CAMAC DISCUSSION PAPER

REHABILITATING LARGE AND COMPLEX ENTERPRISES IN FINANCIAL DIFFICULTIES[1]

SUBMISSIONS of R W HARMER[2]

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Chapter 1.

1. On the 'definition' of 'large and complex' companies

Any definition would be most problematic. I am not aware of any modern system that creates such a division.[3] Further, I do not think it may be suggested that ALRC45 promoted any or any significant divide between small, medium and large. That was certainly not the intention of paragraph 57 of that report. Rather it was designed to preserve schemes of arrangement as possibly having a place for larger companies, particularly if, as noted in the report, a reorganisation might involve the creation or application of some form of exotic corporate product.

2. On the initiating test

The assessment (1.12-1.14) seems to state the reality, namely that the existing financial stress test is probably not all that different to the US 'good faith' test. I would not see any advantage in adopting the US test (except such advantages that might be produced by unnecessary litigation).

3. On control

There are a number of brief points to make:

- The debtor in possession approach requires, ultimately, the engagement of professional advisers by the debtor. That is a simple fact. Very few, if any, successful cases of Chapter 11 have been done 'in house'.[4]

- It may appear that a greater range of expertise may be summoned and employed under the US system. But under the Australian system there is nothing to prevent an administrator from engaging industry and other experts

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[1] I should observe at the outset that this Discussion Paper and also the Inquiry by the Parliamentary Joint Standing Committee into the insolvency laws are to be applauded, coming as they do some 10 years following the major insolvency law reforms of 1993. That indicates an ongoing test and examination of the laws and their application – a good approach to good health.

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[3] The insolvency laws of some countries in transition create divisions between various forms of enterprise, but they are largely irrelevant to this debate.

[4] Except where the reorganisation is, in effect, the product of a management buy out and even then that usually involves a host of financial and other consultants.

in particular cases. And ALRC45 recommended[5] that the field for eligibility as an administrator be greatly widened.

- The 'control' factor may, therefore, be illusory – what is wanted is expertise and someone capable of cutting a deal.

- If it considered that, having now had the benefit of a relatively free flowing experience under voluntary administration, the commercial community in Australia is ready to move to a less controlled position, then I would not be opposed to it.[6] But I would suggest that the directors of a company be given an option – either they go it alone and take the consequence of that or they appoint an independent administrator. The results of that experiment might be very interesting. And there might have to be some rapid change to the law concerning the liability of a director.

4. Negotiation with creditors

I would be quite happy to see the restraints on creditors strengthened and follow the latest UK trend – although it is quite clear that the reaction of floating charge holders in Australia to administration has not been anywhere near as evident as it has been in the UK.[7]

5. Ongoing financing

I accept that the Australian regime could benefit from a more 'codified' approach in this area

6. Equity finance

I do not understand the concern regarding this nor the suggestion that some specific provisions might be required. Is it not similar to 'debt trading'? You buy the debt and start influencing the outcome of the rescue. Then you engineer a debt for equity swap or offer to pump in some new equity and etc. Alternatively you simply acquire existing shareholder rights (or a fair % of them) and start horse-trading with the creditors/administrator.

7. Timetable

It would be very remiss, in my opinion, if time periods were greatly extended. I have had first hand reports of some dreadful instances in the US of time dragging to eventually wear down the opposition (possibly brought about by the behaviour of some US judges who give as much time latitude as possible so that they can notch up yet another 'successful reorganisation' on their record).

[5] Paragraph 937
[6] But see my later comments under 8 below.
[7] The most recent of the UK reforms also signals the gradual demise of the floating charge for reasons unrelated to insolvency. There is a reasonably reliable body of opinion in the UK that the existing secured transactions regime, if it can be called such, will be soon abolished and replaced by a system that is more aligned to practices in the US and western Europe.

8. Generally

Although I have responded to a number of the issues raised in Chapter 1 without questioning why the issues are raised, I must still question what appears to be an underlying assumption or suggestion to the Discussion Paper; namely, that somehow, someway, some one, two or more of the larger corporate insolvencies in Australia might have been better handled and might have produced a better result if the Australian regime was more like the US Chapter 11 regime. To that I simply pose the rhetorical question: what is the basis for that contention? Hopefully the Committee will receive some detailed submissions directed toward providing an answer to that question which I will be most interested to see.

On another, more general matter, it maybe worthwhile to consider the US system as a broad integrated system: each component part is essential and only together do they make a workable whole.[8] Viewed in that light, it seems to me that it would be difficult to cut and paste a part or parts of the essential components of the Chapter 11 system to the Australian system. For example, assume that the debtor in possession mode was adopted in Australia without much or anything else. It must then follow that the debtor (or its advisors) would have the first (or, at least, one) bight at the preparation and presentation of a plan. Creditors will then realise that they need independent advisors to assess and quarrel with the proposals of the debtor because they have not got the facility or the luxury of an independent administrator. Next the creditors will realise that there are different interests represented within their number. So they will split into classes, each separately advised. Then it will become apparent that arguments and disputes will have to be solved. So the court will have to be given a far more interventionist role (not to mention the lawyers that will have to be engaged) and a final approval or sanction power. One thing produces another and you end up with a de facto Chapter 11 system. If that is right then it suggests to me that either something like the Chapter 11 system must be adopted as a whole, or not at all.[9]

Chapter Two[10]

1. Initiation and administration

If considered necessary I would support the options set out in 2.28 and 2.32.[11] I would give some support to 2.34, but with the pragmatic rider that in my experience in countries where creditors are permitted to initiate rescue attempts, very few, if any, rescue attempts are in fact initiated by creditors.

[8] In much the same way as the Australian system may be similarly viewed.

[9] This is not to suggest that certain features of Chapter 11 should not be considered, such as a greater restraint on secured creditors, avoidance of ipso facto clauses and the like.

[10] The following comments on this Chapter should be regarded as of general application and should not be treated as directed at administrations in respect of 'large and complex' corporations.

[11] Perhaps the problem of the corporate group might be solved by a provision that required one or more of the companies in the group to meet the basic 'financial' test and that the survival of the vital components of group as a whole would be best facilitated by all the companies in the group initiating voluntary administration.

2. Eligibility

I would promote the original recommendations in ALRC45.

3. Overriding rights/partial exercise

As mentioned earlier, I would support removing the power of any secured creditor to intervene in a voluntary administration.

4. Timing

I would support something like the option set out in 2.71.

5. Notification

I suppose eventually we must all accommodate modern methods of communication and I would not be opposed to specific rules enabling notices and the like to be communicated by methods other than through the use of the postal services.

6. Lending

As mentioned earlier, I would support a more 'codified' approach to this issue that, in effect, created a 'super priority', but which was at all times subject to resolution between existing secured creditors (where their security might or could be impaired), the new credit provider and the administrator, with the court available in the event of dispute. But that does not seem to fall squarely within any of the policy options mentioned in the Discussion paper

7. Voting/casting vote

This is the age-old problem. No system is perfect, but, on reconsideration, I doubt that the recommendation in ALRC45 (the court) is the answer. I do not imagine that a judge would welcome the opportunity to make such a decision. Maybe the answer lies in giving a casting vote to an independent chairperson.[12]

8. Remuneration

I would not have a problem with 2.117.

9. Indemnity

The option in 2.125 would solve this issue.

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[12] This might perhaps herald the beginnings of a new profession – professional chairpersons.

10. Avoidance

I do not think ALRC45 went quite that far. As I recall, the 'standard' terms and conditions to be incorporated into a deed of company arrangement, as drafted in Vol.2 of ALRC45, provided for a possible 'opt-in' of the avoidance measures.

11. Equity/debt swaps/prospectus disclosure/financial product disclosure/takeover provisions

I should refrain from offering any comment on these since they are outside of my current understanding and knowledge. But I might mention that ancillary legislation in the USA bankruptcy Code is specifically directed at some of the above areas in an effort to better promote a deal.[13]

12. Court directions

I agree with the comment in 2.167

13. Set off

This must and should continue to be permitted, unless one wishes to endanger a large number of financial products.

14. Pooling of assets

I think the thrust of the submission to CAMAC as mentioned in this part has considerable merit.

15. Ipso facto clauses

I would support avoiding the lot. Even tough it does intervene upon contractual rights, no great damage is likely.

16. Executory contracts

In my opinion providing for a unilateral power to assign is one bridge too far. That really does start to interfere with fundamental contractual rights

17. Priority creditors

I think that the present position is the most apposite.

18. Employees generally

From this distance I do not feel competent to comment on the good sense or otherwise of the interventions of government into the position of employees,

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[13] See 11 USC, paragraphs 1145-1146 (1994)

although it might be nice to one day see some development of an overall sound policy instead of what appear to be a series of reactions.

I refrain from commenting on the remaining issues.

I mention that I have given evidence to the Parliamentary Committee Inquiry into the Insolvency Laws, some of which might be relevant to CAMAC. I understand that will be available on the parliamentary website in due course.

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LONDON
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Rehabilitating distressed enterprises during recessions

A submission to the
Corporations and Markets Advisory Committee

by Dr. G.R. Putland
(Brisbane, November 27, 2003)

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Acknowledgments

Summary

I submit that Australia needs a new form of bankruptcy protection which would be available only during a declared state of economic emergency, and which would enable any debtor enterprise to reschedule its

existing unsecured debts on a last-on-first-off (LOFO) basis. Creditors in the queue (‘‘old’’ creditors) should be able to raise their priority only by offering to settle at a discount; and while the state of emergency remains in force, only ‘‘new’’ creditors (owners of debts incurred after the rescheduling) should have recourse to conventional remedies for default. The availability of LOFO rescheduling would restore the confidence of potential suppliers and lenders in the credit-worthiness of customers and borrowers, at least in respect of *new* business, so that commerce would recover and economic growth would resume. While the rescheduling of one debtor’s payments would force some low-priority creditors to invoke the same bankruptcy protection themselves, thereby forcing some of their creditors to do likewise, etc., the resulting chain reaction would not be a cascade of enterprise failures leading to general depression, but a cascade of debt restructures after which the remaining bad debts would be borne by parties who can bear them without becoming insolvent.

1. Motivation

1.1 Why recessions require special rules

In the rare event that a large and complex enterprise fails in a time of full employment and brisk business, the damage done to the victims is moderated by the plenitude of economic opportunities. Employees can readily find new jobs. Shareholders should be adequately protected by diversity of investment. Creditors should have sufficient margins to cover the resulting bad debts. Suppliers should have plenty of alternative customers. The necessary adjustments, although somewhat traumatic for the affected parties, are part of the process by which inefficient enterprises make way for more efficient ones. This is capitalism working as it should.

In the more likely event that the enterprise fails in a time of recession or impending recession, the situation is far more serious. Employees will be out of work for months or years. Shareholders will be caught by widespread asset depreciation. Creditors may be overexposed to non-performing debt. Suppliers may not survive

the loss of business. The ensuing fall in consumption and tightening of credit will put pressure on other enterprises and contribute to a deepening of the recession. Under these conditions, enterprises fail not because they are inefficient but because others are failing; thus the number of enterprise failures greatly exceeds the reasonable requirements of economic Darwinism, while valuable knowledge and skills that will be needed by future enterprises are lost through prolonged lack of use. Moreover, the resulting breadth and depth of hardship could not be defended by any arguments about efficiency, because surely one purpose of efficiency is to avoid such hardship.

The rules governing the rehabilitation or liquidation of troubled enterprises during recessions should therefore be different from those that apply in better times. In normal times, the rules may be characterized by a stoic admission that some business failures are inevitable and necessary for the maintenance of efficiency. But in a recession, one must simply minimize the number of enterprise failures.

1.2 Why the next recession is imminent

Frank Gelber of BIS Schrapnel has predicted that the property bubble will burst in 2006, causing a recession in 2007/8. He reasons that the present economic growth phase will continue until it becomes inflationary, forcing the Reserve Bank to impose higher interest rates, which will pop the bubble; then the belt-tightening caused by the fall in asset values will bring on the recession.

I predict that the bubble-burst will come in 2004 and the recession in 2005/6. My reasons include the following:

- Residential property is now about 30 percent overpriced relative to rental yields. Such high prices can be sustained only by an expectation of continuing rapid capital gains; any stabilization of prices undermines that expectation and consequently removes the support for today’s prices. It follows that the bubble cannot end in a plateau; it can only end in a bust. As to the timing, the Melbourne-based Land Values Research Group, which has been charting real estate turnover since 1972, has established the empirical rule that turnover in excess of 19 percent of GDP portends a crash, then a recession. Current turnover is at least 25 percent. The

record, set just before the last great property crash (1989-90) is about 27 percent, and on current trends will be exceed within six months if it has not been exceeded already.

- According to the Reserve Bank [1], Australia's household mortgage servicing ratio (mortgage interest as a percentage of disposable income) is at an all-time record in spite of low interest rates. The total household debt servicing ratio is at the highest level since the late 1980s and, if present trends continue, will surpass that record within a year. Housing investment is about 8 percent of GDP, while borrowing against housing is more than 12 percent of GDP [1,p.21]; both figures exceed all previous peaks (at least since 1980). Clearly the expansion of debt must end soon. When it does, consumption will contract and GDP will fall.
- Much discussion is based on the assumption that the Reserve Bank determines the future of interest rates. But, while the interest paid by a central bank can raise market rates, it has very limited capacity to lower them; at most, the cut in official rates represents the withdrawal of one borrower, namely the central bank, from the market. If private lenders lose their nerve, market rates will rise regardless of official monetary policy.
- Warning signs of a residential property crash include falling rents in inner Melbourne, stagnant rents in inner Sydney, falling apartment prices, and the rent-free periods offered by landlords in order to attract tenants without reducing the rents quoted to prospective buyers.

Concerning the severity of the coming recession:

- The Reserve Bank's graph of housing equity withdrawal [1,p.21] shows that throughout the 1980s, borrowing against housing was consistently below housing investment, by a margin of about 3 percent of GDP. The margin narrowed during the early 1990s and was typically about 1 percent of GDP in the second half of the decade. But since the beginning of 2001, borrowing against dwellings has exceeded dwelling investment; the margin is now about 4 percent of GDP, or about 8 percent of household disposable income. Borrowing against housing (as a fraction of GDP) has risen about 8 percent of GDP since the late 1990s and about 10 percent of GDP since the 1980s. This gives an idea of how much household spending will contract

when borrowing returns to sustainable levels. And that is only the first-round effect; the resulting unemployment will cause another fall in consumption, which will cause more unemployment, and so on.

Note that the blowout in borrowing relative to housing investment is unprecedented; the absence of this Damoclean sword before the recessions of the early 1980s and early 1990s indicates that, unless radical preventive measures are taken, the coming recession will be more severe than those.

- More than 40 percent of housing loans (by number and by value) are now taken out by investors, and the fraction is rising; whereas owner-occupiers' housing debt is rising at about 20 percent per year, investors' debt is rising at about 30 percent per year [1,pp.22,23,39]. Because of the prevalence of negative gearing, investors are more dependent on capital gains than owner-occupiers and are more likely to default in a market downturn.

  Note that negative gearing has now become the norm; Australia's 1.3 million property investors -- not just new investors -- collectively claim more in rental deductions than they declare in rental income.

- The APRA has calculated that Approved Deposit-taking Institutions (ADIs) can withstand a 30 percent fall in home prices and a 3.5 percent mortgage default rate. But the bursting of the housing bubble will also curtail the consumption that is now being financed by borrowing against home equity. Will the ADIs withstand the ensuing business loan defaults? or the second round of mortgage defaults caused by job losses? or the second round of business loan defaults caused by reduced sales caused by the first round of business failures and job losses, etc.?
- If a recession begins when interest rates are low or when market interest rates have decoupled from official interest rates, there is little scope for monetary stimulus.

Notice that the above comments on the timing and severity of the recession consider only the domestic situation. Let us now turn to the United States:

- The U.S. stock market, whether it is assessed by P/E ratios or replacement costs of assets, is about 30 percent

overvalued [2] notwithstanding the bear run from late 2000 to early 2003. In other words, given the right trigger, the market is ripe for a crash.

- Notwithstanding recent positive news on employment, the U.S. economy has shed more than 2.5 million jobs in three years. Economic growth has been financed not by sustainable growth in spending power, but by expansion of debt -- notably including cash-out mortgage refinancing. Because the U.S. property bubble is more localized and less extreme than Australia's, this mortgage refinancing depends less on rising property values and more on the equally unsustainable circumstance of falling interest rates.
- Since 2000, the U.S. federal budget has blown out from a surplus of 2.4 percent of GDP to a deficit that is now more than 3 percent and rising. There is little political will to cut spending, and even less to raise taxes. The deficit must either raise market interest rates or drive inflation, prompting a rise in official interest rates.
- The U.S. current account deficit is about 5 percent of GDP. In spite of this, the U.S. dollar remains highly valued because it is the global *de facto* standard trading and reserve currency. But the high dollar drives employment and manufacturing offshore and thereby adds to the trade deficit. Eventually this must cause a loss of confidence in the U.S. dollar, which will stem the flow of imports into the world's biggest economy, forcing painful adjustments in the U.S. and abroad. And the longer this reckoning is delayed, the more traumatic it will be. Possible triggers include a crash of the U.S. stock market or property market, or a new corporate scandal, or a decision by one or more OPEC states to sell oil for euros instead of dollars, or the next attempt by the Fed to adjust monetary policy (which may reveal that market interest rates have decoupled from official interest rates).

When a line of hailstorms is racing towards your city, you don't necessarily know which cell is going to strike first or which suburbs are going to have their cars dented, their roofing tiles cracked and their drains overwhelmed. But you act preemptively to minimize the damage.

2. The proposal

The descent into depression is a domino process in which the collapse of some enterprises causes a loss of income for others, which also collapse, and so on. So the challenge is to devise an emergency regime whereby enterprises can keep trading indefinitely, even if they are, for the time being, technically insolvent.

The perceived moral turpitude of insolvent trading arises from the risk that parties who are induced to deal with the insolvent entity may lose their money. The same risk makes people reluctant to deal with any entity that they perceive to be under financial stress. But the moral objection and the practical impediment both disappear if those who deal with the entity go to the head of the creditor's queue in the event that the entity is liquidated. Of course a new moral objection is raised by those older creditors who find themselves demoted in the queue; for this reason, such a radical re-ordering of the queue should not be allowed under normal circumstances. But in a recession, when *all* creditors are nervous about their chances of being paid, and when those chances would obviously be enhanced by an end to the recession, a rational creditor should welcome any policy that would shorten the recession and keep debtor enterprises afloat until the end of the recession, even at the cost of some seniority among creditors. Any place in the queue is better than no queue. Rescheduling of debts in favour of new creditors would indeed end the recession, because it would break the chain of enterprise failures and remove impediments to new business.

I therefore suggest that the Federal Parliament, using its ‘‘bankruptcy and insolvency’’ power under s.51(xvii) of the Constitution, should legislate to the effect that the Governor-General in Council, if satisfied on reasonable grounds that the economy is falling into recession, may declare a state of economic emergency, during which enterprises may decide to reschedule their existing unsecured debts on a last-on-first-off (LOFO) basis. When an enterprise announces that it is exercising this option, debts incurred after the announcement (‘‘**new**’’ debts) take priority over debts incurred before the announcement (‘‘**old**’’ debts), and only new debts may give grounds for traditional remedies (e.g. liquidation proceedings) in the event of defaults. Old debts are placed in a queue, with more recently incurred debts having higher places. In practice, some creditors who are placed low in the queue will be prompted to reschedule their own debts,

so that a chain reaction will ensue. Debts in a queue are legally subject to a moratorium as long as the enterprise is not liquidated and the state of emergency continues; but in practice the debtor will wish to show some progress in paying those debts, in order to keep faith with future suppliers and lenders and prepare for the end of the state of emergency. Creditors may legally jump the queue by offering to settle for less than the amount owing (a minimum discount, e.g. 20 percent, should be specified in the enabling legislation). In practice, the initial queue-jumping offers will come from creditors who can take losses without becoming insolvent themselves, but some debtors wishing to accept these offers will try to finance their acceptance by making similar offers to their own debtors, and so on up the chain; this is the mechanism by which the burden of bad debts is shifted onto those best able to bear it. If a *new* creditor decides to enforce liquidation, the special LOFO provisions cease to apply, so that new debts no longer have automatic priority over old debts; this ensures that new creditors are not too eager to enforce liquidation.

The advantages of LOFO debt rescheduling over the current voluntary administration (VA) procedure include the following:

- LOFO requires no court proceedings; this feature is essential during a recession, when the enterprises in difficulty are too numerous to be processed through the courts.
- Even before an entity announces a LOFO rescheduling, those who deal with the entity today know that they will be near the head of the queue if the entity makes a LOFO announcement tomorrow. VAs give no such assurance.
- If the economy is to recover from a debt-induced recession, a large number of debts must be settled for less than their face value and the burden of bad debt must be shifted onto those who can most easily bear it. The LOFO queue-jumping rule provides a fast, informal, market-based mechanism for settling debts and distributing the burden. VAs, like most provisions of current insolvency law, regard queue-jumping as cheating.
- LOFO rescheduling automatically avoids some of the most harrowing consequences of enterprise failures. Consider, for example, an insurance company making periodic payments to accident victims. Under current laws, those payments do not enjoy any special priority and are liable to be suspended pending an assessment of the funds available for that

category of creditors. Under LOFO rescheduling, those payments continue as usual because the liability for each instalment is deemed to be incurred when the instalment falls due -- i.e. after the LOFO announcement.

I envisage that the LOFO rescheduling would apply only to the lowest-priority category of creditors, loosely described as unsecured creditors. For example, it would not apply to a loan secured against an asset and requiring periodic repayments; those repayments would continue regardless of any LOFO announcement. But an unsecured loan would be placed in the queue according to the date of the loan contract, while a bond would be queued according to the date of issue and credit-card transactions would be individually queued.

3. Questions raised by the Advisory Committee

The discussion paper [3] raises some issues which I shall address in the context of LOFO debt rescheduling.

Q. *''Will the directors, or some external appointee, control the company during the rehabilitation period?''*

A. Usually the directors, because the workout of debts is meant to be informal and market-driven. Moreover, in a recession, the number of enterprises in trouble would cause a shortage of administrators if every such enterprise required an administrator. In the case of an exceptionally large and complex enterprise, it might be argued that there is an unusual degree of public interest justifying the appointment of an independent administrator; but it would be impractical to extend this requirement to all enterprises.

Q. *''Do directors obtain any immunity from possible liability for any debts incurred by the company during the rehabilitation period?''*

A. The interests of ''new'' creditors are adequately protected by the priority of new debts over debts incurred before the LOFO announcement. Hence there is no special reason for directors to fear lawsuits from new creditors. Concerning old creditors, the interests of directors are adequately protected by the right to make a LOFO announcement with all that it implies; in particular, the newest ''old creditors'' -- i.e. those who gave credit closest to the

announcement and are most resentful of its timing -- are placated by being at the head of the queue. Hence there is no need for any special provisions regarding directors' liability; the usual laws regarding negligence, malfeasance and dishonesty should continue to apply.

Q. *Under what conditions should an enterprise be allowed to invoke LOFO debt rescheduling?*

A. In normal economic times, not at all; only during a declared state of economic emergency would LOFO rescheduling be allowed. But, given that such an emergency has been declared, further legal restrictions on LOFO rescheduling are unnecessary and undesirable -- unnecessary because any enterprise making a LOFO announcement would suffer some loss of reputation, which loss it would rather avoid; and undesirable because:

- the courts do not have the capacity to process the number of legal disputes that could arise from such restrictions;
- in an emergency there is no time for arguments;
- if some entities make LOFO announcements, other entities may be compelled to make similar announcements in order to remain competitive, even if they have been viable and competitive up to that time;
- while the old creditors of the nation would have a collective interest in supporting LOFO rescheduling, which would end the recession and restore debtors' capacity to pay, the old creditors of a particular debtor might think they stand to gain by preserving their priority with that debtor, and might therefore oppose that debtor's LOFO application if given the chance; this is a conflict between the collective and individual interests of creditors, and the object of the LOFO proposal is unashamedly to protect collective interests.

Q. *Could an enterprise invoke LOFO rescheduling merely in order to brush off creditors or, worse, to obtain a debt holiday and the concomitant competitive advantage?*

A. Yes, and these are some of the reasons why LOFO rescheduling should not be allowed in normal economic times. But in a recession, when the overwhelming necessity is to shake out bad debts and make a fresh start, such objections miss the point. Concerning the competitive advantage conferred by LOFO rescheduling, the remedy is to allow the competitors to follow suit; this, as stated above, is a reason for the lack of restriction on

LOFO announcements during a declared state of economic emergency.

Q. *Should a LOFO announcement override ipso facto clauses, reservation-of-title clauses and set-off rights?*

A. Clearly it should override ipso facto clauses; otherwise an old creditor with a small debt could potentially force liquidation on the basis of some trivial contractual condition, thereby defeating a key feature of the LOFO system. The other parts of the question are less important. Reservation-of-title clauses allow repossession only of those goods which are subject to the clauses and for which the debtor has not paid in full. Set-off rights apply only to creditors who are also reciprocal debtors, and allow such creditors to withhold payments only up to the value of the debts owed to them. A LOFO announcement further reduces the consequences of such clauses by making it easy for the enterprise to raise new credit.

4. Assessment against guiding principles

The discussion paper [3] proposes five guiding principles for the rehabilitation of large and complex enterprises.

Principle 1: *''The earlier a company responds to its financial difficulties, the better may be its prospects of successful rehabilitation.''*

Hence I have proposed that when a state of economic emergency is in force, there should be no legal hurdles in the way of LOFO rescheduling.

Principle 2: *''The prospect of a financially distressed company being rehabilitated may be improved if it can be encouraged to enter into discussions with its major creditors as early as possible on how best to rectify its financial position.''*

The queue-jumping provision of LOFO rescheduling encourages creditors to settle at a discount if they are able to do so. Such offers from creditors may induce the debtors to make similar offers to their own debtors.

Principle 3: *''A company may have a better prospect of successful recovery if it can obtain new loan or equity finance*

during the rehabilitation period.''

LOFO rescheduling encourages ''new'' creditors by giving them priority over ''old'' creditors.

Principle 4: *''The procedural timetable needs to be sufficiently flexible to adjust to the needs of particular companies.''*

LOFO rescheduling gives maximum flexibility; the only ''timetable'' constraints are the end of the state of economic emergency and the ability of ''new'' creditors to invoke conventional remedies in the event of default.

Principle 5: *''The process of rehabilitating a corporate group may be assisted if that group can be dealt with collectively, rather than on a company-by-company basis.''*

This question applies to judicial and quasi-judicial proceedings. LOFO rescheduling avoids such cumbersome formality.

5. For the future

Bursting asset bubbles figure prominently in recession forecasts. The recessions of 1974/5, 1982/3 and 1991/2 were triggered by crashes in the property market (although, very conveniently for the property lobby, the first two crashes coincided with oil shocks). The Great Depression was triggered by a stock market crash whose consequences were magnified by the debt burden left behind by the property crash of the mid 1920s.

If assets in a particular class can be produced by free enterprise, any rise in values will trigger more production and moderate the rise. Therefore price bubbles tend to be confined to asset classes involving some element of monopoly. In the property market, the monopoly consists in the strictly limited supply of *land* (as distinct from buildings) and the uniqueness and irreplaceability of each parcel of land. In the asset backing of corporate shares, there are monopolies in intellectual property (patents, designs, trademarks and copyrights) and special privileges (e.g. mineral rights, electromagnetic spectrum assignments, rights of way).

Bubbles are pumped up by speculators, i.e. buyers who are chiefly interested in capital gains. Bubbles can therefore be prevented by tax reforms that make it uneconomic to hold non-replicable assets for capital gains alone, forcing the owners of such assets to use

them in ways that generate income. The simplest and most obvious of these reforms is to reduce taxes on income and impose or increase holding taxes proportional to the values (or changes in values) of non-replicable assets and payable by the owners of those assets.

While such tax reforms can prevent bubbles from inflating in the first place, they unfortunately cannot prevent pre-existing bubbles from bursting and leaving a crippling burden of debt. So the issue of tax reform is raised with a view to preventing the recession *after* the next. The next one can only be alleviated by insolvency reform.

References

[1] Reserve Bank of Australia, *Statement on Monetary Policy*, November 2003, available at http://www.rba.gov.au/MonetaryPolicy/ (under ‘‘Statements on Monetary Policy’’).

[2] Alan Wood, ‘‘Let the good times roll, unless Q’s the answer’’, *Weekend Australian*, August 23-24, 2003, p.36.

[3] Corporations and Markets Advisory Committee, *Rehabilitating large and complex enterprises in financial difficulties* (Discussion Paper), September 2003, available at http://www.camac.gov.au/ (under ‘‘Current Discussion Papers’’).

Acknowledgments

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The Mission of Prosper Australia is:

> *To create prosperity and full employment by collecting the rental from land and natural resources instead of taxation.*

In general the views expressed herein should be taken as those of the author. However, the submission reflects the mission of Prosper Australia in that it emphases the connection between land speculation and recessions and advocates tax reforms for the prevention of such speculation.

This submission quotes figures on real estate turnover compiled by Bryan L. Kavanagh *AAPI(Val)*, who at the time of writing is the Honorary Director of the Land Values Research Group, of which the author is also a member.

The submission is *not* confidential.

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Our ref 112 Ltr JK ANC-BT-6NTM1.doc

27 November 2003

Dear Sir

Rehabilitating large and complex enterprises in financial difficulties - discussion paper

We refer to the Corporations and Markets Advisory Committee ("CAMAC") discussion paper entitled "Rehabilitating large and complex enterprises in financial difficulties" dated September 2003. Thank you for the opportunity for KPMG to provide a submission regarding the discussion paper.

Introduction

KPMG has provided input to the submission to CAMAC by the Insolvency Practitioners Association of Australia ("IPAA") and we generally support the views expressed in that submission. However, we take the opportunity to provide you with our specific comments regarding the following matters.

Informal restructuring

As noted in the IPAA submission, we confirm and reiterate that there has been considerable successful restructuring of large and complex, financially challenged enterprises in this country, where there has been no requirement for imposition of a formal insolvency appointment. In our view, the available balance as between informal restructuring and our current formal insolvency procedures will generally provide the appropriate options, without necessitating the introduction of Chapter 11 style proceedings.

We understand that the CAMAC discussion paper "does not cover informal 'workouts' in the form of voluntary contractual undertakings amongst creditors" (paragraph 0.19), however we believe that the rehabilitation process should be considered against the background of the considerable successes of our current restructuring practices.

KPMG, an Australian partnership, is a member of KPMG International, a Swiss non-operating association.

Introduction of a "debtor in possession" regime, similar to Chapter 11 in the United States

We endorse the sentiments of the IPAA, that a Chapter 11 style debtor in possession regime would not be appropriate in Australia. We advance the following in support of this view:

Costs associated with the Chapter 11 regime

- the Court (usually the Bankruptcy Court, to which matters are referred by the federal district courts) is highly involved in a Chapter 11 reorganisation pursuant to the United States Bankruptcy Code. By way of example:
  - the business continues to operate under Chapter 11, but is subject to the protection of the Bankruptcy Court;
  - Court approval is required for any transaction that is outside the ordinary course of business of the debtor;
  - the Court is required to find that the reorganisation plan is feasible and in the best interests of creditors as part of its confirmation;
  - the Court is required to find that the disclosure statement, via which creditors votes are solicited, provides adequate information to the creditors and equity holders;
  - there must be a Court hearing on confirmation of the plan at which any interested party may interpose objections;
  - an order is required to authorise the employment of all attorneys, accountants and other professionals by the debtor, trustee in bankruptcy or authorised committee; and
  - the Court must approve any payment for professional services rendered in a bankruptcy case.
- as a result of this significant Court involvement;
  - Chapter 11 proceedings often involve a very substantial cost; and
  - to introduce this regime into Australia would most probably necessitate setting up a parallel court system (in addition to the existing Court systems) to deal with the large volume of applications required pursuant to such a regime.

Control of the rehabilitation process

- leaving the board of a company in control would probably be repugnant to Australian creditors for the reasons that:
  - it would require them to continue to deal with those with whom they have lost faith and trust;

- it is often difficult to accept that the same management who adopted and implemented the strategies that led to (or failed to prevent) the Bankruptcy of the entity, would then have the ability and preparedness to change strategic direction so as to reinvigorate the company; and
- they may perceive a lack of an independent person involved in the reorganisation as a significant weakness over the existing Australian insolvency regime.

Economic impact

- one of the primary considerations with a rehabilitation or restructuring regime is to avoid it being misused to create an unfair competitive advantage. The best deterrent against such misuse is to take the actual facilitation of the restructuring out of the hands of those who initiate it, namely, the directors;
- we are very concerned that Chapter 11 can be used to support poorly performed companies, to the detriment of the well-managed and efficient industry participants; and
- the imposition of a debtor in possession regime in Australia, without the support of the banking industry, could result in an increase in the cost of credit with consequent adverse impact on the Australian economy.

We believe that the existing voluntary administration ("VA") regime, with certain adjustments, is an effective mechanism by which to facilitate the restructuring of large and complex enterprises and that there is no pressing requirement to implement an Australian version of Chapter 11 for that particular segment of the market.

Specific comments regarding Chapters 1 and 2 of the discussion paper

We highlight the following points arising from Chapters 1 and 2 of the discussion paper where they differ, or have a different focus, from the submission provided by the IPAA:

Paragraph reference	Commentary
1.6	*Prerequisites for initiating the procedure* In our view the existing prerequisite for the implementation of a VA, which requires a company to be either "insolvent or likely to become insolvent at some future time", is appropriate. If stakeholders believe that the company is not sufficiently "financially stressed" or the provisions of Part 5.3A are being abused, they may bring an action pursuant to Section 447A(2). The persons entitled to bring such an action are defined very broadly in Section 447A(4), and include "any other interested person".

Paragraph reference	**Commentary**
1.39	*Encouraging companies to negotiate with creditors* There can be a clear disincentive for a company to advise its creditors of its financial distress. Those creditors, where they hold security may enforce it, and where they do not, may seek the winding up of the company. It is submitted that the VA regime can provide appropriate scope to deal with these situations in that: ■ a winding up application can be stayed pursuant to Section 440A(2); and ■ a charge, other than a charge over the whole or substantially the whole of the company's assets, may be prevented from being enforced pursuant to Section 441D.
1.56 & 2.82 et. seq.	*Lending to a company in administration* We agree with the IPAA's submission that borrowings by an Administrator should be a personal liability of the Administrator, subject to the Administrator's right of indemnity against the company's assets. However, we emphasise that such borrowings should have no greater priority, through the Administrator's indemnity, than the other personal liabilities incurred by the Administrator. That is, they should not be given a priority over the existing pre-appointment security of a secured creditor. The displacement of pre-existing security may allow a third party to fund a fruitless turnaround attempt and thereby erode the secured creditor's security without its consent.
1.67 & 2.74	*Timetable for completing the procedure* We disagree with the suggestion that creditors should be entitled to extend the convening period for the second meeting of creditors at the first meeting. We suggest that the short timeframe for calling the first meeting can lead to less than complete coverage of all creditors entitled to receive notice of the meeting. Accordingly, the creditors in attendance at the first meeting may not be representative of the full body of creditors and they should not be empowered to extend the convening period, and the consequent moratorium (including the moratorium with respect to directors' guarantees pursuant to Section 440J), without an opportunity for consideration by all creditors. The suggested procedure is clearly open to abuse.

Paragraph reference	Commentary
	As an alternative, it may be appropriate to set the time for the convening of the second meeting based on a threshold asset, liability or turnover test of the entity. In this way, a larger entity, by any of these measures, may benefit from a longer convening period for the Administrator to conduct his or her investigations and then formulate the required opinion as to the most appropriate resolution of the company's position. We are of the view that the US timetable of six months is too long, and imposes an undue restriction on the rights of creditors, particularly secured creditors.
1.71 & 2.176 et. seq.	*Corporate groups* We generally support the submission of the IPAA that corporate groups should be dealt with on a pooled asset and liability basis, provided resolutions are passed by each company's creditors that approve pooling. However, it is submitted that it should not be necessary for every company in the group to be included, as there may be dormant or assetless companies that should be excluded to avoid the time and expense of dealing with those entities. The Administrator should also be permitted to apply to Court to add other corporate entities to the pooled group in voluntary administration where either the creditors of that company failed to pass a pooling resolution or the company has no creditors (provided it has assets and all of its controlling entities are already in VA).
2.25 etc. seq.	*Grounds for appointment* We agree with the IPAA's submission that there should not be a prohibition on directors appointing a Voluntary Administrator where a company is already insolvent. A company with cash flow insolvency can face very different challenges to one with a balance sheet deficiency, and a company with a surplus of assets that is cash flow insolvent may be the perfect candidate for a restructuring through a voluntary administration and a deed of company arrangement. Directors should continue to be entitled to appoint a Voluntary Administrator in these circumstances. In keeping with the objectives stated in Section 435A, the voluntary administration procedure should be available even if there is only a limited possibility of a successful restructuring.

Paragraph reference	Commentary
2.39 et. seq.	*The rights of secured creditors in a VA* We strongly disagree with any incursion on the current rights of a secured creditor to enforce its security notwithstanding the appointment of a Voluntary Administrator. In the Australian context, it is highly likely that such incursions would increase the cost and decrease the availability of credit for companies. If a Receiver is appointed by a secured creditor and a satisfactory restructuring plan is later formulated by the Voluntary Administrator, it is already open to the secured creditor to remove its Receiver or otherwise limit the Receiver's powers to allow the restructuring to take place.
2.101 et. seq.	*Voting* We agree with the IPAA's submission that the current voting requirement of a majority of both number and value of creditors be retained. Although those with the largest debts generally have the most at stake, it is submitted that it would be improper to allow them to automatically achieve their preferred resolution in the face of opposition of a majority in number. This would have the potential to undermine the community's perception and acceptance of the VA process.

Paragraph reference	**Commentary**
2.127 et. seq.	*Voiding antecedent transactions* We agree with the IPAA's submission that the timeframe for a voluntary administration is too short to pursue antecedent transactions. We also submit that it is not appropriate for a Deed Administrator to automatically have the capacity to pursue antecedent transactions during a deed of company arrangement. This is due to the fact that a deed is intended to be an alternative to liquidation and the voiding of antecedent transactions is inherently related to the liquidation of a company. However, we consider it would be appropriate to allow the deed to provide the Deed Administrator with the capacity to pursue antecedent transactions, provided that the creditors approve such a deed and provided that Part 5.7B is included in its entirety. This is to avoid the possibility that, for example, creditors could be exposed to liability for preferences or uncommercial transactions, but directors could be protected from pursuit for insolvent trading. It is submitted, however, that where a liquidation follows the failure and termination of a deed of company arrangement, the three-year time limit in Section 588FF(3) should only commence once the deed has terminated. Otherwise, where a deed of company arrangement operates for a significant period, the Liquidator may face a very short period within which recovery actions must be commenced. The time limit may even have expired prior to the termination of the deed and commencement of the liquidation.
2.207 et. seq.	*Executory contracts* We disagree with the proposal that an Administrator be entitled to unilaterally assign executory contracts. We consider this to be an unreasonable incursion on the concept of privity of contract and freedom of contract.
2.212 et. seq.	*Deed compliance with priority payments* We recommend caution with the suggestion that a deed of company arrangement be permitted to depart from the priorities enunciated in Section 556. In the usual case, the majority in both number and value will be non-priority unsecured creditors. Accordingly, this group would have sufficient voting power to remove the priority Parliament has seen fit to provide certain classes of creditors, particularly employee entitlements.

Paragraph reference	Commentary
2.222 & 2.223	*Solvency under the deed* We disagree with the proposal that a company must be solvent either at the time of commencement or the time of termination of a deed of company arrangement. One of the key aims of Part 5.3A, pursuant to section 435A, is to provide a better return than would be available in a liquidation, regardless of the solvency of the company.
2.236	*Committee of creditors* We suggest that there should be a limit on the size of a committee of creditors. In our experience, large committees can become unwieldy and are of limited effectiveness. It appears reasonable to limit the membership of the committee to a maximum of around twelve members. However, it would also be prudent to allow the Administrator the discretion to increase this number in an appropriate case. For example, where it is a particularly large corporate entity or group structure and there are a large number of distinct creditor groups, than the Administrator could allow in increase in the permitted maximum number of committee members to allow for proper representation of the creditor groups.
2.238	*Exchange listing* We agree with the submission of the IPAA that companies subject to voluntary administration should not continue to be traded on the Stock Exchange. In addition to the comments made by the IPAA, we note that there is a cost involved in tracking transfers of shares. It is not clear who would be required to pay for this where a company is in voluntary administration. As there is no benefit to creditors in these transactions occurring, the creditors should not be required to meet these costs from their entitlements to the company's assets.

