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The 5% Fallacy: How Fee Caps Impede Business Rescue for Financially Distressed Companies in Zambia

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ABSTRACT

This study examines the potential drawbacks of the 5% net asset cap on business rescue practitioner (BRP) fees enshrined in Zambia's Corporate Insolvency Act (Act No. 9 of 2017). We argue that this "one-size-fits-all" approach disregards the inherent complexities and unpredictable costs associated with business rescue proceedings. The research analyses the limitations of the fee cap through the lens of minimal net assets in financially distressed companies, the challenges of unforeseen expenses and disbursements, and the inflexibility in accommodating exceptional circumstances. Our findings suggest that the capped fee structure discourages qualified BRPs from undertaking high-risk cases, ultimately hindering the rehabilitation of financially distressed companies and potentially increasing company liquidation rates. The paper concludes by proposing alternative approaches, such as success-based fees, capped hourly rates, and a pre-approval process for exceeding the cap in exceptional cases. These alternatives aim to ensure fair compensation for BRPs while safeguarding against excessive fees, fostering a more effective business rescue ecosystem in Zambia.

Keywords: Business Rescue, Insolvency, Fee Caps, Financially Distressed Companies, Corporate Turnaround, Zambia

INTRODUCTION

1.1. The Critical Role of Business Rescue in Corporate Distress

The global economic landscape is characterized by dynamism and volatility, with companies constantly navigating the challenges of competition, market fluctuations, and unforeseen circumstances. This dynamic environment inevitably leads to situations where businesses encounter financial distress (Fink et al., 2017). In such scenarios, business rescue (BR) emerges as a crucial mechanism to prevent company liquidation and facilitate corporate turnaround (Alexander & Voyle, 2012).

BR proceedings aim to rehabilitate financially distressed companies by restructuring their operations, debts, and ownership (World Bank, 2020). This approach offers a valuable alternative to liquidation, preserving employment opportunities, safeguarding stakeholder interests, and contributing to economic stability (Wong et al., 2018). Recent research underscores the positive societal and economic impacts of successful BR efforts. For instance, a study by Martín-Cruz et al. (2018) demonstrates that effective BR can lead to increased employment retention, improved post-rescue financial performance, and a ripple effect of positive outcomes for related businesses within the local economy.

1.2. Business Rescue Practitioners: Architects of Corporate Revival

The success of BR proceedings hinges on the expertise and dedication of Business Rescue Practitioners

(BRPs) (Ireland & Barnes, 2014). BRPs act as independent specialists, assuming a pivotal role in navigating the complexities of financial restructuring and company revival (Διαμαντής [Diamantīs], 2017). Their responsibilities encompass a wide range of tasks, including assessing the viability of the company, formulating, and implementing a rescue plan, engaging with creditors and stakeholders, and overseeing the restructuring process (Insolvency Practitioners Association of Zambia, 2023).

A competent BRP possesses a unique blend of skills and knowledge encompassing financial analysis, negotiation, corporate law, and business turnaround strategies (Vidya & Ismail, 2019). Effective BRPs require not only technical expertise but also strong leadership, communication, and problem-solving abilities to navigate the often-challenging dynamics of financial distress (Hodge et al., 2018).

1.3. The 5% Fallacy: A Flawed Approach to Business Rescue Fees?

The effectiveness of BR proceedings can be significantly influenced by the regulatory framework governing the process, particularly with regards to compensation for BRPs. In Zambia, the Corporate Insolvency Act (Act No. 9 of 2017) introduced a fee cap, limiting the amount payable to BRPs to 5% of a company's net assets in BR cases. While the rationale behind this cap might be to control costs associated with BR (further explored in Section 2), its potential drawbacks deserve closer scrutiny.

This article argues that the current 5% fee cap in Zambia presents a significant challenge to the effectiveness of BR proceedings. We contend that this "one-size-fits-all" approach disregards the inherent complexities and unpredictable nature of BR cases. The limitations of net assets as a basis for fee calculation, the potential for unforeseen expenses and disbursements, and the inflexibility of the cap in accommodating exceptional circumstances all contribute to a scenario where qualified BRPs may be discouraged from undertaking financially distressed cases.

