Discussion paper

Encouraging and facilitating corporate turnaround

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A paper to inform government in its response to the Senate Economic References Committee's recommendation 61 in its report on the performance of the Australian Securities & Investments Commission, 26 June 2014.

Recommendation 61: The committee recommends that the government commission a review of Australia's corporate insolvency laws to consider amendments intended to encourage and facilitate corporate turnarounds. The review should consider features of the chapter 11 regime in place in the United States of America that could be adopted in Australia.

Link: Economics References Committee, Performance of the Australian Securities and Investments Commission.

Contents

1. Executive summary

Law reform to encourage business rescue in Australia

A legal framework to encourage business rescue in Australia:

- needs to be sufficiently robust in its demands to meet certain business rescue criteria, to prevent directors from using the regime to avoid creditors, with no real or viable plan to turn around
- needs to be sufficiently attractive to directors to encourage them to take action sooner
- requires a sufficiently strong moratorium on creditors to be an effective standstill, but also to be an effective cram down technique in delivering restructurings outside of formal frameworks. That is, to encourage a cultural shift in a creditor's approach to a company in distress, its rights need to be impacted by the regime in a way which has that creditor minded to agree a deal consensually
- will highlight the reality that, a company tends only to be able to deliver a business rescue if it has sufficient cash to support continuing trading and a plan. Companies which leave matters too late, will not be able to afford business rescue and will find themselves, insolvent
- will provide a framework for restructurings to be agreed outside of formal frameworks, which will inevitably be cheaper or at least, better preserve the company's value
- needs to address the insolvent trading concern where parties sensibly attempt a restructuring outside of a formal framework, reverting to the formal framework only where necessary.

To the extent that there is a desire to achieve the above by legislative means, I have reviewed the existing voluntary administration regime and suggest proposed amendments.

The key changes involve:

- creditors standing still – not enforcing rights, not terminating contracts, not taking steps reliant on insolvency triggers (the US automatic stay and principle that 'ipso facto clauses' are not enforceable in insolvency, or the UK concept of a comprehensive 'standstill')
- company-led turnaround – the administrator acting in the best interests of the *company,* to deliver a plan which is supported by accurate financial information, to rescue the company as a going concern
- creditors coordinating their response to the plan

For simplicity, I propose a variation to the existing Part 5.3A of the *Corporations Act* (voluntary administration), as the concepts are generally known in Australia. **However, the variation involves a new corporate rescue regime aimed at early intervention. It is not intended to replace the existing regime for insolvent companies but is in addition to it, and is only available to those companies that have a reasonable prospect of being turned around. To the extent the principles are considered desirable, that new regime could take the form of legislation or a code of conduct broadly bought into by all relevant industry groups that influences conduct and becomes market practice**. It is a regime intended to deliver a clear framework in which distressed but viable businesses can continue to operate, access the support they need and be turned around.

The proposed amendments adopt features from the USA and the UK restructuring frameworks. That is, the concepts are not new concepts, but build on international restructuring practices and precedent.

The proposed business rescue framework, an overview

- The existing Part 5.3A of the *Corporations Act* objectives are to be amended so that an administration may take one of two paths:
  - **to rescue the company as a going concern** (the **First Objective**); or
  - to achieve a better return for creditors than would otherwise be available in liquidation (the **Second Objective**).
- An appointment is to expressly identify whether it is in pursuance of the First Objective or the Second Objective.
- A Second Objective appointment proceeds on the basis of the existing legislation.
- **A First Objective appointment proceeds on the basis of a new framework, summarised below**.