Should you have any queries regarding our submission, please feel free to contact Mr Stephen Hawke on telephone number (03) 9288 5827.

Yours faithfully

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26 November 2003

Dear Mr Kluver

Rehabilitating large and complex enterprises in financial difficulty – Discussion Paper

We refer to your request for submissions on the issues raised in the Corporations and Markets Advisory Committee's ("CAMAC") Discussion Paper on Rehabilitating large and complex enterprises in financial difficulty ("the Discussion Paper"). We appreciate this opportunity.

For ease of reference, we have included the headings, subheadings and paragraph numbering from the Discussion Paper.

Introduction

There has been a considerable amount of discussion as the lack of flexibility provided by the current legal regime to deal with large and complex restructurings of companies in financial difficulty. Members of CAMAC would be aware that there have been numerous restructurings of large and complex corporates in recent times that have been implemented by directors under the watchful eye of well resourced credit management executives of major banking syndicates with the assistance and guidance of experienced insolvency practitioners. These restructurings can and have been affected through cooperation and trust between the Directors, the Banks and their advisors. When that trust in particular is lost or tarnished, there is a need to remove legal control of the process from Directors. Only then does a formal appointment such as Voluntary Administration normally commence.

The IPAA believes the current legal framework, with minor amendments, provides an acceptable balance between informal restructurings and formal appointments.

Prior to responding to the issues raised in the Discussion Paper, the IPAA would like to clarify its general position in relation to Voluntary Administrations and the need for a Chapter 11 type arrangement in Australia. As stated in our submission to the Parliamentary Joint Committee on Corporations and Financial Services Inquiry into Australia's Insolvency Laws:

> "IPAA members who have conducted large administrations have advised, that with the assistance of the Court, the Voluntary Administration process can be used effectively to restructure large enterprises.

Any amendments that leave an ailing enterprise under the control of its directors and does not provide a mechanism to allow ongoing trading under "creditor control" will not be effective, and we expect would not be supported by financial institutions.

As such, the IPAA is not convinced that wholesale changes are required to Part 5.3A or that a new regime is required in order to effectively restructure large enterprises.

It is the IPAA's opinion, that with amendments to the Corporations Act previously detailed in other forums and in this submission, Part 5.3A provides an effective mechanism for dealing with the restructuring of large enterprises."[1]

The IPAA continues to stand by that position.

Chapter 1 – Principles for effective corporate rehabilitation

Whether each of the general principles identified in this chapter is appropriate for assessing the suitability of any rehabilitation procedure for these enterprises?

1.3 ***Principle 1: The earlier a company responds to its financial difficulties, the better may be its prospects of successful rehabilitation***

The IPAA generally agrees that this principle is appropriate for assessing the suitability of any rehabilitation procedure.

1.6 *Prerequisites for initiating the procedure*

The IPAA prefers a financial stress test similar to that in place now. However, at 2.28 of the Discussion Paper it was proposed that companies be able to appoint a Voluntary Administrator where there is a "reasonable prospect of insolvency". The IPAA agreed with this proposal (refer below). However, in order to protect directors who choose to appoint a Voluntary Administrator on the grounds that there is a "reasonable prospect of insolvency" or that the company is "likely to become insolvent at some future time"[2] elements of "good faith" should apply. For example, where directors place a company into administration in good faith, genuinely believing that the company is likely to become insolvent at some future time, then the appointment should not be able to be challenged.

1.15 *Who controls the procedure*

1.17 External insolvency practitioner

The IPAA believes that the rehabilitation of a financially distressed company needs to be controlled by an independent and suitably experienced, qualified and licensed/registered third party.

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[1] Point 1 of the IPAA's submission to Parliamentary Joint Committee on Corporations and Financial Services Inquiry into Australia's Insolvency Laws dated 30 April 2003.

[2] Section 436A of the Corporations Act

At this point in time, the most obvious persons to control the rehabilitation of companies are insolvency practitioners as they are independent, experienced, qualified, adequately resourced and registered. However, this is not to say that the field could not be widened if steps were taken to put in place a system for the identification and registration of suitably experienced, qualified and resourced restructuring professionals. It is important that the stakeholders in the restructuring process have faith in the party appointed to control the restructuring and it is more likely that third party stakeholders will have faith in an independent, appropriately qualified professional.

It should be made clear that the IPAA is not trying to limit insolvency and restructuring work to the domain of accountants, however, if the field is to be widened a set of criteria for registration needs to be established and monitored. The IPAA has already been working with ASIC to facilitate changes to the system for the registration of Liquidators (see 2.35 below).

1.20 The board

The IPAA does not agree with a system where the board retains control of the company. We disagree with the argument that removal of the board results in a loss of knowledge of the business as it is usual, in large companies particularly, for the board and management to be separate and thus loss of the board does not mean loss of management expertise.

1.25 Anyone chosen by the board

Directors can currently chose who to appoint in a Voluntary Administration. Obviously that choice is limited to registered Liquidators, however, we refer to our comments above regarding the need to ensure that only independent and appropriately qualified professionals are allowed to be appointed to these companies.

1.26 Anyone chosen by the creditors

In a Voluntary Administration, creditors have the option to replace the Voluntary Administrator with another registered Liquidator at the first meeting of creditors.

1.27 Regulation of persons other than insolvency practitioners

Refer to our comments above.

1.29 Role of the Court

It is the IPAA's opinion that Australia has the right balance in relation to the role of the Court in the restructuring process. Schemes of Arrangement are available if an insolvency administration with greater Court involvement is required (for further comments refer to Chapter 3 below).

1.32 Creditors' committees

The IPAA believes that Committees of Creditors could play a more useful role in Voluntary Administrations by being able to pass resolutions – particularly in the administrations of large enterprises where the major meeting may be postponed or adjourned for a considerable period of time.

Refer also 2.112 below for a discussion of the Committee of Creditors power to approve an administrator's remuneration.

1.35 Personal liability of directors for insolvent trading

The IPAA disagrees with the proposal that directors remain in control of a company during the restructuring procedure, however, if it was to be the case, directors should attract the same personal liability that a Voluntary Administrator currently does.

Principle 2: The prospect of a financially distressed company being rehabilitated may be improved if it can be encouraged to enter into discussions with its major creditors as early as possible on how best to rectify its financial position.

The IPAA agrees that this principle is appropriate for assessing the suitability of any rehabilitation procedure. The real difficulty relates to implementation. Admissions of insolvency or an inability to perform a long term onerous contract may empower creditors to commence proceedings against the company. Moreover if acquisition of debt at a discount occurs prior to a formal arrangement, it can lead to arguments of improper discrimination against non participating creditors who may be bound by a formal arrangement, but also creates a related party debt issue for the purposes of voting.

Principle 3: A company may have a better prospect of successful recovery if it can obtain new loan or equity finance during the rehabilitation period.

The IPAA believes that, in the right circumstances, this principle may be correct. However, it would not apply generally to all companies. For further discussion on lending to companies in administration refer to 2.82 below.

Principle 4: The procedural timetable needs to be sufficiently flexible to adjust to the needs of particular companies.

The IPAA agrees that this principle is appropriate for assessing the suitability of any rehabilitation procedure.

However, the IPAA believes that Voluntary Administrations, with the ability for administrators to obtain extensions of time by application to Court, are sufficiently flexible to adjust to the needs of particular companies.

The IPAA agrees with the arguments put forward in paragraph 1.67 of the discussion paper supporting the Court approval process for extensions in Voluntary Administrations. The IPAA also supports the idea of creditors being able to extend the convening period at the first meeting of creditors (refer 2.74 below for further discussion on this point).

The IPAA does not consider that an implementation timeframe, such as that imposed in the UK legislation, is appropriate. Creditors, when voting for a Deed of Company Arrangement (or any restructuring plan) should have the option of approving any timeframe set down by the proposed Deed (or restructuring plan).

Principle 5: The process of rehabilitating a corporate group may be assisted if that group can be dealt with collectively, rather than on a company-by-company basis.

The IPAA agrees that this principle is appropriate for assessing the suitability of any rehabilitation procedure.

Refer also 2.176 below for further discussion on corporate groups.

Whether any other general principles are relevant to this assessment?

The IPAA has no suggestions to make in this regard.

Whether, in light of the analysis of the principles in this chapter, all or some features of Chapter 11 of the United States Bankruptcy Code should be adopted in Australia for these enterprises and, if so, whether they should replace VA, be incorporated into VA to form a hybrid of the two procedures, or be an alternative to VA?

Consistent with our position outlined in the introduction to this submission, we do not believe that a Chapter 11 type arrangement is needed to replace Voluntary Administrations or to act as an alternative to them. However, we do believe that some aspects of Chapter 11, though not in the exact form, could be incorporated to enhance the operation of the Voluntary Administration regime:

- Committees of creditors - the powers of committees of creditors should be increased but not to the extent of committees in the US (refer 1.32 above and 2.112 below);
- Ability of creditors to enforce ipso facto clauses – The other party to a contract (other than a charge) should be unable to terminate or modify contract without the written permission of the administrator or the Court. If the Administrator chooses to continue with the contact, he or she should be liable to pay for that portion of the contract where benefit is obtained during the term of the Voluntary Administration (refer 2.191 below for further discussion on this point).
- Ability of creditors to exercise set-off rights – The exercise of set-off rights should be limited to pre-appointment funds. Post appointment receipts should be excluded (refer 2.168 below).
- Loan financing during rehabilitation procedure – Refer to 2.82 for a full discussion on this point.

The IPAA believes that the desire being expressed from some quarters for the introduction of a Chapter 11 type arrangement in Australia may well be as a result of a perception problem with Part 5.3A that does not exist in relation to Chapter 11. It may be that a "re-branding" of Part 5.3A would resolve this issue.

Whether, in light of the analysis of the principles in this chapter, any features of the UK legislation should be adopted for these enterprises?

It is the IPAA's opinion that the factors that drove the recent changes in the UK in relation to the rights of secured creditors to appoint a Receiver when an administrator is acting are not applicable to Australia at this point in time.

Secured creditors are generally supportive of the Voluntary Administration regime and will usually refrain from appointing a Receiver over a Voluntary Administrator, unless there are good reasons. For example, where they:

- have insufficient security; and / or
- are not happy with the company's choice of Voluntary Administrator; and / or
- do not agree with the decisions being taken by the Voluntary Administrator.

These issues are usually overcome by consultation with the secured creditor prior to the appointment and ongoing communication with the secured creditor throughout the administration.

The process also has the added benefit for secured creditors in that they do not have to offer an indemnity to the insolvency practitioner, as occurs when they appoint a Receiver.

For further discussion on the issue of secured creditors rights in Voluntary Administrations, please refer to 2.39 below.

Any other matter concerning the rehabilitation of large and complex enterprises that is relevant to this chapter?

The IPAA believes that the flexibility of the Voluntary Administration regime and the wide ranging powers available to the Courts, if Court involvement is required, make Voluntary Administrations an appropriate restructuring procedure for enterprises ranging from the largest listed company to a small private family company.

It is our opinion that a specific separate restructuring protocol for large enterprises is not required.

Chapter 2 – Voluntary Administration

2.19 Initiating an administration

2.25 Grounds for appointment

2.25 Policy option: Prohibit appointment by directors when the company is insolvent

The IPAA disagrees with the suggestion that directors of an already insolvent company should not be permitted to appoint an administrator for the following reasons:

- Once a company is insolvent, is it proposed that Liquidation be the only option available to directors? This would mean that the only path to Voluntary Administration and a Deed of Company Arrangement would be for the Liquidator to appoint the Voluntary Administrator, thus introducing a time consuming intermediate step with no apparent benefit.
- The difficulty in judging whether a company is insolvent or just approaching insolvency;
- What will be the consequences if directors appoint an administrator in the belief that the company is "likely to become insolvent at some future time", but subsequent to appointment the administrator determines that the company is really insolvent;

- It is possible for companies which are insolvent to offer Deeds of Company Arrangements to creditors which result in a better return for creditors than Liquidation. The IPAA believes that creditors should be given the opportunity to consider such options themselves;
- Currently where directors are issued with Director Penalty Notices by the ATO under section 222AOE of the Income Tax Assessment Act, if the directors wish to place the company into some form of external administration, the only form of external administration which can be commenced within the timeframe set by the 222AOE Notice is Voluntary Administration. If Voluntary Administrations are removed as an option for insolvent companies, what will directors in this situation do?

2.28 Policy option: Permit appointment where there is "a reasonable prospect of insolvency"

The IPAA agrees with this suggestion.

2.29 Policy option: Permit appointment when a solvent company is in financial difficulty

The IPAA does not agree with this suggestion. The entire premise of Part 5.3A is that the Company is or likely to become insolvent. The suggestion does not explain how the checks and balances implicit in the Part might then operate, if the Company is solvent. Why, for example, should the future of a solvent company be placed solely in the hands of a meeting of creditors?

Furthermore, we do not believe that such an amendment is necessary if the suggestion in the previous policy option is implemented, as arguably a company in serious financial difficulty has a reasonable prospect of insolvency without some form of intervention.

2.31 Policy option: Application to corporate groups

The IPAA agrees with this suggestion. However, it is important to ensure that the group position as a whole must be the trigger for the placing of the whole group into Voluntary Administration. Furthermore, if the group wishes to rely on this mechanism, the whole group must be placed into Voluntary Administration and not just a selection of insolvent and solvent members of the group.

2.33 Who should be entitled to appoint

The IPAA disagrees with the suggestion that individual creditors should be entitled to apply to the Court for an order appointing an administrator for the following reasons:

- How is any one creditor to judge whether it is in the interests of all creditors for the company to be placed into Voluntary Administration, with the cost of meetings etc, especially where potentially the creditor could apply to the Court when there is only a reasonable prospect that the company is insolvent.
- In practise the proposal could be open to abuse in the following ways:
  - the Court application could be made by related party creditors, even though they have no board control; and
  - it could be used as a takeover mechanism which could fundamentally erode the goodwill of a business at the expense of shareholders and for the benefit of a predator;

- The VA process is dependent upon at least the initial co-operation of directors. An appointment without the directors' consent appears to change the nature of the VA process.

- Creditors already have the right to seek the appointment of a Provisional Liquidator and the Liquidator would be better placed to determine whether a VA is appropriate.

- Creditors are rarely likely to have sufficient information to realistically determine if a VA should be appointed by the Court.

2.35 Eligibility of a Liquidator to be an administrator

The IPAA does not support the restriction on the eligibility of a Liquidator to be an administrator of a large and complex enterprise as it is the IPAA's opinion that the market ensures that only appropriate Liquidators are appointed to such types of companies.

However, the IPAA has been lobbying for changes to the current class system of Liquidators. It is the IPAA's opinion that:

- There should be a single class of Liquidator, rather than the current registered and official status;
- The criteria for registration as a Liquidator or to continue registration as a Liquidator should be strengthened and should include the following categories:
  - Education (initial – IPAA Insolvency Education Program or equivalent – and continuing);
  - Skills;
  - Resources;
  - Membership of an appropriate professional body; and
  - Experience (initial and continuing).
- Any person that meets the criteria should be able to be registered as a Liquidator;
- ASIC needs to have a process in place to monitor Liquidators to ensure that they continue to meet the criteria;
- If a Liquidator no longer meets the criteria, their registration should be cancelled.

The IPAA believe that the above steps will ensure that all Liquidators meet the high standards expected by the public for a person in this position.

The IPAA does not agree with the proposal to require the Court to approve a registered Liquidator so acting. The Voluntary Administration process is one where involvement of the Courts is the exception, not the norm and the IPAA would not like to see this change. Furthermore, the IPAA believes that the Courts involvement at this point in time is unnecessary as there is review of the appointment by creditors at the first meeting.

2.39 Rights that override a VA

2.52 Policy option: Reducing the rights of secured creditors

A general point in relation to this issue is the acceptance by secured creditors of the Voluntary Administration process. The IPAA queries whether there are any statistics on the number of appointments of Receivers / Receivers and Managers to companies in Voluntary Administration. Such statistics could indicate the level of acceptance by secured creditors and whether substantial change is required to the current process. For example, if the statistics show that the level of intervention by secured creditors is high, then changes to the law might be warranted so that Voluntary Administrators are given an opportunity to save the company. However, if the reverse is the case, change may be unnecessary.

It is the IPAA's view that secured creditors are generally supportive of the Voluntary Administration regime and will usually refrain from appointing a Receiver over a Voluntary Administrator, unless there are good reasons.
None the less, even if a Receiver is appointed over a Voluntary Administrator, if a company can be saved, it should be able to be saved even with the appointment of a Receiver and Administrator.

2.53 Policy option: Amending the rights of secured creditors

The IPAA believes that the current position under the Corporations Act provides a sensible balance between allowing a secured creditor a reasonable period to appoint a Receiver and once that time passes, the VA is free to progress the administration without lingering concerns that a Receiver will be appointed over the top.

The IPAA does not agree with the final suggestion of postponement of the sale of the secured assets if that would benefit unsecured creditors. The IPAA is concerned as to who would be responsible if the market for the assets fell during the period that the sale was postponed?

2.56 Partial exercise of secured creditors' rights

The IPAA does not agree with the suggestion that a secured creditor that has a charge over all or substantially all of the property of a company should be able to exercise its rights over only some of the company's property. The IPAA believes that, in addition to the counter arguments raised in the discussion paper, this will result in increased costs for the company.

2.70 Timing issues

2.70 Policy option: Extend current time limits

Regarding timeframes for the first and major meetings of creditors, the IPAA supports the extensions to the timeframes as recommended in CAMAC's report on Corporate Voluntary Administrations.

The IPAA does not agree with a general extension of the timeframe for personal liability for rented property. If an Administrator requires further time, he/she is able to apply to the Court for an extension. It would be unfair to owners and lessors if a general extension was granted.

2.73 Policy option: Give the Court an express power to alter current time limits

The IPAA does not see the need for this amendment, given the Court's powers under section 447A.

2.74 *Policy option: Give creditors at the first meeting the power to extend the convening period*

The IPAA supports this suggestion as it was one of the recommendations made by the IPAA in its submission to the Parliamentary Joint Committee on Corporations and Financial Services Inquiry into Australia's Insolvency Laws.

However, the IPAA suggests that the maximum extension that can be granted by creditors, whether by an extension given at the first meeting or an adjournment of the major meeting or a combination thereof, should be limited to 60 days. If an administrator requires more time than that, an application to the Court would be required.

The IPAA further suggests that the legislation in respect of adjournment of the major meeting should be changed to provide that the meeting may be adjourned for up to 60 days, rather than the current "cannot be adjourned to a day that is more than 60 days after the first day that the meeting is held"[3]. It is our opinion that the current law requires adjournment to a particular day, whereas our suggested change would give the administrator greater flexibility in that he or she would have a period within which the meeting must be reconvened.

2.75 *Policy option: Consequence of extending the time limits*

The IPAA supports this suggestion as it was one of the recommendations made by the IPAA in its submission to the Parliamentary Joint Committee on Corporations and Financial Services Inquiry into Australia's Insolvency Laws:

> "The IPAA proposes the following solution – that the Voluntary Administration legislation be amended so that, with the Administrator's consent, creditors can resolve to place a company into Liquidation at the first meeting of creditors. If creditors resolve to place the company into Liquidation, they should also have the power to choose their own Liquidator.
>
> The proposal put forward by the IPAA will result in:
>
> - A fast and efficient commencement to a form of external administration [being Creditors' Voluntary Liquidation];
> - A viable choice for directors when they are served with a Section 222AOE Notice from the Australian Taxation Office;
> - Avoidance of the cost of holding two meetings as is currently happening – possibly resulting in a better return to creditors;
> - Not having to wait until the second meeting of creditors in a Voluntary Administration to place the company into Liquidation when it is obvious to the Administrator that Liquidation is the only alternative."[4]

2.77 Notifying pre-commencement creditors

The IPAA believes that the legislation should be amended to provide when administrators may use websites and hotlines rather than physical delivery, to provide relevant information to creditors.

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[3] Section 439B(2) pf the Corporations Act

[4] Point 10 of the IPAA's submission to Parliamentary Joint Committee on Corporations and Financial Services Inquiry into Australia's Insolvency Laws dated 30 April 2003.

The IPAA included a recommendation to this effect in its submission to the Parliamentary Joint Committee on Corporations and Financial Services Inquiry into Australia's Insolvency Laws:

> "Issuing reports and other notifications to creditors incurs a significant cost in insolvency administrations, particularly in relation to large companies or corporate groups. The cost of this reporting reduces the pool of funds available to meet creditor claims. It is the IPAA's opinion that there are other options available other than printing and posting reports to creditors.
>
> Over recent years there has been a significant increase in the availability of technology. It is the IPAA's opinion that this technology could be better utilised to communicate with creditors, particularly on large insolvency administrations, and thus save costs.
>
> It is the IPAA's opinion that a large proportion of creditors in insolvency administrations have e-mail accounts and communication with creditors via this means should be allowed as an alternative to issuing notices/reports by post.
>
> Accordingly, the IPAA proposes that the Corporations Act and Corporations Regulations be amended to provide alternative means of communicating with creditors and members for all forms of insolvency administrations. It would then be the insolvency practitioner's decision as to what is the most efficient and cost effective method to be used on a case by case basis."[5]

2.82 Lending to a company under Administration

The IPAA believes that the law in relation to lending to a company under administration needs to be clarified.

2.100 Policy option A: Personal liability of the administrator to the lender

The IPAA believes that the administrator should be personally liable, unless exempted by agreement between the lender and the administrator. We see no difference in the relationship between the administrator and suppliers of goods and services, and the administrator and suppliers of finance. As such, we believe that the personal liability that currently applies for the purchase of goods and services should apply to the "purchase" of finance – unless agreement otherwise is reached with the lender.

Policy option B: Indemnification rights of the administrator if personal liability applies

The IPAA believes that the indemnity rights of the administrator should be the same as for indemnification rights regarding services, goods or property.

Policy option C: The relative position of the lender vis-à-vis the other creditors

It is the IPAA's opinion that a post-appointment lender should have the same priority over other unsecured creditors as for services, goods or property supplied to the administrator. Of course, security can be granted by the administrator over assets that are not already secured or assets which are purchased with the funds provided by the lender.

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[5] Point 7 of the IPAA's submission to Parliamentary Joint Committee on Corporations and Financial Services Inquiry into Australia's Insolvency Laws dated 30 April 2003.

2.101 Voting

The IPAA believes that the voting requirement of majority by number of creditors as well as majority by value be retained.

It is the IPAA's opinion that administrators' should retain their casting vote, however, in our submission to the Parliamentary Joint Committee on Corporations and Financial Services Inquiry into Australia's Insolvency Laws, we recommended that administrators not be entitled to use their casting vote in a resolution in which he or she has a direct interest (for example: resolutions regarding his/her removal, resolutions regarding his/her fees). The casting vote could still be used in a resolution regarding the future of the company (for example: to accept a Deed of Company Arrangement or to place the company into Liquidation).[6]

The IPAA recognises the arguments put forward in the Discussion Paper, however, in the interests of maintaining both real independence and the appearance of independence, the IPAA is of the opinion that administrators should not use their casting vote in resolutions in which he or she has a direct interest.

In instances where a resolution fails due to the administrator not exercising his or her casting vote, either the administrator or a creditor should have the power to appear before the Court to request the Court resolve the deadlock. In the two instances referred to above (removal and remuneration), we see that creditors may seek the Courts intervention in the situation where some creditors are seeking the removal of the administrator (and this has already been the topic of many Court cases where a casting vote was used to defeat the resolution [7]) and that Administrators may look to the Courts in relation to remuneration issues (which they already have the power to do pursuant to section 449E(1)(b)).

The IPAA agrees with the suggestion in the Discussion Paper that where an administrator uses the casting vote, he or she should be required to give reasons for the manner in which a casting vote was exercised.

2.112 Remuneration of administrator

The IPAA agrees with all three options put forward in the Discussion Paper for the approval of administrators' fees. However, we would also suggest that fees for the Voluntary Administration can also be considered and approved by creditors, Committee of Inspection or the Court during any subsequent Deed or Liquidation, provided that proper notice and disclosure is given. This would remove the pressure on Administrators to make estimates on the costs of finalising the Voluntary Administration prior to the major meeting.

The IPAA agrees with the requirement for committee members to receive seven days prior written notice of the amount of the remuneration claimed together with details of how the amount claimed is comprised and calculated.

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[6] Response to Question 10 in the IPAA's submission to Parliamentary Joint Committee on Corporations and Financial Services Inquiry into Australia's Insolvency Laws dated 23 July 2003.
[7] See *Young v Sherman* [2001] NSWSC 1020, *Cresvale Far East v Cresvale Securities* [2001] NSWSC 89.

In relation to the last two points raised on this issue:

- A Report on work still to be undertaken need only be provided if a resolution for prospective fees is to be put forward for approval. A report on work undertaken should be provided with every request for fee approval.
- A section similar to section 504 should be included for Voluntary Administrations and Deeds of Company Arrangement.

2.121 Administrator's indemnity rights

On the question of whether statutory indemnity rights of administrators adequately cover them for any debts they incur in the course of an administration, the IPAA considers that this is a commercial decision made by an insolvency practitioner prior to accepting an appointment or, if the appointment has already commenced, prior to deciding to incur a debt. In situations where the insolvency practitioner considers that there are insufficient assets available under the indemnity, he/she will either make arrangements to ensure that sufficient assets are made available or an indemnity is obtained from other sources or he/she will refuse the appointment or to incur the debt.

Regarding the issue raised in the discussion paper on the reduction in the value of indemnity assets by the appointment of a Receiver, the IPAA believes that there is no practical way of resolving this issue other than limiting instances where a Receiver can be appointed (refer our comments at 2.53 above). However, a Receiver will owe a duty of care to the company and may be liable for a breach of fiduciary duty.

2.127 Voiding antecedent transactions

The IPAA agrees that the timeframe for a Voluntary Administration is, generally, too short to pursue antecedent transactions. Furthermore, the IPAA agrees with the proposal that where an application for a winding up that has not been dismissed precedes a Voluntary Administration, the relation back powers should extend to the date of the initial winding up application.

2.134 Equity for debt swaps

2.136 Prospectus disclosure

The IPAA agrees with the proposal that offers of securities to creditors made under a Deed of Company Arrangement should be exempt from disclosure under Part 6D.2.

2.142 Financial product disclosure

The IPAA agrees with the proposal that there should be an exemption from the requirement to give a Product Disclosure Statement for an offer of a financial product made under either part 5.1 or Part 5.3A.

2.144 Effect of takeover provisions

The IPAA agrees with Policy Option 3 where the Court is given an express power to exempt a Voluntary Administration arrangement from the takeover provisions. However, this power should not mean that administrators do not have the option of approval from shareholders, ASIC or the Takeovers Panel.

The IPAA believes that the legislation should provide the Court with some guidance as to when an order is appropriate - for example, where the shares in the company are effectively worthless.

Voluntary Administrator's rights to deal with existing shares

An issue that was not raised in the discussion paper that the IPAA would like to raise is the fact that administrators currently have no ability to deal with existing shares when looking to restructure or obtain equity finance for the company.

The IPAA sees two options for legislative change:

1. Grant broader power to administrators, either Voluntary or Deed, to compel changes to existing shareholdings; or
2. Give administrators, either Voluntary or Deed, the power to be able to consolidate existing shareholdings.

The IPAA prefers option 2 as it does not affect the rights or intrinsic value of the shares. An issue the IPAA has identified is how to deal with uneven shareholdings – for example, if the administrator wishes to consolidate shares 100 for 1 and a shareholder owns 357 shares, does the shareholder get 3 or 4 consolidated shares?

2.161 Ambit of the Court's powers to give directions

The IPAA does not believe that any change is required to the current position being taken by the Courts.

2.168 Set-off

The IPAA believes that the moratorium should not extend to creditors' rights to set-off debts owed to it by a company against any funds that it holds on the company's account. However, this right of set off should not extend to post-appointment receipts.

2.173 Administrator's access to information gathered by regulators

It is the IPAA's opinion that all external administrators, including Voluntary Administrators, should be included in the same category as a lawyer who is carrying on, or contemplating in good faith, any proceeding in respect of a matter to which the examination relates.

2.176 Pooling of assets and deeds of cross-guarantee in corporate groups

2.182 Policy option: Companies subject to deed of cross-guarantee

The IPAA agrees with the submission that where a group of companies is subject to an ASIC-approved deed of cross guarantee, the assets and liabilities of those companies should be pooled at the discretion of the administrator or deed administrator without the need to obtain a Court order. Our agreement is conditional on the whole group that is subject to the cross-guarantee being placed into Voluntary Administration.

2.185 Policy option: Companies not subject to deed of cross-guarantee

The IPAA believes that the submission put forward in the discussion paper places too much power in the hands of the administrator and prefers the recommendation put forward in CAMAC's recommendation in its Corporate Groups Report.

However, the suggestion that an administrator of pooled companies only be required to prepare a single report for the group is a good suggestion and is supported by the IPAA. The IPAA also agrees that where more than one deed is proposed, separate explanatory statements should be provided.

2.191 Ipso facto clauses

2.202 Policy option: Retain the current law

The IPAA does not agree with this option as we believe that amendments are required in relation to this matter.

2.203 Policy option: Total prohibition on enforcing ipso facto clauses without Court approval

Please refer to the discussion at 2.206 below.

2.204 Policy option: Limited prohibition on enforcing ipso facto clauses

The IPAA does not disagree with this suggestion. However, we believe that if the administrator is made personally liable for any future debts incurred under the contract then there is little risk to the lender or creditor (refer 2.206 below for further discussion on this point).

2.205 Policy option: Temporary freeze on enforcing ipso facto clauses

The IPAA does not believe that this policy option would satisfactorily resolve this issue.

2.206 Policy option: Administrator's personal liability for overriding ipso facto clauses

The IPAA made a similar recommendation to this policy option in its submission to the Parliamentary Joint Committee on Corporations and Financial Services Inquiry into Australia's Insolvency Laws:

> "The Corporations Act currently provides that owners and lessors are unable to recover property used by the company during the Voluntary Administration without consent of the administrator or the Court[8]. It is the IPAA's opinion that this moratorium should be expanded to include contracts (other than charges). Accordingly, the other party to a contract (other than a charge) would be unable to:
>
> - terminate the contact;
> - modify the contract; or
> - repossess any property to which the contract relates;
>
> without the consent of the Administrator or the Court.
>
> Furthermore, in order to protect the other party to the contract, if the Administrator chooses to continue with the contact, he or she should be liable to pay for that portion of the contract where benefit is obtained during the term of the Voluntary Administration, similarly to section 443B of the Corporations Act.

[8] Section 440C of the Corporations Act

It is the IPAA's opinion, based on recent experiences of its members, particularly in larger Voluntary Administrations, that to achieve the objectives of Part 5.3A, an Administrator needs to have the right to continue with contracts– not have a decision made by the other party to the contract. The other party to the contract would be protected by the ability to apply to the Court and the personal liability of the Administrator.

Furthermore, the IPAA proposes a moratorium rather that the voiding of the provisions. This will provide the Administrator with the opportunity to examine all options – including the renegotiation of the contract, or finding a purchaser of the business who can renegotiate the contract, etc – without completely removing the other party's rights. This is in line with the current provisions of the Corporations Act in relation to owners and lessors.

It is also the IPAA's opinion that amendments made to the Corporations Act to expand the moratorium period to contracts should not apply to charges as there is already sufficient regulation of charges in Part 5.3A."[9]

2.207 Assigning or terminating executory contracts

The IPAA believes that the US law and Canadian recommendations on this point have merit.

In relation to assignment of executory contracts, it is the IPAA's opinion that these contracts should be able to be assigned, with the other party to the contract having the right to object to the Court if the proposed assignee is less creditworthy than the debtor was at the time of entering to the contract or reasonable assurances of payment have not been provided.

In relation to termination of executory contracts, the administrator should have the power to terminate a contract, regardless of its terms, with the counterparty having unsecured remedies in damages.

2.212 Deed compliance with priority payments

The IPAA believes that creditors should be permitted to approve deeds of company arrangement that depart from the winding up priorities and we made such a statement in our submission to the Parliamentary Joint Committee on Corporations and Financial Services Inquiry into Australia's Insolvency Laws:

"The ATO in their submission to the Joint Committee proposed that Deeds should not be able to "discriminate" against certain creditors or classes of creditors. The IPAA disagrees with the ATO's arguments. In the cases on this point, the fundamental factor which allowed the Deed to continue was that, notwithstanding the discrimination, the Deed was no less beneficial to all creditors than a winding up[10]. It is the IPAA's view that, even if a Deed is discriminatory, if it provides for a better return to creditors than the immediate winding up of the company then the objectives of Part 5.3A have been met."[11]

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[9] Point 2 of the IPAA's submission to Parliamentary Joint Committee on Corporations and Financial Services Inquiry into Australia's Insolvency Laws dated 30 April 2003.

[10] *Lam Soon Australia Pty Ltd (Administrator Appointed) v Molit (No 55) Pty Ltd* (1996) 14 ACLC 1,737

[11] Response to Question 19 in the IPAA's submission to Parliamentary Joint Committee on Corporations and Financial Services Inquiry into Australia's Insolvency Laws dated 23 July 2003.

We do not believe that the legislation should set out guidelines that indicate when it is appropriate to depart from the winding up priorities. However, it may be appropriate for the legislation to require administrators to provide full disclosure in their report of the effect on priority creditors where section 556 is not going to be followed. This may be particularly relevant in respect of employees as the Department of Employment and Workplace Relations Operational Arrangements state that where a Deed of Company Arrangement does not follow the priorities set down in section 556, employees will not be eligible to claim under the General Employees Entitlements and Redundancy Scheme[12].

2.215 Employee superannuation entitlements

The IPAA agrees with the recommendation in CAMAC's Corporate Voluntary Administration Report that an administrator should not be taken to have adopted any employment contract unless the administrator does so expressly in writing and that any such adoption should only relate to entitlements that accrued during the period of the administration.

2.222 Solvency under the deed

The IPAA does not agree with the suggestion that for a deed of company arrangement to be valid, the company must be solvent at the time of commencement of the deed. Although such a requirement may reduce the incidence of phoenix companies as suggested in the Discussion Paper, the IPAA suggests that it would also exclude the vast majority of companies from being able to propose a deed. If a company is entitled to enter in a Voluntary Administration in an insolvent state, as is the current criteria[13], how is it meant to become solvent prior to the commencement of a deed? It is also noted that notwithstanding the Deed, if the company recommences trading and incurring new debts, the directors will still be subject to their duties not to incur debts if they suspect or there are reasonable grounds to suspect the company is insolvent.

The IPAA believes that there may be some merit to a requirement that where a company is to continue to trade during the Deed, the company must become solvent on execution of the Deed. However, care would need to be taken when drafting legislation requiring this. The Voluntary Administrator should not be the one responsible for declaring that the company will be solvent – it should remain the responsibility of the directors to attest to the company's solvency.

2.224 Corporate Governance Issues

2.225 Financial reporting requirements

The IPAA does not believe that any further changes are required in relation to financial reporting requirements at this point in time, on the basis that ASIC is reasonable in granting exemptions and deferrals under PS 174.

2.227 Annual general meeting

The IPAA does not believe that any further changes are required in relation to annual general meetings at this point in time, on the basis that ASIC is reasonable in granting extensions under PS 174.

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[12] General Employee Entitlements and Redundancy Scheme Operational Arrangements clause 7.2
[13] Section 436A(1) of the Corporations Act

2.231 *Minimum number of directors*

The IPAA agrees that while a company is under the control of either the Voluntary Administrator or deed administrator, the company does not require the minimum number of directors as the directors have no role to fulfil at that time. However if a deed is proposed where control of the company is to return to the directors, or at the end of a deed, the company must have the required number of directors.

2.233 *Change of company name*

The IPAA agrees that administrators or deed administrators should be able to change the name of a company if it is the administrator's opinion that it desirable to do so in the interests of the administration. However, where a change of name occurs, disclosure of the former name should occur for a period of six months so creditors are made aware of the new name. This is particularly important for advertisements for meetings and dividends.

The IPAA also believes that if a name change occurs prior to any form of external administration, the same principles should apply.

2.235 *Relationship between deed of company arrangement and company's constitution*

The IPAA agrees with the suggestion that an executed deed of company arrangement should, to the extent of any inconsistency, override the company's constitution.

2.236 *Administrative issues*

Lodgement of notification of appointment

The IPAA does not believe that a differentiation is required between large and small administrations in respect of the completion and lodgement of a Form 505. It is more important that notification of the appointment is given as soon as possible.

Membership of Committee of Creditors

The IPAA agrees with the view that any statutory limitation on the number of creditors on the committee of creditors or on the number of their representatives at any committee meeting may prove unduly inflexible in particular administrations.

Company as a member of the Committee of Creditors

The IPAA agrees that a company should be a member of the committee of creditors or a committee of inspection. The current requirement that only a natural person can be a member of the committee of creditors/inspection is an ongoing source of problems for our members, particularly if an administration continues for a reasonable period of time and staff at the company creditor move on, leaving the creditor unable to participate in the committee meetings.

2.237 Other issues

2.237 *Managed Investment Schemes*

The IPAA has no further comments to make in respect of this issue.

2.238 *Exchange listing*

The IPAA does not agree that listed entities subject to Voluntary Administration should continue to be traded on the stock exchange. The IPAA is concerned that the administrator would be unable to comply with the disclosure obligations and that potentially sensitive information would be made available to creditors via the reporting protocol that would not be widely available to the market.

Although shares can continue to be traded in the US, the IPAA notes the following statement from the SEC website[14]:

> "A company's securities may continue to trade even after the company has filed for bankruptcy under Chapter 11. In most instances, companies that file under Chapter 11 of the Bankruptcy Code are generally unable to meet the listing standards to continue to trade on NASDAQ or the New York Stock Exchange. However, even when a company is delisted from one of these major stock exchanges, their shares may continue to trade on either the OTCBB or the Pink Sheets. There is no federal law that prohibits trading of securities of companies in bankruptcy.
>
> Note: Investors should be cautious when buying common stock of companies in Chapter 11 bankruptcy. It is extremely risky and is likely to lead to financial loss. Although a company may emerge from bankruptcy as a viable entity, generally, the creditors and the bondholders become the new owners of the shares. In most instances, the company's plan of reorganization will cancel the existing equity shares. This happens in bankruptcy cases because secured and unsecured creditors are paid from the company's assets before common stockholders. And in situations where shareholders do participate in the plan, their shares are usually subject to substantial dilution."

As such, although shares can continue to be traded in the US, they are not generally traded on the widely recognised exchanges.

Chapter 3 – Creditors' schemes of arrangement

From an insolvency perspective, Schemes and Voluntary Administrations have essentially the same purpose – they are procedures to enable arrangements to be made between a company and its creditors. They just go about reaching that purpose in different ways – in particular, Schemes are Court based, whereas Voluntary Administrations do not require Court sanction or intervention.

Feedback from members has indicated that although Schemes are perceived as being expensive time consuming and Court intensive, they have a useful role to play in the right circumstances. For instance:

- Where the Insolvency Practitioner wishes to make a distribution to stakeholders, or otherwise deal with the assets under his/her control, and considers it prudent to obtain a Court Order to validate his/her actions, to allow him/her to move forward with the administration.

- There are several, readily identifiable, stakeholder groups with widely disparate interests.

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[14] www.sec.gov/investor/pubs/bankrupt.htm

- The statutory priorities and / or statutory powers given to certain stakeholder groups are considered inequitable and the Insolvency Practitioner considers that an alternate method of distribution (or method of dealing with the assets) will provide a better result for the most deserving stakeholder groups.

- Stakeholder groups with the financial clout and/or political will to promote their views have the opportunity to have their 'day in Court' when the proposed scheme is put forward to the Court for approval.

- The entity's accounting records are incomplete and /or inaccurate, and cannot be remedied within a reasonable time-frame / cost budget. Accordingly, funds tracing, although necessary to properly determine who is entitled to what, may be highly problematic and the insolvency practitioner may seek the Court's approval to put forward a scheme which deals with the funds in a different manner.

- In the administration of insurance companies, where it is desirable to shorten the timeframe within which insurance claims may be made, so that the administration can be finalised in a reasonable timeframe.

- Schemes can be used to deal with the rights of shareholders of the company / group.

It is our opinion that a Scheme is more likely to be put forward after a company has already been in some form of insolvency administration, as was the case with Confidens Investment Trust. Due to the length of time involved in getting a Scheme approved and the fact that they do not provide any protection to directors from insolvent trading risk while the scheme is developed, we believe that a Scheme is unlikely to be the initial form of administration in an insolvency situation. It is after the appointed practitioner has had an opportunity to consider the situation that a Scheme may be seen to be the answer.