1.4. Research Question and Methodology

This study investigates the potential drawbacks of the 5% fee cap on BRPs in Zambia's business rescue framework. We employ a qualitative research approach, drawing on a comprehensive review of relevant academic literature, policy documents, and legal frameworks governing BR in Zambia and other jurisdictions. Additionally, semi-structured interviews will be conducted with a purposive sample of BRPs, insolvency professionals, and legal experts to gain deeper insights into the practical implications of the fee cap. Through this combined approach, we aim to critically analyse the limitations of the current system and propose alternative approaches that can ensure fair compensation for BRPs while safeguarding against excessive fees.

1.5. Foreshadowing the Consequences: A Weakened Business Rescue Ecosystem

Our preliminary analysis suggests that the 5% fee cap has the potential to undermine the effectiveness of BR proceedings in Zambia in several ways. By potentially discouraging experienced BRPs from taking on high-risk cases, the cap may lead to a skills gap in this crucial area. Furthermore, the inflexibility of the cap might limit the ability of BRPs to dedicate the necessary time and resources to complex restructuring efforts, potentially hindering the success rate of BR endeavours. Ultimately, these limitations could lead to an increase in company liquidations, with detrimental consequences for employment, economic stability, and investor confidence.

The following sections of this paper will delve deeper into the specific limitations of the 5% fee cap, analyse its potential consequences, and propose alternative approaches that can foster a more robust and effective business rescue ecosystem in Zambia.

BUSINESS RESCUE AND BUSINESS RESCUE PROCEEDINGS

Business rescue plays a crucial role in Zambia's corporate insolvency framework.

As defined in the Corporate Insolvency Act No. 9 of 2017 (Section 2), business rescue proceedings refer to "the process of facilitating the rehabilitation of a company that is financially distressed." This structured approach aims to offer financially troubled companies a chance at recovery by providing for:

1. Temporary supervision and management: The rescue proceedings allow for the temporary oversight of the company's affairs, business, and property.
2. Moratorium on claims: Creditors are granted a temporary hold on enforcing their claims against the company, providing breathing room for restructuring efforts.
3. Development and implementation of a rescue plan: The core objective is to develop and implement a plan for company turnaround. This plan focuses on restructuring the company's finances, operations, and ownership to maximize the likelihood of the company continuing as a viable entity ([Corporate Insolvency Act No. 9 of 2017], Section 2(c)).

THE FEE CAP AND RATIONALE

3.1. The Corporate Insolvency Act and the Fee Cap

The Zambian Corporate Insolvency Act (Act No. 9 of 2017) serves as a cornerstone for insolvency and business rescue proceedings within the country. Introduced in 2018, the Act aimed to modernize the legal framework for dealing with financially distressed companies, transitioning from a liquidation-centric approach to one that prioritizes business rescue (Moira Mukuka Legal Practitioners, 2019). A key provision within the Act is the introduction of a fee cap on the compensation payable to Business Rescue Practitioners (BRPs). This cap restricts the maximum fees that BRPs can earn to a percentage of the company's net assets in the case of business rescue proceedings.

3.2. Rationale for the Fee Cap: A Cost-Control Perspective

The Zambian government's rationale for implementing a fee cap on BRPs can be primarily understood through the lens of cost control. The underlying assumption appears to be that capping fees will prevent excessive charges levied on financially distressed companies, potentially hindering their chances of successful rehabilitation. This aligns with broader trends in insolvency legislation globally, where concerns about rising insolvency practitioner costs have prompted calls for greater fee transparency and regulation (European Commission, 2019).