Appointment and timeline

- **A First Objective appointment can only be made, if accompanied by a statement by the directors that there is a reasonable prospect of rescuing the company as a going concern**. Also, the appointment is to be **supported by a financial forecast** for the proposed convening period, evidencing sufficient cash flow to continue as a going concern for that period. The directors may propose how long the convening period is to be, but it cannot exceed six months[1]. The directors **must agree to deliver a rescue plan** within a set timeframe of appointment.
- At the first creditors meeting, **a creditors committee is to be appointed to coordinate a response to the rescue plan**[2]. I suggest that a market standard creditor committee letter be established for this purpose. The UK market standard coordinating committee appointment letter is a good starting point.
- During the convening period, a rescue plan is to be delivered to creditors for consideration and monthly financial information should also be delivered to creditors.
- At the end of the convening period, the second creditors meeting is held. At that meeting, **creditors vote whether or not to approve the rescue plan**. No other matter is put to creditors at this meeting. A plan is approved if agreed by the requisite majority unsecured creditors and each secured creditor.
- If creditors vote against the plan, an interested party may apply to the Court for Court approval of the plan. **The Court may approve a plan**, irrespective of the degree of support by creditors including secured creditors. For a plan to be approved by the Court, it is to be in the best interests of the company and its creditors taken as a whole.[3]
- **The agreed or approved plan is effected by entry into** the relevant agreements which document the deal, which will include **a restructuring agreement, entry into which brings the administration to an end**.
- If the Court does not approve the plan, the First Objective administration becomes a Second Objective administration, with a short period of time before a further meeting is held for the creditors to vote on any

[1] Up to six months is directed at medium to large companies; a shorter period is sensible for small companies, where the creditor matrix and operations are not complex, and several months is sufficient to devise and agree a rescue plan.

[2] A small company may not require a creditors committee, or it may not be cost effective to appoint such a committee. In such cases, this requirement can be waived and the rescue plan is negotiated with all creditors. Whether it is more cost effective to have a committee or negotiate with each individual creditor will depend on the circumstances of the particular company.

[3] Court approval is not an essential element of a corporate rescue framework; there will be divergent views on whether this is desirable. It is more aligned to the US position, although in Australia creditors (by class) can be subjected to schemes of arrangement under Part 5.1 of the *Corporations Act*. There are cost implications of including such a mechanism. I raise it for discussions purposes.

DOCA proposal, liquidation or that the administration end. Alternatively, if the company is insolvent, the Court may order that it be wound up.

- The First Objective convening period may be extended by the company and its creditors or the Court for up to six months at a time, but not exceeding a total of [2] years.[4] Any extension requires a statement by the directors that there continues to be a reasonable prospect of rescuing the company as a going concern and evidence of sufficient cash flow to continue to trade for the extension period. I suggest a maximum of six month blocks, because it is difficult to accurately estimate cash flow for any longer period.
- **If at any time the Administrator believes that a rescue is not viable and/or the company has insufficient cash to trade as a going concern during the convening period, the Administrator may declare that the First Objective administration shall become a Second Objective administration.**[5]

The Administrator

- Under a First Objective appointment, **the Administrator must have restructuring and turnaround experience**.
- **The Administrator is to act in the best interests of the company, with the primary objective of rescuing the company as a going concern and increasing the value of the company**.
- **The Administrator has control of the company** and is personally liable during an administration[6]. However, the directors and management are to assist the Administrator, and **the directors remain obligated to deliver the rescue plan**.

Creditors

- The creditors committee are to be separately advised. The creditors committee appointment letter will address the terms of their appointment, but will include the right to engage advisors and charge a coordination fee, which expenses are to be priority expenses in the administration, along with the Administrator's costs.[7]
- Individual creditors seeking advice about their individual positions must engage their own advisors, at their own cost.[8]

The moratorium or 'automatic stay'

- **The moratorium in a First Objective appointment is to be broad.**[9]

[4] Square brackets denote a suggested timeframe, throughout the document, for discussion purposes.

[5] This is an important element, to avoid abuse of the framework by directors.

[6] If the framework is delivered via code of conduct, rather than legislation, I anticipate that the directors will remain in control and a person will be appointed with restructuring and turnaround experience to advise the company, such as a corporate adviser, and/or a chief restructuring officer may also be desirable (**CRO**). The downside to this arrangement is that the directors may not agree to implement difficult decisions, required to turn the company around. A cultural change will assist to alter such behaviours.

[7] Where a company is not able to remain profitable without the assistance of a corporate turnaround framework, there are inevitable costs associated with the support that the company benefits from, when it accesses the framework. Those costs are an investment in that company's future. I recognise the need to manage costs, relative to the size and complexity of the company. There will need to be discussion on that point.

[8] This is not to suggest that any contractual provisions of indemnity or like are overridden, but such costs will be part of the pre-existing claim and not a priority expense under the legislation.