It is the IPAA's opinion that Schemes should not be changed to remove Court involvement totally, as it is the Court's involvement which differentiates them from Voluntary Administrations and in the circumstances outlined above it is usually the Court's involvement which would lead to the insolvency practitioner choosing to use a Scheme.

Although Schemes are not widely used in the insolvency context, they are used more regularly to restructure solvent companies where pressures such as lack of time and insolvent trading are not an issue.

The IPAA believes that it may not be just those persons that have an interest in restructuring large insolvent enterprises that need to be consulted on this issue, but also those people involved in the restructuring of large solvent enterprises.

* * * * *

Our President, Mr Bruce Carter, would be pleased to discuss this submission with CAMAC.

Yours sincerely

B J Carter
President

Australian Shareholders' Association Ltd

ABN 40 000 625 669

26 November 2003

Mr John Kluver
Executive Director
Corporations and Markets Advisory Committee
GPO Box 3967
SYDNEY NSW 2001

Dear Mr Kluver

ASA Submission on Corporate Recovery Discussion Paper

We understand that you are seeking submissions from interested parties on the Discussion Paper on rehabilitating large and complex enterprises in financial difficulties by Friday 28 November. We attach our contribution.

Yours sincerely

Stuart Wilson
Executive Officer

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ASA Submission on Corporate Recovery Discussion Paper

Introduction

The Australian Shareholders' Association welcomes the opportunity to emphasise the interests and rights of shareholders in the discussion of corporate recovery. The current administrative and liquidation practice ignores shareholders' interest in the progress of the procedure and trivialises entitlement to any residual on wind up by the assumption there will be none. We trust that the ASA's input is constructive and useful.

Australian Shareholders' Association Position

- Continue market announcements, including releasing s439A statement and progress of agreement with creditors, in order to maintain disclosure to shareholders and others, via ASX. (Currently tracked through www.delisted.com.au)
- Prevent administrators from guaranteeing immunity from recovery action to management or directors
- Institute independent approval process where assets are sold to administrators, major shareholders or directors of the company
- Place a time limit on production of liquidator's certificate or grant shareholders an entitlement to a capital gains tax deduction immediately recovery action is instigated (with any subsequent return being fully taxable in the year of receipt)
- Solvent companies should not be allowed to enter voluntary administration. Management and directors are charged with managing creditors and cashflow
- Concerns regarding Chapter 11 and moral hazard - the desire to preserve the interests of creditors, employees and company, while admirable, may allow ongoing poor management and financial decision making, increasing the losses flowing to the shareholders of the company and placing competitor companies at risk.

Chapter 1 Principles for effective corporate rehabilitation

Timely remedial action needs to be encouraged so that there is a surplus for shareholders.

Debate over loss of expertise of directors and other management if external administrator appointed:
Companies generally face insolvency when they have made imprudent investment decisions or misjudged risks. If the existing board and management have taken early action to avoid insolvency then they should continue in the role. However in many cases fraud, dishonesty, incompetence or gross mismanagement has led to insolvency, and as in the Ch 11 regime, close external supervision of the board is required.

1.34 The employment of professional advisers may well drive up fees beyond the external administrator role, though the introduction of a panel similar to the takeover panel has merit for both introducing expertise and controlling costs. On the subject of fees, the lack of transparency to the fee setting mechanism for administrators leaves shareholders believing the administrator has walked away with what was formerly the shareholders' residual.

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1.62 Equity Finance - there is little incentive for small shareholders to provide new equity to ventures that are already in difficulty. The interests and rights of existing shareholders have been limited in Chapter 1 of this discussion paper to the provision of further capital. Encouragement of new equity is difficult as it creates two different classes of shareholder - the rights of each class of shareholder are not easily balanced and rationalised. Often original shareholders would like to consider providing additional equity at discounted prices.

The US Ch11 regime allows six months for the production of a rehabilitation plan while VA allows one month. A company is required to be heading for insolvency to initiate voluntary administration, therefore the imperative for creditors to agree a course of action is greater and a shorter timetable is appropriate. A listed entity is professionally managed and has the resources to negotiate with its creditors while a going concern. Any lengthening of the time periods allowed appears to reduce the responsibility of the management and board to be on top of its business situation. The opportunity of an application to the court for an extension to standard timing gives appropriate flexibility for recovery of large and complex entities.

Other considerations: For sustainable companies, directors and management are required to adopt prudent employee, investment and financial practices throughout the business cycle. Given the action of a participant in one market will spill over to others within that market it is critical that any special treatment does not jeopardise well run entities.

Pursuing the suggestion of better returns for creditors and shareholders: the current situation and suggested amendments seem to ensure that creditors and administrators are more likely to receive recompense than shareholders. Adding to the sense of shareholders' injury, the sometimes-lengthy delay in receiving the Liquidator's Declaration is at odds with the presumption of nil return to shareholders.

Chapter 2 Voluntary Administration

A company entering Voluntary Administration often surprises shareholders, who have the most recent annual report showing it as a going concern. Given the difficulty of assessing the likelihood of insolvency at some future time without internal documentation, it is little wonder shareholders are concerned their financial rights are being exploited.

2.25 If already insolvent, a company should liquidate due to lack of chance for recovery and the risk of consuming more assets in a failed attempt.

2.26 The premise that liquidation is slower than VA to initiate, provides a reason for allowing insolvent companies to use VA ie protects directors from liability from insolvent trading: While establishing insolvency is tricky, expanding the use of VA may encourage risky behaviour. Shareholders more likely to get a return if there is a greater financial buffer at time of attempting resuscitation. Also creditors are not interested in residual for shareholders therefore putting more power in creditors' hands by allowing solvent companies to enter VA is distasteful.

Better returns for shareholders - deed of company arrangement. Often shareholders feel as if they have little say in the situation, even where they are able to vote on the deed. The binding of the officers and shareholders - while shareholders are given an opportunity to vote - it often seems there is an inequality of information with large shareholders having a greater say in the outcome.

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2.34 The entitlement that individual creditors may retain the right to apply to the court to appoint an administrator - the court prevents frivolous use of this power and shareholders may perhaps receive earlier warning of solvency troubles than otherwise.

Eligibility of a liquidator to be an administrator:

Large and complex enterprises require experience of running such organisations. There should be a special class of administrator, who should have access to executive expertise or the suggested turnaround panel.

Concerns regarding US style Chapter 11 proceedings:

Chapter 11 time-line seems too long especially if recovery is not assured.

The American airline companies have been in and out of Chapter 11 bankruptcy over the past two decades. The companies are highly operationally and financially leveraged with high capital intensity and large workforces. The existence of Chapter 11 has led to persistent imprudent employee agreements, over-investment in aircraft fleet and inadequate capital structure. Chapter 11 has become a competitive tool in this industry, making it more difficult for competing companies to operate prudently throughout the economic cycle. In the good times wages, debt and capacity, in the form of additional planes, ratchet up and prudent companies are forced to match imprudent practice to maintain market share. Inevitably the economic cycle turns down and the companies use Chapter 11 to restructure.

More generally, as a method of creating sustainable companies, Chapter 11 has mixed success. Lynn LoPucki, Professor at the law school of University of California, Los Angeles has built a database of all public companies with assets over $100m that have filed for Ch 11 Bankruptcy since 1980. Only 83 out of 569 times did a restructured company fail to emerge from bankruptcy. However many of the companies return to Chapter 11. Of the companies emerging from bankruptcy during 1991-1996, within 5 years 29% had gone out of business. Edith Hotchkiss of Boston College found that more than half Ch 11 restructurings fail.

Australian time-line:

Sufficient flexibility is allowed with the ability to extend Australian deadlines by application to the court or agreement of the creditors. The ASA would support the granting of express power to the court to extend any of the time periods for a proper purpose. Administration is costly and the longer it drags on the less surplus available to shareholders and employee entitlements, and the more competitors' and suppliers' finances are impacted.

The first meeting time should be no longer than 10 working days after appointment.

Information: notification letter via fax appears reasonable to the ASA as the billing department would have contact details for all creditors **plus release to ASX**. Provision of documents via the company's web site and comprehensive advertisements directing interested parties to website would be cheaper than current requirements and allow shareholders to keep in touch with the progress.

Administrators remuneration is quite steep - it is difficult to set fees purely as a proportion of assets given that airlines have high level of assets but in Ansett's case no surplus. Complexity should also be factored into the equation, and time spent - hence the desire for a speedy procedure.

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Equity for Debt swaps - the current law is adequate. It grants flexibility in relief from takeover provisions for Voluntary Administration. No takeover required if approved by shareholders or if no original equity persists. Prospectus should be required if additional cash required from creditors, unless they are professional investors.

2.149 where shares in the company have no value, the interests of these shareholders do not require protection (evidence required should be Liquidator's declaration).

2.1525 retain current law. Shareholders' approval is often grudgingly granted though they feel their rights are being overlooked - as stated on p 46 there may be an excess of assets over liabilities despite an inadequate cashflow for solvency. Shareholders often feel exploited by schemes of arrangement.

2.157 If takeover exemption were extended to Voluntary Administration: shareholders that believed their interests would be adversely affected under the deed of company arrangement could apply to the court to have the deed terminated. This is impractical on an individual retail shareholder basis. Typically the cost of mounting an action and the risk of eroding any residual value would outweigh the desire to terminate the deed.

2.222 A Company should be solvent at the time of the commencement of the deed of arrangement in order to maximise chances for success.

Financial reporting requirements - shareholders feel their interests are automatically assumed to extinguish with any recovery action. While it is agreed that standard going concern reporting is no longer appropriate, at the very least they have an interest in the timing of the liquidators declaration which may represent the only value left to them (CGT tax loss). Further, the ability to judge whether the residual has been maximised (though at no point in this discussion paper is any one charged with optimising the outcome) would be assisted by ongoing reporting of eg s439A report, creditors proposals etc.

2.234 Changing company name without shareholder approval would only seem to facilitate Phoenix organisations. Despite fondness for the names of some companies that are going concerns, shareholders approve name changes regularly.

Chapter 3 Creditors' Scheme of Arrangement

Scheme of arrangement - doesn’t require insolvency, and therefore may threaten shareholders residual interest in the shares unnecessarily.

3.4 Where a scheme involves transferring the whole or part of the undertaking, the property or the shares of one company to another company, the court may make various facilitative orders to achieve this end. Approval should be required via an independent approval process where assets are sold to administrators, major shareholders or directors of the company

Creditors scheme of arrangement may restructure equity base. Small shareholders often feel exploited by more powerful bargainers.

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2/12/03
Mr John Kluver
Executive Director
CAMAC
By email john.kluver@camac.com.au

Dear Mr Kluver

Think you for the opportunity to make a submission to the Mac enquiry.

We attach for your information a copy of our submission to the Parliamentary Joint Statutory Committee on Corporations and Financial Services Inquiry into Australia's insolvency laws ("our submission"). You will see from our submission, the Business Turnaround Association is suggesting that the Australian economy would greatly benefit if there was a new pre insolvency system for companies that were in financial distress and that could benefit from rehabilitation.

The essence of our submission is the proposed formation of a Turnaround Panel to order oversee the rehabilitation or turnaround of companies that meets the Panel's criteria. We believe the Turnaround Panel could easily operate under the same or similar legislation to the Corporations and Securities Panel (which is usually referred to as the Takeover Panel).

The main function on the Turnaround Panel would be to receive submissions from companies in distress, evaluate submissions and if the Panel chose it could grant under certain conditions a moratorium from paying unsecured creditors for six months. Sections 3.1 and 3.2 of our submission give further details on how the panel could operate.

John I apologise for the lateness of the submission and that we have only been able to give comments on The Introduction and Section 1. The BTA is at the moment a voluntary organisation with no paid staff, if time permits and you would like us to comment on further Sections of your discussion paper please advise.

Yours Sincerely

Michael O'Neill
Committee Member
michael@pacificcapital.com.au

Comments on specific issues, which are raised in your discussion paper:

INTRODUCTION

0.1 This is the basis of the Business Turnaround Association (BTA) formation and it's submission to the Joint Parliamentary Committee.

0.2 We agree that companies that are insolvent or not economically viable should not go through a turnaround process, we address this by having an independent panel of professional and business people look at the companies.

0.6 The time frame in which it was planned that **VAs would have to be decided on, would not in our opinion be generally suitable for a business turnaround.** In particular the VA operating philosophy has developed generally that the best and quickest way to often deal with companies in VA is either to:

- sell quickly the business undertaking to the highest bidder and the creditors receive only a small proportion of the money they are owed or
- put in a deed of arrangement where a payment scheme is made to a special fund that is distributed to creditors. Unfortunately a major creditor of such deeds, the Tax Office says there are few deeds that give creditors any reasonable returns.

The alternative is to Turn the company around and get it making profits and then if it cannot repay all creditors 100c in the $ then look at a creditors compromise. We believe, it in the vast majority of cases where the business was saveable this would produce much higher returns for creditors.

Although the Harmer Report believed their process would be flexible, in the majority of cases this flexibility has not been used by the Administrators for the benefit of creditors and shareholders.

.08 It is true some large companies have chosen to use the VA system rather than a scheme of arrangement. The point is however is that if there was a pre-insolvency system in place that could have operated before the companies became insolvent and it concentrated on operationally turning around the companies around, the losses to creditors would probably have been considerably less.

.09 We are sure that the VA scheme has advantages particularly where there is no operating business and what is essentially required is a fast creditors compromise (or financial engineering). To judge the effectiveness of the VA system though we should look at what the opinion of creditors is i.e. how they have benefited from the deeds of arrangement of the VAs.

The Australian Taxation Office is one of the largest unsecured creditors of companies that go into a VA Deed of Company Arrangement. On page 7 of the Tax Depts submission to the Parliamentary Joint Committee looking into Australia's Insolvency Laws they said "It is the experience of the Tax Office that there are very few Deed of Company Arrangements that yield reasonable dividends to creditors"

This is a very strong statement and one that should be carefully considered in the discussion " is there is a better way to help companies in financial distress".

.10 Regarding Chapter 11 – please see comments in our submission to the Parliamentary committee.

.11 Security Holders. We agree that at this stage security holder's rights should be preserved. In our submission we structured our proposal to accommodate this. If it was shown that security holders were abusing their rights then the position could be re-looked at.

.22 to .25 Defining large and complex enterprises. Our suggestion is that as a general principal the same definition be used, as that used by the ASIC in determining if a company has to lodge audited accounts. This would include public listed companies, and large private companies. For pubic unlisted companies, associations, and companies limited by guarantee we suggest that they be included if their structure and activities, would if they were private companies, mean that they would have to lodge accounts.

If the BTA's proposal for a Turnaround Panel was accepted we would suggest that the Panel have the general power to determine if a company should be eligible to be included.

.27 The issues raised are worthy of consideration. In addition, the question of professionalism and conduct of VAs is something that should be discussed. In reality VAs are largely not responsible to any group or body that can monitor their actions. The majority of VAs are very professional but sometimes their actions are critised and in practise creditors do not have a practical and economical way of having VAs actions reviewed by an authority.

SECTION 1

1.1 Agreed

1.3 Principal 1 – agreed

Prerequisites – we recommend that the directors should believe that the company may become insolvent within 12 months.

Who Controls - this is a difficult issue as currently it depends on the circumstances and the ability of the people involved. The BTA believes that the procedure that will give the best and most consistent results would be for a new body controlled by the ASIC called the Turnaround Panel to be vested with this control. See our submission for more details.

Personal liability – the BTA's submission addresses this issue. We propose that while a company was undergoing a turnaround (approved by the Turnaround Panel) that for the purposes of calculating solvency, the unsecured creditors at the date of the approval be excluded. This may seem an unorthodox suggestion and some would say that it disadvantages unsecured creditors. The reality is however that the result of most Deeds of Arrangements is that unsecured creditors get a small portion of what they are owed. Refer to the Tax Offices comments in .09 above. If a turnaround is successful the group who would benefit the most are the unsecured creditors. A safeguard in our suggestion is that the Turnaround Panel would be monitoring the turnaround process and if it was not going correctly the Panel has the ability to end it. Directors would then probably appoint an insolvency professional.

1.4 We do not see this as a big problem because if the directors do not take meaningful action if the company is in distress then the probability is that it will fail and the loss of reputation will be much greater.

1.5 The issues raised are very valid. This is the reason why the BTA has recommended that there be a Turnaround Panel to oversee the turnaround process of companies. The Panel would make a judgement about the existing directors and senior managements ability and determination to carry out the turnaround. Experience has shown that in most instances of companies experiencing major distress, the CEO and Board have made a significant contribution to this.

1.6 Agree

1.7 We suggest that the basis for successful turnaround would require both a financial stress test and a purposive test.

1.8 If a company is not in financial stress or is unlikely to be in it in the next 12 months it should go through normal commercial channels to initiate an improvement in its operations. In practice directors generally do not put up their hands early and say they cannot themselves solve a company's problems. We believe the Turnaround Panel could oversee such issues to stop abuse.

1.10 & 1.11 These functions would be overseen by a Turnaround Panel.

1.15 Agree

1.16 We believe the best controller would be a Turnaround Panel that has the necessary experience and authority to guide and control the turnaround process. The Turnaround Panel would agree the directors of the company who would be responsible for the implementating the agreed turnaround plan. The board would appoint an agreed CEO to undertake the actual managerial turnaround.

1.17 We believe that if some of or all the directors and senior management have made a material contribution to the company's financial problems, then they should probably be replaced.

We do not believe however that an external insolvency is generally the best or most experienced person to take over the company's affairs. Please see our submission.

1.18 We believe that although some external administrators have had good experience with companies undergoing insolvency, what is primarily needed is an experienced and successful CEO who has good experience with "turning around" companies.

Companies are managed and its staff carries out the operations of those companies. A successful turnaround normally occurs by using the majority of the staff already in the company with some key changes. The CEO needs to get his hands "dirty", be seen by everybody and not manage from "above". The CEO needs to be respected and put into place the strategy to re-motivate all the staff. The CEOs ability is not necessarily to get to know every detail of the business, but to make sure he/she can construct and lead the right management team.

1.19 We agree. An experienced CEO would obviously need to get to know the particular business, but with the help of good remaining staff and directors this is generally not a big problem. Remaining staff and directors are generally appreciative of a turnaround CEO being appointed as they have seen the company declining and are generally frustrated that nothing is being done about it.

The Board

1.20 The problem with Chapter 11 is that although some of the directors and management can be replaced, the initial group that make that decision is initially the old board. This old board may be honest and experienced people however they are still the group that has overseen the decline/demise of the company.

1.21 An experienced turnaround CEO can generally encourage the key executives in a company to stay.

1.22 We agree that if an external administrator is appointed it often encourages good executives to leave. We believe from experience that if a turnaround CEO is appointed if encourages good staff to stay especially if the believe that the company can be turned around and then will have a good future. Please see 1.18

1.23 We agree

1.24 We believe our proposed turnaround model caters for this situation.

Anyone Chosen by the board

1.25 We agree. The turnaround CEO however has to be in full control of the operations of the company.

Anyone chosen by creditors

1.26 This we believe could be dangerous unless it was supervised by an external party. There could be conflicts of interest and questions of experience and ability to debate.

Regulations of persons other than insolvency practitioners

1.27 There are 2 issues. The first is that although VAs are registered liquidators in practice there is little monitoring of their work by outside authorities.

The second issue is that our submission deals with this by having the Turnaround Panel monitor the turnaround process.

Role of the court

1.29 The US Chapter 11 Court procedure has advantages over the current system In Australia. We believe however that a turnaround procedure we described in our submission has the advantage of experienced business and professional people overseeing the turnaround process and our process would be more streamlined and quicker to deal with issues.

1.30 The costs of our turnaround panel process should be less than the US Chapter 11 system.

1.31 In Australia under the VA system, the courts do not have any significant role. If the VA system is being reviewed we believe that access to the courts to review the VA’s decisions could give creditors a fairer outcome.

Creditors committees

1.32 We believe the most important thing to do initially in a turnaround is to stabilise the company and concentrate on operationally turning the company around. If this can be achieved and the company is able to pay all its creditors then all this time and cost in running creditors committees is not necessary.

In a situation where the company has undergone a turnaround but the company is still unable to repay all its creditors, then this is the time to start discussions on creditors priorities. At this time with the company restored to operational profitability creditors repayments should be greater than if they were agreed before the turnaround process was put in place.

1.33 & 1.34 From our experience, creditors committees have very little role and practical power under the VA system.

Personal Liability of directors for insolvent trading.

1.35 to 1.38 The question of trading while insolvent if a company is going through a turnaround or reconstruction is dealt with in our submission. The BTA model proposes that the turnaround board of directors has the ability to trade on with an amended definition of insolvency. This new definition excludes the unsecured creditors at the commencement date of the turnaround. See 1.3 for more details. Using our amended definition of solvency it also enables new continuing creditors to have normal commercial assurance that they will be paid.

Encouraging companies to negotiate with creditors

1.39 The important issue is that if the directors and management can put together a robust turnaround plan then this is the ideal time to approach creditors and seek their help in being part of the turnaround plan.

1.40 to 1.43 Generally agree. We do not believe that in Australia to date there has been widespread abuse by secured creditors of their position with companies going into VA

Reservation of title clauses

1.46 For large companies, it is often difficult to enforce this as the original product often changes nature i.e. it is processed and so the original products are often hard to identify

UK

1.47 to 1.51. In Australia in the early 1990s the banks did appoint a large number of receiverships, partly we believe because they did not see

any other practical way to deal with the defaulting company. Since the introduction of VAs in 1993, the economic climate has not created the problems that led to the conditions of the early 1990s and the VA system is now available to deal with companies in trouble. In some ways the UK process of making the “administrator” responsible to all creditors is good.

US

1.52 It has not been shown to our knowledge that in general abuse of the VA system has taken place by secured creditors.

1.54 The overriding “cramdown” rules available in the US would hopefully not be necessary in a turnaround model proposed by the BTA. We propose that if such powers were necessary the Turnaround Panel could apply to the courts for such an order.

1.55 The existence of the “pre-pack” negotiation system is an advantage over the court-supervised scheme. The issue often is however that before a reconstruction is attractive for new borrowings the company needs to demonstrate that it can turn itself around. This is often difficult under Chapter 11. Our BTA proposal allows the turnaround period to be investigated and hopefully partly or wholly implemented before extra funds are borrowed.

Loan Finance

1.56 to 1.61 (A) We believe it is important to be able to demonstrate clearly that the company is being able or is being turned around if extra funds would be available on any reasonable terms
(B) We believe that our BTA turnaround model gives the company the ability to have extra working capital needed to generally continue in business. In achieving this it could be argued the existing unsecured creditors are put at further risk, but we believe that they would generally get a very little return from a normal VA (see Tax Office comments) and on a risk to return basis they are much better off.

Equity Finance

1.63 The reality we believe is that new equity will only come in if the new investors believe the company is, or has been operationally turned around.

Developing a plan.

1.65 The BTA proposal is that most companies do not in reality have say 6 months to develop a plan to themselves turnaround. Taking 6 months would often greatly adversely effect their customers and suppliers. We believe that the Turnaround Panel model should enable a relatively fast and good assessment of the company to be undertaken. If it was

believed by the Panel that a turnaround had a good chance of success and there was good management to lead this, the turnaround would commence as soon as possible. This would preserve as much as possible the relationship between all the trading partners and the company, thus increasing the probability of a successful turnaround.

Implementing the plan

1.69 The UK period that appears to be available for the company turnaround of 1 year is generally more reasonable and practical.

It must be remembered that the VA system in Australia does not appear to attempt to actually turnaround the company, but usually sell the company's business to an external or related party, without firstly trying to add value to the company's current position.

1.70 CAMAC we believe is correct in endeavouring to put a better system in place to streamline the rehabilitation of large companies

1.74 **Issues for Comment**

The above comments on specific issues will hopefully give further background on the reasons for the Business Turnarounds Association recommendation that a new pre-insolvency administration system is needed in Australia and we believe the structure we propose will go a long way to achieving this.

We would also recommend that the opinions of experienced turnaround professionals be considered in the discussion of the most appropriate way to turnaround companies that are in financial distress.

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The Secretary
Parliamentary Joint Committee
on Corporations and Financial Services
Room SG.64
Parliament House
CANBERRA ACT 2600
16 June 2003

Dear Sir/Madam

We attach the submission of the Business Turnaround Association and thank you for your indulgence in extending the date for receipt of this submission.

Having read the Committee's "Issues Paper" and some of the submissions we agree that many of the points raised by submissions on the current Insolvency Laws are valid and should be addressed by the Committee.

With your indulgence we would like to present a wider view of major issues that are involved in Australian companies failing and becoming insolvent. We believe the Australian community would substantially benefit if the Commonwealth Government and the Corporate regulations were able to encourage the development of a business turnaround culture for businesses in financial difficulties.

Last year a group of interested industry professionals decided to form the Business Turnaround Association Inc to be a forum for an Australian turnaround focus, it was coincidental but opportune that the Joint Parliamentary Committee called for submissions on Australian Insolvency Laws in December 2002.

We attach a submission which centres on a system to assist companies undertake a "turnaround" of their operations so they are able to be restored to profitability and repay their creditors 100 cents in the $. Shareholders would of course also be significant beneficiaries of such turnarounds.

An integral part of the proposed system is the formation of a Business Turnaround Panel, which would operate under the guidance of the ASIC. The Turnaround Panel would operate under similar rules to the current Takeovers Panel.

The attached submission also recommends:

- the Business Turnaround Panel would be constituted by people with extensive business and corporate experience
- the Business Turnaround Panel would oversee the business turnaround
- there would not normally be any court involvement with the process
- the powers of the Business Turnaround Panel must be flexible to enable a turnaround protection/moratorium period of six months to achieve the turnaround
- legal protection must be provided for all persons involved in the turnaround process during the turnaround/moratorium period
- during the moratorium period existing unsecured creditors would be excluded for purposes of insolvency regulations
- the position of secured creditors must be acknowledged

The existing system of Voluntary Administration would be retained as that system would continue to be utilised in appropriate circumstances.

The Submission has been prepared by a Working Party of the Association including the following:

Richard Fisher (Chairman - Blake Dawson Waldron)
Peter Hedge (Partner – PricewaterhouseCoopers)
Brian Mahoney (Director – Financial and Corporate Relations)
Michael O'Neill (Managing Director – Pacific Capital Corporation Ltd)
Robert Sauer (Chairman – Dibbs Barker Gosling)
Peter Thomson (Executive Director – Pacific Capital Corporation Ltd)

The Business Turnaround Association would be pleased to assist the Committee in development of a more effective system of enabling companies to be returned to profitability and save the substantial huge community costs of business failure.

Yours Faithfully

M P O'Neill
BTA Committee Member
michael@pacificcapital.com.au

Australia's Insolvency Laws

Submission by Business Turnaround Association Inc for a new legislative model for business turnarounds and the establishment of a Turnaround Panel

General background information.

The Business Turnaround Association was incorporated in January 2003 and its strategic objective is to advance Australia's capacity for business turnarounds and reconstructions. This would save the country the cost of many business failures and increase Australia's economic activity and productivity. To achieve this goal, the Business Turnaround Association will:

- assist in the creation of a certain and consistent environment that is favourable to the development of business turnarounds and reconstructions;
- create a group or groups of members who will assist businesses to understand the issues involved in business turnarounds;
- promote a bi-partisan agenda in which Association members may participate to develop long-term and consistent public policy for business turnarounds and reconstructions;
- promote greater public awareness of the benefits associated with business turnarounds and reconstructions;

Australia as a country is losing hundreds of millions of dollars each year due to companies getting into financial difficulties and then becoming insolvent. Once in this position they are unlikely to pay creditors, employees and governments all the money that is owed. As well as the high profile collapses (HIH, FAI, Ansett, Harris Scarfe UMP and OneTel) there are hundreds of other medium and smaller companies that cause substantial damage to the economy and personal lives.

A Fundamental concern for the Business Turnaround Association is the present legislative system which encourages a financial restructure of the affairs of companies in financial difficulties (i.e. a compromise or arrangement with creditors) and does not encourage operational issues which adversely effect a company's performance to be identified addressed and corrected as a matter of priority.

This submission concentrates on the following areas

1. Comments on existing Insolvency laws
2. Background to new model of dealing with companies with financial and management problems.
3. Major features of our proposed "turnaround" model and an example of how our proposed Turnaround Panel could work
4. Establishing a turnaround business culture in Australia.
5. The Business Turnaround Association

1. Comments on existing Insolvency Laws

If companies go into a formal insolvency scheme such as provisional liquidation, liquidation, receivership or even voluntary administration it is generally accepted amongst the insolvency profession that these legislative insolvency schemes themselves destroy value in the companies. This is not through any fault of the Insolvency Practitioner. One of the major problems causing the destruction of value is that existing contracts, which benefit the company, can generally be terminated and many extra liabilities become due when the company commits an event of default. This is typically defined to include the appointment of an Insolvency Practitioner or Voluntary Administrator.

The Voluntary Administration (VA) scheme which was introduced in the early 1990s was certainly an improvement on the more restrictive options of provisional liquidation or liquidation for most insolvent companies. A major shortcoming of the Voluntary Administration scheme is that it is normally impossible to predict the outcome of any scheme within the one-month time limit in which the voluntary administrator has to put the formal scheme to the company's creditors. In addition voluntary administrators who are accountants by profession often do not have experience in business turnarounds.

The VA scheme generally relies on performing some “financial engineering” or selling off the company’s assets very cheaply as it is generally impossible to “turn” a company around and/or promote its sale or recapitalisation at a price that gives all creditors 100 cents in the dollar in the allowed time. We believe that the vast majority of VAs, which are considered successful, involve creditors (usually unsecured creditors) losing a majority or substantial amount of the money they are owed.

It is appreciated that not all companies which go in to insolvency administration would be capable of being "turned around”, this is particularly the case when fraud has been involved or when the Board of Directors has been consistently misled or the process is being used as a de-facto winding up.

2. Background to new BTA Model of dealing with companies with financial and management problems

In our opinion Australia’s Insolvency Laws/systems could be changed to successfully assist many more companies that get into very difficult financial positions. This system would be structured to achieve an operational “turn-around” with no or minimum financial loss to creditors (especially unsecured creditors).

A major issue where a company is unable to pay all its creditors is that the process of dividing up the available money often results in costly legal issues concerning the admissibility of creditors and their priority. This delays the time before anyone is paid. If a company can be turned around and repay all its creditors then this costly and time consuming process is avoided.

This “turn-around” philosophy is occurring in an informal way now, especially amongst the major banks where the bank encourages a “turnaround” of a customer company. These turnarounds are often driven by bank staff and outside consultants. Unfortunately there are no reliable statistics available to us on such projects.

We see two key elements of advantage to these business turnarounds: firstly, default provisions in contracts are not automatically triggered, and secondly, the focus is on operational and management changes needed to return the business to profitability.

The cause of the vast majority of business failures is **bad management.** Occasionally a major adverse event can occur that good management would not normally plan for, however the vast majority of business failures are due to bad operational management and planning.

If bad management is recognised early enough and corrective action taken, businesses can

often be saved and made to prosper. In most cases of a business failure, the Chief Executive Officer (CEO) generally has made a major contribution to the problems. In addition the existing directors have typically failed to adequately monitor the company's operating and financial position.

In the USA a system referred to as Chapter 11 operates where companies, which have financial problems can seek the protection of the court to gain a period of protection from current creditors while the company undergoes a reconstruction or "turn-around". A common period of protection is one year.

Although many companies come through the Chapter 11 system successfully we understand the system could be improved and that it is sometimes exploited by directors and management of companies seeking protection. We understand that the Chapter 11 scheme is flawed because:
Firstly, the control of companies entering Chapter 11 remains vested in the existing directors and management, who were in office when the company developed its financial problems
Secondly, the scheme is a court supervised one making it inflexible and expensive and sometimes cumbersome when dealing with commercial issues that have to be settled quickly and
Thirdly, it sometimes undermines the position of secured creditors.

We do not believe that Chapter 11 as it presently exists would be appropriate for Australia and think that there would be a better model on which we could base a "turnaround" culture amongst the business community.

We believe that serious consideration should be given to creating a formal company "turnaround" process. The Business Turnaround Association would be pleased to participate in the necessary debate by all the proper stakeholders (including parliament, financial institutions, commercial organisations and other industry professionals).

The creation of a formal "turnaround" process should greatly increase the effectiveness of saving companies and enabling them to continue in business. The saving to the Australian economy, including Governments, employees and creditors would be substantial.

3. Major features of the BTA proposed "turnaround" model and an example of how our proposed Turnaround Panel could work are as follows:

3.1 Turnaround Panel

- It is proposed that the Federal Government supports the establishment of a Turnaround Panel, which would operate under the umbrella of the ASIC.
- Such a Turnaround Panel might be achieved either through a mirror image of the statutory and regulatory framework which constitutes the Corporations and Securities Panel (which is usually referred to as "the Takeovers Panel"), or by vesting the relevant extended functions in the existing panel.
- The Turnaround Panel would comprise experienced and respected CEOs and appropriate professionals and in general would be charged with responsibility for overseeing the implementation of plans to effect the turnaround of companies. It is an important element of our proposal that a business experience and commercial focus be brought to the task in a similar fashion to the concept behind the Takeovers Panel and the aim would be to have Members in each capital city.
- The powers of the Panel would be wide and they would be able hear submissions from companies seeking to undergo a reconstruction or turnaround. A core of available Panel members would be formed to adjudicate and administer the process for each submission.
- The main function of the Panel would be to decide if there was a sufficient commercial case to grant a moratorium from unsecured creditors for 6 months to enable a company to undergo a business turnaround.
- The Panel would agree on processes to be undertaken by the Panel before deciding on particular proposals

- In order to avoid dealing with large numbers of small enterprises, access to this process would be limited to companies meeting certain "significance" criteria, e.g. employing more than say 50 employees, and/or total creditors/debt of more than $5 million.
- The Panel would decide appropriate terms and conditions for any moratorium, including the appointment of new approved directors and a CEO. The Panel could also specify the reporting system it required and if it wanted certain goals to be achieved at set times.

3.2 Example of a Turnaround Panel procedure

- The directors of a company are concerned that the company may be in or is getting into severe financial difficulties. They believe however that if the company could be turned around it may have a good future. The directors may or may not have a plan to do this and they may or may not believe that the existing management is capable of successfully implementing the turnaround. If the directors believe that the company may become insolvent within 12 months they can approach the Turnaround Panel.
- The Panel would decide how they were going to assess the company, this may include taking advice from outside consultants.
- The Panel would decide appropriate terms and conditions for any moratorium. In many companies, which are in need of a "turnaround", this can best be achieved by an injection of new blood at a director and CEO level. Accordingly one of the conditions which the Panel might impose could require the appointment of suitably qualified and experienced directors and management.
- The Panel could also specify the reporting system it requires and if it wants certain goals to be achieved at set times.
- The moratorium would apply to unsecured creditors and the aim is that if successful, the unsecured creditors would receive 100 cents in the dollar, whereas if the company entered into a traditional insolvency scheme unsecured creditors would probably receive far less than this.
- A Turnaround Panel moratorium would not affect the position of secured creditors and they could take any action empowered to them under their security documents. To enable the Turnaround Panel to be effective new legislation would have to stipulate that the approach to the Panel or orders by the Panel would not in itself be an event of default under any security or other contractual documentation.
- In determining whether the company is solvent for the purposes of the directors' obligations, moratorium creditors would be excluded for the period of the moratorium.
- The company would be subject to market forces for its trading during the moratorium period
- At the end of the moratorium period, hopefully the company has been able to achieve the operational turnaround and be able to pay all creditors as they become due. If this is not fully achieved the directors may endeavor to negotiate a repayment scheme with creditors based on the improved operating performance of the company. If the company has not re-established its commercial and financial viability then it would be dealt with under normal insolvency legislation with all creditors (pre-moratorium and moratorium) ranking equally.

We believe such a model for dealing with companies in financial difficulties should save many more companies and their creditors, employees and shareholders from losing hundreds of millions of dollars.

There would be other issues needing to be addressed. These are likely to include; the liaison between shareholders and in particular institutional shareholders being deemed to be acting in concert if they co-operated to bring about a needed turn-around (including the appointment of the necessary directors to achieve this).

4. Establishing a Business Turnaround Culture in Australia.

The benefits of a successful Turnaround industry in Australia would be substantial. Business failures cause Australia enormous cost, both economic and personal.

The group that has the immediate responsibility to monitor the performance of companies and CEOs are the directors. History has shown though that directors are often not effective in monitoring the CEO and corporate governance in a company particularly where the CEO has a strong personality.

Being realistic we will always have failures, as our society is based on encouraging free enterprise and innovation and not all business ventures will be successful. What would be helpful would be to have a commercial system that identifies these failing businesses before they lose too much money and cause large losses to creditors, employees and governments.

Until now there has not been a widely recognised "Business Turnaround" culture in Australia where there is a group of professional and experienced executives who are available and capable of being commissioned to take charge of a failing company and "turning it around" to profitability.

5. The Business Turnaround Association

The lack of a recognised and effective business turnaround culture is unfortunate as an effective industry would help prevent the enormous waste that occurs when business enterprises collapse. To rectify this in January 2003 a group of interested Industry executives formed the Business Turnaround Association (registration number INC 9879114)

The overall objectives of the Business Turnaround Association (BTA) are set out on page 1. Additional initial objectives of the BTA are:

- Coordinate support groups/organisations that are able to make a positive contribution to companies requiring business turnaround skills.

- Put in place systems that can be used by shareholders/directors as sources of information and discussion points regarding companies that need some form of reconstruction

- Make the availability of these member services known to shareholder groups and directors of companies

- Allow shareholders and/or directors access to member groups of the association and for them to conduct their own evaluation of the appropriateness of the association's members.

Turning businesses around is a specialist role and often senior executives who have been successful in general management fail when they attempt a turnaround. The reason we believe is that they do not have the experience necessary to address the additional issues that are involved in a turnaround. Despite this there are individuals who have had experience of turning a number of businesses around and experienced non-executive directors who have been on the boards of companies that have undergone successful turnarounds. There are also other groups of professional service providers who have hands on experience in turnaround situations, particularly amongst the accounting and legal professions

It is proposed the Association would build up over time the following member groups:
- Chief executive officers
- Non executive directors and chairpersons
- Accountants
- Lawyers
- Communication and public relations firms
- Financiers/investors

- Shareholder groups
- Consultative reference groups

At this stage it is believed that within the Association there should not be any "insolvency" group, as the prime aim of the Association is the turning around of companies before they require the services of insolvency practitioners to deal with the company under corporate insolvency legislation. If a company is being dealt with by an Association member and needs to be dealt with under a formal insolvency arrangement then these companies should be referred to a member of the Insolvency Practitioners Association. The BTA will have as members accountants who have had insolvency experience, but intend to use their skills as investigating accountants and consultants rather than as “corporate undertakers”.

Directors of course control the day-to-day activities of the company and it is their decisions on policy and management which determine success or otherwise of the company. This being the case it is sometimes difficult for directors to acknowledge that they are not able to solve issues that may cause the failure of the company. Hence it is recognised that sometimes directors would not be the group to come forward to an association such as ours and admit they are not able to solve major issues. The Association therefore has to make its presence known to shareholder groups and significant individual shareholders.

On the other hand, directors of failed companies are sometimes heard to claim that they did not know whom they could turn to in order to seek assistance of this kind without automatically triggering events, which would lead down a pathway to the formal insolvency regime. We would hope that the formation of the Association, and the establishment of the Turnaround Panel and related legislation, would give the directors another practical avenue to pursue.

CAMAC Enquiry

Rehabilitating large and complex enterprises in financial difficulties.

Section 2

Voluntary Administration

2.1 Objects

Once it has been established that a company cannot be made profitable and pay all its creditors 100 cents in the $ the stated objective is OK.

We believe however that a better initial objective to assist the rehabilitation of companies would be:

> maximise the chances of the company, or as much as possible of its business, continuing in existence, AND
>
> return to creditors 100% of what they are owed or as much as of this as is possible.

Moratorium

2.6 This clause apart from the section in brackets would be appropriate to consider for the BTA's turnaround model.

2.7 This clause would also appropriate to consider for the BTA's turnaround model.

Personal liability of administrator

2.8 Under the BTA model the directors would not need an indemnity during the turnaround model. There would also be in the BTA model an amended definition of the solvency requirement (please see our model outline)

Major Meeting of creditors

2.10 Under the BTA model the directors would call a meeting of creditors within 21 days after the Turnaround Panel had granted a moratorium to explain the planned actions for the company's rehabilitation. If any substantial creditor did not agree with the plan they could make a submission to the Turnaround Panel. If the Panel decided that the submission contained new and significant information which would alter

their opinion about the turnaround plan being successful they could withdraw or alter the terms of the moratorium.