Research suggests that excessive fees charged by insolvency practitioners can indeed pose a challenge for financially distressed companies. A study by Ismail et al. (2014) examining insolvency proceedings in Malaysia highlights how high fees can deplete a company's already limited resources, diminishing the viability of rescue attempts. Similarly, research by López-Hernández and Lozano-Hernández (2017) analysing the Spanish insolvency framework suggests that a lack of fee regulation can lead to situations where insolvency practitioners prioritize maximizing their fees overachieving optimal outcomes for stakeholders.

The Zambian government might also be drawing on experiences from other African countries that have implemented fee caps in insolvency proceedings. For instance, South Africa's Companies Act (Act No.71 of 2008) prescribes a tiered fee structure for insolvency practitioners, with limitations based on the value of the company's assets (South African Institute of Chartered Accountants, 2023).

3.3. Potential Alternative Motivations: Beyond Cost Control

While cost control appears to be the primary rationale, there might be additional, less explicitly stated motivations behind the fee cap. One potential consideration could be a desire to streamline the business rescue process. By establishing a pre-defined fee structure, the government might aim to expedite the appointment of BRPs and reduce administrative burdens associated with fee negotiations. However, this potential benefit needs to be weighed against the risk of discouraging experienced BRPs from taking on complex cases due to insufficient compensation.

Another consideration could be concerns about the level of expertise and professionalism within the Zambian business rescue practitioner community. A capped fee structure might be viewed as a mechanism to ensure that all BRPs charge reasonable fees, potentially mitigating concerns about exploitation of financially distressed companies. However, such concerns could be more effectively addressed by implementing robust qualification and accreditation processes for BRPs, alongside effective monitoring and enforcement mechanisms.

3.4. Mechanics of the Fee Cap: A Tiered Structure

The fee cap in Zambia is structured as a tiered system, with different maximum percentages applicable to receivership/liquidation and business rescue proceedings (PwC Zambia, 2019). Section 8.1 of the Corporate Insolvency Act (Act No. 9 of 2017) establishes a cap of 10% of the net proceeds for receivership or liquidation. In contrast, Section 8.2 sets a lower cap of 5% of the net assets of the company for business rescue proceedings. The Act also defines "net proceeds" (Section 8.4) and "net assets" (Section 8.3) to provide clarity on the calculation base for these fees.

THE FALLACY OF THE 5% CAP: LIMITATIONS IN REAL-WORLD BUSINESS RESCUE SCENARIOS

The seemingly straightforward 5% fee cap on net assets for business rescue practitioners (BRPs) in Zambia exposes significant limitations when applied to the complexities of real-world financial distress situations. This section dissects the key shortcomings of this approach, highlighting how it disincentivizes qualified BRPs from undertaking high-risk cases, ultimately hindering the effectiveness of business rescue proceedings.

4.1. Minimal Net Assets: A Flawed Foundation for Fee Calculation

A critical flaw in the 5% net asset cap lies in its fundamental assumption that financially distressed companies possess substantial net assets. In reality, companies on the brink of insolvency often have minimal net assets, having depleted resources through operational losses, debt burdens, and asset sales undertaken to stay afloat (Alexander & Voyle, 2012). A study by Demirgüç-Kunt et al. (2015) analysing insolvency proceedings across multiple jurisdictions highlights this trend, demonstrating a negative correlation between a company's financial health and the value of its net assets.

This reality renders the 5% cap insufficient to cover the time, expertise, and potential litigation costs required for a successful turnaround. Consider a scenario where a struggling manufacturing company with net assets of ZMW 1 million (approximately USD 58,823 as of April 30, 2024) enters business rescue. Under the 5% cap, the maximum fee a BRP could earn would be ZMW 50,000 (approximately USD 2,941). However, effectively restructuring this company might involve extensive negotiations with creditors, developing a comprehensive turnaround plan, and potentially navigating legal challenges related to contracts or debt restructuring. The capped fee would likely fall short of adequately compensating a qualified BRP for the time and effort required for such a complex undertaking.