[9] The broad moratorium, which mirrors a UK style comprehensive standstill or a US automatic stay coupled with the principle that ipso facto clauses are unenforceable in insolvency, applies solely to business rescue circumstances. I do not agitate such a broad stay for existing insolvency measures as is the case in the US. I see no reason why, in the case of an unviable insolvent company, ipso facto clauses should not be respected, as is the case in the UK.

- It should bind **secured creditors and unsecured creditors, restricting them from** taking any steps to recover unpaid pre-appointment debt, from terminating contacts by reason of the appointment or **taking any other action** to enforce rights in insolvency or **because of the appointment**.
- All floating / retention of title property is to be available to the company in the ordinary course, for working capital purposes. Funds are not set aside for individual creditors.[10]
- **It is to be an effective standstill, which preserves the value of the company and permits the company to trade in the ordinary course, while the company negotiates a rescue plan.**

- **The creditors are to be protected by such a broad moratorium as follows**:
  - creditors are not able to take any action for (and may not accept) repayment of pre-appointment debt, however, they are to be **paid official base rate interest plus a set margin on their debt** during the First Objective administration
  - creditors shall **not be obligated to extend new credit to the company in administration** (as suppliers or lenders, for example under working capital facilities, although existing obligations under existing contracts including standard terms of trade cannot be terminated)[11]
  - **if creditors do extend new credit, post-appointment trading debt is an expense of the administration**
  - **new money loans** are not repaid during the administration (other than ordinary working capital movements under working capital facilities and interest), but instead **are given new money priority** in any rescue plan (or if the plan fails, preferential treatment in any ensuing DOCA or liquidation as an expense of the administration)
  - creditors **may apply to the Court** to take certain enforcement action – however, the Court should be reluctant to approve any individual action if the creditor is adequately protected and/or the action would adversely impact the prospects of rescue
  - the concept of **new money priority should be introduced as a means of providing adequate protection**. For example, if a secured creditor or a retention of title creditor suffers loss during a First Objective administration which does not result in an agreed plan (by virtue of downward movement in the value of the property, causing an unsecured claim or larger unsecured claim), then that loss is given preferential treatment in any ensuing DOCA or liquidation, in the case of fixed property, ahead of employees, and in the case of floating property, after employees.
- If in the Administrator's view, certain contracts should be terminated (for example, the company may be over-hedged), then such contracts may be terminated.
- A UK market standard standstill agreement (and the chapter 11 automatic stay) is a good starting point for the breadth of an effective standstill and market standard carve-outs.

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[10] It is the support of the creditors as a whole together with an effective standstill, that ensures the continued flow of working capital and preserves / enhances the value of same. The creditors as a whole are to benefit; not individual creditors.

[11] "New credit" means liability in excess of the exposure of a creditor to the company as at the administration date. If a supplier has a quote or ongoing obligation to deliver goods, then the supplier must deliver such goods, but does not need to meet new quotes. If a new quote issued, the supplier is not permitted to insist on new underlying terms of trade, which is an effective attempt to 'terminate' the old terms; creditors are prevented from taking any such action in consequence of the appointment . A hedging counter-party cannot terminate a hedging contract, but is not obligated to provide new hedging. A lender cannot terminate an overdraft facility, but is not obligated to increase the limit, ordinarily pegged to its day one exposure (ie the appointment date).

Detailed response

To develop and fully appreciate any new framework, it is necessary first, to consider the following:

- what does a business rescue culture look like, and how does this compare to Australia?
- what do other jurisdictions do differently, focusing on the USA and the UK?
- what features of those frameworks might we adopt in Australia?

These matters are addressed in Chapters 2, 3 and 4 of this paper. Building on the answers to these questions, I then turn to address:

- the proposed changes that might be made in Australia in more detail, as summarised above **(Chapter 5)**
- the more immediate law reform that might be introduced. In particular, I suggest that section 588G of the *Corporations Act* should be amended to provide a defence to directors who take reasonable steps to avoid liquidation **(Chapter 6)**.

In Chapter 7, I consider the benefits of change to Australia.

Empirical evidence

I am conscious that government will look to empirical evidence of the assertions in support of law reform. There are industry bodies who are better placed to collate such evidence at an industry-wide level. There will be others who make submissions, to provide their views and evidence.

Given my experience, I consider that my observations comprise part of the empirical evidence to be gathered. **The primary purpose of this paper however, is to provide a possible framework based on entrenched overseas precedent, for government to consider**.