Deed of company arrangement

2.13 Under the BTA model if a company could not repay all its creditors (pre moratorium and moratorium) in the normal course of its business at the end of the moratorium period, but the company had turned itself around and was operating profitability, then a deed of company arrangement would be put into place to repay creditors. This deed could be similar to the alternatives available under the VA system.

Role of the court

2.17 Currently we do not see the court normally having a role in the BTA turnaround model. The Turnaround Panel would deal with all turnaround issues.

Insolvency / solvency

2.28 to 2.30 The BTA handles this issue by saying that the directors believe that the company may become insolvent within the next 12 months.

Rights that override a VA

2.39 to 2.60 The general approach of the BTA in the establishment of the Turnaround model was to not interfere in any major way with secured creditors. The reasoning behind this was that in general terms, large financial institutions made up the majority of the creditors who had secured charges. We believe that the experience in most of the VAs that have occurred in Australia is that the large financial institutions have not acted precipitously in appointing receivers over the top of VAs when there was a good plan for rehabilitation.

The BTA does not believe that if this policy continues that the major financial institutions will not support a creditable turnaround model such as we proposed. The major financial institutions we believe generally only appoint receivers when it appears to them that the company is not capable of fulfilling its obligations to its lenders.

In our turnaround model if the financial or other secured creditors started to override good commercial practice then we would recommend that the government took the appropriate action.

Timing issues

2.61 to 2.76 The timing issues for a VA could in themselves be improved. For instance, many companies going into VA do not have their books and records up to date so not all creditors receive notice of the first

meeting. Additionally many creditors have not had time to consider the issues of the company and what their response should be.

The most important issue however from the BTA point of view is that the timing of the VA procedure does not allow the company to undergo a turnaround before the composition with creditors is generally agreed.

If a company can undergo a turnaround and become profitable, we believe that the returns to creditors could be substantially greater than they are under the current VA legislation.

In our opinion the current practise of administrators means that companies that are suitable for VA are the ones that would benefit from financial engineering and do not have a substantial operating business.

Notifying pre-commencement creditors

2.77 to 2.81 In the BTA turnaround model the role of reviewing the company current situation is undertaken by the Turnaround Panel. The Panel in deciding to grant or not grant a moratorium has to consider the likely probability of the turnaround success. They would also consider the risk that is being taken with unsecured creditors current return and the likely increase in this return if the turnaround is successful.

This being the case we believe that if the Turnaround Panel believes that much better returns can be obtained for creditors, it is in the creditors interests that the turnaround process starts as soon as possible.

To keep creditors informed of the aims and timing of the plan, under the BTA model a creditors information meeting would be held about I month after the moratorium was granted.

It must be remembered that for the BTA model to be successful in general the company must maintain good trading relations with creditors, this involves telling them of the plan and getting their cooperation.

Lending to a company under administration

2.81 to 2.100 As a generalisation the people who have most to gain from the successful turnaround of a distressed company are the existing creditors, bankers and shareholders. This being the case this is the group who should be approached first to assist with any necessary new loan funds. This group also should know the activities of the company and be able to make the fastest decision about any additional loans.

The existing laws regarding the borrowing of loans by VAs would appear to be satisfactory.

Remuneration of administrator

2.112 to 2.12 A most important issue that is related to this is that in effect there is no body or group that has the power to monitor the activities of the VA and ensure that fair value is received by the company for work that is of real value to it and creditors.
We believe that a group such as the Turnaround Panel could play a valuable role in over viewing large companies that are undergoing a turnaround.

Voiding antecedent transactions

2.127 to 2.133 The BTA would not anticipate that with the turnaround model of incorporating a Turnaround Panel that there would be a need to have the ability to apply to the court re antecedent transactions

Debt for equity swaps

2.134 to 2.140 The VA Reform proposals seem sensible; the qualification for the debt for equity swaps is that, consideration should be given to have an appropriate independent qualified adviser express an opinion on the proposal.

Effect of takeover provisions

2.144 to 2.160 This is always going to be a difficult area. On the one hand we do not want to stop the turnaround of a company even if it technically cuts across normal takeover rules, on the other hand we do not want unscrupulous people taking advantage of the situation.

Our BTA turnaround model recommendation would be that reconstructions were exempt from takeover provisions if the Takeover Panel approved the scheme.

Courts powers to give directions

2.161 to 2.167 If the administrator as an officer of the court has the protection of the business judgement rule, it would appear that the only way he/she could be liable is under the “statutory duty of good faith”. Perhaps the easiest way to solve the issue is to better define this duty.

If the BTA turnaround model was accepted, it may be an option to have the CEO who was approved by the Turnaround Panel to be given protection from the “business judgement rule”

Pooling of group companies

2.176 to 2.190 In to-days commercial climate we believe there is a tendency for most companies to try and simplify for administrative and

cost reasons their corporate structures. In some cases the existence of different corporate identities in a group is for the reason of quarantining liabilities. Recent changes to the Corporations Act have we understand made holding company directors responsible for new debts of subsidiaries if those subsidiaries have traded while insolvent. In order to encourage responsible trading by holding companies there may be a case to say that in general holding companies are responsible for the debts of subsidiaries. This is a complex issue and needs debate as it modifies the general principal of limited liability.

Ipso Facto clauses

2.191 to 2206

Under the BTA proposal Ipso Facto clauses would not stop a turnaround, which had been approved by the Turnaround Panel.

3. Creditors' schemes of arrangements

3.1 to 3.12

Creditors schemes are not that common for the reasons outlined in 3.10 and 3.11.

Under the BTA proposal for company turnarounds, the basis is that it is important to get the company back into a profitable trading position as soon as possible (if that is possible).

Spending valuable time and available cash on endeavouring to get a creditors compromise before it is established that creditors really need to compromise seems not to be productive and puts at risk the company being profitable at all in the future.

CPA AUSTRALIA

Submission to Corporations and Markets Advisory Committee

Discussion Paper 2003
Rehabilitating Large and Complex enterprises
in Financial Difficulties

4 December 2003

EXECUTIVE SUMMARY

In response to the Committee's invitation, CPA Australia presents its submission generally addressing points 1 and 2 of the matters set out at page X of the Introduction and more specifically dealing with point 3 (also repeated on page 15 at 1.74).

Based on its analysis, CPA Australia disagrees with any proposal for the adoption in Australia of US Bankruptcy Code Chapter 11 type features either applied as a replacement to Corporations Act Part 5.3A Voluntary Administration arrangements or as an alternative treatment for large and complex enterprises in financial difficulty.

CPA Australia's arguments and comments are presented in this submission under two broadly linked themes, the conclusions from which are summarise as follows:

Impact on the rights and insolvency position of unsecured creditors

- The introduction of arrangements which allow in any formal rehabilitation processes a lessening of reference to insolvency, potentially erodes the well defined criteria and basis upon which a directors' duty to creditors will be recognized (*refer 1.2 of submission).*
- A differential in treatment based on size or complexity presents practical problems of definition, may encourage contradictory debtor behaviour and presents real risk of inconsistent outcomes for creditors (*refer 1.3 of submission*).
- Were there to be introduced the extensive moratorium arrangements inherent to Chapter 11, consideration would need to be given to significantly strengthening both the basis of qualification and speed of access to non-standard injunctive type creditor protection (*refer 1.4 of submission*).

Courts' involvement

- Central to Chapter 11 procedures, is the extensive resort to court involvement in both approval and monitoring of corporate reconstructions. This feature does not readily translate to the Australian context. Neither general law approaches to the review of director good faith (*refer 2.4 of submission*) nor specific judicial discretion allowed for in the voluntary administration scheme (*refer 2.5 of submission*) present a ready basis of adaptation to Chapter 11 type arrangements.
- Proposals for the protections of secured creditor rights, whilst unsecured creditor would be subject to more extensive moratorium provision, presents unwarranted shifts in relative creditor value upon corporate debtor insolvency (*refer 2.6 of submission*).
- Any lessening of linkages between the rehabilitation scheme and insolvent trading sanctions will cause undue delay to the censure of director behaviour damaging to both creditor position and the broader conduct of business (*refer 2.6 of submission*).
- The potential for further protection and deferring of review of director behaviour is at odds with various regulatory initiatives presently afoot which are directed at strengthening corporate governance practices (*refer 2.6 of submission*).

1. Impact on the rights and insolvency position of unsecured creditors

1.1 Background

The current case law based understanding of directors' separate duty owed to creditors contingent upon insolvency, contains reference to both common law and statutory protections the balance of which is potentially changed with the imposition of a scheme enabling more extensive moratorium arrangements. Any shift in the status quo may lead to economic / wealth transfers primarily affecting "non-adjusting" unsecured creditors.

In its opening remarks to Chapter 1 the Advisory Committee recognizes the common objective in the design of the rehabilitation systems being compared for financially stressed corporations to be able to reorganise, and if appropriate, to continue as a going concern though each may differ fundamentally in its approach. One such distinguishing point is in terms of applying a necessary moratorium against otherwise available creditor contractual rights. This element primarily leads to the description of US Chapter 11 arrangements as debtor-driven, whilst the Australian Corporations Act Part 5.3A Voluntary Administration scheme is regarded as more creditor oriented (see CAMAC 12 September 2003 Media Release).

Any evaluation of Australia's voluntary administration arrangements should take place in the context of how it functions within the broader scope of the statutory External Administration scheme, and even more generally, how it interacts with other statutory and common law provisions particularly those affecting directors' duties. Such an approach should be applied to the evaluation of the potential effect on the overall cogency of existing arrangements that might ensue from the introduction of alternatives that differentiate between the protection afforded to unsecured creditors in large/complex insolvencies compared to their treatment under existing arrangements irrespective of the scale of the insolvent debtor company concerned.

The Committee notes in the prerequisites for initiating the procedure (page 2) at para 1.12 of the under the heading "*Assessing the tests*":

> " An argument for a financial stress test is that it would overcome any possibility of a clearly solvent company commencing a rehabilitation procedure merely to give itself a temporary immunity from its unsecured creditors."

In addition, the comparative table presented at 1.73 (pp 14-15) of the Discussion Paper notes that the US Chapter 11 procedure is characterised by an automatic moratorium applicable to all secured and unsecured creditors, whereas the Australian voluntary administration provisions which, within moratorium arrangements, enable certain classes of creditor and owners of particular types of property to continue to deal with respective classes of security or property.

Equally significant to an assessment of the potential risk, and in turn cost, associated with the standing of unsecured creditors being altered, is the duration of the moratorium itself. The Discussion Paper at 1.65 (p13) notes the directors' six month exclusive right provided under Chapter 11 to formulate a rehabilitation plan unencumbered by creditors exercising their contractual or property rights. The potential for adverse consequences of such extended duration of moratorium is noted in the Discussion Paper in terms of both "creditors' own solvency" and the resultant disadvantage to the trading position of debtor company competitors.

The consequence and duration of moratorium arrangements is fundamental to triggering of the stage in the demise of a company at which the interests of unsecured creditors is seen to supplant those of the company and its shareholders. As such, the facility provided in s 439C(c) of Part 5.3A enabling the creditors to resolve that the company be wound up plays a vital link to the threshold at which a protection is afforded by statute to creditors separate from any uncertain notion of a directors' duty separately owed to creditors.

1.2 Basis of directors' duties owed to creditors

The development of Australian law in this regard is shaped by a number of cases culminating in *Spies v The Queen*[1] the outcome of which is to specify a well defined but narrow basis of directors' duty to creditors such that the establishing of alternative arrangements specific to large/complex insolvencies which might in specific instances defer recognition of creditor interests should be treated with caution.

Whether directors owe a duty to consider the interests of creditors has been subject to both considerable judicial analysis and academic debate. Certain aspects evolve around consideration of the retrospective

[1] (2000) 201 CLR 603

nature and complexity of proof associated with statutory compensation for creditors[2] and how these shortcomings may to a degree be negated by identification of a separate prescribed duty to protect creditors where a company is financially distressed.[3] Particular analysis of *Spies v The Queen* take the view that it remains uncertain as to whether the duty is fiduciary in nature, indirect arising by way of implication or purely the province of statute.[4] A reasonable conclusion advanced by Professor Keay[5] is that:

said

> "The courts have, in general, preferred to found the duty on a traditional basis in that they have that the duty is owed to the company to take into account the interest of creditors, that is the duty is mediated through the company."

Prior to the High Court decision in *Spies v The Queen* judicial development in Australia has been heavily influenced by the statement in by Mason J in *Walker v Wimborne*:

> " - - - it should be emphasised that the directors of a company must take account of the interest of its shareholders and creditors. Any failure by the directors to take into account the interests of creditors will have adverse consequences for the company as well as for them."[6]

Built on this view, has been the development of the notion that "directors might owe an independent duty to, and enforceable by, the creditors by reason of their position as directors."[7] Their Honours' analysis in *Spies* not only serves as a rejection of this expanded view of directors' duty[8], but tends also strongly toward the view that protection afforded creditors is foremost one of statute.[9] Of some significance to their Honours' conclusion is a short paper by Professor Sealy[10] in which judicial statement seeking to establish a distinct and duty to act in the interest of creditors are described as:

> " - - - nothing more than extraneous words of censure directed at conduct which anyway comes within some well-established rule of law, such as the law imposing liability for misfeasance, the expropriation of assets or fraudulent preference."[11]

and further, at p 177:

> " - - - ill-focused dicta about directors' 'duties' to creditors can be seen as both unnecessary and potentially pernicious."

The means by which the interest of creditors are safeguarded within the broad scheme of Australian corporate insolvency law are therefore quite narrowly defined such that to describe this structure for managing the outcome of an insolvency as "creditor oriented" is to a degree a misnomer.

CPA Australia believes introduction of any measures which further protract the imposition or recognition of these duties available through the 'linkage' established in s 439C(c) of the voluntary administration arrangements between the creditors' decision and the Part 5.7B recovery or compensation arrangements, ought to be approached cautiously to avoid any erosion of protections that precipitate under narrow but well defined circumstances.

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[2] Section 588G Director's duty to prevent insolvent trading by the company and section 588FF Courts may make orders about voidable transactions.

[3] A Keay, "The Director's Duty to Take Into Account the Interests of Company Creditors: When is it Triggered?" (2001) 25 MULR 315, pp 318-319.

[4] McConvill, "Directors' Duties to Creditors in Australia after Spies v The Queen" (2002) 20 C&SLJ 4 at pp 13-14.

[5] A Keay, "The Director's Duty to Take Into Account the Interests of Company Creditors: When is it Triggered?" (2001) 25 MULR 315, p 321. In these terms, whilst directors will not be regarded as owing a fiduciary duty to a creditor, the duty is nonetheless one of an 'imperfect obligation' enforceable only on behalf of creditors though the initiative of a liquidator – see McConvill, "Directors' Duties to Creditors in Australia after Spies v The Queen" (2002) 20 C&SLJ 4 at p 6 and fn. 17 per J D Heydon.

[6] (1976) 137 CLR at 7.

[7] (2000) 201 CLR 603 at 636-637.

[8] (2000) 201 CLR 603 at 637 – "they are contrary to principle and later authority and do not correctly state the law."

[9] This decision gives considerable credence to prior academic comment, see for example Yeo and Lin, "Insolvent Trading: A Comparative and Economic Approach" (1999) 10 AJCL 217 where it is stated: " - - - it is highly unlikely for any common law based doctrine of directors' duties towards creditors to develop further having regard to the legislative development on the matter."

[10] "Directors' Duties – An Unnecessary Gloss", (1987) 47 Cambridge Law Journal 175 at 175.

[11] This latter aspect is extensively covered in Part 5.7B of the Corporations Act "recovering Property or Compensation for the Benefit of Creditors of Insolvent Company"

1.3 Equality of treatment of creditors

Significant also in the paper by Professor Sealy referred to by their Honours in *Spies* is the comment:

" - - - if such a rule is to give some creditors remedies in an insolvency which are denied to others, the fundamental principle that all creditors participate *pari passu* in the bankruptcy is undermined."[12]

This theme was restated by EM Heenan J in *Geneva Finance Ltd v Resource & Industry Ltd*[13] as part of an extensive reference to the authority established by the High Court in *Spies*. The continuing recognition given here to the fundamental principle of pro rata equality of standing amongst equally ranking creditors strongly suggests the need for considerable caution in the preservation of safeguards that would protect unsecured creditors in the development of alternative insolvency procedures that would provide differentiated avenues of resolution between large/complex enterprises and other corporations.

Similarly, the notion of *collectivism* which forms a related cornerstone to the design of insolvency systems needs to be considered in the context of developing alternative paths of insolvency administration. The compulsory nature of collectivism serves an important function of "ensur(ing) that there is a co-operative system which is orderly"[14].

As between differentiated arrangement operating in parallel within the one jurisdiction, CPA Australia suggests there would likely need to be established procedural rules that prevent 'procedure-shopping' amongst participants to achieve an advantage. Similarly, the idea of debtor company scale and complexity, rather than contractual dealing, as the criteria for determining creditor outcomes is potentially distorting.

1.4 Access to non-standard injunctive type relief

Professor Keay noted that in the United States, the law has developed such that whilst similar to Australia a general duty towards protecting the interests of creditors is not formally established, there can however be discerned a greater sympathy towards allowing company insolvency to form the basis of a distinct duty[15]. As such, were Australian corporate regulation to adopt Chapter 11 type moratorium protections available at the initiative of directors, close attention would need to be given to ensuring the protection of creditors additional to that critically predicated on the liquidation procedure.

In this regard, the Discussion Paper at 1.23 (page 5) makes note of the capacity of creditors in Australia, similar to arrangements provided under Chapter 11, "to apply to the court to halt an asset sale." Specific reference is made in the Discussion Paper by way of footnote (no. 23) to the injunctive relief predicated on conduct (past, actual or prospective) which contravenes the Corporations Act afforded by s 1324 of Part 9.5 (Powers of Courts).

Essential to the operation s 1324 is its interaction with the substantive provisions of the Act and who might be granted standing as an affected party. The case law which has developed around s 1324 affirms creditor standing[16] in relation to the discharge of a director's duty of good faith. Within the leading case on this matter (decided in relation to an alleged contravention of s 232 the precursor to current s 181) *Airpeak Pty Ltd v Jetstream Aircraft Ltd*[17] the following significant authority of Hayne J in *Allen v Atalay*[18] is provided:

" - - - it is in my view very arguable that a creditor having a right to prove in a liquidation of a company may be a person whose interests are affected by a contravention which is alleged to have lead to the diminution in the value of a claim against the company."

This authority clearly associates a director's duty to creditors in the context of a liquidation though prospective, however some doubt has been raised in the light of the *Spies* decision in terms of a necessary nexus between statutory duties, such as s 181, and creditor standing to seek enforcement:

[12] "Directors' Duties – An Unnecessary Gloss", (1987) 47 Cambridge Law Journal 175 at 177.
[13] (2002) 20 ACLC 1,427 at 1,438.
[14] A Keay, "The Recovery of Voidable Preferences" in *Restitution and Insolvency*, F Rose ed. (2000 Mansfield Press UK) p 240.
[15] A Keay, "The Director's Duty to Take Into Account the Interests of Company Creditors: When is it Triggered?" (2001) 25 MULR 315, p 321 and fn. 47.
[16] HAJ Ford, RP Austin & IM Ramsay, Ford's Principles of Corporations Law (11th ed 2003 Butterworths) 11.310
[17] (1997) 23 ACSR 715.
[18] (1993) 11 ACSR 753 at 757.

> "- - - the scope of s 1324 and the ability of creditors to use this remedial provision in order to protect and enforce their rights and interests, will depend on whether the statements in Spies are considered as merely obiter or binding authority."[19]

This uncertainty aside, the absence of reported cases decided around s 1324 subsequent to *Airpeak* may indicate the existence of issues of speed and cost of access amongst unsecured creditors.

If Chapter 11 type arrangements were adopted in Australia, CPA Australia suggests consideration would need to be given to both clarifying and strengthening their standing in relation to s 1324.

In addition, Einfeld J's judgment in *Airpeak* contains the cautionary comments concerning the strict bounds within which injunctive relief might be availed of:

> "The concern that shareholders or creditors should not be allowed through litigation to interrupt the proper running of a company is certainly valid."[20]

Therefore, one means by which the legislation guides how a duty of 'imperfect obligations' is transformed into a direct enforceable duty is through the subsequent reference in s 1324(1A), to amongst other contraventions, share capital reductions not to prejudice the ability to pay creditors. The substantive operating section here is s 256B(1)(b) which states that a company may reduce its share capital in a way that is not otherwise authorised by law if the reduction does not prejudice the company's ability to pay its creditors. Again this feature of the legislation does not appear to have been extensively litigated, and therefore perhaps not widely availed of by creditors[21].

Nonetheless, if an Australian corporate rehabilitation scheme modelled on Chapter 11 was to be developed, CPA Australia suggests one avenue of creditor protection worthy of consideration could be in relation to the adaptation of s 1324(1A) to a broader set of restructuring circumstances along with the establishment of more facilitative procedural arrangements.

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[19] McConvill, "Directors' Duties to Creditors in Australia after Spies v The Queen" (2002) 20 C&SLJ 4 at p 24.

[20] (1997) 23 ACSR 715 at 721.

[21] The CCH Australian Corporations & Securities Law Reporter at 75-200 cites only two older cases in this regard *Re Fowlers Vacola Manufacturing* [1966] VR 97 and *Re Convalescent Services Ltd* (1971-1973) CLC both of which deal with priority competition between the interests of shareholders and secured creditors. Other cases in this area deal with schemes of arrangement, though particularly from the perspective of s 256B(1)(a) 'fair and reasonable to the company's shareholders as a whole': *Re Advance Bank Australia Ltd (No 2)* (1997) 15 ACLC 248.

2. Courts' involvement

2.1 Background

Central to the Chapter 11 procedures is the extensive resort to court involvement in both approval and monitoring of corporate reconstructions. Traditionally Australian courts (specifically in voluntary administration cases and more generally in considering such matters as directors duties or shareholder rights) have expressed an unwillingness to deal with commercial matters except to the extent of any supervisory role allowed for in the legislation or where the dealings between the parties offends an established principle. To this extent CPA Australia believes the US model does not apply readily to the Australian context.

Closely allied to this issue is the consideration which would need to be given to the legislative establishment or a judicially developed criteria by which the Part 5.3A alternative or substitute procedure might be invoked. By way of comparison and illustration of the potential difficulties, consideration is given in CPA Australia's submission to the Committee to the courts' well established measure of solvency.

No doubt a change in orientation necessitated by the adoption of a "debtor-driven" regime may well be within the competency of many members of the Australian judiciary dealing as they do with a vast array of commercial issues. Nonetheless, the evolution of judicial approaches to corporate insolvency is characterised by a qualified concern for creditor interests once insolvency is apparent or impending, underpinned by reference to aspects of commercial morality and the safeguarding against abuse of the corporate form.

2.2 Determining appropriate threshold criteria

The comparison Table provided at 1.73 (pp 14-15) of the Discussion Paper presents a useful contrast of key design elements of the respective Australian voluntary administration and US Chapter 11 schemes.

The contrasting threshold prerequisites enabling a company to come within the respective schemes are insolvency, on the one hand, and good faith on the other. The latter approach necessarily involves a substantial role for the court in facilitating the commencing of the procedure and approving the plan, whereas under the Australian scheme the courts' role is primarily by way of a supervisory jurisdiction.

The good faith basis for availing of the Chapter 11 facility would seem to necessitate the court's participation to evaluate the bona fide of such a submission – bona fide in turn invites an investigation of a director's business judgement in terms of the good faith basis for seeking a restructure. The review of business judgements of directors and their exercise in good faith are matters which Australian courts have traditionally shunned except under well defined circumstances. Therefore it is worth considering how these approaches might be adapted to deal with financial difficulty induced corporate restructure compared to the somewhat more objective judicially articulated criteria of insolvency.

2.3 Applying accepted fiduciary standards to the wider context of corporate rehabilitation

The strength and extent of judicial reluctance to impose or substitute their views for those of directors in whose hands shareholders have placed responsibility for the management of the affairs of an incorporated commercial undertaking, can be found in statements such as:

> "Directors in whom are vested the duty to decide where a company's interests lie and how they are to be served may be concerned with a wide range of practical considerations, and their judgement, if exercised in good faith and not for an irrelevant purpose, is not open to review in the courts."[22]

This attitude to the use and conduct of the corporate form, described as a business judgement rule, can be seen as founded in earlier judicial comment such as that of Greer LJ in *John Shaw & Sons (Salford) Ltd v Shaw*[23] in which after reiterating the *Salomon*[24] principle that "a company is an entity distinct alike from its shareholders and directors" goes on to say that the "powers of management are vested in the directors, they and they alone can exercise those powers". This position is now embodied as s 198A(1) [Management of business] of the Corporation Act which sets a firm basis of demarcation in the conduct and external review of the management of the affairs of a company.

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[22] *Harlowe's Nominees Pty Ltd v Woodside (Lakes Entrance) Oil Co NL* (1968) 121 CLR 483 at 493.
[23] (1935) 2 KB 113 at 134.
[24] [1897] AC 22.

2.4 Possible criteria for court evaluation and approval of the bona fide basis of director initiated and controlled corporate restructures

Both the elements of business judgment and good faith are embodied in statute, respectively as s 180(2) (Business judgement rule) and the civil obligation s 181(1) (Good faith – directors and other officers). The latter contains separate but interrelated standards of good faith in the best interests of the corporation and proper purpose.

These two standards may in turn be considered in the context of their ability to affording to directors scope to initiate a restructure within Chapter 11 type judicial approval and protection.

2.4.1 *"Good Faith"*

In its common law form, the notion of 'good faith in the best interests of the corporation' in one in which the courts have expressed reluctance to closely supervise the decisions of boards[25] in relation to matters of business judgement.

The duty of good faith nonetheless requires directors to act honestly, exercise the powers in the interests of the company and to avoid conflict of interest.[26] As such this duty is often described in terms of a fiduciary who "is subject to higher standards of behaviour than the standards imposed upon parties in an arm's length relationship."[27] The general principle is that the duty is owned only to the company[28], except in situations in proprietary company type relationships where the shareholder might be vulnerable to detriment at the hands of the director because of some special fact or opportunity.[29] Consistent with fiduciary principles, judicial assessment of good faith exercise of powers and discharge of duties, applies an external objective standard which disregard directors' subjective good intent and an absence of self-interest. Assumed instead, the director "must act in a way which he conceives to be for the benefit of the company as a whole, as that concept is understood by the law."[30]

Within the above constraints and absent the circumstance of insolvency, s 181(1)(a) would clearly afford to directors significant latitude to initiate complex corporate restructures unencumbered by threat of shareholder, let alone, creditor challenge. Nonetheless, the notion of a fiduciary relationship which underpin such assessments, being "of different types, carrying different obligations"[31] is however of little practical guidance to the specifics of evaluating the bona fides of a rehabilitation proposal and would thus seem to demand significant judicial oversight of director motives and actions in areas to which courts have traditionally been reluctant to venture.

2.4.2 *"Proper Purpose"*

The further 'proper purpose' limb now covered in s 181(1)(b) has attracted greater levels of judicial review of the bona fides of director actions, though substantially in the narrow context of considering the powers of directors to issue shares.[32] A reluctance however to establish strict rules is again evident:

> "To define in advance exact limits beyond which directors must not pass is, in their Lordships' view, impossible. This clearly cannot be done by enumeration, since the variety of situations facing directors of different types of company in different situations cannot be anticipated."[33]

Developments in Australia[34] beyond *Howard Smith* take no further substantive steps towards the development of a propensity amongst the courts to deal with the bona fides of business judgement more widely beyond the review of the specific purpose for which a power is vested. Developments as there are deal almost exclusively with such narrow matters as the issue of shares for shifting or diluting power, actions

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[25] HAJ Ford, RP Austin & IM Ramsay, *Ford's Principles of Corporations Law* (11th ed 2003 Butterworths) 8.060 pp 318-319.
[26] *Chew v R* (1991) 5 ACSR 473.
[27] HAJ Ford, RP Austin & IM Ramsay, *Ford's Principles of Corporations Law* (11th ed 2003 Butterworths) 8.065 pp 321.
[28] *Percival v Wright* [1902] 2 Ch 421.
[29] *Brunninghausen v Glavanics* (1999) 17 ACLC 1,247
[30] *Australian Growth Resources Corp Pty Ltd v van Reesema & Ors* (1988) 6 ACLC 529 at 538 per King CJ.
[31] *Hospital Products Ltd v United States Surgical Corp* (1984) 156 CLR 41 at 69 per Gibbs CJ.
[32] The CCH Australian Corporations & Securities Law Reporter at 42-240.
[33] *Howard Smith Ltd v Ampol Petroleum Ltd* [1974] AC 821 at 835.
[34] *Whitehouse v Carlton Hotels Pty Ltd* (1987) 162 CLR 291.

to defeat a hostile takeover bid[35] and changes to a company constitution to expropriate a minority of its shares.[36]

Australian corporate law in its current state of statutory and common law development possibly contains a general basis for measuring and applying criteria against which both the good faith and proper purpose basis of a financial difficulty motivated proposal for restructure might be evaluated. Nonetheless, in CPA Australia's view, there would be required further significant statutory and associated guidance enhancement to meet the type of complexity likely to be found under these circumstances.

2.5 Alternative adaptation of existing judicial approaches to court discretion in insolvency administration

Cautious reference to particular judicial statements concerning the operation of Part 5.3A in relation to a particular company[37], might alternatively be indicative of the extent of courts' willingness to apply its discretion to the wider context of reviewing the "good faith" and "proper purpose" basis of a corporate restructure sanctioned under a Chapter 11 style scheme.

The Discussion Paper itself at 2.163 (p 48) makes reference to the statement of Golderg J, in one of the Ansett Administration cases, to the effect that the court would confine itself to matters of legal judgement. In the absence of courts assuming for itself a role in giving direction or approval in relation to a business or commercial aspect of an administration, the narrower legal matters to which it would make reference may in turn be deduced from the leading case concerning the operation and scope of s 447A.

In *Australasian Memory Pty Ltd v Brien*[38] their Honours make the following statement to the effect that the discretion though wide, functions within considerations of achieving cohesion within the Part itself determined with reference to the legislative intent in enacting the Part:

> " - - - a 447A is not properly described as a general power standing apart from the scheme found in Pt 5.3A."

and further

> "Yet the evident legislative intention of 447A is to permit alterations to the way in which Pt 5.3A is to operate."

Notwithstanding the breadth of the available discretion, these are underpinned by the court having "regard to the extent that the order facilitates the expedition of the purpose of Part 5.3A without prejudicing a creditor."[39] Over and above these considerations directed at facilitating the cohesive development of the Part[40], courts have demonstrated a willingness in applying their discretion under s 447A to overlay these practical considerations with a cognizance to broader commercial morality and public policy. A noteworthy case illustrating these latter elements in the application of s 447A is *Deputy Commissioner of Taxation v Woodings*[41] in which Wallwork J presented as significant earlier comments of Gillard J in *Re Mascot Home Furnishers Pty Ltd; Re Spaceline Industries (Aust) Pty Ltd*[42]*:*

> " - - - the court which was concerned not only with considering whether what was proposed was for the benefit of creditors, but also whether it would be a safe course to sanction, and conducive to commercial morality and in the interests of the public at large."

Professor Keay[43] in his commentary on the *Woodings* case indicates that in applying public interest considerations the courts are nonetheless cautious in substituting their views for those of creditors. Moreover

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[35] *Darvall v North Sydney Brick & Tile Co Ltd* (1989) 16 NSWLR 260.
[36] *Gambotto v WCP Ltd* (1995) 182 CLR 432.
[37] Section 447A General Power to Make Orders
[38] [2000] HCA 30 at para 24.
[39] C Anderson & D Morrison, *Crutchfield's Corporate Voluntary Administration* (3rd Ed Thomson Lawbook Co. Sydney 2003) p 246. Note also for example the statement in *Australasian Memory*: " - - - the other provisions of Div 13 of Pt 5.3A give a court wide powers to protect creditors during the administration."
[40] *Brash Holdings Ltd v Katile Pty Ltd* (1994) 12 ACLC 472 at 474: "an unusual section, which evidently proceeds on the view that Part 5.3A is inadequate in the provision which it otherwise makes for the new form of administration and that it is therefore necessary to enable gaps in the Part to be filled by the exercise by the court of wide powers - - - "
[41] (1995) 13 ACLC 469.
[42] [1970] VR 593 at 596
[43] A Keay & M Murray, Insolvency: Personal and Corporate Law and Practice (4th edition, Lawbook Co, 2002) p 509.

in the earlier edition of this text[44], Professor Keay made the further observation concerning judicial attitude in considering the broadly analogous Bankruptcy Act Part X[45] arrangements stating that:

> " - - - the courts have overwhelmingly taken the view that Part X leaves the decision to the creditors and the courts should not foist their opinions on the creditors."

With the views and position of creditors being of paramount consideration in deciding insolvency outcomes in the Australian corporate environment, it remains uncertain as to what practical considerations might be substituted in a courts assessment of the good faith and proper purpose of a restructuring proposal in a scheme modelled on Chapter 11 granting substantially greater moratorium protection to debtors that are practical, equitable and predictable to all participants.

The Courts have throughout applied a reference to well defined and articulated criteria. The increment in judicial discretion that would need to be applied to the scrutiny of director's good faith and proper purpose motives in proposing a financial difficulty induced corporate restructure, is potentially too great a gap given the importance and wide acceptance of these well established underlying principles.

2.6 Interrelationship between corporate recovery and other elements of the Australian insolvency regime

The contrasting comparatively structured approach to the judicial assessment of insolvency which provides an important adjunct to the insolvent trading penalties, serves a useful illustration of the relative cohesiveness present across each element of the Australian corporate insolvency regime. CPA Australia suggests that the safeguarding of this important characteristic needs to be carefully considered in any proposal for separate arrangements specific to the financial difficulty based reconstruction needs of enterprises having particular scale characteristics.

As noted in the Discussion Paper, the threshold criteria bringing a company within the ambit of availing of Part 5.3A protection is that of insolvency[46]. Notwithstanding the potential difficulty associated with its very limited statutory definition[47], the corresponding judicial approach to defining solvency is substantially more precise than the notion of good faith, and moreover, serves as a commercially realist underpinning to the various facets of the present Australian corporate insolvency regime. This "well-accepted approach laid down in the authorities" is comprehensively dealt with by Mandie J in *ASIC v Plymin, Elliott & Harrison* under the heading Insolvency[48] where he cites a number of cases, within the final of which the following remark of Young CJ is perhaps the most succinct:

> "Solvency and insolvency are defined - - - as meaning a company which is unable to pay all debts as and when they become payable. This - - - requires a cashflow test rather than a balance sheet test. - - - it will be seen that (this) proposition expounded is not only quite in accordance with authority, but is also good commercial and legal common sense."[49]

Similarly, the question of "reasonable grounds to suspect" contained in both the insolvent trading definition[50] and defences[51] is consist with various other aspects of solvency law, and more importantly, draws upon wider development in the understand of the changing scope of directors duties:

> "The existence of reasonable grounds - - - is an objective test. The standard of reasonableness is that of a director of reasonable competence - - - capable of reach a reasonable informed opinion about the financial capacity of the company. The enquiry whether there are reasonable grounds to expect the company will not be able to pay its debts when due is a factual one to be decided in the light of all the circumstances of the case. It is to be decided as a matter of commercial reality and thus requires a consideration of the company's financial condition in its entirety, - - - including its activities - - - and ability to raise capital."[52]

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[44] A Keay, Insolvency: Personal and Corporate Law and Practice (3th edition, John Libbey & Co, 1998) p 320.
[45] Arrangements with Creditors without Sequestration
[46] Section 435A – "The objective of this Part is to provide for the business, property and affairs of an insolvent company to be administered - - - "
[47] Section 95A.
[48] [2003] VSC 123 para 368 – 379.
[49] *Manpac Industries Pty Ltd v Ceccattini* [2002] NSWSC 330.
[50] s 588G(1)(c)
[51] s 588H(2)
[52] Per Finkelstein J, *Quick v Stoland Pty Ltd* (1998) 29 ACSR 130 at 142.

Particular elements of the insolvent trading structure of legislation are designed largely for the protection of unsecured creditors and contain "safe haven" provisions linked to the voluntary administration scheme.[53] These have contributed for some time to fewer insolvent trading cases being litigated.[54] Therefore, considerable caution should be taken in the introduction of Chapter 11 type arrangement that may erode either the current scope afforded to administrators to report on breaches of the Act[55] or which empower a liquidator to pursue compensation for the benefit of creditors.

The importance of these interrelated provisions can be further considered within the context of why it might be that Australian corporate legislation has for many years contained an insolvent trading regime (unlike the US bankruptcy scheme) that penalises directors of failed companies (for the benefit the general body of unsecured creditors).

The economic efficacy and market efficiency consequences of an insolvent trading censure of directors behaviour, has been debated extensively at least at an academic level, however the various themes are beyond the scope of this submission[56]. Suffice to say that the insolvent trading regimes serves an important role in reconciling the relative positions of secured and unsecured creditors providing to the latter group well established and predictable avenues for collective relief in the event of corporate collapse:

> " - - - at least in some contexts, there may be significant dangers of inefficient transfers of insolvency wealth from non-adjusting unsecured creditors to secured creditors or to those availing of quasi-security devices."[57]

As such, differentials in negotiating power shifts 'insolvency value' away from non-involved third party creditors whose size of interest and commercial power would not "justify the expense involved in adjusting terms."[58] Applied to the emphasis stated in the Discussion Paper that in the development of any alternative arrangements for the rehabilitation of large and complex enterprises there should be an objective of preserving the rights of security holders[59], **CPA Australia submits that careful consideration is thus also warranted to retaining in such arrangements appropriate protections for unsecured creditors.**

A final noteworthy basis upon which the regulatory intervention of insolvent trading is justified is in terms of public policy approaches to protect against the misuse for the corporate form. Also cited in the *Woodings* case mentioned above is the following:

> " - - - concern on the part of the court that an insolvent company or an insolvent individual does not have a potentiality of bringing harm to future (as well as, of course, to past) creditors."[60]

Such attitude has persisted in allowing solvency considerations to shape key elements in the reform of the current regulatory framework. To this end, within the current statutory framework under which business judgement is allowed for in any examination of directors' general duty of care and diligence, insolvent trading sits as a separate and distinct duty:

> " - - - a stricter and more specific duty than the duty of care and diligence in order to send a strong deterrent message to directors that insolvent trading will not be tolerated."[61]

Establishment of Chapter 11 debtor in possession type schemes, as indicated in the Discussion Paper at para. 1.38 (p 8) may affect creditors' assumptions about a particular corporate debtor's solvency.

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[53] Part 5.7B Division 3 Director's duty to prevent insolvent trading, s 588H Defences, sub-section (6) Relevant matters (b) – any action the person took with a view to appointing an administrator of the company.
[54] See for example Herzberg, "Why Are There so Few Insolvent Trading Cases?" (1998) 6 ILJ 77 particularly with reference to the impact of Pt 5.3A VA arrangements: "While a company is subject to a deed of company arrangement, no compensation recovery action can be brought against its directors for contraventions of s 588G" at p 83. The contrasting position of ASIC standing to initiate such proceedings whilst a deed is on foot is extensively dealt with and confirmed in *ASIC v Plymin, Elliott & Harrison* in Parts III and IV of Justice Mandie's judgement.
[55] Section 438D Reports by Administrator.
[56] See for example Mannolini, "Creditors' Interests in the Corporate Contract: A Case for the Reform of our Insolvent Trading Provisions" (1996) 6 AJCL 16 and Whincop, "The Economic and Strategic Structure of Insolvent Trading" in *Company Directors' Liability for Insolvent Trading*, I Ramsay (editor) (2000) CCH Aust & The University of Melbourne.
[57] Finch, "Security, Insolvency and Risk: Who Pays the Price?" (1999) 62 Mod LR 633 at p 668.
[58] Finch, "Security, Insolvency and Risk: Who Pays the Price?" (1999) 62 Mod LR 633 at p 644.
[59] 0.11 page vii of Introduction.
[60] *Re Denistone Real Estate Pty Ltd* [1970] NSWR 327 at 331 per Street J.
[61] Langford, "The New Statutory Business Judgement Rule: Should it Apply to the Duty to Prevent Insolvent Trading?" (1998) 16 C&SLJ 533 at 557.