4.2. Unpredictable Expenses and The High-Risk Factor

Business rescue proceedings are inherently complex, often involving unforeseen challenges and complications. These complexities can lead to unanticipated expenses that fall outside the scope of the capped fee structure. For instance, protracted legal battles with creditors or disgruntled stakeholders may necessitate significant legal fees exceeding initial estimates. Furthermore, the need for specialized expertise, such as turnaround consultants or industry specialists, might arise during the rescue process, incurring additional costs not factored into the capped fee.

The capped fee structure discourages BRPs from taking on high-risk cases where unforeseen expenses are a distinct possibility. Experienced BRPs operate businesses and require a reasonable return on their time and expertise. When the potential compensation is capped at a level that may not even cover the time commitment and leave no buffer for unforeseen expenses, BRPs are more likely to prioritize cases with lower risks and more predictable cost structures. This can lead to a situation where financially distressed companies with complex turnaround needs struggle to attract qualified BRPs, ultimately hindering their chances of successful rehabilitation.

4.3. Lack of Flexibility: Stifling Complex Restructuring Efforts

The inflexibility of the 5% cap creates a disincentive for BRPs to engage in complex restructuring efforts that may require significant time and resources. Business rescue often necessitates a multifaceted approach, encompassing debt restructuring, operational adjustments, asset sales, and potentially even mergers or acquisitions. Effectively navigating these complex processes requires a significant investment of time and expertise from the BRP.

The current legislation offers no provisions for exceeding the fee cap in exceptional circumstances. This lack of flexibility discourages BRPs from undertaking cases where a successful turnaround might hinge on a more time-intensive approach. Furthermore, the capped fee structure creates a disincentive for BRPs to propose innovative solutions that might require additional upfront investment but have a higher potential for long-term success. In such scenarios, BRPs may be tempted to suggest fewer effective solutions that fit within the confines of the capped fee, potentially jeopardizing the company’s long-term viability.

The limited flexibility of the 5% cap can have negative consequences beyond discouraging BRPs from undertaking complex cases. Without the ability to adjust fees for exceptional circumstances, companies may be pushed towards less effective solutions, such as asset stripping or liquidation. These approaches often result in job losses, lost economic value, and a diminished confidence in the overall business rescue framework.

POTENTIAL CONSEQUENCES OF THE 5% FEE CAP

The seemingly simple 5% fee cap on net assets for Business Rescue Practitioners (BRPs) in Zambia carries the potential for significant unintended consequences. This section explores the potential negative impacts of this policy, focusing on how it might discourage experienced BRPs and ultimately lead to an increase in company liquidations, with detrimental social and economic effects.

5.1. Discouraging BRPs: A Skills Gap in the Making

The capped fee structure has the potential to discourage experienced and qualified BRPs from undertaking financially distressed cases in Zambia. When the maximum compensation for a complex, high-risk case barely covers the time commitment and offers no buffer for unforeseen expenses, experienced BRPs are likely to prioritize cases with lower risks and more predictable fee structures. This can lead to a situation where financially distressed companies with the most complex turnaround needs struggle to attract the most qualified BRPs.

The potential consequence of this discouragement is the gradual emergence of a skills gap within the Zambian business rescue practitioner community. Experienced BRPs who are consistently under-compensated for complex cases may be more likely to exit the field altogether, or to focus their expertise on less risky insolvency work such as liquidation. Over time, this could lead to a decline in the overall quality and experience level of BRPs available to handle complex business rescue proceedings.

A diminished pool of experienced BRPs can negatively impact the quality of services offered during business rescue proceedings. Less experienced BRPs may lack the necessary skills and knowledge to effectively navigate complex financial restructuring, negotiate with creditors, and develop viable turnaround plans. This can ultimately decrease the success rate of business rescue efforts, further undermining confidence in the system and potentially leading to a vicious cycle of discouragement for both BRPs and financially distressed companies.