My observations in this paper and the proposed framework are founded on my personal experience in the restructuring and insolvency industry since 1995, where I began as an accountant in the insolvency team of Arthur Anderson, Adelaide. I moved to the law in 1997. My experience stems from working in the industry, speaking to clients and colleagues in the industry, reading publications and attending seminars, in Australia, the UK and the Middle East, since that time. **In my dealings in the UK and the Middle East, I worked on restructurings alongside persons globally recognised as some of the best in the world in the restructuring industry, and involving parties from the UK, the Middle East, USA, Europe and Asia**.

I have shared a draft of this paper (or discussed the topics addressed in this paper) with a number of business leaders in Australia for discussions purposes and to obtain their input, including banks, alternative capital providers, turnaround professionals and accountancy firms. While I have not asked any one of them to endorse my views and indeed, there are examples where such persons disagree with my views, this final paper incorporates so far as practicable, given the varying perspectives across the sectors, the observations of those people.

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I am happy to discuss any aspect of this paper, including to provide specific examples in support of my views (albeit in general terms where I am constrained by confidentiality) and to provide the next level of detail which will be required if law reform is to move forward.

2. What does a business rescue culture look like?

What does a business rescue culture look like?	What does Australia look like?
Coordinated, cooperative effort to increase the value of the debtor.	Debtor is perceived as a failure and a wrongdoer.
Perceived benefit to the company and creditors viewed as a whole.	Enforcement and rights of creditors paramount.
Part of a free market economy, which does not unduly penalise risk takers.	Individual creditor rights preferred over the interests of the company and the creditor body as a whole.
Creditors protected via concepts such as adequate protection, new money priority and equalisation/loss sharing.	Risk takers who cause loss to creditors should be penalised, including personally.
Stems from an entrepreneurial society (USA). **Stems from a society that desires to be globally competitive (UK).** **And more recently, societies that have had to manage loss in a less aggressive manner with the onset of the global financial crisis (USA, UK, Europe, Middle East).**	**Stems from an old feudal system where creditors were the wealthy and powerful.** **Stems from an island culture – overly regulate to protect.**
Changes to a legal framework will only promote business rescue, if founded on policies aligned with a business rescue culture.	Australia's culture impacts the way we respond to distress, as illustrated below.

What does a business rescue culture look like?	What does Australia look like?
Businesses responding to the first signs of underperformance and financial stress, before serious distress kicks in. First signs of financial stress look like: • Actual or potential breaches of covenants in lending documents. Company is probably carrying too much debt. • Ordinary creditors are being paid, either within terms or on agreed deferred terms. • Operational issues, with aspects of the business underperforming (propped up by the performing businesses, but becoming a drag on overall profit). • The company's financial position will decline if nothing is done. **Early intervention means that there is a chance that the business can be turned around (even if some ultimately fail).**	**Businesses ignoring the first signs of underperformance and financial stress, leading to inevitable serious distress.** Serious distress looks like: • Actual breaches in lending documents, likely to have been rolled for a period of time. Difficult conversations with lenders, including threatened enforcement. • Ordinary creditors are being stretched, with promises to pay not being met and creditors either reluctantly agreeing to further deferrals or issuing default notices and threatening legal action. • The company is, or is likely to be, insolvent. • Operational issues are pronounced, with underperforming aspects of the business causing losses, issues within the management team, staff morale is suffering, there is a lack of vision/business strategy. **Late intervention means that there is almost no prospect of turning the business around (and almost all will fail).**
Company directors taking necessary steps to deliver a company-led turnaround plan. That is, taking steps to: • **retain the initiative** • **ensure the continued support of key stakeholders** • **obtain a realistic assessment of the position** • **make critical operational improvements to build a sustainable future, and** • **be fully funded by a sustainable capital structure.**	**Directors doing nothing.** Directors and management burying their head in the sand. Ignoring the problems, assuming they will go away. Directors confusing turnaround advisors with insolvency advisors thus viewing them all as corporate undertakers and not engaging them. **Directors asking for more time, and more time being agreed, but with no future plan.** Poor information systems and an inability to deliver accurate financial information, resulting in an inability to realistically assess the position. Company directors and management reluctant to make difficult decisions, such as downsizing, selling underperforming assets, dealing with weaknesses in the management team or at board level (exacerbated in the case of family companies).