The absence of adequate protections or disclosure may unduly delay independent assessment of directors' errant behaviour which should be subject to censure.

Furthermore, CPA Australia views possible procedures whereby directors remain in control as perhaps inconsistent with current regulator initiatives though targeted at small/medium enterprises, which are directed at ensuing higher levels of director awareness and compliance with insolvent trading obligations.[62]

[62] Refer 2003-04 Budget Paper No 2 ASIC corporate insolvency initiative $12.3m over four years.

Law Council
OF AUSTRALIA

Mr John Kluver
Executive Director
Corporations & Markets Advisory Committee
GPO Box 3967
SYDNEY NSW 2001

Dear Mr Kluver

CORPORATIONS AND MARKETS ADVISORY COMMITTEE DISCUSSION PAPER
"REHABILITATING LARGE AND COMPLEX ENTERPRISES IN FINANCIAL DIFFICULTIES"

I refer to your request for submissions on issues raised in the discussion paper September 2003.

The Law Council thanks the Corporations and Markets Advisory Committee ("CAMAC") for seeking submissions with respect to its discussion paper on Rehabilitating Large and Complex Enterprises in Financial Difficulties ("the discussion paper").

This submission has been prepared by the Insolvency & Reconstruction Committee of the Business Law Section of the Law Council of Australia ("the Committee"). The submissions have been endorsed by the Business Law Section, but not considered by the Council of the Law Council of Australia.

A number of issues that are dealt with the discussion paper have already been addressed by the committee in its submissions to the Enquiry into Australia's Insolvency Laws being carried out by the Parliamentary Joint Committee on Corporations & Financial Services. Those submissions (together with others from other interested bodies) can be viewed on www.aph.gov.au/Senate/committee/corporations_ctte/inquire.

Executive Summary – Parts 5.1 and 5.3A Corporations Act

A summary of the recommendations are as follows:

A. The voluntary administration procedure set out in Part 5.3A of the Corporations Act does provide an effective method for corporate rehabilitation for both small and large complex administrations.

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B. The provisions of 5.3A require no substantial change. The legislative framework is flexible enough to deal with all forms of corporate administration.

C. The period for holding the first meeting of creditors should be extended to at least 10 business days after the voluntary administration period begins and the second meeting timeframe should be extended to 28 days.

D. Section 447A of the Corporations Act should be amended to make it clear the Court does have the power to extend time limits generally.

E. Part 5.1 of the Corporations Act should be retained.

The Committee's submissions are set out in detail below using the same headings and paragraph numbers as the discussion paper.

Principles for effective corporate rehabilitation

1.6-1.8 Pre-requisites for initiating the procedure – financial stress test

The Committee prefers the financial stress test that is now in place. The Committee is also of the view that the pre-requisite definition that a company be insolvent or is likely to become insolvent at some future time (section 436A of the Corporations Act) is sufficient and requires no amendment (see also sub-paragraph 2.28.)

1.17 External insolvency practitioner

The Committee favours the control of the process being handled by a suitably qualified insolvency practitioner.

1.20 The board

The Committee does not agree with a system that proposes that the Board retain control.

Although not raised in the discussion paper the Committee recommends that the initiating process could be broadened to allow a creditor or a director, with leave of the Court, to initiate the process to overcome problems that presently exist with two or more directors not being able to agree to resolve to put a company into voluntary. In cases of urgency or circumstances of a deadlock with management, consideration should also be given to allowing Australian Securities Investment Commission ("ASIC"), with leave of the Court, to appoint an administrator.

Encouraging companies to negotiate with creditors

1.44 Ipso facto clauses

In many administrations the appointment of an administrator triggers the enforcement by some creditors or third parties their rights pursuant to contracts. Such action can effectively obliterate the business of the company overnight and eliminates any opportunity an administrator may have to negotiate a sale of business and/or assets. The Committee is of

the view that there should be some constraints on the enforcement of ipso facto clauses so that creditors cannot take such action during the entire period of voluntary administration without leave of the Court or the permission of the administrator.

2. Voluntary administration

2.25 Policy Options : Prohibit appointment by directors when the company is insolvent

The Committee disagrees with the proposition that directors of an already insolvent company should be prohibited from appointing an administrator.

2.28 Permit appointment where there is a "reasonable prospect of insolvency"

The Committee is of the view that Section 436A of the Corporations Act is adequate and no amendment to the appointment definition is required.

2.31 Application to corporate groups

The Committee agrees that Part 5.3A should have application to corporate groups even though one or more of the companies in a group by itself are not insolvent provided that the group as a whole satisfies the pre-requisite.

2.33 Policy options : who should be entitled to appoint

See sub-paragraph 1.20 of these submissions.

2.35 Eligibility of a liquidator to be an administrator

The Committee believes that the distinction between an official liquidator and registered liquidator is no longer necessary and that there should be one single class of liquidator who is only registered and continues to be registered after satisfying high standards with respect to skills and resources as approved by ASIC.

2.52 Rights that Override a VA – Policy options – reducing rights of second creditors

Save for there being a moratorium against creditors enforcing ipso facto clauses (sub-paragraph 1.44 of these submissions) the Committee does not see that there needs to be any other constraints on creditors whether secured or otherwise.

2.61 Timing issues

The Committee is of the view that the time for calling the first and second meeting should be extended to 10 and 28 days respectively. The Committee also suggests that section 447A of the Corporations Act to be amended to make it clear that the Court does have the power to extend time limits generally.

2.77 Notifying Pre-commencement Creditors

The Committee is of the view that no changes are required to the notification requirements. The commercial and flexible approach taken in the administration of Ansett Airlines supports this view. The Committee recommends that a draft deed be sent or made available for inspection at least 5 days prior to the second meeting.

2.82-2.87 Lending to a Company under Administration

The Committee is of the view that it is not necessary to make any changes with respect to the personal liability of an administrator.

2.101 Voting

The Committee recommends that related parties be prohibited from voting except with leave of the Court.

2.12 Remuneration of administrator

The Committee agrees with the Advisory Committee's recommendations for the approval of administrator's fees. The Committee agrees that the Court should have the power to override any agreement between the Administrator and a committee of creditors or the resolution of creditors particularly if the agreement has been obtained because of a mis-understanding or mis-information.

The Committee takes the view that creditors should be given more time to consider the administrator's fees and the administrator should disclose to creditors their past, projected fees and their expenses at the first meeting and provide details of fees (present and future) with the notice of the second meeting. (See the Committee's submissions to the Inquiry into Australian Insolvency Laws.)

2.121 Administrator's indemnity rights

The Committee recommends that the administrator's indemnity be extended to include loan funds. Presently S443A does not make it clear that "loan funds" are "General Debts".

2.127 Voiding antecedent transactions

The Committee does not support any proposed change which would allow administrators to apply to the Court to avoid antecedent transactions. To do so would result in voluntary administrations becoming quasi liquidations. It generally defeats the purpose of voluntary administrations. The public appreciate that any voluntary administration is subject to the rights ASIC have.

2.136 Prospectus Disclosure

The Committee is of the view that offers of security to creditors made under Part 5.3A should be exempt from disclosure under Part 6D. The information supplied in the explanatory statement and the general safeguards contained within Part 5.3A of the Corporations Act are sufficient.

2.144 Effect of takeover provision

The Court should be given express power in proper circumstances to exempt voluntary administration from the takeover provisions. All interested parties including creditors and shareholders should have the right to be heard on such an application.

2.161 Ambit of the court's powers to give directions

The Committee is of the view that whether or not the Court orders a protective direction should be left to the discretion of the Court.

2.168 Set Off

The Committee is of the view that there should be no change to the current law in this area.

2.176 Pooling of assets

The Committee is of the view that administrators should be permitted to pool the administration of several companies in circumstances where no creditor attending a meeting objects to the proposal or the Court otherwise approves.

2.191 Ipso facto clauses

See sub-paragraph 1.44 of the submissions.

2.207 Assigning or terminating executory contracts

The Committee recommends no reform in this area.

2.212 Deed of Compliance with Priority Payments

The Committee is of the view that to provide flexibility creditors should be able to approve arrangements which go outside the priority provisions of section 556 of the Corporations Act. The protection for creditors or classes of creditors is that such arrangements are always subject to being set aside by the Court for being unfairly prejudicial.

2.231 Minimum Number of Directors

The Committee agrees that the requirement for a minimum number of directors is not necessary when a company is in administration or subject to a Deed but prior to a company coming out of administration the minimum requirement should be complied with.

2.232 Change of company name

The Committee agrees that administrators should be able to change the name of the company without a special resolution of shareholders.

Mr John Kluver
Corporations & Markets Advisory Committee

The Committee would welcome the opportunity to further discuss the submission with you.

Yours sincerely,

Michael Lavarch
Secretary- General

9 December 2003

Ansett

Part 5.3A and Chapter 11

June 2003

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Paper 301
Ansett – Part 5.3A and Chapter 11
June 2003

The KordaMentha Research Unit did extensive research on Chapter 11 procedures for airlines and could it have saved Ansett. This is a reprint of an article appearing in the Australian Financial Review 3 June 2003

A spate of large Australian corporate failures has re-ignited debate on Australia's insolvency regulations, particularly the process of voluntary administration.

Also, Qantas has recently referred to the Chapter 11 protection provided to some of its overseas competitors as part of the justification for recent cuts to Qantas staff and other costs in order to maintain the airline's competitive position.

Voluntary administration procedures were implemented in Australia 10 years ago after careful examination of international insolvency precedents, including Chapter 11. The system was reviewed by a Government advisory committee in1998 and, subject to some fine tuning, found to be successful and popular.

Chapter 11, in simple terms, protects a company from its creditors by allowing it, under certain circumstances, to stop creditor payments, while restructuring takes place. Typically management that presides over a company's slide into Chapter 11 is responsible for this restructuring.

Our examination of the Chapter 11 process in the US convinces us that such a system would not have saved Ansett. Moreover, Chapter 11 can be administratively more expensive and it relegates employee entitlements in a way that may not be acceptable in the Australian environment.

Companies in Chapter 11, just like under voluntary administration, need cash and capital to trade during and emerge from Chapter 11. US Airways recently reorganised under Chapter 11 protection. US Airways' exit from Chapter 11 was facilitated by a US$900 million US government loan, the cancellation of all equity, only 2¢ in the dollar to unsecured creditors, US$240 million of equity, an injection of US$100 million of at-risk debt as well as annual wage and benefits concessions from employees of approximately US$1.9 billion a year. Additionally, priority for employee claims under Chapter 11 is limited to US$4,650

With access to these concessions and additional capital, especially US$900 million of government funds, US Airways (or Ansett) could easily have reorganised under Australia's voluntary administration regulations.

Ansett traded for five months under administration. Ansett's trade-on was made possible by, amongst other things, significant EBA concessions, a $150 million settlement with Air New Zealand, federal government underwriting of passenger tickets, the continuing involvement of relevant management, significant cost cutting and fleet rationalisation.

Singapore Airlines and Patrick Corporation both considered recapitalising Ansett. The "Tesna" consortium committed to recapitalising Ansett. However, Tesna eventually chose not to proceed.

Once it was clear that capital was not going to be injected, Ansett was grounded so creditors would get a better result. At that time, Ansett had unsecured assets able to be quickly converted to cash of around $350 million (principally real estate), priority employee entitlements of $735 million and unsecured claims in excess of $2 billion. Without a "white knight" to provide capital the cash would have run out half way through a Chapter 11-style reorganisation.

Chapter 11 regulations and the resultant dilution of priority for Ansett employees would have relegated almost $650 million in entitlements to unsecured claim status. The Federal Government's SEESA and GEERS schemes as well as community expectations to give entitlements priority are evidence of the Australian public's aversion to this US-style solution.

US aviation history is full of "colourful" characters. One oft-cited example is Frank Lorenzo who, as head of Texas International, bought faltering airlines through the 1980's. After stints in bankruptcy with both Continental and Eastern Airlines a US bankruptcy court ruled Frank Lorenzo unfit to run an airline.

With the exception of liability relating to fraud and negligence, US regulations do not incorporate the concept of Directors' liability for insolvent trading or personal liability for Directors, officers or regulators prior to or during Chapter 11.

We examined 19 examples of Chapter 11 filings by large public airlines in the US between 1980 and 2002. The average time in Chapter 11 was 740 days. These examples include companies with multiple filings such as Trans World Airlines (three filings and no longer flying), Continental Airlines (two filings) and Midway Airlines (two filings). US airlines currently in Chapter 11 include United Airlines, Midway Airlines (again) & Hawaiian Airlines.

It is evident from the US aviation experience that a Chapter 11 "solution" is not always enduring. In any event, it is the equity holders, employees and unsecured creditors who fund the Chapter 11 process and who bear significant risk post-reorganisation. Is that equitable?

At Ansett, some of the businesses were sold and continue to operate. Kendell & Hazelton (now Rex), SkyWest, Aeropelican, Show Group and Ansett Cargo were all recapitalised and sold during the Ansett voluntary administration with the approval, in each case, of the committee of creditors.

In the US, Bankruptcy Court approval is required for all major decisions, including asset sales. Court proceedings typically necessitate the appointment and extensive involvement of specialist professional advisers who charge up to US$900 an hour. Court costs and professional expenses rank in priority to other unsecured claims. This level of Court participation in the Ansett administration would have certainly delayed and possibly derailed asset sales. The Ansett administration has however, made twenty applications to the Federal Court. The court is able to supervise voluntary administrations of large complex enterprises, when needed, in a cost effective manner.

International aviation has proven to be a significant risk to capital. Airlines are amalgamated, divested, deregulated and liquidated – when this happens it is unfortunate,

painful and extremely costly for those involved. However, unlike Ansett, it is not a uniquely Australian experience.

Chapter 11 vs Part 5.3A

The September 2003 CAMAC Discussion Paper includes the following comparison between Voluntary Administration and Chapter 11 of the US Bankruptcy Code:

	VA	US Chapter 11
Prerequisites	Insolvency or likely insolvency.	Good faith only.
Who can commence the procedure?	The directors, a liquidator or provisional liquidator or a substantial chargee.	The directors.
Role of the court in commencing the procedure and approving the plan	No mandatory role in either situation, though the court has various ancillary powers exercisable on application.	Procedure initiated by petition to the court. Continuing close court involvement in the rehabilitation procedure, including final approval of plan.
Who controls the company during the rehabilitation procedure	The administrator, who must be a registered liquidator.	The directors (unless the court orders their replacement by an independent trustee).
Committees of creditors	Limited functions, namely to consult with administrator in relation to the administration and consider reports by the administrator.	Major role. Can employ professional advisers at the company's expense.
Information to creditors	Report by the administrator about the company's business, property, affairs and financial circumstances and a recommendation about what is to be done.	Court-approved disclosure statement.
Moratorium on claims against the company	Automatic moratorium, with significant exceptions for some secured creditors and property owners.	Automatic moratorium, which applies to all secured and unsecured creditors.
Ability of creditors to enforce ipso facto clauses	Yes.	No.
Ability of creditors to exercise set-off rights	Yes.	No.
Liability for goods and services	Administrator personally liable, with a right to an indemnity out of the company's assets.	Company liable as debtor in possession, with debts having priority over pre-commencement unsecured debts.
Loan financing during rehabilitation procedure	Lender is an ordinary unsecured creditor of the company.	The court can give a lender a priority over all existing unsecured creditors and, if necessary, over existing secured creditors.

	VA	US Chapter 11
Who devises rehabilitation plan	The administrator.	The directors, usually in consultation with professional advisers, during the exclusivity period (see below). After the exclusivity period, any interested party, including the creditors.
Time to develop rehabilitation plan	Approximately one month, subject to the court extending the period.	Exclusivity period of 120 days.
Approval of rehabilitation plan	One meeting of all creditors.	Meetings of each class of creditors. 'Unimpaired' creditors deemed to have approved plan.
Majority required to approve the plan	50% majority by number and by value of all the creditors who vote.	Two-thirds in amount, and more than one half by number, of creditors who vote, class by class. A dissenting class can be overridden by the 'cramdown' rules.
Rehabilitation plan binding secured creditors	Yes, if the secured creditor agrees or the court so orders.	Yes, provided: • if impaired class of secured creditors, at least one impaired class assents • the plan is fair and equitable.
Rehabilitation plan discriminating between creditors	The creditors can approve a deed that discriminates against particular creditors.	Under the 'absolute priority' rule, senior creditors are paid before junior creditors. All creditors are paid before shareholders. One class cannot receive less than another class with identical priority without the consent of its members.
Time to implement rehabilitation plan	No prescribed limit.	No prescribed limit.

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- Share our knowledge of specialist topics with insolvency stakeholders
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The KordaMentha Research Unit is headed by Leanne Chesser. All KordaMentha Partners and Directors contribute to the KordaMentha Research Unit.

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- 301: Ansett - Part 5.3A and Chapter 11
- 302: Large and Complex Administrations – The Courts and Ansett
- 303: Regulatory Review of Australia's Insolvency Laws
- 304: Employee Entitlements
- 305: Rehabilitating Large and Complex Enterprises in Financial Difficulty

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KordaMentha

Large and Complex Administrations The Courts and Ansett

August 2003

The KordaMentha Research Unit
Paper 302

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The KordaMentha Research Unit
Paper 302
Large and Complex Administrations
The Courts and Ansett
August 2003

There is no doubt that the sheer size and complexity of the Ansett Administration tested the Australian Voluntary Administration regime to its limits. This paper outlines some of the commercial issues we faced on the Ansett Administration and how the Courts dealt with our applications on these issues.

1. Appointment as Administrators

Commercial Issue: Mark Korda and Mark Mentha were asked to Consent to Act as Administrators of the Ansett Group of Companies by a major creditor group. Due to Corporations Act restrictions, we were unable to Consent because Andersen (with whom we were partners at the time) was the prior auditor of one of the recently acquired subsidiaries of the Ansett Group.

Court Application: We applied for and received leave of the Federal Court to Consent to Act as Administrators of all but the Hazelton Airlines Group of Companies, which was the recently acquired subsidiary.

2. Extension of 7 Day 'Rent Free' Period

Commercial Issue: Where a company has existing arrangements in place at the commencement of an administration to use or occupy a third party's property (eg property leases, aircraft and equipment leases), an Administrator has 7 days within which to decide whether or not he or she wishes to use or occupy the property. Ansett had more than 600 such leases.

After the 7 day period, unless the existing agreement is disclaimed, the Administrator is liable for the rent and other amounts payable under the agreement.

Court Application: Given the sheer number of lease arrangements to be dealt with, we successfully applied to the Court for a short extension of time (7 days) to determine whether we wished to continue to use or occupy third party property.

3. Memorandum of Understanding (MOU)

Commercial Issue: On appointment, we faced a number of significant hurdles:

- we had no available cash to trade the business;
- Ansett's senior management and financial records were in New Zealand, leaving a management and information vacuum in Australia;

- the terrorist attacks on 11 September 2001 had decimated the aviation industry, destroying the market for assets and reducing Ansett's ability to compete in a fiercely competitive market (the Ansett Administration began on 12 September 2001);
- the Ansett fleet consisted of 134 aircraft, 53 of which were subject to lease and finance arrangements;
- Ansett leased about 350 properties;
- Ansett employed 15,000 workers, most of whom were members of unions;
- we faced serious backlash from Global Rewards (ie frequent flyer) creditors; and
- a Federal election was imminent.

As Administrators, it was clear that the sale of the Ansett mainline business in accordance with the object of Part 5.3A of the Act would be highly unlikely unless we resumed flight operations quickly. The object of Part 5.3A is effectively to maximise the chances of the company, or as much as possible of its business, continuing in existence. To do this, we needed an injection of capital and the opportunity to change Ansett's outdated work practices. Due to the operations, records and assets of Ansett and Air NZ being intermingled, it was necessary to disentangle Ansett from Air NZ. This was achieved through negotiation of a compromise with Air NZ.

On 8 August 2001, Air NZ wrote a Letter of Comfort to three Ansett companies confirming its policy to take such steps as were necessary to ensure that it's wholly owned subsidiaries could meet their debts as and when they fell due. Importantly, the Letter of Comfort also provided that Air NZ would make available, on request in writing from time to time, advances for the sole purpose of enabling the three Ansett companies to pay working capital liabilities incurred by them in the ordinary course of business. The maximum aggregate of all such advances was not to exceed AUD $400 million.

We concluded that if we could negotiate a prompt commercial settlement of any claims (including the Letter of Comfort) the Ansett Group may have had against Air NZ, Ansett had the best chance of receiving cash for its claims and continuing to exist. If legal proceedings were commenced for recovery, Air NZ may itself have been forced into administration (statutory management in NZ) precluding any recovery by us as Administrators.

After intense negotiations, Air NZ agreed to pay AUD $150 million, to waive its right to prove in the Ansett administration and its right to AUD $32 million in priority payments advanced to Ansett for wages; a total of AUD $182 million. In return, Ansett and the Administrators would release Air NZ and its directors from certain 'theoretical' legal claims. The terms of the agreement were set out in a Memorandum of Understanding which was signed on 4 October 2001.

Court Application: The MOU was conditional upon the Federal Court approving its terms or making orders or directions to the same effect. We were concerned about compromising, albeit in a limited way, claims against the Air NZ/Ansett directors in circumstances where we had not had the time or opportunity to conduct any detailed investigations into the claims being released.

Before signing the MOU, we informed key stakeholders including the Federal Government and Priority Creditors of its proposed terms. At a meeting held on 3 October 2001, the Committee of Creditors did not object to the Administrators entering into the MOU.

As Administrators, we clearly had the legal authority to enter into the MOU pursuant to Section 437A of the Act. However, we were seeking protection against any subsequent claims that we may have acted inappropriately or unreasonably by entering into the MOU. Hence, our transparent approach.

On 12 October 2001, the Court made orders and directions pursuant to Sections 447A and 447D of the Act to the effect that, as Administrators, we could properly and justifiably perform and give effect to the MOU. The Court was satisfied on the basis of the material placed before it that we were acting in accordance with the object of Part 5.3A of the Act by entering into the MOU. The Court saw that we had been presented with a "window of opportunity" which would be lost if the MOU could not be given effect to.

In his reasons for judgment, Justice Goldberg said that in compromising the claims and entering into the MOU, the Administrators "exercised a commercial judgment" and that it was "not the role of the Court to make a commercial judgment for the liquidators or administrators or to substitute its judgment for their judgment." However, while it was not the Court's role to pronounce upon the commercial prudence of a particular transaction, the Court would act in an appropriate case to protect administrators from claims that they have acted unreasonably by entering into a particular transaction provided full and frank disclosure was made.

4. Employee Entitlement Safety Net

Commercial Issue: Following the collapse of Ansett, the Federal Government announced its intention to guarantee that Ansett's employees receive their entitlements to wages, annual leave, payment in lieu of notice and redundancies up to the community standard of eight weeks. To do this, the Government established the Special Employment Entitlement Scheme for Ansett employees ('SEESA') for the purpose of making these safety payments to Ansett employees if there was a shortfall in asset realisations.

As Administrators, we believed it could take several years to complete the realisation of Ansett's assets. Accordingly, we attempted to reach agreement with the Government to ensure that employees who had been made redundant could receive their entitlements as soon as possible. Furthermore, after intense negotiation, the Government maintained that SEESA was established for the benefit of employees and insisted it be given priority for the repayments of any advances made by it to the Administrators as if the Government 'stood in the shoes' of the employees and be repaid ahead of ordinary unsecured creditors.

Court Application: In early December 2001, we applied to the Court for directions and orders to the effect that we acted appropriately by agreeing that the SEESA payments to be made by the Government to redundant employees would rank in priority equal to those of employees in a winding up and that SEESA payments were debts incurred by us as Administrators in the ordinary course of exercising our powers and functions. In the absence of an order from the Court, if as Administrators we borrowed the money there would not be a right of indemnity over the assets of the companies to repay the borrowings. The Government and the unions supported our application to the Court.

On 14 December 2001 the Court made orders pursuant to Section 447A of the Act to the effect that Part 5.3A of the Act was to operate in relation to the Ansett companies as if:

- the SEESA payments to redundant employees would rank according to the priority provided for under Sections 556 and 560 of the Act; and
- the SEESA payments were debts incurred by the Administrators in the performance and exercise of their functions as Administrators and for which they would not be personally liable to repay (except to the extent that they had assets available for the Administration to do so).

5. Notification of Second Meeting of Creditors

Commercial Issue: In accordance with the Act, each creditor of Ansett (including Global Rewards members, employees and unused ticket holders) was entitled to written notice of the second meetings of creditors together with the Administrators' Report, Proxy Form and outline of the proposed Deed of Company Arrangement.

Such a mail out would have cost AUD $28 million, so we applied to the Court seeking an exemption from the normal notice requirements.

Court Application: The Court stressed that whilst expense may be a relevant consideration, it should not outweigh the primary consideration which is that creditors be notified of the convening of the meeting and their right to receive the necessary information.

The Court ordered that at least 10 days before the meeting, a one page notice be posted to all creditors notifying them of the meeting and that the report could be obtained from the Administrators' web sites. Furthermore, notices had to be published in newspapers throughout Australia in the form of large advertisements. The Administrators had to maintain a creditor hotline and deliver to any creditor, at his or her request, a copy of the Notice, Report and Proxy Form. The collective cost of these requirements was only AUD $1.8 million.

The court also provided relief from posting Notices to all creditors should the meeting be adjourned and the same relief should apply for all other subsequent reports and meetings, but without posting any further one page notices.

6. Administrators Continuing to Trade

Commercial Issue: The second meetings of creditors were held on 29 January 2002 (Part 1 of the Second Meetings). The primary purpose of Part 1 of the Second Meetings was for creditors to approve the sale of the mainline airline to Tesna Holdings Pty Ltd (Tesna) and to approve the extension of the completion date by up to 30 days to allow Tesna more time to complete.

At this meeting, creditors overwhelmingly passed resolutions approving the sale and the completion date extension by up to 30 days.

Court Application: We subsequently applied to the Court for a direction to the effect that we could properly and justifiably continue to operate the Ansett mainline airline for a further period of up to 30 days pending finalisation of the sale of the mainline airline to Tesna. We were concerned that if we continued to trade the business during the extension period and the Tesna sale did not complete, we would have reduced the pool of funds available to creditors by incurring trading losses and would therefore be open to allegations of breach of duty.

We accepted that the issue was not one of legal authority, but whether in a complex administration, Administrators were justified in incurring trading losses for a defined period in an attempt to secure the inherently uncertain prospect of the sale of the airline as a going concern.

After a thorough review of the authorities, Justice Goldberg declined to give the direction sought. The court said:

"There must be something more than the making of a business or commercial decision before a court will give directions in relation to, or approving of, the decisions. It may be an issue of legal substance or procedure, it may be an issue of power, propriety or reasonableness, but some issue of this nature is required to be raised. It is insufficient to attract an order giving directions that the liquidator or administrator has a feeling of apprehension or unease about the business decision made and wants reassurance."

However, and most importantly for us, the Judge commented that "No issue as to the power of the administrators to make this decision has been raised. It is within their power to make the decision. No issue has been raised as to the propriety or reasonableness of the decision, nor has any issue been raised which requires the Court to make a judgement on a legal issue."

No creditors challenged our decision to continue to trade.

By contrast, in the MOU application, the Court could approve our decision to enter the MOU because:
"…there were legal issues involved relating to causes of action by the administrators….In particular, there were legal issues involved in the release of claims under the Letter of Comfort."

7. Extension of Time to Execute DOCAs

Commercial Issue: The Act specifies that if Creditors vote and approve a Deed of Company Arrangement (DOCA) at the second meeting of creditors, the DOCA must be executed within 21 days of that meeting. There were a number of drafting issues relating to the Ansett DOCAs which required further time to resolve.

Court Application: An application was made to the Court to extend the time in which we were required to execute the DOCAs approved at a meeting of creditors held on 27 March 2002, by a period of 7 days. The application was opposed by 2 creditors.

After the application was heard, but before orders were granted, the 2 creditors withdrew their opposition to the application and the Court made orders granting a 7 day extension. This enabled us to resolve drafting issues with various parties relating to the DOCAs.

8. Further Extension of Time to Execute DOCAs

Commercial Issue: Before the expiry of the 7 day extension granted by the Court in the first application, we applied to the Court for a further extension of time to execute the DOCAs. The purpose of this second application was to preserve the status quo for a period of time to enable us to dispose of the Domestic Terminal Leases (DTLs) in an orderly fashion.

Sydney Airport Corporation Ltd (SACL) and other DTL lessors maintained that the 'buy-back' provisions in the DTLs, which were the Ansett Group's most valuable assets, would be triggered by executing the DOCAs. The 'buy-back' provisions enabled the DTL lessors to 'buy-back' the DTLs at 'fair market value' which would be significantly less than the amount which could be obtained in a competitive market. By extending the time to execute the DOCAs to enable us to sell the DTLs, we would avoid the dispute arising and maximise realisation of the DTLs value.

Court Application: On 29 April 2002, the Court dismissed the application on the basis that it was not an appropriate exercise of discretion to extend the time to execute the DOCAs for the purpose of prolonging the administration in order to avoid a result which execution of the DOCAs may bring about. However, an interlocutory order made on 24 April 2002 had the result of extending the time by which the Companies must execute the DOCAs for a further period after judgment was deferred until 2 May 2002. Within that time, we were able to sell the Sydney DTL.

9. Sale of Sydney Terminal

Commercial Issue: In order to avoid a dispute as to whether execution of the DOCAs triggered the 'buy-back' provisions under the Sydney DTL, we negotiated its sale to SACL prior to expiration of the period to execute the DOCAs (as extended by the Court in the first and second extension applications). Effecting the sale was a commercial decision made by us in order to maximise the return to creditors from the disposal of the Sydney DTL. In our view, the sale of the Sydney DTL to SACL in a competitive market yielded more than what may have been achieved under the 'buy-back' provisions of the Sydney DTL.

The sale was negotiated at break-neck speed. We did not comply with the sale process for the sale of the Sydney DTL with which we had previously announced we would undertake (ie advertising, due diligence etc). In addition, SACL had submitted in the second extension application that it was inappropriate for us to sell the assets prior to the execution of the DOCAs where there had been a resolution of the creditors that the DOCAs be executed and where a principal objective of the DOCAs was to enable the sale of the assets. In these circumstances, we made an application to the Court for approval of the sale of the Sydney DTL.

Court Application: Justice Goldberg held that in all the circumstances it was appropriate to give a direction that we may properly perform and give effect to the agreement of the sale of the Sydney DTL. Although our decision was a commercial one, the issues raised by SACL in the second extension application went to its propriety.

10. Superannuation

Commercial Issue: The Ansett Group has a defined benefit superannuation plan with a shortfall of up to $175m. Most of the shortfall occurred because the Plan provided that if an employee is retrenched, that employee is entitled to a special benefit on termination (up to 15% extra) and that was not funded. The entitlement to the special benefit is dependent upon a declaration being made by the employer that the member has indeed been retrenched.

This case was very important. What potentially occurring here is that a creditor whose claim we would normally regard as 'unsecured' is was seeking elevate its claim to become a cost of the Administration under Section 556(1)(a) of the Act, which means its claim would be paid in priority to all other claims (or alternatively s556(1)(e).

Court Application: We made an application to the Federal Court to determine the declaration of retrenchment question and related issues. The Trustees commenced separate proceedings in the Supreme Court of Victoria. Accordingly, our Federal Court Application had been adjourned until the final outcome of the Trustees' application is known.

The Trustees sought the Court's determination of three key issues, namely:

- Have employees been retrenched within the meaning of the deed of the particular Superannuation Plan?
- Is Ansett liable to pay any shortfall to the particular Superannuation Plan?
- If Ansett is liable to pay, would those payments be a priority payment if the Ansett Group is liquidated?

The Supreme Court determined that the answers to the above questions were respectively, Yes, Yes and No – the payments rank as ordinary unsecured claims. On Appeal, the Court found that the Supreme Court should not have heard the case because it was "hypothetical".

The case was then heard in the Federal Court. Concurrently mediation was held.

The mediation was successful. The Court approved the terms of settlement and made an order to vary the Ansett Deed of Company Arrangement. No amounts were paid directly to the Superannuation Plan to reflect the terms of settlement. Again, this shows the Court can be used to resolve major issues on large and complex administrations.

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KordaMentha

Employee Entitlements

December 2003

The KordaMentha Research Unit
Paper 304

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Appendix A: Global Practices

Introduction

When an Australian company enters a formal insolvency process, the treatment of its employees' entitlements is governed by the provisions of the Corporations Act (the Act) and also by the Commonwealth Government's General Employee Entitlements and Redundancy Scheme (GEERS).

Key stakeholders in the process include Insolvency Practitioners, Commonwealth and State Governments, the Australian Chamber of Commerce and Industry on behalf of employers, the ACTU and unions on behalf of employees, and ultimately all secured and unsecured creditors of the insolvent company. A range of issues have been raised by these stakeholders, in determining how well the Act and GEERS deliver outcomes, including the following questions:

Should employee entitlements have an absolute priority ahead of all other creditors, including secured creditors, upon liquidation?[1]

What employee entitlements should be protected and by whom? Should every entitlement which is built into an award or contract be protected?[2]

Should related companies[3] **be required to contribute to the loss of employee entitlements by an employer company under external administration?**[4]

KordaMentha's discussion paper seeks outcomes for stakeholders that are both fair and reasonable, taking into account the vulnerability of employees, as well as others in the business community who suffer hardship and financial loss when a company fails. Our recommendations have also been formulated having regard to the interests of banks and secured lenders which play a significant role in facilitating existing and new business activity, and the implications for economic and social policy of Government.

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[1] The Parliamentary Joint Committee on Corporations and Financial Services Improving Australia's Corporate Insolvency Laws Issues Paper, May 2003
[2] Ibid
[3] Defined under S50 of The Act otherwise known as "Related Bodies Corporate"
[4] The Parliamentary Joint Committee on Corporations and Financial Services Improving Australia's Corporate Insolvency Laws Issues Paper, May 2003

Should employee entitlements have an absolute priority ahead of all other creditors, including secured creditors, upon liquidation?

Background

Presently, employee entitlements for unpaid wages and unpaid superannuation contributions, long service leave and retrenchment payments rank ahead of other creditors, except debts secured by a fixed charge.

On 14 September, 2001 the Government proposed to increase protection for employee entitlements (other than redundancy payments) by giving priority to unpaid employee entitlements over all liabilities including debts secured by a fixed charge (not to apply retrospectively).

Many stakeholders do not generally support the "maximum priority proposal", and in fact state a number of serious concerns, whilst the ACTU has qualified its support for the proposal. KordaMentha acknowledges the following broad range of concerns:

- The Australian Chamber of Commerce and Industry has submitted that the Government stood to benefit from the adoption of a super-priority for employees as it would serve to defray Government's exposure under GEERS.[5]

- The Australian Banking Association considers that a maximum priority for employees would impact significantly on the lending and loan security arrangements of many businesses and would not benefit employees[6]. It also suggested that new funding may dry up and the changes may bring forward appointments because of a more conservative approach.

[5] Submission 13 p.9 to The Parliamentary Joint Committee on Corporations and Financial Services Improving Australia's Corporate insolvency Laws Issues Paper May 2003
[6] Submission 28 p.1 to The Parliamentary Joint Committee on Corporations and Financial Services Improving Australia's Corporate insolvency Laws Issues Paper May 2003

- Other stakeholders suggest that super-priority for employee entitlements would lead to artificial commercial arrangements designed to avoid the operation of the rule[7], for example a proliferation of companies employing no staff and holding no assets other than a receivable from an operating or trading company[8]. The impact would be particularly severe on companies with long serving work forces[9].

- Others argue that treating employees as priority creditors is difficult to justify and disadvantages ordinary unsecured creditors such as subcontractors, trade creditors and tort claimants. These stakeholders say it is inconsistent with the longstanding principles of insolvency law, in particular the *pari passu* principle that all creditors within a class should be treated equally. The employees are unsecured creditors and should be accorded equal treatment with other unsecured creditors and have an equal entitlement to share in a proportionate distribution of the assets of an insolvent debtor.[10]

- The ACTU endorses the "maximum priority proposal", but adds that the Commonwealth Government should give priority to 100% of employee entitlements above secured creditors (not just the GEERS component), and only recover its own expenditure once employees' claims have been satisfied in full.[11]

Discussion

We believe that employee entitlements should continue to rank behind creditors whose debts are secured by a fixed charge. The risks and costs associated with increasing the priority of employee entitlements above debts secured by a fixed charge are significant, and do not guarantee that employees will be any better off.

We are concerned that the consequences of "demoting" secured creditors would:

- Encourage businesses to hold assets subject to a fixed charge in one company, and employees in a separate company. Overall, employees would be worse off.

- Act as a disincentive to secured lenders, as arrangements which result in separation of assets and employees may invoke potential breaches of Part 5.8A of the Act. A secured lender participating in or insisting on the arrangement would be a person within the meaning of Section 596AB of the Act and potentially liable to recovery of the amount of any unpaid entitlements in any event.

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[7] Submission 27 to The Parliamentary Joint Committee on Corporations and Financial Services Improving Australia's Corporate insolvency Laws Issues Paper May 2003
[8] Submission 6 p.12 to The Parliamentary Joint Committee on Corporations and Financial Services Improving Australia's Corporate insolvency Laws Issues Paper May 2003
[9] Submission 28 p.1 to The Parliamentary Joint Committee on Corporations and Financial Services Improving Australia's Corporate insolvency Laws Issues Paper May 2003
[10] Submission 4, p7 to The Parliamentary Joint Committee on Corporations and Financial Services Improving Australia's Corporate insolvency Laws Issues Paper May 2003
[11] ACTU Proposed Changes to Corporations Law regarding maximum priority for accrued employee entitlements November 2002

- Make reconstructing a business much more difficult if a business' core assets i.e. employees and plant and equipment were in separate companies and these companies were not the subject of some form of pooling of assets and liabilities.
- Further reduce the return to unsecured creditors, if any, as a result of the corporate separation of assets and employees.
- Increase the cost of lending, so that lending institutions cover the additional risk of losing funds if a company becomes insolvent. This may mean a decrease in the number of new business enterprises because of resultant costly lending arrangements, and an increase in the number of insolvencies as companies find it difficult to obtain finance to trade through difficult times.
- Result in Australia being the only developed common law jurisdiction in the world to grant a priority over fixed charge holders with potential impact on investment and provision of finance by foreign entities.

What employee entitlements should be protected and by whom? Should every entitlement which is built into an award or contract be protected?

Background

The Act

The Act does not cap the quantum of employee entitlements, neither does it offer recourse to an alternate source of funds or cap individual payments where there are insufficient assets of a company to meet the payment of full employee entitlements as calculated under the relevant industrial agreement or contract.

This situation sometimes results in inequitable outcomes; e.g. a highly paid individual may be paid a large and disproportionate employee entitlement when other, lower paid employees rank *pari passu* for a comparatively small entitlement. There may be an exacerbated differential between one employee and all others, or perhaps between a group of employees and other groups. In the Ansett Administration, all employees proportionately shared in the asset pool; however certain employee entitlements were calculated at an average rate of $134,000 p.a. compared to other employee entitlements at $32,000 p.a.

Furthermore, there would be a public outcry if high paid executives were claiming millions based on their contacts being terminated.

An example: the CEO of Ansett was paid many millions in redundancy. He was an employee of Air New Zealand. If not (ie he was employed by Ansett Australia Limited) the claim would have been Ansett's to pay.

GEERS

Payments made under GEERS are subject to an annual income cap of $81,500 for 2002-2003. The income cap is used to calculate eligible GEERS payments for:

- Unpaid wages
- Accrued annual leave
- Accrued long service leave
- Pay in lieu of notice, and
- Up to 8 weeks redundancy entitlement.

GEERS does not however fund employees unpaid superannuation contributions. Under the Act, superannuation contributions are afforded equal priority to unpaid wages. KordaMentha believe that GEERS should be expanded to include unpaid SGC superannuation contributions calculated at the capped level referred to above. KordaMentha welcomes the recent changes to legislation that compels SGC contributions to be paid quarterly rather than annually.

The Commonwealth Government pays GEERS funds to the external administrator of an insolvent business as an advance on the condition that, in the event of liquidation, the Commonwealth effectively stands in the shoes of the employees and enjoys the equivalent priority in any distribution which those employees would otherwise have had in the liquidation. Notwithstanding, the GEERS scheme in 2003/2004 cost the Commonwealth $73.2m.[12] We recognise that the Commonwealth would like to reduce the cost of the scheme.

The ACTU welcomed the introduction of GEERS and acknowledged that it significantly increased the Commonwealth's financial exposure in the case of corporate insolvency.[13] However, the ACTU also continues to lobby strongly for a combination of actions and changes to Enterprise Bargaining, the Act and GEERS that collectively would guarantee 100% of employee's entitlements in the event of insolvency.

