishing to pursue the acquisition of a distressed business, however, consideration should be given to the alternative, and interested parties need to be realistic rather than opportunistic to ensure their proposals are considered credible.

In summary, our key recommendations for potential buyers are:

- Keep it simple – complex or ambiguous DOCA proposals are less attractive to administrators and creditors.
- Within reason, cash today is almost always better than payment over time – remember the longer the payment period, the longer the deed administrator's appointment runs, and consequently the higher the fees will be, resulting in a diminished return for creditors.
- Cash is only part of the deal – whilst cash (ideally upfront) is essential, administrators will also place emphasis on the adoption of leases and offers of employment to current staff, to reduce contingent claims.
- Engage early – whether a DOCA proposal is acceptable is a decision for creditors, but it often rides on the recommendation of the administrator. Getting their buy-in to the process is important, and you should allow sufficient time to negotiate the DOCA with the administrator, who will do their best to maximise the return to creditors.
- Seek appropriate advice – understanding the returns available to creditors both in a liquidation and in the DOCA scenario is key. To be successful, evaluate the alternatives available under liquidation, including insolvent trading and antecedent transaction recoveries. This is an area that requires specialist expertise and shouldn't be overlooked.

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