5.2. Increased Liquidation Risk: A Domino Effect of Negative Consequences

One of the most concerning potential consequences of the 5% fee cap is the increased risk of company liquidations. If the capped fees discourage experienced BRPs from taking on complex cases, and less experienced practitioners lack the necessary skills for effective turnaround, the success rate of business rescue proceedings is likely to decline. This translates into a higher number of companies being pushed towards liquidation as a seemingly more viable option, despite the associated economic and social costs.

The rise in company liquidations can have a ripple effect of negative consequences. Job losses are a major concern, as companies undergoing liquidation often face the need to downsize or cease operations entirely. This can have a significant impact on livelihoods, particularly in sectors with high concentrations of employees within a single company. Furthermore, increased liquidations can contribute to economic hardship by reducing overall economic activity, potentially impacting tax revenues and hindering investment opportunities.

Beyond the immediate economic impacts, a rise in liquidations can also have negative social and reputational consequences. Increased unemployment can lead to social unrest and a decline in living standards. Furthermore, a business rescue framework perceived as ineffective due to high liquidation rates can damage investor confidence and discourage new business ventures, further hindering economic growth.

ALTERNATIVE APPROACHES FOR FAIR COMPENSATION OF BRPS IN ZAMBIA

The limitations of the current 5% net asset fee cap in Zambia necessitate exploring alternative approaches that ensure fair compensation for BRPs while safeguarding against excessive fees. This section examines three potential solutions: success-based fees, hourly rates with a capped maximum, and a pre-approval process for exceeding the cap in exceptional circumstances.

6.1. Success-Based Fees: Rewarding Results

Success-based fees offer compensation to BRPs contingent upon a successful outcome in the business rescue process. This approach incentivizes BRPs to dedicate the necessary time and effort to achieve a positive turnaround for the company. Success could be defined by various metrics, such as the preservation of a certain percentage of jobs, the successful restructuring of debt, or the continued operation of the company as a going concern.

Pros:

1. Aligns BRP interests with those of the company and stakeholders: By linking compensation to successful outcomes, success-based fees incentivize BRPs to prioritize achieving a viable turnaround plan.
2. Encourages innovation and creative solutions: Knowing that a successful outcome will translate into higher compensation, BRPs may be more likely to explore innovative restructuring approaches.

Cons:

1. Potential for cherry-picking cases: BRPs might be more selective in accepting cases, prioritizing those with a higher likelihood of successful outcomes and shying away from high-risk situations.
2. Difficulty in defining success metrics: Determining clear and objectively measurable criteria for a “successful” outcome can be challenging, potentially leading to disputes between BRPs and stakeholders.

6.2 Hourly Rates with a Capped Maximum: Balancing Time and Cost

An alternative approach involves establishing hourly rates for BRP services, coupled with a pre-defined maximum fee limit. This method ensures a degree of predictability in costs for financially distressed companies, while still compensating BRPs for the time and expertise invested in the case.

Pros:

1. Increased transparency and cost predictability: Companies have a clearer understanding of potential fees upfront, allowing for better budgeting and planning.
2. Rewards time commitment and effort: BRPs are compensated based on the hours dedicated to the case, ensuring fair remuneration for their expertise.

Cons:

1. Potential disincentive for efficient work practices: If hourly rates are high, there might be less emphasis on completing the rescue process efficiently to avoid exceeding the capped maximum.
2. Difficulty in setting appropriate hourly rates: Determining fair and competitive hourly rates for BRPs can be challenging, potentially leading to under- or over-compensation depending on the complexity of the case.

6.3 Pre-approval Process for Exceeding the Cap: Flexibility for Exceptional Circumstances

A potential solution involves maintaining a baseline fee cap on net assets but introducing a process for BRPs to seek pre-approval from a designated body (e.g., a regulatory board or professional association) to exceed the cap in exceptional circumstances. This approach balances the need for cost control with the flexibility to compensate BRPs adequately for complex cases.

Pros:

1. Ensures fair compensation for complex cases: BRPs with well-justified proposals for exceeding the cap can receive appropriate compensation for their expertise.
2. Maintains cost control for simpler cases: The baseline fee cap still applies to less complex rescue proceedings, preventing excessive fees.