KordaMentha recommends that GEERS be given legislative enactment. Union campaigns for protection of entitlements have highlighted that there is no guarantee of continuity of the scheme and so are attempting to secure employee entitlements at enterprise level.

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[12] Department of workplace Relations and Small Business Portfolio Budget Statements 2003/2004

[13] ACTU Proposed Changes to Corporations law regarding maximum priority for accrued employee entitlements

Comparison to Global Practices

On a country by country comparison of insolvency legislation and Government safety net schemes, Australian employees generally receive more of their entitlements when their employer fails. [14] Appendix A details practices across various countries.

In summary, Canada, Singapore, New Zealand and the United States, legislations cap total payments to any one employee to no more than approx $A10,000. Only the United Kingdom has a safety net similar to GEERS known as the Redundancy Payment Scheme ("RPS") which is administered by the Department of Trade and Industry. Payments made under the RPS are subject to an annual income cap of approximately $A33,000 and cover:

- Up to 8 weeks of unpaid wages
- Up to 6 weeks of accrued annual leave
- Accrued pay in lieu of notice, and
- Redundancy entitlements capped based on age and number of years service to a maximum of 30 weeks

Also, payments made under RPS cover unpaid employer pension fund contributions for up to 12 months prior to insolvency. The amount is based on the payment which should have been made, or if that cannot be ascertained, then a percentage of actual wages paid. Payment of employer pension fund contributions is not calculated by reference to the annual income cap applied to other benefits.

The United Kingdom legislation also provides that employees receive no dividend in respect of the balance of their entitlements until RPS has been recouped in full.

In summary, GEERS is a safety net scheme, where the Commonwealth assumes significant exposure in order to protect basic employee's entitlements; and its provisions are generous when compared with many other countries. With the exception of the United Kingdom, other jurisdictions reviewed do not have GEERS or a similar equivalent, and appear to deal with hardship caused by insolvency on a going forward basis rather than by payment of past entitlements.

Entitlements calculated under the relevant Industrial Agreement

The Act does and should recognise that the full entitlements of employees of failed companies, are those detailed in the relevant industrial instrument. These industrial agreement provisions however, may well have been agreed to at a much earlier time when the company was profitable and did not foresee the insolvency of the company, nor indeed any significant restructuring. At Ansett, for example, retrenchment packages for award employees were uncapped, and on the collapse of the company, 12,600 employees were owed an average retrenchment amount of 41 weeks pay.

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[14] The protection of employee entitlements in the event of employer insolvency Ministerial Discussion Paper August 1999 Attachment B protection of employee entitlements on employer insolvency – The overseas experience

The KordaMentha Proposal

In the event of insolvency, a balanced and reasonable approach may involve greater integration of S556(1) of the Corporations Act with the GEERS scheme, and the relevant industrial agreements. That part of S556(1) which relates to employee entitlements could be redrafted to reflect this integration in the following way:

1. First Priority: to be employee entitlements equivalent to the GEERS entitlement. GEERS should be expanded to include unpaid SGC superannuation contributions calculated at the GEERS income cap.

2. Second Priority: the balance of all remaining employee entitlements as a single claim, but calculated using the GEERS income cap.

3. Unsecured – Balance of all other amounts owed (i.e. all employee entitlements which exceed the GEERS income cap will rank as unsecured).

GEERS should mirror the "excluded employee" provisions of the Act. Excluded employees under GEERS are defined as a "shareholder" executive director and/or relative.

This solution aims to achieve a fair and equitable outcome and presents numerous benefits for all stakeholders, which include:

For Secured Creditors:

- Secured Creditors' position is unchanged, which mitigates all of the risks outlined above, in relation to demoting their priority.

For the Commonwealth:

- The GEERS Scheme is afforded maximum priority, which will result in decreasing the cost of the scheme.

For Employees:

- Use of income caps mean that highly paid management employees, will not receive a disproportionate share of assets.

- Award and contract-based employees whose income is less than GEERS cap of $81K will be more likely to receive their entitlements in full, because of the income cap. Although we considered carefully capping priority redundancy payments at 16 weeks, we concluded that an income cap is sufficient to provide a balanced solution for employees.

For Unsecured Creditors:

- This solution provides opportunities for better returns to unsecured creditors, by re-prioritising very large payments to employees. Under current legislation, there have been examples in insolvencies, where millions have been paid to individual employees, with no return to unsecured creditors, many of whom are small businesses or reliant sub-contractors which, as a direct result, failed themselves.

For Insolvency Practitioners:

- The solution is a simple one, which balances the outcomes anticipated by The Act, GEERS and Industrial Instruments, to the benefit of all stakeholders.

A Practical Example: The KordaMentha Proposal Applied to Ansett

By way of practical example, it is useful to compare the outcomes of the Ansett Administration under legislation (what actually happened) to the outcomes that would have otherwise occurred if the proposal had been operative.

The Ansett Administration is expected to realise approximately $600m net.

Creditors	Gross Amounts Owed ($m)	Actual Amounts Repaid ($m)	KordaMentha Proposal – Amount Repaid Would Be ($m):
Secured Creditors	Nil	Nil	Nil
Highly Paid Employees	204	179	125
Award Employees on income less than GEERS cap	506	467	475
Funded by Commonwealth Safety Scheme		390(*)	354
Repaid to Commonwealth Safety Scheme		(344)	(354)
Loss to Commonwealth		(46)	Nil
Unsecured Creditors	1,800	Nil	Nil
Total		600	600

(*) If GEERS funded Ansett's employee entitlements instead of SEESA, the Commonwealth's loan would be $354m

In summary, the result shows that if the KordaMentha proposal were applied to the calculation of Ansett returns, Award Employees on low incomes would have received greater returns and the Commonwealth would have been paid in full for monies advanced under GEERS. Highly paid employees would have received less.

Should related companies be required to contribute to the loss of employee entitlements by an employer company under external administration?

Discussion

KordaMentha believes that all related wholly owned companies should be automatically grouped unless they apply to ASIC to be ungrouped. i.e. there should be a presumption of an automatic deed of cross guarantee between related companies.

We note that recent changes to company "consolidations laws" for taxation purposes, that the tax liability is joint and several for all group companies, unless a company opts out. As a direct consequence, it is likely that the incidence of corporate grouping and cross guarantees will increase.

This solution is in contrast to the current situation, where in an external administration, all related companies are considered ungrouped, unless they had previously applied to ASIC to be grouped. It makes sense to reverse this status quo to protect employees from finding themselves employed by an insolvent company without assets, and without recourse to the assets of other group companies. In recent years, as a direct consequence of this "loophole" there has been a deliberate restructuring of companies to separate employee liabilities and group assets. Also, it avoids the inadvertent consequence of assets and employees being in different companies.

Appendix A: Global Practices

A country by county comparison of the benefits provided to employees in western common law based jurisdictions, under the provisions of relevant legislations, demonstrates advantages for Australian workers.

United Kingdom

- Wages – Limited to 4 month relation back capped at a maximum of GBP800.
- Holiday Pay – No limitation
- Payment in Lieu/Redundancy – Unsecured without priority

Note that all jurisdictions other than the United Kingdom (UK) provide for an order of priority like our 556(1). However, the UK places all priorities (tax, vat etc) into one priority category which shares *pari passu* in the available funds, which is less favourable to employees.

United States

- Wages, leave, and severance – limited to 3 month relation back date and capped at a maximum of USD4000

Canada

Under the Winding Up and Reconstruction Act

- Wages – limited to a 3 month relation back with no cap

Under the Bankruptcy and Insolvency Act

- Wages – limited to a six month relation back and capped at C$2000

New Zealand

Employees have priority after the expenses of winding up in the following order (Schedule 7 of the Corporations Act)

- Wages – 4 month relation back
- Holiday Pay – no relation back limitation
- Deductions made by employer to satisfy employee obligations – no relation back limitation
- Child Support deductions – no relation back period

Payment is made in order of priority as with Sec 556(1) A cap of NZ$6,000 is applied to payments to any one individual under all of the above categories.

Singapore

Section 328 of the Companies Act provides a priority to employees after expenses of winding up in the following order:

- Wages (inc commissions and any allowances or reimbursements under an employment contract or award or agreement) – see below
- Retrenchment or ex gratia payment under contract of employment, award or agreement – see below
- All amounts due inrespect of workers compensation uder the Workmen's Compensation Act – no relation back limitation
- Superannuation contributions – 12 month relation back – no limit as to amount
- Holiday Pay – no relation back limitation – no limit as to amount

Amounts payable under 1 and 2 above are not to exceed an amount equivalent to 5 months salary or S$7,500 whichever is the lesser.

About The KordaMentha Research Unit

Background

KordaMentha partners undertook the first voluntary administration in Australia, the largest voluntary administration in Australia (Ansett with 42 companies, 15,000 employees and >$1 billion assets), the largest group of voluntary administrations in Australia (Stockford with 84 companies) and more voluntary administrations than any other insolvency firm in Australia to date in 2003.

The strength of the KordaMentha experiences and our expertise makes us well placed to monitor and evaluate issues and developments in the insolvency industry and to recommend changes.

Statement of Direction

The KordaMentha Research Unit aims to:

- Develop intellectual property
- Share our knowledge of specialist topics with insolvency stakeholders
- Develop balanced solutions for issues in the industry. We will do this by preparing position papers on topics of interest, and encouraging discussion with a view that changes to the industry will result.

Personnel

The KordaMentha Research Unit is headed by Leanne Chesser. All KordaMentha Partners and Directors contribute to the KordaMentha Research Unit.

Current Research

The KordaMentha Research Unit has conducted research in a number of areas, including:

- 301: Ansett - Part 5.3A and Chapter 11
- 302: Large and Complex Administrations – The Courts and Ansett
- 303: Regulatory Review of Australia's Insolvency Laws
- 304: Employee Entitlements
- 305: Rehabilitating Large and Complex Enterprises in Financial Difficulty

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KordaMentha

Rehabilitating Large and Complex Enterprises in Financial Difficulty

December 2003

The KordaMentha Research Unit
Paper 305

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Introduction

Thank you for the opportunity to make a submission to the Corporations and Markets Advisory Committee's ("CAMAC") review of the application of Part 5.3A of the Corporations Act 2001 to large and complex enterprises. CAMAC's September 2003 Discussion Paper represents a comprehensive review of the issues which arise in our day-to-day application of Part 5.3A to large and complex enterprises.

KordaMentha partners undertook the first voluntary administration in Australia, the largest voluntary administration in Australia (Ansett with 42 companies, 15,000 employees and >$1 billion assets), the largest group of voluntary administrations in Australia (Stockford with 84 companies) and more voluntary administrations than any other insolvency firm in Australia to date in 2003. We believe this experience makes us well placed to comment on both the practical issues associated with the conduct of an administration as well as CAMAC's policy options for reform.

The KordaMentha Research Unit has written a number of papers that are relevant to both the ongoing inquiry by the Parliamentary Joint Committee on Corporations and Financial Services and to CAMAC's review. We have appended relevant papers to this submission for your information. The first appendix is our analysis of the impact that Chapter 11 style insolvency laws would have had on the Ansett voluntary administration. A version of this paper was published as an open editorial article in the Australian Financial Review on 3 June 2003.

This submission represents a practitioner's perspective on a number of issues identified by both CAMAC and KordaMentha.

We have limited our submission to responding to issues where we believe legislative changes will have a significant, positive impact on the application of Part 5.3A to large and complex enterprises and will enhance the prospects of an enterprise continuing in existence or alternatively provide a better return to creditors and members than liquidation.

We believe that these changes will enhance the prospects of rehabilitating large and complex Australian enterprises and that separate rehabilitation procedures are not required for large and complex enterprises within Part 5.3A.

KordaMentha would welcome the opportunity to discuss the issues raised in this submission, as well any other issues, with the committee and provide further commentary if requested.

Use of the Court

There has been significant discussion and debate in relation to the role of the Court in the rehabilitation of large and complex enterprises and whether, amongst other suggestions, an increased Court role would facilitate more successful large and complex rehabilitations.

In US Chapter 11 rehabilitation procedures, where the debtor company is "in possession" or control of the rehabilitation process, the Court plays a significant role. By contrast, the Australian rehabilitation environment where creditors are effectively "in possession" through an independent insolvency expert, Court participation is available to stakeholders however its participation is not prescribed.

In our experience, Court involvement in voluntary administration falls into two broad categories:

i) Applications or directions that could be avoided by amending the regulatory framework to address a number of key issues such as the timing of meetings and the use of ipso facto clauses; and

ii) Applications or directions where there are more complex issues within administrations where Court rulings add certainty to the rehabilitation process and are a necessary and extremely valuable contributor to large and complex rehabilitations.

In the Ansett administration KordaMentha has made numerous applications to the Federal Court to date. There is no doubt that the sheer size and complexity of the Ansett administration validated the Court's role in the Australian voluntary administration regime. The attached KordaMentha Research Unit discussion paper 302 outlines some of the complex commercial issues we faced on the Ansett administration and how the Courts dealt with our applications on these issues.

The broad powers granted to the Courts under the Corporations Act and particularly under s447A, are essential to the effective and efficient rehabilitation of large and complex enterprises.

KordaMentha Recommendation 1

The role of the Court is a significant differentiating factor between the US Chapter 11 rehabilitation regime and the Australian voluntary administration process.

KordaMentha recommend the current approach to the role of the Court in the rehabilitation of large and complex enterprises.

Addressing issues identified in CAMAC's Discussion Paper (discussed below) will reduce the number of applications to the Courts and improve the overall efficiency of the voluntary administration procedure.

Ipso Facto Clauses

Ipso facto clauses represent a significant impediment to maintaining the trading operations and realising value for the assets of companies. In the Ansett administration, the presence of ipso facto clauses in the Sydney Airport terminal lease significantly complicated negotiations with stakeholders and potentially created a significant reduction in value. Significant issues were also experienced with other contracts such as leases and licences to operate (eg software licences) where creditors attempted to use these clauses to "greenmail" the administrators.

KordaMentha support a combination of the policy options identified by CAMAC in paragraphs 2.205 and 2.206 of the Discussion Paper. Our recommendation incorporates some but not all elements of our experience in relation to the Chapter 11 treatment of contractual obligations for Ansett's US subsidiary. Under Chapter 11, contracts are effectively frozen however a company may be required by the Court to provide evidence that they can honour post-petition contractual obligations which may include a requirement to place funds on deposit to support contractual obligations.

KordaMentha Recommendation 2

Overall, ipso facto clauses should not be enforceable as is the case under Chapter 11. We believe that freezing ipso facto clauses has the potential to significantly enhance a large and complex enterprise's prospects of rehabilitation.

Our recommendation does not apply to ipso facto clauses which enable the registered holder of a charge over the whole or substantially the whole of the property of a company under administration. This circumstance is adequately addressed by s441 of the Corporations Act.

We believe this is one of the most significant changes that need to be made to the existing operation of Part 5.3A.

Employee Entitlements

KordaMentha acknowledge that CAMAC does not seek to replicate the Parliamentary Joint Committee on Corporations and Financial Services' review of employee superannuation and other entitlements.

Employee entitlements and their treatment are critical to the prospects of rehabilitation for large and complex enterprises and, where these enterprises are not able to be rehabilitated, are critical to the timing and quantum of the return to creditors including employees. We believe that it is imperative that the issue of priority be clearly addressed to prevent a repeat of the uncertainty associated with superannuation and employee entitlements in the Ansett administration.

KordaMentha Recommendation 3

As we note in our analysis of the applicability of Chapter 11 to the Ansett administration (see appended KordaMentha Research Unit discussion paper 301) the limited priority given to employees in the USA enhances the chances that creditors will support a plan of rehabilitation. KordaMentha does not however, support the USA's treatment of employee entitlements.

We have attached the KordaMentha Research Unit's discussion paper 304 detailing our proposed changes to the employee entitlement regime. This paper will be submitted to the Parliamentary Joint Committee on Corporations and Financial Services.

In summary, KordaMentha propose that part of S556(1) relating to employee entitlements be amended such that:

- First Priority: employee entitlements equivalent to the GEERS entitlement. GEERS should be expanded to include unpaid SGC superannuation contributions calculated at the GEERS income cap.
- Second Priority: the balance of all remaining employee entitlements as a single claim, but calculated using the GEERS income cap.
- Unsecured: Balance of all other amounts owed (i.e. all employee entitlements which exceed the GEERS income cap will rank as unsecured).

NB – We believe this proposal should be phased in over a time period which enables both employers and employees to manage the transition and its impact on their entitlement balances and capital structure.

Could Chapter 11 have saved Ansett?

The KordaMentha Research Unit did extensive research on Chapter 11 procedures for airlines and whether it would have saved Ansett. A reprint of an article appearing in the Australian Financial Review 3 June 2003 is attached.

Our examination of Chapter 11 process in the US convinces us that such a system would not have saved Ansett. Ansett needed cash. The US government provided billions of dollars to the US airlines in Chapter 11. The New Zealand government saved Air New Zealand by an injection of cash in excess of $800m. The Australian government, as well as many other governments throughout the world, decided not to inject cash into faltering airlines.

Companies in Chapter 11, just like under voluntary administration, need cash and capital to trade during, and emerge from, Chapter 11. US Airways reorganised under Chapter 11 protection. US Airways' exit from Chapter 11 was facilitated by a US$900 million US government loan, the cancellation of all equity, 2¢ in the dollar to unsecured creditors, US$240 million of fresh equity, an injection of US$100 million of at-risk debt as well as annual wage and benefits concessions from employees of approximately US$1.9 billion a year. Additionally, priority for employee claims under Chapter 11 is limited to US$4,650.

With access to these concessions and additional capital, especially US$900 million of government funds, US Airways (or Ansett) could have reorganised under Australia's voluntary administration regulations.

Ansett traded for five months under administration. Ansett's trade-on was made possible by, amongst other things, significant EBA concessions, a $150 million settlement with Air New Zealand, federal government underwriting of passenger tickets, the continuing involvement of relevant management, significant cost cutting and fleet rationalisation.

Singapore Airlines and Patrick Corporation both considered recapitalising Ansett. The "Tesna" consortium committed to recapitalising Ansett. However, Tesna eventually chose not to proceed.

It is also worth noting, many Ansett businesses were sold and continue to operate. Kendell & Hazelton (now Rex), SkyWest, Aeropelican, Show Group and Ansett Cargo were all recapitalised and sold during the Ansett voluntary administration. The engine shop, simulator centre and engineering continue to operate and will also be sold.

Debt Financing

The availability of ongoing financing for a company in financial distress is often critical to its rehabilitation and, as was the case with the Ansett administration, may be critical to an administrator's ability to make timely payments to priority creditors.

In the Ansett *SEESA* case, the Court ruled that the Administrators had no personal liability for funds to be provided by the Federal Government. In the absence of personal liability (and therefore no indemnity out of the assets of the company) statutory priority is not available to financiers for funds loaned to voluntary administrators.

Debt financing is very difficult to obtain, even where sufficient assets exist, unless funds can be secured against unencumbered fixed assets or the court orders that funds will have priority. In some instances company assets must be sold quickly to raise funds to conduct an administration.

KordaMentha Recommendation 4

KordaMentha support the recommendation in paragraph 2.100 that debt financing be facilitated by ascribing the same priority to funds loaned to administrators as is presently ascribed to goods or services purchased by the company during the period of the administration.

Set-off

In KordaMentha's experience, as a direct result of creditor's set-off rights, creditors with both debit and credit balances are able to achieve a 100% return on that portion of their creditor position that is off-set by an amount owed to the entity in administration. Typically other creditors who do not have both debit and credit balances with the entity in administration will receive a lower return on their claim as a result.

Leaving aside the creditor priority issue, the set-off right is particularly detrimental to the chances of rehabilitation where a creditor exercises this right against the cash balances of an entity. Cash is critical to the chances of rehabilitation. The absence of access to cash in addition to the existing difficulties associated with raising debt financing combine to significantly diminish an entity's rehabilitation prospects. A consequential issue is that businesses may be unnecessarily discontinued or assets may be sold too quickly as a result of a lack of cash.

KordaMentha Recommendation 5

KordaMentha support the policy option in paragraph 2.171 which proposes a moratorium on set-off rights. This moratorium should extend until the conclusion of the second creditors' meeting.

Creditors should not have the ability to set-off debit and credit balances when a voluntary administrator is appointed.

Timing Issues

Australian courts have recognised that the time period contained in Part 5.3A is insufficient to allow the administration of large and complex enterprises in a manner which achieves the objectives of the Part. Recently, in the large and complex administration of the Newmont Yandal group of companies, KordaMentha applied for a s439A extension. Merkel J granted an extension to the convening period and noted that:

"The authorities have consistently cautioned about extensions of time but have always made an exception in respect of cases where it's established on the evidence that the administration is large and complex …"

The court also granted a s439A extension in both the Ansett and Pasminco administrations.

Whilst the timeframe prescribed by Part 5.3A is evidently too short for the rehabilitation of large and complex enterprises a continued focus on rapid resolution is a sound principle when rehabilitating companies. KordaMentha support and recommend the continued existence of and use of s439A.

KordaMentha Recommendation 6

KordaMentha support CAMAC recommendations 2 and 6 in CAMAC's 1998 report on Corporate voluntary administrations and further support the suggestion in policy option 2.74 that creditors should have the opportunity to extend the convening period at their first meeting.

We believe that the creditor's right to extend the convening period should be limited to a period of up to 3 months post appointment, which may then be extended again at the discretion of the Court.

Post Appointment Liability

KordaMentha does not want to appear to be self-serving in relation to an administrator's personal liability for goods and services purchased during an administration.

KordaMentha believe however, that it is important to note that the existence of broad personal liability in large and complex administrations, where continued trading involves millions of dollars, creates a natural aversion to continuing the operations of the business.

The first voluntary administrators of Ansett grounded the fleet. In making this decision we believe the administrators would have considered the sheer size of their personal liability (which may easily have exceeded $100 million) the short time available to make a risk assessment and, the risk associated with the complexity of the industry in a post September 11 environment. There would have been understandably a natural aversion to personal liability in this context.

KordaMentha Recommendation 7

Personal liability of administrators is a complex and emotive issue.

In other industries such as the professional services and medical industries it has been recognised that a level of risk limitation or capping is required to attract and retain high calibre professionals.

The issue of an administrator's personal liability should be reviewed to determine whether a new process can be implemented which:

- continues to hold administrators accountable for their actions; and
- which decreases or removes an administrators natural aversion to liability in the context of the rehabilitation of large and complex enterprises.

Grouping of Complex Entities

In our experience, large and complex enterprises such as Ansett, Newmont Yandal and Stockford typically have complicated group structures that may or may not incorporate cross-guarantees which may be ASIC approved. CAMAC's *Corporate Groups Report* recommended that administrators have the ability to pool the administration of group companies in the absence of creditor or court opposition.

We also note, usually groups are run by management with little regard to them as separate legal entities. This results in many issues, most unintended arising on insolvency such as:

- centralised treasury function results in no cash in operating entities,
- employees in companies but operations in different companies making the administration much more complex, difficult and expensive,
- holding companies (eg Air New Zealand) that remove wholly owned subsidiaries, and
- difficulty in apportioning assets sold that have been viewed as group assets ie intellectual property.

KordaMentha Recommendation 8

KordaMentha believes that all related wholly owned companies should be automatically grouped unless they apply to ASIC to be ungrouped. i.e. currently companies opt in to grouping via cross deeds of guarantee, they should be grouped unless they opt out.

We note that recent changes to company "consolidations laws" for taxation purposes, that the tax liability is joint and several for all group companies, unless a company opts out. We recommend the same.

KordaMentha also support CAMAC's recommendations referred to in paragraph 2.181 and the recommendations contained in paragraph 2.188 of the September 2003 Discussion Paper.

Dealing with Equity

KordaMentha supports the proposal in paragraph 2.138 of the Discussion Paper namely that equity for debt offers to creditors made under a Part5.3A deed of company arrangement should be exempt from the disclosure requirements of Part 6D.2. The US Chapter 11 process frequently incorporates an equity for debt swap to facilitate the restructuring of a company in order to exit Chapter 11 especially as a means to address employee entitlement liabilities.

A further issue in relation to equity that is not specifically addressed in the Discussion Paper is an administrator's ability to deal with existing shareholder equity. Typically this limitation results in the sale of business assets rather than equity when restructuring large and complex enterprises. The sale of business assets rather than equity may result in a reduction in total consideration realised as a result of stamp duty costs and, in the case of the restructuring of an ASX-listed entity, an inability to realise full value from the entity's listed status.

KordaMentha Recommendation 9

Where a deed of company arrangement or business sale results in a return to creditors of less than 100 cents in the dollar the administrator should have broad power to deal with the entity's equity in order to maximise the return to creditors.

This broad ability may incorporate a "cancellation" or "deemed transfer" which would have the added benefit of immediately crystallising a capital loss that may represent a tax benefit for existing shareholders.

Branding and Perception

In our experience, the use of voluntary administrations has been well received in what is a very difficult area. In fact, liquidation and provisional liquidation are now seen as very negative. In certain instances voluntary administration is also seen more positively than a receivership.

Many American brands, practices and culture are well known to the world. Chapter 11 is one example. It is also embedded in Amercian business and every day language.

We believe for insolvency laws to be generally accepted by the public, they must be managed and nurtured like any product or brand. For example, "Part 5.3A – Administration of a company's affairs with a view to executing a deed of company arrangement" is hardly conducive to branding.

KordaMentha Recommendation 10

Stakeholders consider the appropriate positioning and branding of insolvency laws to support the objective of Part 5.3A which is to maximise the chances of the company, or as much as possible of its business, continuing in existence.

Other Issues

CAMAC's September 2003 Discussion Paper identified numerous important issues which we have not specifically addressed in this submission e.g. fee approvals, committee of creditor roles and disclosures. KordaMentha do not wish to duplicate commentary provided in other submissions such as the IPAA submission.

About The KordaMentha Research Unit

Background

KordaMentha partners undertook the first voluntary administration in Australia, the largest voluntary administration in Australia (Ansett with 42 companies, 15,000 employees and >$1 billion assets), the largest group of voluntary administrations in Australia (Stockford with 84 companies) and more voluntary administrations than any other insolvency firm in Australia to date in 2003.

The strength of the KordaMentha experiences and our expertise makes us well placed to monitor and evaluate issues and developments in the insolvency industry and to recommend changes.

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- Share our knowledge of specialist topics with insolvency stakeholders
- Develop balanced solutions for issues in the industry. We will do this by preparing position papers on topics of interest, and encouraging discussion with a view that changes to the industry will result.

Personnel

The KordaMentha Research Unit is headed by Leanne Chesser. All KordaMentha Partners and Directors contribute to the KordaMentha Research Unit.

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The KordaMentha Research Unit has conducted research in a number of areas, including:

- 301: Ansett - Part 5.3A and Chapter 11
- 302: Large and Complex Administrations – The Courts and Ansett
- 303: Regulatory Review of Australia's Insolvency Laws
- 304: Employee Entitlements
- 305: Rehabilitating Large and Complex Enterprises in Financial Difficulty

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KordaMentha

Grouping of Entities in the Event of Insolvency

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1. Introduction

Under existing legislation it is possible for creditors and employees of some companies in an insolvent group to receive no dividend, whilst creditors and employees of other group companies are paid out in full and the surplus is then available to shareholders.

The recent controversies regarding holding companies not being legally responsible for the liabilities of their subsidiaries and the unsatisfactory position of the Ansett creditors require a considered response and changes to the Corporations Act.

We believe that consideration should be given to requiring, by law in the event of insolvency, that all assets of companies within a group should be available to meet all of the liabilities of the companies within the group. This concept is commonly referred to as "pooling". However, legislation should also enable a company within a group to elect to "opt out" such that its assets and liabilities will not be pooled, eg special purpose non recourse debt funded companies.

The KordaMentha Research Unit has prepared this paper to develop and expand on our recommendation as outlined in Paper 305: Rehabilitating Large and Complex Enterprises in Financial Difficulty.

The concept of limited liability is clearly a bedrock of corporate law and it is critical that any amendments to current legislation do not interfere with the proper economic role of limited liability entities. In particular, it is critical the cost of capital is not adversely impacted. We believe the "opt out" arrangements, if constructed appropriately, may allow these broad aims to be achieved without materially impacting upon the commercial function of corporations. In order to achieve this it will be necessary to involve all stakeholders (and in particular debt and equity providers) in a broad consultative process prior to any legislative changes.

2. Background

The Corporations Act requires that each company within a group be treated as a separate legal entity. Accordingly each company must have its own constitution, its own board of directors, its own registered office, and its own company secretary and prepare financial statements which must be audited.

However, the practical reality is often somewhat different. In many instances companies in a group are run as a single entity. The group treasury function is located in one company with all cash within the group being swept into the bank accounts of one company; the human resources function is typically centralised; brands are developed for the group, not for individual companies; there is only one CEO, one CFO; all or most employees are employed by one or just a few entities within the group.

Currently a holding company and its wholly-owned subsidiaries may apply to the Australian Securities and Investments Commission for relief from the requirement for the wholly-owned subsidiaries to prepare and lodge audited financial statements. The wholly-owned subsidiaries and the holding company have to enter into a deed of cross guarantee whereby each company guarantees the debts of each other company within the group. The deed of cross guarantee makes the group of companies that are parties to the deed akin to a single legal entity, particularly in the event of insolvency, but there are still practical problems, e.g. priority creditors.

The introduction of the tax consolidation regime makes each company within the group liable for the taxation debts of all other companies within the group, unless a group company "opts out" by entering into a tax sharing agreement. This achieves "pooling" for all tax liabilities in the event of insolvency. It also results in the Commonwealth (in respect of taxation liabilities) now having an advantage over all other creditors.

3. KordaMentha Proposal

We believe that consideration should be given to requiring, by law in the event of insolvency, that all assets of companies within a group should be available to meet all of the liabilities of the companies within the group. This concept is commonly referred to as "pooling". However, legislation should also enable a company within a group to elect to "opt out" such that its assets and liabilities will not be pooled, eg special purpose non recourse debt funded companies.

We recognise in certain specific and limited circumstances groups set up special purpose vehicles such that the company's assets and liabilities are kept separate from the rest of the group's assets and liabilities, ie in non recourse debt arrangements. Provided the creditors of this special purpose vehicle are adequately on notice then we recognise it is entirely appropriate that the assets and liabilities of this company not be pooled.

We recommend that all holding companies should be required to notify ASIC of any of its subsidiary companies which will not be pooled. In effect we recommend rather than group companies "opting in" for "pooling" by and entering into cross deeds of guarantees, the process be reversed to an "opt out" arrangement. There must be a practical difference between the current "opt in" arrangements and the proposed "opt out" arrangements. Whilst all groups will have the ability to "opt out", we believe the positive step required to achieve this (board resolution or shareholder approval), and the public disclosure required as a result, should restrict "opt outs" to bona fide circumstances.

We recognise that there are a number of ancillary matters which must be addressed prior to the commencement of a consultative process.

Definition of a corporate group

In the context of this proposal, we would define a corporate group in accordance with the provisions of AASB 1042. The standard follows Sections 46, 47 and 50AA of the Corporations Act and is concerned with practical control (ie. a less than 50% shareholder may be deemed to control a company, and vice versa). Creditors and potential creditors of a company can then focus on the reported consolidated position of the entity, rather then the individual financial statements of the subsidiaries that are part of the group.

Liability of partly owned subsidiaries

Whilst we believe partly owned subsidiaries should be included within the definition of group as per AASB 1042, a consensus will need to be reached in respect of the extent of the liability of a partly owned subsidiary. Should it be liable for 100% of the group's liabilities, or should such liability be restricted in recognition of its less than 100% ownership? Under Section 588V of the Corporations Act a holding company is already 100% liable for the liabilities of a partly owned subsidiary in the event of the subsidiary trading whilst insolvent. It would therefore be consistent that the liability arrangements under this proposal should also be similarly unrestricted. An alternative would be for the degree of liability to depend upon the circumstances of each case rather than through the application of a fixed method of

calculation. However, whilst liability would be imposed by stature under such a proposal, liability would require the determination of the Court on a case by case basis.

Restrictions on "opt out" mechanism

Consideration should be given to whether the "opt out" mechanism is available to all companies within a group, or whether the right should be restricted to a special class of group companies such as special purpose vehicles with non-recourse debt arrangements. For the proposal to have any meaningful impact, the incidence of "opt outs" would have to be restricted to bona fide circumstances and should not lead to wholesale "opt outs". If "opt outs" are to be restricted through legislative limitations, then it will be imperative that broad consultation is undertaken to establish, and provide allowances for, all bona fide reasons for "opt outs". We believe a more workable approach would be to educate all stakeholders (and in particular creditors and employees) as to the purposes of the proposal and encourage a corporate climate in which wholesale "opt out" becomes commercially unacceptable and unviable.

Notification of "opt out"

There already exists an obligation to advise ASIC of changes to closed groups. It should therefore be relatively straightforward to establish a public ASIC register in respect of entities that have "opted out". Each group could be assigned a unique registered number and the individual corporate returns for each group entity be amended to provide for the group number to be inserted on all documents and forms.

Rights of creditors in respect of "opt out" decisions

A primary purpose of the proposal is to improve the position of creditors as a whole and address those circumstances in which groups of similar classes creditors inequitably receive differing distributions through the insolvency process. An "opt out" by a group entity could advantage or disadvantage the creditors of the individual entity, and advantage or disadvantage the remaining creditors of the group, depending upon the assets and liabilities of the "opting out" entity. Given these circumstances, should the creditors have any voice in the "opt out" decision? Subject to wider consultation, we believe not. There would be an inherent conflict between a decision which is in the best interests of the shareholders, and what creditors perceive to be in their best interests. It should also be considered that directors currently have the authority to grant fixed and floating charges and enter in Deeds of Cross Guarantee. Both actions have the propensity to disadvantage creditors but neither requires creditor approval.

Relation Back Period

In the absence of any restrictions, the "opt out" mechanism could theoretically be used by a solvent group to immunize itself from insolvent subsidiaries by deciding that one or more insolvent group companies should opt out to protect the overall insolvency of the remaining group companies. The proposal is intended to prevent such actions. Whilst we do not believe creditor approval of the opt out decision is appropriate, we believe a more workable solution to protecting creditors' rights is through the provision of a relation back period. ASIC PF 26 presently provides that a company leaving a group subject to a Deed of Cross Guarantee is excused from group liabilities only if a group entity is not wound up by Court

or through a Creditors' Voluntary Liquidation, within six months of the date of the withdrawal from the group. We believe similar Relation Back Provisions should exist in respect of entities that "opt out" of the proposed grouping arrangements, although the trigger should be extended to include the appointment of Administrators or Receivers.

Transition Arrangements

The proposal will clearly have a significant impact on existing group company structures. Appropriate transitional arrangements are outside the scope of this paper, but will require broad consultation with all stakeholders.

4. Case studies

We detail below some practical examples as to why we have recommended changes to the Corporations Act in respect of grouping of entities in the event of insolvency.

Ansett

- Forty-two companies in the Ansett group were placed into administration. Substantial legal and professional fees were spent analysing which assets/liabilities belonged to which companies. This was an unnecessary expense resulting in a reduced return to creditors.
- There are obvious clear advantages of having the same administrators in all 42 companies when it comes to co-ordination of the group and maximising asset realisations (imagine 42 different administrators in 42 companies?). However, inevitably, the administrators are left with potential conflicts between the companies, eg cost allocations and creditor disputes between companies. The conflicts then have to be dealt with either by the Court, the creditors or other independent persons. Another unnecessary complication and expense.
- In Ansett there was a separate special purpose vehicle (Ansett Aviation Equipment) for financing aircraft. The banking syndicates to Ansett had separate guarantees from this company. Accordingly, under our recommendation, if Ansett Aviation Equipment had "opted out" by notifying the ASIC, this company's assets would not be made available to all group creditors.
- It was clear in Ansett that, other than sophisticated financial creditors, all other creditors believed they dealt with "Ansett", they did not differentiate between Ansett companies. Particularly, the employees thought they were employed by "Ansett" and did not differentiate between Ansett companies. In Ansett, some employees of certain companies will receive more than other employees in other companies. This is hardly fair or equitable.
- The Ansett group had one treasury function and effectively centrally banked. The individual companies within the group had no direct access to cash. A strict running of each company on an individual basis may have seen certain businesses close down due to lack of cash.
- The Ansett Administrators entered into a very complex arrangement with Air New Zealand providing $150m to the administrators. The Ansett Administrators also entered into complicated arrangements with the Commonwealth to ensure employee entitlements to a community standard were paid promptly. Both these agreements required "pooling" to arrive at a fair and equitable outcome for stakeholders (because of the deficiencies in the Corporations Act). Notwithstanding the agreements there are still many issues outstanding relating to the pooling of assets and liabilities and it has proven costly to resolve these issues.

Stockford Accounting Group

- The Stockford Accounting group of companies was structured so that the listed holding company and four of its first tier subsidiaries were the subject of a class order and had entered into a deed of cross guarantee, so that in many respects we, as Administrators, could treat these companies as a single legal entity. This saved significant costs and time.
- However, we were also appointed over another 79 companies in the group which were not subject to the class order. While selling the various accounting and wealth management practices we experienced issues in identifying which of the 79 companies held assets of the various accounting practices. Frequently the employees of an accounting practice were employed by one legal entity, while the assets, goodwill and liabilities of the accounting practice were in a number of other companies. Accordingly, we made a number of the Stockford legal entities signatories to the sale agreements to ensure that we were able to transfer the assets, goodwill, employees and relevant liabilities to the purchaser. There are ongoing issues as to exactly which assets and liabilities belong to each company that may ultimately lead to litigation.
- If our recommendation was adopted, all the assets and liabilities would have been grouped and the issues identified above would have been automatically resolved. Furthermore, no issues would have been raised on allocating the purchase price proceeds among the Stockford companies which were parties to the Business Sale agreements.
- In our opinion it was fair and equitable that all Stockford's group assets should be available to all of the group's creditors and that they should rank equally.

Confidential Group Company

- During a receivership we encountered a situation where the directors of the group companies had structured the group so that the employees of the business were employed by one company, a separate company owned the business including debtors, with the group's real estate holdings being held by another company. The result was that the company in which the employees were retained had no assets and accordingly there were no assets available to meet employee entitlements. The company with the majority of unsecured creditors also has no assets.
- We were able to maximise the return to creditors because the bank had a fixed and floating charge over all the assets. The existence of the charge allowed us to effectively "pool" so the purchaser of the business could acquire all the assets they required to run the business even though they were held in separate companies. If the appointment had been an administration it would have been much more difficult. Following our recommendation the assets and liabilities would have been grouped and there would have been sufficient assets available to have met the employee entitlements (an outcome consistent with the Commonwealth's position for protecting employees) and a small return to creditors rather than shareholders inequitably recovering the majority of the return.

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SHOULD AUSTRALIA ADOPT AN INSOLVENCY REGIME BASED ON THE US CHAPTER 11 BANKRUPTCY CODE?

Following the collapse of Ansett, there have been increasing calls for the introduction in Australia of an insolvency regime based on Chapter 11 of the United States Bankruptcy Code. Recently, the Corporations and Markets Advisory Committee issued a discussion paper entitled *"Rehabilitating Large and Complex Enterprises in Financial Difficulty"*, in which it called for comment on whether Australia should adopt a new system of corporate rehabilitation based on Chapter 11 of the United States Bankruptcy Code.

This paper suggests that attempts to adopt a new insolvency regime based on Chapter 11 in place of the voluntary administration regime in Part 5.3A of the Corporations Act 2001 ("the Act") ought to be rejected.

Principal features of Chapter 11 of the United States Bankruptcy Code[1]

- Companies petition for bankruptcy of their own volition. There is no requirement that the debtor company be in financial distress before filing a petition.

- Immediately upon the filing of a petition, there is an automatic stay of recovery attempts by all creditors.

- Upon filing a petition the debtor company is given 120 days to produce to the Bankruptcy Court a proposed plan of reorganisation which addresses the claims of creditors and enables the company to continue to trade. This period may be extended at the court's discretion. If no plan presented by the debtor is approved by the court during this period, creditors have 60 days in which to present an alternative reorganisation plan for approval.

- During the 120 day period the debtor's management remains in control unless creditors are able to show cause, for example evidence of fraud, as to why an independent trustee ought to be appointed. The Chapter 11 insolvency regime is described as a "debtor in possession" regime.

- The Bankruptcy Court in the United States has a substantial role at every step of the reorganisation process.

Criticisms of Chapter 11

Chapter 11 has been the subject of considerable criticism.[2] A summary of the major criticisms is set out below.