What does a business rescue culture look like?	What does Australia look like?
The company's turnaround plan is supported by financial forecasting, evidencing that the company can afford the plan, and will deliver the operational and capital improvements in the stated period. **The terms of that plan are negotiated with key stakeholders and agreed, ordinarily and ideally, outside of insolvency administrations.**	**Directors responding too late, not to the operational issues and unsustainable capital structure, but to creditor demands.** Directors at this point seeking advice. In many cases, only insolvency solutions are realistically on offer. **Directors considering their own positions and whether to resign.** Advice to the financially distressed company varies as follows: • front-ended advice that restructures the balance sheet to buy time, not deliver long-term sustainability • back-ended advice that focuses on insolvency solutions, the appointment of receivers and voluntary administrators, providing a defence to insolvent trading (but otherwise ensuring the loss of board control and destruction of value) • aggressive advice that thwarts any conciliatory solutions, such as turnaround attempts. **There is some experience of directors engaging in turnaround efforts, particularly in larger companies. However, such processes usually commence well after the problems have emerged and at a time when there is growing creditor pressure.** The experiences of which I am aware , tend to involve stories of crisis with issues ranging from lenders and other creditors being uncoordinated and/or unsupportive, key board members resigning, senior creditors exiting and the already difficult position being intensified by a need to respond to threatened or actual suit, and regulator action. Often, such companies are on the brink of voluntary administration or receivership throughout the restructure. In Australia, this is our experience of a successful restructure.

What does a business rescue culture look like?	What does Australia look like?
Lenders engaging in discussions with their borrowers at the first sign of emerging problems, seeking out a company-led turnaround plan. Lenders standing still. Lenders coordinating their response to the borrower. Lenders supporting any immediate new money need as a priority lend.	There is increasing experience of lenders engaging early. **However, the landscape tends to follow a pattern:** • Lenders will try and identify issues early. However, they intervene because their lending documents give them a right to do so. At that point, it is often too late. • Lenders put customers on notice of breaches and events of default. Lenders reserve all rights. • Lenders may agree to provide the company time if the risk profile permits, interest repayments are being met, and/or their security covers the debt. • However, there is no company-led turnaround during the time given and the financial position of the company deteriorates. • Alternatively and increasingly, with a rapidly deteriorating risk profile (resulting in an increasing cost of capital to the lender) time will not be available and speed of recovery will be important. • The company moves into workout mode and the lenders now determine what the company will do, ie sell what secured assets in what order. • Other creditors issue default notices and threaten to enforce rights unless their own positions are dealt with. • **As the situation becomes more grave, an administrator may be appointed or the lenders enforce rights, appointing a receiver. Lenders may look to exit.** In the above context, it is worth mentioning that lenders are reluctant, or are being advised, not to get too involved outside of formal enforcement measures, for fear of shadow directorship and *Bell Group*-like liability. Lenders also comment that turnaround efforts can be resource intensive and capital cost heavy, particularly following a default event. Early engagement by customers is key to reducing the capital cost and better enabling the prospect of a successful turnaround.

What does a business rescue culture look like?	What does Australia look like?
	Responsible lending guidelines can make it difficult for banks to extend new money to customers in financial difficulties.
If all key stakeholders cannot agree, and no other contingency plan is viable, insolvency administrations and schemes may be used to force through a deal which has the support of the requisite majority. However, this is viewed as undesirable as it adversely impacts corporate value. Creditors will ordinarily, therefore, prefer a consensual deal rather than being crammed down, ie being bound to a worse outcome as a dissenting creditor.	**Creditor-led workouts and insolvency solutions are called restructurings, even when they effectively involve the fire sale of assets and significant haircuts / out of the money solutions. Such solutions are touted as plan A solutions, rather than contingency planning.**

3. What do other jurisdictions do differently? Chapter 11 in the USA and INSOL principles derived from the 'London approach'

Chapter 11 – an overview

The recommendation made by the Senate Committee in its report on ASIC's performance of 26 June 2014 (recommendation 61) proposes that consideration should be given to features of the Chapter 11 regime in place in the USA, that could be adopted in Australia.