Cons:

1. Potential for bureaucratic delays: The pre-approval process might introduce administrative burdens and delays in the business rescue process.
2. Risk of subjectivity in approval decisions: The criteria for exceeding the cap need to be clear and objectively assessed to avoid favouritism or inconsistency in approvals.

6.4 Analysis of Potential Effectiveness

Each of these alternative approaches offers potential benefits over the current 5% net asset cap. Success-based fees can incentivize successful outcomes but require careful design of success metrics. Hourly rates with capped maximums offer transparency and a reward for time commitment but require setting appropriate rates. A pre-approval process for exceeding the cap provides flexibility for complex cases but necessitates a streamlined, objective approval system.

The optimal approach might involve a combination of these elements, tailored to the specific needs of the Zambian business rescue framework. Further research, including comparative analysis of alternative fee structures in other jurisdictions, can inform the development of a more nuanced and effective approach to BRP compensation in Zambia.

CONCLUSION: RETHINKING FEE CAPS FOR EFFECTIVE BUSINESS RESCUE IN ZAMBIA

This analysis has examined the limitations of the current 5% net asset fee cap for Business Rescue Practitioners (BRPs) in Zambia. The capped fee structure, while seemingly straightforward, presents significant drawbacks in real-world scenarios. Companies on the brink of insolvency often have minimal net assets, rendering the capped fee insufficient to adequately compensate BRPs for the time, expertise, and potential litigation costs required for a successful turnaround (Demirgüç-Kunt et al., 2015). Furthermore, the complexity of business rescue proceedings can lead to unforeseen expenses, and the capped fee structure discourages BRPs from taking on high-risk cases where such expenses are a distinct possibility. Finally, the inflexibility of the cap disincentivizes BRPs from engaging in complex restructuring efforts that may require significant time and resources.

These limitations can lead to a skills gap within the BRP community, as experienced practitioners are discouraged from undertaking complex cases due to insufficient compensation. Ultimately, this can result in a higher number of company liquidations, with associated negative consequences such as job losses, economic hardship, and a decline in confidence in the business rescue framework (Wong et al., 2018).

Effective business rescue procedures play a crucial role in promoting economic growth and stability by offering viable alternatives to liquidation for financially distressed companies. A well-functioning business rescue framework can facilitate successful restructurings, preserving jobs, and ensuring the continued operation of valuable businesses. However, this effectiveness hinges on attracting and retaining qualified BRPs with the necessary expertise and experience. By adopting a more nuanced approach to BRP compensation, the Zambian business rescue framework can incentivize the participation of experienced practitioners, ultimately leading to a higher success rate for rescue efforts and a more robust and resilient corporate environment.

Moving Forward: A Nuanced Approach

This analysis has explored alternative approaches to BRP compensation, including success-based fees, hourly rates with capped maximums, and a pre-approval process for exceeding the cap in exceptional circumstances. Each of these approaches offers potential advantages over the current system. Success-based fees can incentivize successful outcomes but require careful design of success metrics. Hourly rates with capped maximums offer transparency and a reward for time commitment but require setting appropriate rates. A pre-approval process for exceeding the cap provides flexibility for complex cases but necessitates a streamlined, objective approval system.

The optimal approach might involve a combination of these elements, tailored to the specific needs of the Zambian business rescue framework. Further research, including comparative analysis of alternative fee structures in other jurisdictions, can inform the development of a more effective system. This could involve, for instance, establishing tiered fee structures based on the complexity of the case, or introducing a risk-adjusted fee component to incentivize BRPs to take on high-risk cases.

Ultimately, the goal is to ensure fair compensation for BRPs while safeguarding against excessive fees. By fostering a system that attracts and retains skilled practitioners, Zambia can create a more robust business rescue framework, facilitating successful corporate turnarounds and promoting a healthier overall economic environment.

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