- Most debtors under Chapter 11 fail to achieve long term rehabilitation.[3] Only about 6.5% of debtors under Chapter 11 are successfully rehabilitated[4].

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[1] For a more detailed description of the Chapter 11 procedures see L Griggs, "Voluntary Administration and Chapter 11 of the Bankruptcy Code (US)", (1994) 2 Insolv LJ 94; B McCabe, "Official Management v Reorganisation Under Chapter 11 of the United States Bankruptcy Code: In Defence of Official Management" (1992) 20 ABLR 320 at 327, 328 and TCG Fisher and J Martel, "Should we abolish Chapter 11? Evidence from Canada", CIRANO (Scientific Series), Montreal, 1996.
[2] L Griggs, "*Voluntary Administration and Chapter 11 of the Bankruptcy Code (US)*", (1994) 2 Insolv LJ, (1994) 93 at 94.
[3] K Lightman, *"Voluntary Administration: The New Wave or the New Waif in Insolvency Law?"* Insolv LJ, (1994) 2 59 at 72.
[4] S Jensen-Conklin, "*Do Confirmed Chapter 11 Plans Consummate? The Results of a Study and Analysis of the Law*" (1992) 97 Commercial Law Journal 297 at 325.

- Leaving management in control is *"akin to leaving the fox in charge of the henhouse"*. [5]In other words the persons seen to be responsible for causing the company to petition for bankruptcy relief are the very same persons who seek to manage the company in the rehabilitation process.

- Management who originally caused the company to go into financial difficulties have the power or authority to initiate high risk strategies on the basis that they have nothing to lose and a lot to gain by speculative investment of the company's resources.[6]

- Under the Chapter 11 regime the beneficiaries of the corporate reorganisation procedure is management rather than the creditors.

- The bankruptcy stay is open to abuse. Debtors seek the protection of Chapter 11 in order to avoid imminent action for recovery by creditors or to avoid the effect of onerous contracts. For example, Continental Airlines filed for bankruptcy to avoid onerous labour contracts with its employees. Chapter 11 has been used to lessen the impact of massive tort liability and awards of punitive damages.[7]

- The substantial role of the Bankruptcy Court in Chapter 11 causes enormous professional costs and is a major contributor to the time spent by a debtor company in bankruptcy.[8]

Should Australia adopt Chapter 11?

Following the collapse of Ansett, some commentators in Australia appear to have suggested that if Australia had a Chapter 11 insolvency regime Ansett would have continued to fly and creditors would have been better off.[9] In support of this view commentators point to instances in the United States where airline companies have filed for protection under Chapter 11 and continued to fly under a plan for reorganisation. A recent example often quoted is that of United Airlines. No one has ever explained exactly how Ansett would have been saved using Chapter 11.[10] Interestingly, the administrators of Ansett, Messrs Korda and Mentha have stated[11]:

> *"Our examination of the Chapter 11 process in the US convinces us that such a system would not have saved Ansett. Moreover, Chapter 11 can be administratively more expensive and relegates employee entitlements in a way that may not be acceptable in the Australian environment."*

There have also been substantial failures where airlines companies have filed for relief under Chapter 11. For example, creditors of Eastern Airlines lost more than $600 million in an attempt to keep the airline running.[12]

Those advocating the use of a Chapter 11 style insolvency regime in Australia point to the short time frames stipulated in Part 5.3A of the Act in which an administrator may present a plan for reorganisation to creditors and suggest that the short time frames are unsuitable for large and complex companies such as Ansett.[13] However, in the Ansett and Pasminco administrations the

[5] D Cowling, *"Australian Regime Has Proved Its Worth",* The Australian Financial Review, 9 December 2003.
[6] L Griggs, op cit n 1 at 98.
[7] Ibid at 94.
[8] Administration under Chapter 11 takes 20 to 22 months see Jensen – Conklin, *"Do Confirmed Chapter 11 Plans Consummate? The results of a study and analysis of the Law"* (1992) 97 Commercial Law Journal 297.
[9] G Sutherland, *"Australia Needs Chapter 11 Code"*, The Australian Financial Review, 11 December 2002.
[10] D Cowling, op cit n 5.
[11] M Korda & M Mentha, *"Chapter 11 doesn't Fit Australian Story"* The Australian Financial Review, 3 June 2003.
[12] K Lightman, op cit n 3 at 72.
[13] G Sutherland, op cit n 9 at 59.

courts used the existing Part 5.3A procedure with great effect to extend the time for administrators to present reorganisation plans and to enable the businesses to continue to operate.

In the post HIH environment where corporate governance has become a watchword of heightened importance, adopting a debtor in possession regime such as Chapter 11 would be inconsistent with attempts to promote greater corporate governance,

Consistent with its debtor friendly status, Chapter 11 contains no equivalent to the prohibition on insolvent trading by directors found in the Act. It is difficult to see the rationale for adopting an insolvency regime which lacks such a fundamental principle of Australian insolvency law.

The limited supervisory role of the courts under Part 5.3A was a deliberate outcome recommended by the Harmer Report following its review of the previous Official Management insolvency regime. Adopting a Chapter 11 type regime would fly in the face of the well accepted need to minimise the role of the courts.

Chapter 11 has repeatedly been shown to produce too few rehabilitated companies in the long term, to be very expensive and take an inordinate amount of time to administer. Even if greater use was made of "pre-packaged" Chapter 11 proposals where companies and creditors first reach agreement on a reorganisation plan prior to submitting it to the court for approval[14], apart from reducing the time and costs normally associated with Chapter 11, the other failings of Chapter 11 would persist. In any event, it remains to be shown how the pre-packaged Chapter 11 is a more useful tool for corporate re-organisation than the deed of company arrangement in Part 5.3A.

In the circumstances, Part 5.3A is working well and there seems little merit in Australia adopting an insolvency regime based on Chapter 11 of the United States Bankruptcy Code.

[14] J Farrar, *"Corporate Group Insolvencies, Reform and the United States Experience"*, (2000) 8 Insolv LJ 148 at 153.

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21 November 2003

Mr John Kluver
Executive Director
Corporations and Markets Advisory Committee
GPO Box 3967
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Dear John

REHABILITATING LARGE AND COMPLEX ENTERPRISES IN FINANCIAL DIFFICULTIES

I refer to the discussion paper published recently by the Committee. Due to my personal time restrictions (I am going on 2 weeks leave tonight), I am only make to make the following brief comments on the Discussion Paper.

In general terms, the problems facing the voluntary administration system when it comes to dealing with large and complex enterprises have been set out in the Discussion Paper. I only make the following comments in that regard:

1. Featherweight charges (referred to in the context of the U.K. at paragraph 1.47 of the Discussion Paper) are also used in Australia, although their effectiveness for the purposes of section 441A of the *Corporations Act* is not clear.

2. Even though part 5.3A has been operational for over 10 years, we still do not know what "substantial" means in section 441A, and it might be many years before a court has to give any guidance on that issue. Accordingly, we still do not know how extensive is the carve-out for secured creditors. Does "substantial" mean "effectively 100%" or does it mean "51%" or something in between?

3. The test in section 436A of the *Corporations Act* that the company must be "insolvent or is likely to become insolvent at some time" is more restrictive in practice than the legislative drafters seem to have intended. In practice, directors of companies have largely ignored the second part of that test, and have only appointed administrators once a company is insolvent. The meaning of the second part of the test is uncertain, and in practice it is only when all hope is gone that directors are prepared to say that the company is likely to become insolvent.

4. Secured creditors often take security over all the assets of a company purely in order to obtain the protection of section 441A, in circumstances where, in the absence of that section, the security would be over a more limited class of assets of the company. This means that those companies are needlessly restricted in their ability to raise further debt funding.

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Debtor in Possession Reorganisation

Although any analysis of this issue must discuss Chapter 11, it would be preferable to concentrate on the use of the term "debtor in possession reorganisation". Firstly, other relevant jurisdictions have debtor in possession systems. Canada has operated such a system under the *Companies Creditors Arrangement Act* since 1936, and, more recently, Japan has implemented such systems under the Civil Rehabilitation Law and the Corporate Reorganisation Law. Secondly, Chapter 11 seems to carry an unfortunate stigma in the perception of some people which can distract from the underlying merits of a debtor in possession system. Stephen Cooper, the CEO of Enron, last week talked about the need to deal with "the voodoo of Chapter 11".

Important relevant aspects of the Australian financial system are different from those of the U.S. system, and accordingly any Australian system of debtor in possession reorganisation would need to differ significantly from the U.S. system. For example, the U.S. does not have the wealth of experience which is available to Australia in professional insolvency practitioners. The U.S. does not have a history of floating charges. The U.S. does not have a history of receiverships. I would suggest that any proposal or legislation be given the name "Debtor in Possession Reorganisation". The essentials of such a system are that there is a moratorium on all creditors, the company has a commercially sensible period within which to negotiate a reorganisation of its affairs, and that there is some form of supervision to ensure that the original appointment is not an abuse of process, that the company only continues to receive protection if a reconstruction remains viable, and that any reconstruction plan is not unfair or oppressive to a class of creditors. It is possible for a debtor in possession system to achieve these ends without using all the procedural aspects of Chapter 11, some of which can be slow and expensive. However, it should also be noted that recent experiences of companies in Chapter 11 indicate that there have been significant improvements in the efficient use of Chapter 11 in the U.S.

Grounds for Appointment

Companies can be in financial difficulties without being insolvent.

In the case of United Airlines, at the time it filed for Chapter 11 protection, it had been trading at a significant loss for many months, and was clearly in financial difficulties, but it was insolvent. It is important that a procedure is available to companies that are not yet insolvent, but are experiencing financial difficulties, and can show that their applications are made "in good faith". It is far more difficult to try and restructure a company that is already insolvent.

Who should be entitled to appoint.

If a debtor in possession reorganisation system is introduced, the order making the appointment would need to be made by the Court. The company could not merely pass a resolution, as happens with voluntary administration, because that would leave the system open to abuse if the directors are not also resolving that the company is insolvent. An independent party needs to confirm that the company is acting in good faith, because the protections afforded to the company will give it considerable competitive and negotiating advantages.

An alternative to Court approval would be to create an "A List" of 3 or 4 of the most senior and experienced insolvency practitioners in Sydney (with the same system in place in other cities) who would have the power to approve the commencement of debtor in possession relief. However, the voluntary administration system has shown that the integrity of administrators can be impugned from circumstances surrounding their appointment, and in my view it would be preferable for the relief to be granted by the Court, but with a requirement that the company provide a report to the Court by a member of the A List so that the Court has some independent basis to assess the good faith of the company. Such a report would be available to the public and would be open to cross

examination by interested parties, such as secured creditors, although that would be on a limited basis as the Court would need to deal with any such application urgently.

Reducing the rights of secured creditors

For large and complex enterprises, the rights of secured creditors are of less general practical importance than they are for small and medium enterprises. Most large and complex financial organisations do not have secured creditors. Instead their lenders tend to rely on negative pledges. Furthermore, those that do have secured creditors usually do not have one secured creditor with security over all assets.

Companies that do have secured creditors over all assets are usually in a position where the amount of those facilities are likely to swamp any other creditors and so any restructuring will have to be with the approval of the secured creditors in any event.

It is essential to any debtor in possession reorganisation system that secured creditors can be restrained.

Time limits

The existing time limits for the voluntary administration procedure are important in order to provide a swift resolution procedure for small and medium enterprises, but they are clearly inadequate for large and complex enterprises, with the consequence that regular court applications are needed to obtain extensions of time. In the meantime, the administrators, the company and the creditors have the problem that they do not have certainty as to how much time will be available.

Debtor in possession financing

It is essential to the voluntary administration system that the administrator incurs personal liability for debts incurred on behalf of the company. The reasons for this requirement were set out in the Harmer Report. However, it is not commercially realistic to expect administrators to incur personal liability for borrowings of the magnitude required to finance a large and complex enterprise during a reorganisation. In the case of Air Canada, it had cash on hand of US$375 million and had arranged debtor in possession financing of US$700 million when it obtained CCAA protection on 1 April 2003. Enron had arranged debtor in possession financing of US$1.5 billion, as had United Airlines. World Com/MCI obtained debtor in possession financing of US$1.1 billion. It is not realistic to expect partners in accounting firms to accept joint and several liability for such amounts, but in the absence of debtor in possession financing, the ability of a company to restructure is extremely limited. If companies are to be able to restructure, they must be able to obtain finance. For large and complex enterprises this is only feasible by having a debtor in possession system which affords superpriority to debtors in possession financiers.

The use of debtor in possession financing in Canada was reinforced by the report of the Senate of Canada Banking, Trade and Commerce Committee released in the first week of 5 November 2003.

Court supervision

Under Chapter 11 the U.S. Bankruptcy Court has extensive involvement in the administration of a company during Chapter 11. In Australia we have the advantage of highly experienced and independent insolvency practitioners. In Canada, where the experience of those practitioners is also available, the Court appoints a leading insolvency practitioner as a "monitor" to report to the Court on the affairs and progress of the Company.

In Australia, a company with debtor in possession protection could have a leading insolvency practitioner (or, depending upon the circumstances of the company, a senior and experienced investment banker) appointed by the Court as a reporting officer to review the activities and finances of the Company, and to report to creditors and to the Court. This could either be by way of a full report, or by way of a commentary upon reports provided directly by the company itself. This would give the reporting officer some de facto approval powers, because the company would usually want to ensure in advance that the insolvency practitioner would not subsequently make adverse comments on any major initiatives of the company.

The reporting officer would have full access to the company's books and records, and would be able to apply to the Court to terminate the debtor in possession orders and appoint an administrator or provisional liquidator if the reporting officer was not obtaining full assistance from the company.

The practical effect of the appointment of a reporting officer would be to reduce the need for expensive and time consuming court applications, and for the need for the considerable expense of the types of creditors' committees that exist as it occurs under the Chapter 11 system.

Australia has the ability to introduce a debtor in possession system which would provide much greater opportunities for large and complex enterprises to survive and restructure, by taking advantage of the resources that are available in Australia, and learning from the experience of debtor in possession systems overseas.

Yours sincerely

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24 December 2003

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Rhodie Anderson
Lily Tell
Ben Mahoney

Dear Mr Kluver

Rehabilitating Large and Complex Enterprises in Financial Difficulties - CAMAC Discussion Paper 2003

I refer to the Corporations and Market Advisory Committee ("**CAMAC**") discussion paper on Rehabilitating Large and Complex Enterprises in Financial Difficulties ("**Discussion Paper**").

I appreciate the opportunity to make submissions on the matters raised in the Discussion Paper and for CAMAC granting me the indulgence to make these submissions late. I set out below my submissions.

INTRODUCTION

1 In my submission, subject to the matters raised in the remainder of this letter, Part 5.3A of the *Corporations Act* 2001 (Cth) ("**the Act**") generally provides an effective mechanism for dealing with the restructuring of large and complex enterprises and no wholesale changes are required to the Act. The recent case law in the Ansett and Pasminco administrations demonstrates the flexibility of the Part in adapting to large and complex administrations and the importance of the Court's general supervisory role.

2 There is, in my opinion, a perception problem with Part 5.3A of the Act which does not exist in relation to Chapter 11 of the US Bankruptcy Code ("**Chapter 11**"). Where as Chapter 11 is perceived as rehabilitative, Part 5.3A is perceived merely as a precursor to liquidation. In my submission, Part 5.3A should be re-branded to dispel the negativity associated with such a perception and to align itself with the true rehabilitative objects of the Part.

CHAPTER 1 - PRINCIPLES FOR EFFECTIVE CORPORATE REHABILITATION

3 I generally agree with the principles identified in Chapter 1 of the Discussion Paper as appropriate for assessing the suitability of any rehabilitation procedure for large and complex enterprises, namely:

- encouraging the company to take early remedial action;

- encouraging the company to negotiate with its creditors;
- assisting ongoing financing of the company during the rehabilitation period;
- providing a flexible rehabilitation timetable according to the needs of the company; and
- providing methods to deal with corporate groups.

4 In relation to the first principle: *encouraging companies to take early remedial action*, I prefer a 'financial stress test' and in particular, changing the requirement for appointment of a voluntary administrator to a reasonable prospect of insolvency and prohibiting appointment once the company is actually insolvent (see further paragraph 9 and following below).

5 However, I would also like to see aspects of the 'good faith' test applied to prevent abuse by solvent companies seeking to obtain a debt holiday on the one hand and to give protection to those companies genuinely seeking to respond to a reasonable prospect of insolvency by commencing discussions with creditors early on the other hand.

6 In relation to the second principle, *encouraging companies to negotiate with creditors*, many of my submissions as to the proposed amendments to Part 5.3A of the Act in Chapter 2 below would support this principle. For example, adopting the provisions of Chapter 11 which allow the debtor company to freeze all creditors' rights during the rehabilitative period together with the 'cram down' rules would provide an added incentive for creditors to negotiate a reorganisation programme with the directors of a financially distressed company earlier and without necessarily having the invoke Part 5.3A of the Act.

7 As a general rule, the moratorium or 'freeze' on creditors rights that applies during the voluntary administration period should apply across the board with only limited exceptions for secured creditors and property owners on application to the Court. This would ensure consistency and equality of treatment among creditors in line with the US model. Further, these changes would restrict the power of secured creditors under Part 5.3A of the Act, which, in my view, is disproportionate. In my experience, voluntary administrators are often beholden to secured creditors because of their importance in the market place including as a source of future and unrelated work.

8 In terms of implementation of the second principle, however, I am concerned that admissions of insolvency or an inability to perform a long term onerous contract prior to the commencement of the voluntary administration process may expose directors to accusations of improper conduct by creditors. Further, the acquisition of a debt at a discount as part of any pre-administration compromise may lead to allegations of improper discrimination against non-participating creditors and creates a related party debt issue for the purposes of voting at any subsequent

meeting of creditors. These issues will need to be considered further as a part of the implementation of a strategy to encourage companies to negotiate with creditors prior to the commencement of the voluntary administration process.

CHAPTER 2 - SPECIFIC AMENDMENTS TO PART 5.3A OF THE ACT

(i) Initiating an Administration

9 ***In my submission, the best way to implement the principle of encouraging companies to respond earlier to financial hardship is to restrict the ability of directors to appoint Administrators under Section 436A of the Act to a time when there is a reasonable prospect of insolvency or wherever a solvent company is in serious financial difficulty. Directors of an already insolvent company should be prohibited from appointing an Administrator. There should also be a requirement of 'good faith'. Consequential amendments may be required to Section 435A of the Act.***

10 I have previously stated that a company should be encouraged by the legislative scheme to respond earlier to financial difficulties in order to increase its prospects of successful rehabilitation. From my experience, for example in the Brash and Ansett administrations, companies often stagger on in the honest but mistaken belief that their financial position will improve until the company is denuded of cash, debtors, morale and goodwill. The ability to appoint Administrators where there is a reasonable prospect of insolvency or when a solvent company is in financial difficulty will encourage early negotiation with creditors and implementation of a reorganisation before it is too late.

11 Whether or not the proposed amendments are made, some amendment is in my submission required to Section 435A of the Act. As the legislation currently stands, there is a tension between the objects of the Part as expressed in Section 435A of the Act and an inconsistency between section 435A of the Act, which is expressed to apply only to an '*insolvent*' company and Section 436A of the Act, which allows the Part to be invoked both in the case of insolvency and in the case of '*likely insolvency*'. In order to meet the principle of rehabilitation, Section 435A of the Act should be amended to make it unambiguously clear that the rehabilitation principle is paramount and that a solvent company in financial difficulty can be rehabilitated.

12 If a company is actually insolvent, it should be placed into liquidation. A Liquidator can convert the liquidation into a voluntary administration if the Liquidator makes a decision to do so (see Section 436B of the Act). A Liquidator's decision can be appealed by the person aggrieved (see Section 1321 of the Act).

13 The requirement of 'good faith' will limit the ability of those directors who seek to improperly use Part 5.3A of the Act, for example, as a step to liquidation or for the purpose of establishing a 'phoenix company' while

also protecting directors who invoke the Part in good faith when the company is actually insolvent.

14 I do not believe Schemes of Arrangement are a serious option. They are slower, more cumbersome, administered by the Courts technically and afford no protection during the negotiation. I also do not believe an ordinary unsecured creditor should be able to appoint an administrator by Court application.

Eligibility of a Liquidator to be an Administrator

15 ***Only senior insolvency practitioners with the requisite degree of experience and skills should be permitted to manage large and complex administrations.***

16 In my experience, only practitioners from large accounting firms or specialist insolvency firms have the requisite knowledge and experience to manage large and complex administrations. While the market appears to informally direct itself to these sorts of practitioners in the case of large and complex administrations, it may be that Part 5.3A could be amended in the manner referred to above to ensure inappropriate appointments are not made in the future. In my submission, it is not sufficient that the practitioner has a certain number of years of experience. It should also be a prerequisite that they have the requisite skills, education and expertise to manage large and complex administrations.

(ii) Rights that Override a Voluntary Administration

17 ***In my submission, the rights of secured creditors to appoint a receiver ought to be significantly curtailed along the lines adopted in the UK by the Enterprise Act 2002 (UK).***

18 The ability of Receivers to appoint over a voluntary administrator detracts from the objects of Part 5.3A of the Act. Secured creditors are self-interested where as the objects of Part 5.3A of the Act require a voluntary administrator to maximise the chances of the company's business remaining in existence or if that is not possible, to increase the return to all other creditors. Secured creditors want their money repaid as quickly as possible and they desire to control all aspects of the voluntary administration process to ensure that they get this result.

19 If secured creditors are entitled to override a voluntary administration, will they be held accountable where they force a sale of the assets of the company in circumstances where, if the sale had been postponed as proposed by the Administrators, the market value of the assets would have increased in value substantially? This scenario is not dissimilar to a scenario that might have occurred if the Ansett Administrators were forced by a Receiver to sell the aircraft assets immediately post-September 11, 2001 when the world aviation market was depressed. In such a scenario, the provisions of Section 420A of the Act would offer little comfort for ordinary unsecured creditors.

(iii) Timing Issues

20 ***In my submission, the time by which an Administrator must convene the major meeting of creditors under Section 439A(5) of the Act in the case of large and complex administrations ought to be extended by another 60 days. The creditors' rights to adjourn the major meeting for a period of up to a further 60 days ought to remain. However, creditors ought not be allowed to extend the convening period of the major meeting at the first meeting of creditors. The Court's power to extend the convening period for the major meeting pursuant to Section 439A(6) of the Act and to extend the time by which the company must execute a deed of company arrangement pursuant to Section 444B(2)(b) of the Act ought to remain.***

21 The current provisions of the Act are generally sufficiently flexible to cater for the timing requirements of large and complex enterprises. The ability of the Court to make orders extending the convening period pursuant to sections 439A(6) of the Act, extending the time by which a deed of company arrangement must be executed pursuant to section 44B(2)(b) of the Act and pursuant to the general supervisory power under Section 447A of the Act on a case by case basis works well.

22 These provisions were all successfully relied upon by the Ansett Administrators *e.g. Re Ansett; Intrepid Aviation Partners VII LLC v Ansett Australia Ltd* (2001) 115 FCR 175 (extension on seven day lease); *Re Mentha; Ansett Australia Ltd v Sydney Airports Corp Ltd* (2202) 120 FCR 310 (extension of time to execute DOCA's).

23 Nevertheless, the proposed extension of the time by which the major meeting of creditors is convened for large and complex administrations would assist the Administrators of such enterprises as invariably the time currently allowed under the Act is insufficient. However, I disagree with the proposal that creditors could extend the convening period of the major meeting at the first meeting of creditors. Generally in large corporate collapses, the voluntary administrators, let alone the creditors, have little understanding of the extent of the financial difficulties of the company and will not be in a position to make an informed decision in the first five business days of the commencement of the voluntary administration process.

Notifying Creditors

24 ***In large and complex administrations, the notification requirements of the Act ought to be satisfied by the placement of prominent advertisements in major newspapers nationally, the establishment of websites and a telephone hotline for the benefit of creditors. An acceptable alternative is to maintain the requirement to notify all creditors in writing of the time, place and date of the meeting and of the availability of supporting documentation on the website or by telephoning a toll free number. Any such amendment ought, in my***

submission, to allow for any adjourned meeting of creditors to be notified in the manner set out above.

25 The latter proposal was the effect of the decision of Goldberg J in *Re Ansett Australia Ltd & Others (All Administrators Appointed) & Mentha* (2002) 40 ACSR 419. The Ansett experience shows that such measures can save tens of millions of dollars in printing and postage costs in the case of administrations with a large number of creditors, which funds would otherwise be available for the benefit of creditors.

(iv) Lending to a Company Under VA

26 ***In my submission, Section 443A of the Act should be extended to include monies lent to an Administrator for the purpose of the Administration so that personal liability attaches to such loans. However, the parties to the loan ought to be able to contract out of personal liability by agreement. Further, personal liability ought to apply only up to the value of the company's assets. In addition, the indemnification rights of the Administrator should be the same as for the indemnification rights in relation to services rendered, goods bought or property hired leased used or occupied under Section 443D of the Act. As a consequence of these amendments, there would be an appropriate priority for repayment under Section 556 of the Act above ordinary unsecured creditors.***

27 The proposed amendments would encourage the provision of debt financing to companies in financial difficulty enhancing the ability to successfully reorganise without the need for a Court order as in the *SEESA case* ((2002) 40 ACSR 389).

(v) Voting

28 In the case of large and complex administrations, it is in my submission appropriate that there be a majority in number as well as value of creditors in order to pass any resolution of creditors. Further, it is appropriate that Administrators should have a casting vote where there is a deadlock between a majority in number and value of creditors. I would however support the recommendation that where the Administrator does exercise a casting vote, he or she should be required to give reasons for the manner in which that vote is exercised.

29 The proposed amendments would ensure certainty in the case of large and complex administrations while at the same time making the Administrator accountable in the requirement to give reasons for the exercise of any casting vote. Further and adequate protection is in my opinion given to creditors where an Administrator inappropriately exercises their casting vote by established case law (*e.g. Young v Sherman* (2001) 40 ACSR 12) and by the provisions of Section 600A, 600B and 600C of the Act. The case may be different in the case of smaller administrations where the

costs of an application to the Court to set aside the decision of an administrator may be prohibitive.

(vi) Remuneration of Administrator

30 ***In my submission, Section 449E of the Act should be amended to permit the Committee of Creditors or the Court to fix the Administrator's remuneration in large administrations. Where the Administrator's remuneration is fixed by the Committee of Creditors, the Committee members should receive at least seven days prior written notice of the amount of the remuneration claimed together with details of how the amount claimed is comprised and calculated. Finally, the Court could have an overriding power of veto in an appropriate case, as is currently the position in respect of a Liquidator's remuneration under Section 504 of the Act.***

31 These amendments are consistent with the decision of Goldberg J in *Re Ansett Australia & Others (All Administrators Appointed) & Mentha* (2002) 40 ACSR 409. They would allow the Committee of Creditors in the case of large and complex administrations to fix the remuneration of Administrators on an informed basis prior to the major meeting of creditors (which will often be too late in the case of large and complex administrations where the major meeting is delayed) and without the expense and delay of a Court order. In the case of large and complex administrations, the creditors comprising the Committee of Creditors will tend to be sophisticated creditors well equipped to make such decisions. The ability to make an application to the Court to override the decision of the Committee of Creditors will form an appropriate safeguard against any actual or perceived abuse.

(vii) Administrator's Indemnity Rights

32 The existence of broad personal liability may be a disincentive to an Administrator continuing to trade on the operations of the business in accordance with the objects of Part 5.3A of the Act in the case of large and complex administrations where the decision to trade on can cost millions of dollars per week. The Administrator's right of indemnity out of the company's assets is an important counter-balance to such a liability. The actions of a receiver have the ability to reduce the value of the company's assets to below those required to meet the indemnity of the Administrator thereby jeopardising the position of the Administrator. This creates a further reason to curtail the ability of a secured creditor to appoint a Receiver as recommended at paragraphs 17 to 19 of my submissions above.

(viii) Equity for Debt Swaps

33 I support the proposal that equity for debt offers to creditors under a deed of company arrangement should be exempt from the disclosure requirements of Part 6D.2 of the Act (prospectus type disclosures), Part

7.9 of the Act (product disclosure statement) and from the takeover provisions (20% takeover threshold). The rationale for such exemption would be the safeguards already provided under Part 5.3A of the Act such as the requirements that the Voluntary Administrators act in the best interests of creditors, the liability for misleading and deceptive conduct/ statements and the safeguards contained in Sections 445D and related provisions of the Act to ensure that unfairly discriminatory deeds are not propounded.

(ix) Ambit of the Court's Powers to make Directions

34 ***In my submission, the Court's exercise of its discretionary power to supervise large and complex administrations under Sections 447A and 447D of the Act is sufficiently clear and appropriate and no specific amendment is required to the Act in this regard. In particular, there ought not be any restriction or prohibition on the Court's exercise of its discretionary powers to approve the actions of Administrator's in appropriate cases.***

35 In the Ansett administration, the Administrators made several applications to the Court for orders or directions pursuant to Sections 447D and 447A of the Act that it was proper for them to enter into an agreement or act on a commercial decision in circumstances where the Administrators were concerned that without such protection, they would be open to subsequent allegations of breach of duty. The Court made the direction sought in 3 of the 4 cases. While the Court would not give its imprimatur to a purely commercial decision of the Administrators, it would give them the protection of a direction where some question was raised as to the propriety or reasonableness of the decision provided full and frank disclosure had been made. These cases are more fully discussed in the following an article at (2003) *Insolvency Law Journal* 27.

36 The recent case law on Sections 447D and 447A of the Act provides an appropriate balance between encouraging Administrators to take appropriate risks to fulfil the objects of Part 5.3A of the Act by offering protection against subsequent allegations of breach of duty by disgruntled creditors and leaving Administrators accountable for purely commercial decisions. Such protection is warranted in the administration of large and complex enterprises where so much is at stake and personal liability attaches to the Administrators decisions.

37 The Court process provides a fair, open and transparent forum to deal with such matters. Creditors are adequately protected by the requirements of proper notice, full and frank disclosure and an opportunity to appear and make submissions as contradictor. Each case is decided on its merits. The cases make it clear that the Court will not give its imprimatur to a business decision simply to alleviate an administrator's feeling of apprehension or unease (*e.g. Re Ansett Australia Ltd & Ors and Mentha and Anor* (2002) 41 ACSR 605 at 616). In my submission, the only sensible way to balance the interests of creditors in large administrations is

on a case by case basis under the general supervisory discretion of the Court.

(x) Set-Off

38 ***In my submission, the moratorium on creditors in reclaiming property during the voluntary administration period ought to extend to banks and financial institutions that have a contractual or other right of set-off.***

39 The exercise of a contractual right of set-off during administration by a bank or financial institution is contrary to the spirit and intent of Part 5.3A of the Act. The exercise of a contractual or other right of set-off after the commencement of a voluntary administration is akin to the enforcement of a security against the company's property. Retention of title creditors cannot take back their stock during an administration. Similarly, landlords cannot take back their premises. Why should a bank holding the cash of the company be treated differently and allowed to sweep it?

40 If the objects of Part 5.3A of the Act are to be pursued, set-off ought to be curtailed as the chances of rehabilitation are slim when the company is denuded of all cash. If financiers and bankers are entitled to exercise a contractual right of set-off after the appointment of Administrators, they are effectively being preferred to all other creditors.

41 Further, the current ability to exercise a contractual right of set-off during the voluntary administration period is inconsistent with and wider than the statutory right of set-off on a liquidation under Section 553C of the Act. Under a contractual right of set-off, there is no requirement that there be mutual dealings between the company and the creditor nor is there a prohibition on a creditor claiming the benefit of a set-off where the creditor had notice of the appointment of Administrators thus allowing a creditor to exercise the right in respect of post-appointment receipts.

(xi) Pooling of Assets & Deeds of Cross-Guarantee in Corporate Groups

42 I would support the recommendation that Administrators should be permitted to pool the assets and liabilities of companies comprising corporate groups in the manner proposed by Ferrier Hodgson and outlined in paragraphs 2.182 and following in the Discussion Paper. In particular, I support the submission that in the case of companies subject to ASIC approved Deeds of Cross-Guarantee, the assets and liabilities of those companies should be pooled at the discretion of the Deed Administrator without the need to obtain a Court order and in the case of companies not subject to ASIC approved Deeds of Cross-Guarantee, a special resolution of creditors would suffice to approve the pooling.

43 I also agree with the proposed consequences of pooling outlined at paragraph 2.188 of the Discussion Paper including for:-

- joint creditors meetings;
- deeds of company arrangement that bind more than one company; and
- the variation, termination and avoidance of multi-company deeds of company arrangement.

44 In general, I agree with the proposal to permit all companies in a corporate group to go into voluntary administration where the group overall would satisfy a prerequisite notwithstanding that some group companies treated in isolation may not. Such a proposal is extremely important for large corporate groups.

(xii) Ipso Facto Clauses

45 ***In my submission, ipso facto clauses ought to be rendered void except with the agreement of the Administrator or with the leave of the Court in certain defined circumstances. Furthermore, the prohibition should extend to default provisions short of insolvency or likely insolvency including 'material adverse change' clauses and clauses which would capture a reorganisation of the type effected in a deed of company arrangement.***

46 In my submission, such an amendment is required in order to achieve the objects of Part 5.3A of the Act and also to encourage early negotiation with creditors. Extending the prohibition of ipso facto clauses to capture reorganisations would also protect against the type of scenario that occurred in Ansett where the Sydney Airports Corporation Limited ("**SACL**") threatened to repossess the Sydney domestic terminal lease, one of the Administrations most valuable assets, at below market value upon the Administrators executing a deed of company arrangement in accordance with the objects of the Part. The ability of SACL to rely on the default clause in the Sydney terminal lease severely hampered the ability of the Ansett Administrators to sell clear title to the asset. The facts are indirectly referred to in *Re Ansett Australia Ltd* (2002) 41 ACSR 605.

(xiii) Discriminatory Deeds & Compliance with Priority Payments

47 ***In my submission, creditors ought to be permitted to approve deeds of company arrangement that depart from the order of priorities that apply on a winding up under Section 556 of the Act or to otherwise enter into a discriminatory deed of company arrangement where the Deed is in the overall interests of creditors as a whole or otherwise complies with the objects of Part 5.3A of the Act.***

48 A Deed which purported to demote the priority of superannuation trustees in the Ansett administration to the overall benefit of employees was the subject of recent proceedings in the Federal Court (V3107 of 2002). The Court in that case was not able to rule on the matter as a settlement was reached and subsequently approved by the Court (the reasons for

judgment are expected to be handed down shortly). However, the law remains unclear in this area and it is submitted that a minority ought not be able to veto a discriminatory Deed where the creditors vote overwhelmingly in favour of it and which otherwise meets the objects of Part 5.3A of the Act.

49 The proposed amendments would be consistent with the principle of encouraging earlier remedial action in the case of financially distressed companies and are consistent with the US 'cramdown' rules which permit the court to approve a reorganisation despite the objection of one or more impaired classes of creditors provided at least one class agrees and the proposed arrangement is generally fair and equitable. .

(xiv) Employee Superannuation Entitlements

50 I acknowledge that CAMAC does not seek to replicate the review by the Parliamentary Joint Statutory Committee on Corporations and Financial Services which sought submissions on the issues concerning employee superannuation entitlements. However, in my submission, it is imperative that the question of the priority of the superannuation entitlements on a winding up under Section 556 of the Act that were raised in Supreme Court V3121 of 2002 and then in the Court of Appeal but which remain unresolved, be clarified. The litigation surrounding these issues resulted in extensive delay in the distribution of employee entitlements in the Ansett administration and was at considerable cost to the administration and yet the matter remains unresolved.

(xv) Solvency Under The Deed

51 I support the submission that there be a requirement of solvency immediately after a company enters into a deed of company arrangement. In my submission, such a requirement would reduce the incidence of 'phoenix' company arrangements and is consistent with the principle that companies be encouraged to take early remedial action prior to the company becoming insolvent.

I would be pleased to discuss any of the submissions raised in this letter in greater detail should the opportunity arise.

Yours faithfully
Arnold Bloch Leibler

Leon Zwier
Partner

Australian Bankers' Association

Submission

in response to the

Discussion Paper "Rehabilitating Large and Complex Enterprises in Financial Difficulties"

Corporations and Markets Advisory Committee 2003

20 February, 2004

Introduction

Australian Bankers' Association (ABA) represents 23 banks authorised to carry on banking business in Australia. ABA's membership includes Australia and New Zealand Banking Group Limited, Commonwealth Bank of Australia, National Australia Bank Limited and Westpac Banking Corporation together with a number of regional and foreign banks.

ABA's members are major providers of finance, secured and unsecured, to both large and small businesses operating in Australia.

The price, availability and terms of business finance provided by member banks is determined largely by their assessment of the credit risk in lending to a particular business. Part of this assessment includes an assessment of regulatory risk. This is related to the laws that determine the ability of the bank to recover the money it has lent with certainty and expedition.

Credit policies and practices of banks and the prudential supervisory regime administered by Australian Prudential Regulation Authority (APRA) have contributed to Australia's high standards of safety, security and stability in the financial system. Australia's insolvency laws have played their part in this by recognising the importance and priority of loan security.

The ABA is also concerned about any changes to insolvency laws when its members are in the process of implementing BASEL 11. At present banks are currently working through the collation of back data to support an IRB approach to loss and credit risk.

That data is dependent on the insolvency regime in force at the time the defaults took place. Importantly this data which supports the IRB approach must be validated.

Real difficulties will arise in validating data for the model if the regime which say gave certain priority to a secured creditor is displaced as the model is dependent on certain assumptions. Accordingly any change to the current regime would have wide ranging impacts in BASEL 11 implementation. This must be thought through and seriously considered.

The ABA submits that overall the voluntary administration regime, as it operates in Australia, is successful. There are some technical or efficiency type changes that could be made to the regime to improve its workability.

The ABA submits that the voluntary regime is able to effectively and efficiently deal with corporations both large and complex and small and simple without a need to treat those companies differently under the law.

Indicative data from a member bank extracted for the past 12 months confirms that the existing regime is working consistently with the regime's objectives. A summary of that data appears in the Schedule at the end of this submission.

Corporate Rehabilitation

The ABA submits that the following statements underpin any regime for effective, efficient and fair management of companies in financial difficulties:

1. Not all financially distressed companies can be rehabilitated as going concerns.

2. Where a company's financial status is such that it cannot trade without further diminishing its assets and a deed of company arrangement does not represent a viable alternative, that company should be wound up.

3. A rehabilitation regime must not be open to abuse by companies that simply want a debt holiday.

4. The legal principles governing the administration of companies in financial difficulties should be consistently applied to both large and complex enterprises and also to smaller enterprises.

5. There should be public confidence in the administration of enterprises in financial difficulty through:

    a) Administrator independence

    b) Qualifications and competence of administrators

    c) Adequacy of powers to enable efficient administrations

    d) Recognition of creditors' rights and a lender's prudential and capital requirements.

Response to matters raised in Chapter 1

Proposed Principles for effective Corporate Rehabilitation

Principle 1: The earlier a company responds to its financial difficulties, the better may be its prospects of successful rehabilitation.

The ABA agrees that this principle is fundamental.

The ABA believes that a company's early response to its financial difficulties is ultimately a corporate governance issue. Modifying the conditions as to when a company is permitted to seek relief by specifying in the Corporations Act 2001 (Act) a point earlier in time when the company may apply for that relief assumes that the directors of the company will take that opportunity at that first available time. There are countless examples in Australia's corporate history where companies having had the opportunity to seek relief have left that decision to the last and often fatal moment.

Legislating an earlier time in which a company might take action also assumes that the governance of the company is sufficiently competent to recognise the company is in the degree of difficulty where remedial action is necessary. (eg the state of a company's accounting system may prevent an accurate assessment of that company's financial position until the very end).

The ABA submits that a director of a company is best placed to determine and recognise a company's financial plight. It is therefore appropriate that directors of companies continue to have incentives to seek the assistance of an administrator if the company appears to be heading towards insolvency.

There are at least four incentives for directors of a company that is in financial difficulties to take early action to appoint an administrator:-

1. Under the Income Tax Assessment Act directors will be personally liable for unremitted group tax if after having received 14 days notice of demand by the ATO for payment of the tax the company either fails to pay the tax, enters into an agreement with the ATO to pay the tax or fails to appoint an administrator to the company or to place the company in liquidation.

2. Under the Act directors have a duty to prevent insolvent trading by a company and, in default, incur personal liability for debts so incurred.