The key features of Chapter 11 are:[12]

- A debtor in possession model – the debtor remains in control of the company during the proceedings.
- Court driven – the proceedings are overseen by the Court and the Court has the power to approve a plan which is not supported by all creditors, by way of cram down.
- Ordinarily, the proceedings will last at least 12 months and up to around three to five years.
- Typically, the proceedings are reported to be very expensive. As such, smaller companies tend not to avail themselves of Chapter 11.

The key steps can be summarised as follows:

- **the debtor files a petition in Court, which commences the Chapter 11 proceedings and triggers an automatic stay**. The automatic stay is broad, preventing creditors from taking enforcement action against the debtor without Court approval. Secured creditors are bound by the stay. Any **relief from the stay** which may be granted by the Court **is subject to the principle of adequate protection** (for example, periodic payments or additional / replacement security)
- the petition includes a statement of the debtor's assets, liabilities, income and expenses, and a summary of its financial affairs
- thereafter, **the debtor files monthly operating** reports setting out income and expenses, made available to all creditors (enabling creditors to assess the feasibility of the plan referred to below)
- the debtor is required to attend a meeting of creditors to answer creditor questions under oath (this ordinarily takes place around 30-45 days after commencement)
- **the debtor presents a reorganisation plan to its creditors** (involving for example, a deferred payment plan of a discounted debt) and a disclosure statement (describing the manner in which creditors will be treated under the plan and the extent to which their rights will be impaired)[13]

[12] This overview is based on my summary understanding of Chapter 11 reorganisation proceedings, based on my reading of relevant texts and articles. I have not worked in the USA, nor have I been directly involved in a Chapter 11 proceeding. There will be other practitioners who have worked in the USA who will have a more sophisticated understanding of the regime. Their views should be sought, to the extent such details are required by government.

- **creditors are asked to agree to the plan**, which may involve negotiation and variation to the plan – a committee of creditors may be appointed to assist with such negotiations
- **classes of creditors may be offered different terms**, including two classes who share equal priority may be offered different terms
- if all creditors do not agree to the plan, **the debtor may ask the Court to approve it** – this is called a cram down motion, where the Court is asked to impose the plan on non-consenting creditors. Creditors who do not oppose a cram down motion are deemed to have accepted it (in the UK this is the 'snooze you lose' principle not uncommon in restructuring transactions)
- in considering whether to approve a plan, the Court will be guided by two principles. Firstly, does the plan unfairly discriminate and, secondly, is the plan fair and equitable. There is much case law surrounding these principles, which are in turn subject to further considerations such as the principle of absolute priority and the new value doctrine. All go to the circumstances in which a plan will be imposed on non-consenting creditors
- once the plan is approved by the Court (including by way of cram down), **the plan takes effect as a new contract with creditors** and the debtor commences making payments under it. A creditor may sue on any default under the approved plan
- **following payments in full under the plan, any impaired debt is written off and the debtor is discharged from the Chapter 11 proceedings**.[14]

Not all Chapter 11 proceedings proceed in the manner above. **If the plan is not approved or the plan fails, the Chapter 11 proceedings may become Chapter 7 liquidation proceedings**.

Additionally, **it is possible that competing plans are filed**. Generally, the debtor usually has the exclusive right to propose a plan for 120 days (or 180 days for small businesses). In some cases, at the end of that exclusivity period, creditors will file a competing plan (this may incorporate an alternate reorganisation plan, or can provide for liquidation or takeover of the debtor's assets and business). In this case, **absent agreement, the competing plans are litigated**, which is said to increase the cost and risk to the debtor of its restructuring plan failing.

INSOL principles derived from the 'London approach' – an overview

The International Association of Restructuring, Insolvency and Bankruptcy Professionals (**INSOL**) principles are a set of guidelines derived from 'the London approach', which outline global best practice to achieve a consensual restructuring.

These principles are well-entrenched in the European market and routinely deliver successful restructurings on a consensual basis, without the need for insolvency administrations or Court intervention.

The INSOL principles are recognised in other regions, including the Americas, the Middle East and Asia. Where UK and European banks are involved, they will expect adherence to the INSOL principles as 'market standard' practice.

[13] There is no deadline for filing a plan (unless ordered by the Court), other than for small businesses who have 300 days or such further time as granted by the Court to file a plan. The Court may waive the requirement for small businesses to file a disclosure statement. A small business is defined by reference to a cap on its total debt, subject also to there being no committee of creditors appointed by the Court.