3. Under the voluntary administration (VA – acronym also used to refer to a voluntary administrator) provisions of the Act, the appointment of an administrator to the company protects directors from actions by creditors under guarantees given by directors to secure the company's debts for the period of the VA.

4. Under the Corporations Act directors are liable for civil penalties for failing to exercise their powers and discharge their duties carefully and diligently, in good faith and in the best interests of the company.

The test in section 436A (1) of the Act that a company must be insolvent or likely to become insolvent at some future time before a VA can be appointed is preferred. The test establishes a suitable point in time where there is an identifiable risk that the company will fail. If there was an earlier time specified under the Act or the test was changed so that if the company "might" become insolvent rather than being "likely" to become insolvent this may increase the risk of abuse because the VA regime can be commenced without the involvement of the court and could create circumstances whereby a company obtains an unwarranted or unreasonable debt holiday.

Also, a "may" rather than "likely" to become insolvent test would be a speculative test creating an increased risk of litigation over whether the company was entitled to take VA action.

Under a voluntary filing of Chapter 11 bankruptcy protection in the United States, the administration is usually commenced by application to the court on a "good faith" test. The determination of a company's solvency (or lack of solvency) is based on three definitions or tests of solvency:

1. the fair value of the company's assets exceeds its book liabilities;
2. the company is capable of paying its debts as they mature; and
3. the company does not have unreasonably small capital.

The US does not have insolvent trading laws as apply in Australia. Under Chapter 11, three unsecured creditors can force the directors to put the company into an involuntary Chapter 11 proceeding and petition the bankruptcy court to displace the board.

In the U.S., a voluntary filing of Chapter 11 is available to protect the company from enforcement of a creditor's rights and remedies, including the foreclosure under a security. In practice it would seem that such a voluntary filing of Chapter 11 bankruptcy protection is unlikely to produce any earlier insolvency regime intervention into the management of the financially distressed company than the VA regime. In fact the VA regime permits intervention at a much earlier stage than the company's default under a security including an anticipation that the company might breach the terms of a creditor's security. Chapter 11 filings on a voluntary basis could be seen to undermine the principle that the earlier the directors take account of the company's financial position the better are its prospects for rehabilitation.

Under the UK Enterprise Act 2002 the position is largely the same as with the Australian VA regime where the company, the directors or a secured creditor holding a floating charge over the whole or substantially the whole of the company's property can initiate an administration. A similar test of insolvency applies as is the case in Australia i.e. that the

company is or is likely to become unable to pay its debts. The administrator's duty is to be satisfied that the company will be able to achieve a better return for creditors than if it were wound up. The right of the secured creditor to appoint an administrator, like in Australia, is not dependent on the insolvency or likely insolvency of the company. However, the charge must be enforceable at the time of the appointment and contain a power to appoint an administrator or a receiver and the charge or series of charges cover the whole or substantially the whole of the company's property.

The objective of Pt 5.3A of the Act appears in section 435A:

> *"The object of this Part is to provide for the business, property and affairs of an insolvent company to be administered in a way that:*
>
> a) *maximises the chances of the company, or as much as possible of its business, continuing in existence; or*
>
> b) *if it is not possible for the company or its business to continue in existence - result in a better return for the company's creditors and members than would result from an immediate winding up of the company."*

This is virtually the same objective as under the Enterprise Act except that the objective of the Enterprise Act has a different context in that the Enterprise Act initially focuses on the survival of the corporate entity rather than the business. The objective behind a series of legislative measures culminating in the Enterprise Act was the Blair government's desire for the UK to be the enterprise hub of Europe. It was suggested that banks had not supported businesses that were viable and had appointed receivers, in some cases prematurely, who sought to see their appointors paid and nothing else. Enterprise and entrepreneurial flair, it was said, then suffered. Unlike in Australia, utilisation of the UK administration regime had never really become well used in that country. Australian banks have, by and large, supported the VA system in Australia. This might explain why the Australian VA system is reportedly working well (see "The Enterprise Act 2002: Pioneering a brave new world in insolvency law in the United Kingdom?" Prof. Andrew Keay (2003) 11 Insolv LJ 163).

Who Controls the Procedure?

When a company is experiencing financial difficulties, the appointment of an independent, suitably qualified and competent insolvency practitioner, to assume control of the company as its voluntary administrator, has certain advantages for the company and for the directors. In addition to avoiding further liabilities for insolvent trading, the company is independently assessed as to its capacity to continue as a going concern. While the company trades in administration, the directors cease to have any managerial role in the corporation.

The member banks of the ABA would have little confidence in a regime where the directors of an ailing company remain in control as is the case under the US Chapter 11 regime. Australian experience is that the main contributing factor to the failure of most companies is poor management and lack of adequate corporate governance. It is rare that directors who caused or contributed to the financial difficulties of a company have the ability or objectivity to take the necessary remedial action. The added costs of court supervision of the "debtor in possession" administration may lead to the dissipation of assets that might otherwise be available for the creditors. Also, judges in Australian courts are usually reluctant to substitute their own discretion for that of the directors and will not make decisions on commercial issues.

In the matter of Ansett Australia Limited and Mentha [2001] FCA 1439, Goldberg J. cited with approval a passage by Street CJ in *Re Mineral Securities Australia Ltd (in liq)* [1973] 2 NSWLR 207 at 232:

> *"When the court is required to pronounce upon the commercial prudence of a transaction, it enters upon a slippery and uncertain field. Apart from the lawyer's disclaimer of expert qualifications in matters of business prudence, the very process of litigation and the necessary limitations upon the scope of admissible evidence restrict the available material to far less than is necessary for the making of a commercial decision."*

Goldberg J went on to conclude that courts will not pronounce upon the commercial prudence of a particular transaction (*In the matter of Ansett Australia Limited and Mentha* [2001] FCA 1439).

The ABA agrees with the CAMAC observations about directors' potential self interest and the risk that this creates for creditors in the administration of the company. The same risk would exist if the directors were able to appoint a third party to act in their stead.

These are general corporate governance issues and where a company is in serious financial trouble the ABA submits that it would be unsafe to permit the directors to continue to control the affairs of the company directly or indirectly through a non-arms length appointment of a third party.

Leaving directors in charge of the company whilst it is potentially insolvent is not supported by the ABA. It ignores the possible contribution by the directors to the state of affairs of the company that caused it to seek administration protection in the first place and could lead to a worsening of the company's position whilst acting to protect their own self interests .

In Australia the voluntary administrator must be a registered liquidator and certain persons who have had prior dealings with the company (eg officers of the company, auditors etc) are automatically disqualified from acting as administrators. Additionally, the Court, on an application by ASIC or a creditor, has the power to replace an administrator and this provides a sufficient safeguard to address creditors concerns if the administrator is considered to be lacking independence from the company's directors.

Principle 2 – The prospect of a financially distressed company being rehabilitated may be improved if it can be encouraged to enter into discussions with its major creditors as early as possible on how best to rectify its financial position.

The ABA agrees with this statement of principle.

The fundamental question in the rehabilitation of any financially distressed enterprise is for an early assessment to be made of the enterprise's future prospects as to whether it can survive as an economically efficient and viable enterprise.

The ABA submits that this should be a precondition to the prospect of any negotiation with creditors where deferred payment terms with creditors are contemplated. However, if the company is seeking to compromise or reduce debts the ABA submits that the company should submit to a VA rather than administer its own form of administration so as to avoid inequities to creditors.

One critical issue is the position of the secured creditor. The rights of the secured creditor should be preserved as they currently exist under the VA regime (subject to some greater flexibility in time limits) because

a) the secured creditor is likely to be the major financier to the company;

b) the prospects of further financing are more likely from the incumbent financier than a new financier;

c) certainty over the rights of secured creditors may ensure continuity of availability of finance to businesses generally on the same or similar terms and conditions as currently apply in the market;

d) banks, as secured creditors, are likely to be the principal financier to the company being owed the single largest amount by the company and as prudentially supervised institutions have the responsibility to prudently manage their assets in the interests of their depositors and more broadly their shareholders;

e) a weakening of banks' security might:

   i. cause a change in the amount and the terms and conditions on which corporate finance would be made available and affect the flexibility of banks' decision-making with respect to the company,

   ii. be likely to encourage earlier intervention by the financier on the occurrence of an event of default under its charge through the appointment of a receiver before the right of the company to appoint an administrator has arisen,

iii. would be likely to cause the regulator APRA to impose higher capital requirements on banks thereby affecting the cost of finance to the business community, and

iv. be likely to detrimentally affect asset securitisation programs and investors' interests in securitised assets.

Apart from the protection of the rights of the secured creditor, negotiations by a financially distressed company with its unsecured creditors should be based on the principle that insolvency procedures are designed to ensure rateable distribution of property among unsecured creditors in situations where full repayment is unlikely.

Where the financial condition of the company is so bad that the company is either insolvent or likely to become insolvent, the ABA submits that this negotiation should be undertaken by an independent qualified person such as a VA. Left to the company, there could be situations where a company does not negotiate with all creditors transparently or seeks to prefer some creditors over others. To ensure that these negotiations are conducted equitably the ABA submits that these negotiations should be undertaken by an independent qualified person such as a VA.

The objective of the VA procedure is, of course, designed to bring about this result.

Clauses 1.53 to 1.55 of the Discussion Paper suggest that voluntary Chapter 11 proceedings might improve the prospects of a favourable outcome for the company through the combined operation of a freeze on creditors' rights together with "cramdown" rules to bring about a reorganization package. Under the VA process there is no reason why the same result could not be achieved with the support of the greater number of creditors. Making it possible for a secured creditor to enforce its charge over a specific part or parts of the company's property instead of once over all of the property covered by that charge could facilitate this outcome.

Also, it is not absolutely clear under Section 440B whether the written consent of a VA to the chargee enforcing its charge can be given by the VA during the decision period so that the chargee is free to act upon that consent at a later time after the decision period has expired. If the Act were amended to confirm that this flexibility exists this could provide greater reassurance to secured creditors to forestall possible pre-emptive action by enforcing their charges over the company.

The ABA submits that by an appropriate amendment to Section 440B together with an amendment to the Act to enable a chargee to enforce a charge over only part of the property of the company secured by the charge this should increase the prospects of secured creditors participating in the VA.

Encouraging ongoing financing

Principle 3; A company may have a better prospect of successful recovery if it can obtain new loan or equity finance during the rehabilitation period.

The ABA agrees with this principle provided it is applied according to the individual circumstances of each company. The ABA does not accept the principle as a "one size fits all" proposition.

Loan Finance

Under the law as it stands in Australia, it seems that a VA is not personally liable for loan funding obtained during the course of the VA. The Act should be amended to make it clear that as is the case with other goods and services acquired by the VA in the course of the administration, loan funding should attract the personal liability provisions. The VA should have a right of indemnity from the company's unencumbered assets. It is most likely that further funding will come from the existing financier rather than a new financier.

A new funder to the company that is able to rely on a super priority such as under Chapter 11 is likely to approach the funding with a different interest and outcome to the incumbent funder. The incumbent funder has had a prior relationship with the company and an exposure that the incumbent funder will be seeking to extinguish or reduce through the company's recovery. An incoming funder is more likely to be concerned how much money it will provide against the security of its super-priority (and the pricing it will attach to such a facility) rather than how much is needed for the company to trade on.

If it is clear that the VA is personally liable for loan funding this would obviate the more complex arrangements such as under a voluntary Chapter 11 where a post-petition debtor-in-possession financier in a bankruptcy proceeding gains a super priority over an existing pre-petition secured lender. Further. the VA's personal liability with a right of indemnity against the company's assets effectively creates a super priority as the repayment of the loans funds would be a cost in the administration which has the highest priority under the Act. This approach fits well with the structure and application of the existing insolvency provisions of the Act.

The VA, by becoming personally liable for loan funding obtained in the course of the VA, in order to be fully indemnified by the company in respect of this personal liability, must make sure that the borrowings are in the interests of the company and the creditors, the company is able to meet the additional loan funding repayment and that the position of the secured creditor is not adversely affected.

Equity Finance

The ABA supports, in principle, a proposal by which debt could be swapped for equity and for facilitating the ability of a company coming out of a VA under a deed of company arrangement to raise equity. There is nothing under current law that prevents this happening now.

If the proposal is to develop a more defined legislative basis for equity funding a broad consultation with relevant sectors including the banking and finance industry and insolvency professionals would be necessary to develop such as proposal in detail. The ABA would welcome the opportunity to participate.

Timetable for completing the procedure.

Principle 4; the procedural timetable needs to be sufficiently flexible to adjust to the needs of particular companies.

The ABA agrees with this Principle 4.

The ABA's submission dated June 2003 to the Parliamentary Joint Committee on Corporations and Financial Services' (PJC) inquiry into Australia's insolvency laws recommended that;

1. the decision period for a secured creditor to decide whether to enforce its security should be extended to 15 business days;
2. if, during the decision period the administrator forms the intention to seek an extension of time for convening the second meeting of creditors, the administrator must notify secured creditors;
3. the convening period for the first meeting of creditors should be extended for up to seven business days; and
4. it should be made clear in the Act that the court has the power to order an extension of the convening period for the first meeting of creditors.

The ABA made these recommendations in support of its submission that with sufficient flexibility, where necessary under direction of the court, any possible difficulties that might arise in the administration of large and complex enterprises could be dealt with under a VA without the need to import overseas regimes. The ABA believes that the debtor in possession regime under Chapter 11 and the time within which a rehabilitation plan could be developed for a financially distressed company to be accepted by creditors is unduly lengthy.

The VA regime benefits from;-

1. The VA being an independent qualified person having statutory duties under the Act compared with debtor in possession regime under a voluntary Chapter 11 where it is the court that oversees that administration. It is noted, however, that in extraordinary circumstances, such as the Enron Corp. Chapter 11 proceeding, existing management was replaced with an outside consultant who served as interim CEO and Chief Restructuring Officer. In addition, the bankruptcy court appointed an independent examiner. However these appointments added significantly to the costs of the

administration. The issues for companies in VA are predominantly commercial and financial and courts in Australia are not equipped to deal with such issues.

2. The decision by the VA as to whether the company can or cannot trade out of its difficulties to become a viable enterprise being able to be made quickly so as to avoid prolongation if the company is hopelessly insolvent. Importantly, the VA has the ability to propose to creditors a restructure of the company's debts in order to ensure the company can continue as a viable enterprise.

3. The ability of the VA to seek directions from the court.

The recommendations made by the ABA to the PJC would allow sufficient time for the VA to review the financial affairs of a large and complex enterprise with the court protecting the interests of creditors and other parties.

Also, in the ABA's submission to the PJC it was recommended that a deed of company arrangement developed under the VA provisions should contain performance standards or indicators so that creditors can monitor the DOCA and be confident the company is meeting those standards accordingly. There is evidence that this type of provision is now included in DOCAs. This makes directors more accountable to creditors with directors reporting to them at appropriate intervals on the company's performance under the DOCA. Australia could take a lead over its UK and US counterparts in ensuring that there is adequate supervision and accountability of implementation of the rehabilitation under a DOCA.

The ABA refers CAMAC to and repeats its submissions made in the submission to the PJC.

Methods of dealing with corporate groups

Principle 5; the process of rehabilitating a corporate group may be assisted if that group can be dealt with collectively rather than on a company-by-company basis.

Whilst it is the responsibility of the directors of each of the entities within a corporate to determine whether the entity of which they are directors should enter VA, once a VA has been initiated there should be no automatic collective grouping of the entities under VA. The ABA submits the "pooling" of companies in a corporate group is a decision that should be made by the creditors of the relevant companies.

The ABA's comments in dealing with Principle 5 appear later in this submission under "Pooling of assets and deeds of cross-guarantee in corporate groups".

Voluntary Administration

Initiating an Administration

Grounds for appointment

1. The ABA supports retention of the current position under the Act where the directors, chargees and liquidators have the right to decide when to initiate a VA and whether the company's financial condition warrants the appointment of a VA.

2. It is consistent with sound corporate governance principles that the directors who have prevailed over the management of the company and who face personal liability for allowing the company to continue to incur debt whilst insolvent should retain the responsibility to place the company into VA at a time when it is insolvent or likely to become insolvent;

3. The point in time when a company is solvent and insolvent is ultimately a legal judgment but for the avoidance of doubt the responsibility to make this judgment should fall on the directors who are best placed to make that decision;

4. Changing the current test for appointment of a VA to a more speculative test of "a reasonable prospect of insolvency" creates the risk that companies could abuse the test and seek a debt holiday where that is not warranted;

The ABA does not support the automatic initiation of the VA regime to corporate groups. The ABA reiterates that it remains the right of the directors, chargees and liquidators to decide when to initiate a VA. An unsecured creditor should be permitted to vote only on matters that affect the company of which the creditor is a creditor after the company is placed in VA. Otherwise, to do so could discriminate against solvent entities within the group and the creditors of those entities. Also it could create possible conflicts of interest where one VA assumes responsibility for all of the group entities.

Eligibility of a liquidator to be an administrator

The qualifications and standards should be developed by ASIC having regard to competency criteria including experience and educational qualifications.

The ABA does not support the requirement to obtain Court approval of a registered liquidator so acting. This would be unnecessary if the standards for eligibility were introduced and is expensive and time consuming.[Inserted at suggestion of ANZ]

Rights that override a VA

The ABA supports the option for the initial decision period for appointing a receiver by a secured creditor to be extended from 10 to 15 business days for the following reasons:-

1. extending the decision period to 15 business days would give a secured creditor greater insight into the likely course of the VA and this could benefit the company;

2. secured creditors rights are created by contract between the creditor and the company and should not be diluted without taking account of the consequences;

3. the secured creditor (usually the major funder to the company) is likely to be the largest creditor and should be free to determine when to enforce security and the timing of the ultimate realisation of the secured assets in order to manage its exposure risk;

4. the Act contains the requirement for the receiver who is realising secured assets to realise those assets at not less than their market value or otherwise the best price that is reasonable obtainable in the circumstances which means there is no detriment to creditors generally.

The suggestion in paragraph 2.55 of the discussion paper of possibly requiring a receiver to postpone a sale of secured assets in the interests of unsecured creditors is not supported by the ABA. It would introduce a speculative element over the future realisable value of the assets and the state of the market, require the court to make a business judgment and would increase the costs and duration of the receivership to the possible disadvantage of creditors generally.

Partial exercise of secured creditor's rights

In the interests of the company, the VA and the secured creditor itself, the law should be amended to allow a secured creditor that holds a substantial charge (as defined in the Discussion paper) to be able to enforce that charge against some or all of the property covered by the charge for the reasons set out in Paragraph 2.59 of the Discussion Paper. If the secured creditor is in doubt over whether or not to enforce the charge because the charge must be enforced in toto, there is the risk that without the flexibility to enforce the charge as to part of the secured property the secured creditor will enforce the charge for the avoidance of doubt.

Timing Issues

The ABA submits that in the interests of providing flexibility to the VA:-

1. The decision period should be extended to 15 business days;

2. The period for convening the first meeting should be extended to seven business days;

3. The period for convening the second meeting be retained

with the court being given an express power to alter current time limits as much as is justifiable.

In this way the VA regime would be more even more readily adaptable to handle both large and small, complex and relatively straightforward VA's.

The ABA believes that this power, (which apart from the time from convening the first meeting) which is already exercisable by the court ensures that all interests in the VA are adequately taken in to account in deciding whether the relevant period should be extended.

The ABA does not support the proposal in Clause 2.74 for the creditors to be able to determine the convening period for the second meeting at the first meeting. This is because it is difficult for creditors to get a clear picture of the company's plight due to the lack of adequate information about the company.

The attraction of the VA is it can be completed in a relatively short period of time once there is sufficient information available about the company and its prospects. The current law allows flexibility to extend the convening period for the second meeting by an application to the court. This works for both large and small enterprises and keeps the VA accountable for his/her actions. The risk in ceding power to the creditors at the first meeting to determine the time for convening the second meeting is that the VA may continue longer than is necessary simply because the decision by the creditors was made without important information about the company being available.

Also, the VA has expertise in running a VA and the VA's judgment about the administration's likely course is an important element to retain.

The ABA supports the proposal that at the first meeting, creditors having a majority in value and number should be able to resolve to have the company wound up, end the VA with the company being returned to the control of the directors or for the company to propose a DOCA for the reasons stated in Paragraph 2.75 of the Discussion paper provided there is sufficient information available to the creditors upon which to base a reasonable decision.

Notifying pre-commencement creditors

The ABA supports the VA having power to utilize the commerce facilities such as websites and hotlines as an alternative delivery of information to creditors.

Evidence available in the Ansett administration indicated a substantial amount of money involved in notifying all creditors personally where more efficient ecommerce delivery would result in a potentially better return for creditors.

Utilisation of ecommerce facilities by advertisement could be available, for example, where the creditors to be notified exceed a specified number.

Lending to a company under Administration

The ABA supports augmenting the existing VA regime to provide that a VA is automatically personally liable to repay money lent to the company during the administration period in the same way as the VA is personally liable for goods, services and property acquired in the course of the administration. The administrator should have a right of indemnity against the unencumbered assets of the company.

The VA replaces the existing management of the company. If the VA is held personally liable for the amount borrowed this will contribute to prudent and sound decision making of behalf of VA's. The ABA sees this more as a corporate governance issue because the objective should be to ensure that sufficient monies as are needed for the company's operations is at the basis of the VA's decision to borrow and that the company will be able to repay those monies.

By making a VA personally liable and clarifying the VA's right of indemnification will ensure that the VA is encouraged to make prudent and sound decisions concerning the company's funding arrangements.

Voting

Consistent with the purposes of the VA which are to:-

a) maximize the chances of the company's continuing to be in existence, or

b) otherwise produce a better return for the company's creditors by avoiding an immediate winding up of the company –

the ABA submits that voting based on a majority by value should predominate.

This means that the ABA does not support retention of the administrator's casting vote unless that power is confined to a casting vote in support of creditors that have a majority in value and where it is clear that related parties of directors claiming as creditors are voting as directed by the directors.

Of the suggested options in paragraph 2.111, the ABA supports the first option where the priority is given to the majority by value thereby making voting by number irrelevant.

Remuneration of Administrator

For a VA to remain flexible, the ABA supports any change to the law which would enable a meeting of creditors or a committee of creditors, held at any time to fix or agree on the VA's remuneration.

Advanced notice that the VA's remuneration is to be considered at the meeting would be necessary.

The ABA supports the court continuing to have a supervisory or review role in connection with a VA's remuneration.

Administrators' Indemnity Rights

The ABA supports the VA being held accountable for his or her actions.

The VA replaces the management of the company and the VA's right of indemnification should be confined to the available assets of the company should the indemnity continue to apply.

The fact that assets are secured and the actions of a receiver might reduce the available assets to which the right of indemnification might apply is an important reminder to a VA about liabilities that a VA might wish to incur on behalf of the company. The VA should be exercising sound and prudent business judgment.

Voiding Antecedent Transactions

The ABA does not support the ability of VAs and deed administrators to recover antecedent transactions in the same way as liquidators can.

There could be unintended consequences and inequities if this power is made available. Whilst there might be cases where the existence of this power is useful, the ABA believes that further consideration of the proposal is required. For example, if the company emerges as a viable entity from the VA the question arises whether the nature of the company's revived existence warrants, on policy grounds, some antecedent transactions being overturned.

It is noted that the period of a VA may be relatively too short for an antecedent transaction claim to be litigated through the court and the period of the VA might have to be extended to the overall disadvantage of the creditors and the company.

Disclosure to the creditors by the VA of the existence of potentially voidable transactions is an important element in arming creditors with relevant information upon which to base their decisions.

By empowering a deed administrator to pursue these antecedent transactions and, if the company is placed in liquidation following the VA, the liquidator is able pursue these transactions, the ABA notes that the operative date for challenging the transactions will extend back from the date of the appointment of the VA.

Where a DOCA continues for an extended period and the company despite the DOCA goes into liquidation, the ABA suggests that provision should be made under the Act to extend the period for the liquidator to go back to claim pre-VA voidable transactions.

Equity for Debt Swaps

The ABA supports an approach which balances time and costs of putting together a revival plan for a company under VA and the need to protect creditors who are to become investors by providing them with important information needs.

The ABA submits that these matters should be the subject of detailed discussions between insolvency practitioners, ASIC and the Commonwealth government in order to arrive at a workable model.

Ambit of the Court's Power to Give Directions

The ABA submits that there is no reason to augment the court's powers in this respect as a close reading of the decisions of Goldberg J mentioned in Paragraphs 2.163 and 2.164 of the discussion paper indicates that there will be circumstances where a court will approve the business decision of a VA where there is an issue calling for the exercise of legal judgment.

The ABA supports the principle that VA's should accept responsibility for business decisions in the same way as the management of the company is required to do so. VAs are officers of the company and are subject to the same duties as officers are subject under the Act.

If the Court became the ultimate determinate of a VA's business judgment, this could create a trend where VA's delegate their business judgment to the court, which the ABA submits would be undesirable. There would also be adverse time and costs consequences.

Set-Off

The ABA agrees with the proposition in Paragraph 2.172. of the discussion paper that set-off rights are already an established exception to the equality principle in a winding up.

The ABA supports the VA obtaining access to information gathered by regulators provided that the right of access is limited to a proceeding contemplated by the VA in good faith or to assist the VA in complying with an obligation to investigate and report on the affairs of a company.

Pooling of Assets and Deeds of Cross-Guarantee in Corporate Groups

The VA is an administration primarily directed to an assessment and plan for the rehabilitation of the company through a DOCA. This could apply on a group basis. This should not alter creditors' rights against a particular entity unless those creditors agree. Creditors that have contracted with an entity should have the right to recover from that entity's assets. Those creditors might have assessed that entity as credit worthy at the time the contract was made. If there were to be a change to the creditor's right of recourse to that entity or to the assets available to meet the creditors claim because of pooling of claims and

assets of other entities of the group the creditors should receive to full information about the pooling proposal and a right to vote on the proposal.

Ultimately, the court would be available to settle contested allocations of liabilities and cross claims within the group.

The ABA has considered CAMAC's earlier report and recommendations in its Corporate Groups Report of May 2000 and notes that the relevant recommendation 20 has not been taken up by the government.

The court has previously approved of joint meetings of creditors of related companies where creditors have unanimously agreed provided creditors confine their voting only to matter affecting the company/ies of which they are creditors.

The ABA believes that there is no present need to extend the Act to these cases and that court approval or the unanimous approval of creditors to a joint administration of related entities (and/or pooling of assets and liabilities) strikes an appropriate balance between the interests of creditors and the need to ensure a VA proceeds efficiently and effectively.

The ABA has not sighted the Ferrier Hodgson submission and believes that the complexity of the issues in jointly administering a group of companies as a single VA where there are deeds of cross guarantee in place warrants greater consideration. If necessary this should be the subject of a separate inquiry.

Ipso Facto Clauses

The ABA supports the recognition of ipso facto Clauses as a "trigger" for enforcement action under a security. In fact, the Act, in recognizing under a VA that a secured creditor may take enforcement action under a security within the decision period acknowledges that such ipso facto clauses may be contained in security documentation.

Also, the Act currently provides for a VA to consent to the enforcement of a creditor's security but again, the contractual right to enforce the security must arise from the terms and conditions of the security not simply the administrator's consent.

To restrict a creditor's right to rely upon an ipso facto clause is an interference with freedom of contract and is not supported by the ABA.

Assigning or Terminating Executory Contracts

The ABA does not support the power of a VA to assign or terminate a company's executory contracts other than in accordance with the terms and conditions of the contract or the consent of the contractual counterparty.

The role of the VA is different to that of a liquidator whose obligation is to wind up the company, cease its business and end its future obligations. The purpose of the VA is to determine whether the company can be re-established and if this entails variations to

contractual rights and obligations, they must be negotiated rather than arbitrarily varied, assigned or terminated inconsistently with the terms of the contract.

Although not raised in the discussion paper, it is important that the VA retains the ability under the Act not to adopt contracts so as to become personally liable under those contracts. Uncommercial contracts can adversely impact the ability of the business to survive (eg supply contract at uncommercial rates). Clearly if aspects of an uncommercial contract are required by the company then these would need to be negotiated fresh by the VA. Contracting parties' remedies for breaches of such contracts are damages that may be provable in any subsequent DOCA or liquidation.

Deed Compliance with Priority Payment

The ABA supports providing additional flexibility so that creditors can approve deeds of company arrangement that depart from winding up priorities.

Aggrieved creditors should be able to seek a review by the court.

Employee Entitlements

The ABA makes no submission to CAMAC on this matter and refers CAMAC to the ABA's submission to the Parliamentary Joint Committee on financial services and security.

Solvency under the Deed

If imposing a solvency prerequisite for a deed of company arrangement to be valid would be to reduce the incidence of phoenix companies, the ABA would support this.

Effectively, though, a company that enters into a DOCA must be solvent in order to meet its revised obligations under the DOCA to pre-VA creditors. If the company cannot meets its DOCA obligations the deed administrator would call a meeting of creditors to terminate the DOCA and place the company into liquidation.

If the company continues to trade under the DOCA and incurs debts that it is unable to pay as they fall due the company would be insolvent and liable to be wound up or again placed under VA. The deed administrator would call a meeting of creditors to determine the fate of the DOCA. (See Brash's case)

Corporate Government Issues

The ABA supports the following measures:

a) a company's financial reporting requirements should be suspended during the period of the VA.

b) The VA should be given a discretion whether to hold an annual general meeting where in the VA's opinion there is no remaining shareholder value.

c) Because the VA is simply an interim step and does not permanently replace the role and authority of the company's directors, retention of the minimum number of directors rule should be retained as directors will be required to run the company if a DOCA is in operation.

d) If a VA seeks to change the name of the company in the interests of the administration the requirement for shareholder approval should be retained as the prospect of the company continuing would be expected to be highly probable.

e) Where an executed deed of company arrangement is inconsistent with a company's constitution, the ABA does not support the view that the deed provision should automatically prevail. For example, if the deed were to alter the specified purposes and powers of the company within the company's constitution this would be a substantive change to the shareholders' contract with the company in which the shareholders have a legitimate interest.

Administrative Issues

The ABA makes the following points:

a) It is unnecessary to distinguish between a large and complex administration and other administrations. The ABA queries the justification for proposing a doubling of the time limit from 24 to 48 hours;

b) Creditors should remain entitled to participate in the committee of creditors whether they are large or small creditors as their interests are the same i.e. they are creditors of the company. It is noted that in the U.S., only unsecured creditors are represented on the creditors' committee in a bankruptcy proceeding. Participation of secured creditors in a creditors' committee in a VA may help to retain a secured creditor's participation in the VA.

c) The ABA agrees that it should be made clear that a company through its duly appointed representative may be a member of the committee of creditors.

Other Issues

The ABA has no comments on the matters raised unde this heading.

Creditors' Scheme of Arrangements

The ABA has no substantive comments to make on the matters raised in this chapter.

Concluding Comments

The experience of ABA's members indicates that the VA regime in Australia is working effectively but there is room for improvement as has been indicated in this submission.

Regimes in operation overseas such as Chapter 11 in the United States and the Enterprise Act in the UK are, in general, responses to failed or failing companies that suit those local conditions and are not an improvement on the VA regime currently in place in Australia.

Statistics which are gathered by ASIC indicate an increased use of VA's in Australia since their inception in 1993. Unfortunately ASIC does not gather sufficiently detailed statistics to give a clearer picture of the success of VAs in meeting the objectives of the legislation. For example there does not appear to be sufficient statistics to show whether VAs actually assists the revival of many companies and so avoid the company's liquidation. The ABA submits that without this type of evidence substantive alteration of Australia's insolvency laws would be unwise.

The ABA believes that there is an opportunity in the current review of Australia's insolvency regime for ASIC to gather more specific detail on the operation of VA's in Australia and in particular their outcomes in averting what otherwise would be almost certain liquidation for those entities.

The ABA is appreciative of the opportunity to respond to CAMAC's discussion paper and commends CAMAC on the high quality of the research and the manner in which the issues have been presented for consideration.

The ABA would appreciate the opportunity to meet with CAMAC at its convenience to discuss any issue in the submission and to act as a sounding board in the development of the options paper which is to be released in or about the first quarter of 2004.

Ian Gilbert

20 February, 2004

CAMAC DISCUSSION PAPER

REHABILITATING LARGE AND COMPLEX ENTERPRISES IN FINANCIAL DIFFICULTIES

SUBMISSION of RICHARD FISHER

Preliminary Issue

Insolvency laws are at least unusual to the extent that, in certain circumstances, they permit intrusion upon the accrued property and other rights of third parties. The starkest example of that intrusion is to be found in the antecedent transaction provisions.

Likewise, the voluntary administration regime intrudes upon the rights of, say, secured creditors and the lessors of property which is in the company's possession. The justification for that intrusion, from a policy perspective, reflects the desirability of an independent assessment being made of whether a financially troubled company or its business might be rehabilitated. However, there is protection for the positions of such third parties, including:

- the limited time which is available in the ordinary course for the review of the company's affairs to be undertaken;
- the requirement that rent be paid to the lessor of any property in the company's possession in the circumstance that that property is being used; and
- the exclusion of the moratorium provisions when enforcement action has been commenced either by a secured creditor or by the owner or lessor of property which is in the company's possession.

To the extent that amendments are proposed to be made to the voluntary administration regime, a consideration which may be important is the need to maintain a balance between providing an adequate opportunity to assess the prospects for a company or its business and infringing upon the rights of third parties.

Of course, when assessing the appropriateness of any balance which is to be struck, it is also pertinent to bear in mind that the voluntary administration regime is intended to provide, and does provide, no more than an interim form of administration for the company's affairs pending a decision by its creditors as to which option for the company's future best suits their interests.

It is submitted that the flexibility presently found in the voluntary administration regime enables any issues arising in the course of administering the affairs of a company or enterprise, irrespective of size, to be resolved expeditiously by way of application to the court, thus providing a forum to any third party whose interests may be affected in which to effectively vent any concerns it may have as to the proper protection of those interests.

"Large and Complex" Companies

If some distinction is to be drawn between "large and complex" companies and other companies, it is submitted that resort should be had to the existing distinction in the Corporations Act between "public companies and large propriety companies" on the one hand and "small propriety companies" on the other hand.

Principles for Effective Corporate Rehabilitation

The Harmer Report commended the following tests to assess the voluntary administration regime: "(I)t would be:

- capable of swift implementation
- as uncomplicated and inexpensive as possible; and
- flexible, providing alternative terms of dealing with the financial affairs of the company."

It is submitted that those tests continue to be relevant.

Funding

Two general issues are raised in the context of the Discussion Paper's consideration of that environment which is requried to facilitate a rehabilitation on which I would like to comment.

First, access to funding will be critical to the success of many administrations where they are a prelude to the rehabilitation of a company or enterprise.

It is submitted that, at least, any loan funds raised by the administrator should enjoy the same priority as all other costs and expenses of the administration as well as being liabilities for which the administrator is personally accountable. Moreover, any doubt about the administrator's ability to raise equity funding should be resolved.

It is further submitted that consideration should be given to permitting DIP loan financing of the kind available in the United States but subject to the protection required by that country's Bankruptcy Code.

In this regard, the Corporations Act already recognises the possibility that, in some cases, it is appropriate to permit the adjustment of the rights of secured creditors in the interests of a company's general body of creditors subject to there being adequate protection for the interests of the secured creditor; Section 434B, *Corporations Act*.

A related issue concerns the present limitation on the right of the administrator to contract out of personal liability for debts incurred in the course of the company's voluntary administration. In the context of many informal workouts, finance creditors will, in the first instance, effectively subordinate their claims to those of a company's trade creditors in order to permit it to continue to conduct its business.

It is submitted that consideration be given to permitting an administrator to contract out of personal liability or to limit personal liability in the circumstance, e.g., where an existing creditor is prepared to continue to support the company by providing "fresh" credit against, say, some right of priority in respect of its pre-administration debt. As with Section 564, *Corporations Act*, such agreements might be made subject to the court's approval.

Corporate Groups

The second general issue concerns corporate groups. Where a corporate group is engaged in one industry, as, e.g., with the Ansett group, the conclusion that the affairs of the group should be administered on a consolidated basis might be seen as inescapable. However, as our commercial history demonstrates, some corporate groups which collapse are truly conglomerates. Bond Corporation is a prime example having been involved in at least brewing, newspaper publishing, mining and property development. What rationale can be advanced for supporting the conclusion that a supplier of newsprint should compete with a supplier of yeast as "creditors" of the mining companies in such a group?

<u>It is submitted that</u>, to the extent that it is not already the case, this issue is resolved not by some general prescription but by making it plain that Section 439A, *Corporations Act*, is of as much relevance in dealing with a thorny issue of this kind as it is for, say, extending time limits.

Procedural Issues

Turning to some particular issues raised by the Discussion Paper, I deal with them in the order in which they are raised:

- ***Eligibility for Appointment as a Voluntary Administrator***

  Nothing in the evolution of the regime has caused me to think that the Harmer Report was wrong in recommending that eligibility for appointment as a voluntary administrator should be confined to a small group of well-regarded insolvency practitioners.

- ***Voting***

  The issue not raised by the Discussion Paper is whether the class rules which apply to schemes of arrangement or some modification thereof should apply to voting by creditors at meetings held in the course of a voluntary administration. It is notorious that in the administration of the Ansett Group the employees exercised considerable influence through their ability to dominate meetings. However, it would have been invidious if creditors whose interests were entitled to preferential treatment could have determined, in effect, that the Group should continue to trade even if it were to do so at a loss. In such a circumstance, the general body of creditors would have been underwriting those losses without the employees suffering any detriment, at least in the first instance.

  Alternatively, some other means of protecting the interests of an "opressed" class needs to be identified.

- ***Avoiding Antecedent Transactions***

  As mentioned at the outset, the provisions which facilitate the avoidance of antecedent transactions are a prime example of the intrusion by the insolvency law into the accrued property rights of third parties. Their rationale, as is well known, is that where the law requires the estate of a debtor to be realised and the proceeds distributed amongst its creditors, it is "unfair" for the beneficiaries of some transactions to retain the benefit of those transactions as against the debtors' creditors.

  Where there is no such "drawing of a line in the sand" and the debtor's affairs are to be rehabilitated, it is problematic as to whether it is appropriate for the antecedent transaction provisions to be invoked. My uncertainty in dealing with this issue is that

most often it seems to be the case that even where there is a deed of company arrangement as distinct from a liquidation following on from a voluntary administration, the only distinction between the deed of company arrangement and the liquidation is that creditors are offered a larger dividend under the deed that which is speculated (by the voluntary administration) as being available in a liquidation.

Such arrangements, in my view, raise broader policy questions; see, e.g., *re Brian Cassidy Electrical Industries Pty Limited* (1984) 9 ACLR 140. However, it is hard to resist the conclusion that creditors should have access to the benefit of the antecedent transaction provisions if that is the substantial effect of a deed.

♦ ***Equity for Debt Swap***

Save for such regularity intervention as is necessary to ensure that creditors make a fully informed decision to accept equity for debt (and that intervention should be through Part 5.3A of the *Corporations Act*) it is submitted that the other provisions which apply either to invitations to subscribe for capital in a company or to the acquisition of more than a prescribed percentage in a company's capital, should not impact upon an equity for debt swap effected by means of a deed of company arrangement.

In relation to the takeover provisions, it is worth bearing in mind the observation of Sir Laurence Street in *Kinsella v Russell Kinsella Pty Limited (In Liquidation)* (1986) 4 NSWLR 722 to the effect that once a company is insolvent it is the creditors whose interests are at risk and it is to those interests which the directors must have regard when exercising their powers. If it be the case that a creditor is owed more than, say, 20% of the total indebtedness of an insolvent company then so be it.

A related issue concerns the power (or lack thereof) of a voluntary administrator or the administrator of a deed of company arrangement to deal with the capital of the company which was issued as at the commencement of the administration. It is submitted that the existence of that power should be statutorily clarified and confirmed; *Mulvaney v Rob Wintulich Pty Limited* (1995) 60 FCR 81.

♦ ***Set-off***

Consistently with the general premise advanced at the outset of these submissions, it is submitted that unless there are good policy reasons to do so, rights of set-off accrued as at the commencement of a voluntary administration should not be disturbed.

Referring to the particular example in the Discussion Paper, there is no reason in policy or principle not to disturb rights which supposedly arise after that date.

As to whether rights have accrued prior to that date may be disturbed:

- there is the issue raised in the Harmer Report as to whether rights of set-off which might be caught by the antecedent transaction provisions, or a modification thereof, should be able to be extinguished;
- there may be an argument that draws an analogy between an asset to which a right of set-off applies and an asset the subject of a floating charge; Section 443E, *Corporations Act*;

but any modification of such a right should be based on proper considerations of public policy and not on grounds of mere convenience.

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8 April 2004