[14] It may be that certain secured debt is amortised over a longer period; in which case, the discharge may take effect once all unsecured debt is repaid under the plan.

Relevantly in the Asian region, while the Chinese corporate insolvency law incorporates a reorganisation regime similar to Chapter 11, culturally this region will strongly prefer out of court, consensual solutions. Moreover, it is reported that almost 30 percent of global bank exposure to China sits with UK banks.[15] It is likely then, that in China we will see consensual restructurings of any impaired debt in line with, or adopting features of, the INSOL principles.

If Australia wishes to remain in step with regional partners and beyond, and given the success of the INSOL principles in achieving consensual restructurings, consideration should also be given to features of the INSOL principles which could be adopted in Australia's legislative framework.

An overview of the INSOL principles is:[16]

- Where a debtor is found to be in financial difficulties, **all relevant creditors should be prepared to cooperate with each other** to give sufficient (though limited) time (a "Standstill Period") to the debtor for information about the debtor to be obtained and evaluated and for proposals to resolve the debtor's financial difficulties to be formulated and assessed, unless such a course is inappropriate in a particular case.
- During the Standstill Period, **all relevant creditors should agree to refrain from taking any steps to enforce their claims against or (otherwise than by disposal of their debt to a third party) to reduce their exposure to the debtor** but are entitled to expect that during the Standstill Period their position relative to other creditors and each other will not be prejudiced.
- During the Standstill Period, the debtor should not take any action which might adversely affect the prospective return to relevant creditors (either collectively or individually) as compared with the position at the Standstill Commencement Date.
- **The interests of relevant creditors are best served by coordinating their response to a debtor in financial difficulty**. Such coordination will be facilitated by the selection of one or more representative coordination committees and by the appointment of professional advisors to advise and assist such committees and, where appropriate, the relevant creditors participating in the process as a whole.
- During the Standstill Period, the debtor should provide, and allow relevant creditors and/or their professional advisors reasonable and timely **access to, all relevant information relating to its assets, liabilities, business and prospects, in order to enable proper evaluation to be made of its financial position** and any proposals to be made to relevant creditors.
- Proposals for resolving the financial difficulties of the debtor and, so far as practicable, arrangements between relevant creditors relating to any standstill should reflect applicable law and the relative positions of relevant creditors at the Standstill Commencement Date.
- Information obtained for the purposes of the process concerning the assets, liabilities and business of the debtor and any proposals for resolving its difficulties, should be made available to all relevant creditors and should, unless already publicly available, be treated as confidential.
- **If additional funding is provided during the Standstill Period or under any rescue or restructuring proposals, the repayment of such additional funding should, so far as practicable, be accorded priority status** as compared to other indebtedness or claims of relevant creditors.

Separately, in the consensual restructuring environment, Australia should already be adopting these principles.

[15] Article titled "Global bank exposure to China doubles" by Marion Williams, 12 June 2014, published by Finsia at http://www.finsia.com/news/news-article/2014/06/11/global-bank-exposure-to-china-doubles.

[16] Taken from the INSOL International Statement of Principles for A Global Approach to Multi-Creditor Workouts: https://www.insol.org/page/57/statement-of-principles.

However, a cultural shift is likely required to facilitate that approach.

It is arguable that legislative change in the way formal administrations are conducted may assist to bring about that cultural change.

- For example, following the introduction of the *Enterprise Act 2002* in the UK, secured creditors were no longer entitled to appoint administrative receivers and instead, were only able to appoint an administrator by way of enforcement action. Some say this enhanced the restructuring landscape in the UK with banks preferring consensual deals, although others comment that the cultural shift occurred first with the development of the 'London approach' in the 1990's. Those principles were formally articulated by the British Banking Association (after the introduction of the *Enterprise Act*) in 2004.[17]
- Changes to the insolvent trading law would also assist to drive a cultural change.

[17] 'The London Approach' – British Banking Association 'Policy Bulletin' of 16 February 2004 (www.bba.org.uk/policy/article/london-approach/fx-and-money-markets-policy).

4. Features of the Chapter 11 regime and the INSOL principles that could be adopted in Australia

Chapter 11 – features that might be adopted in Australia

There is much criticism of Chapter 11, including that it is a lengthy and costly process tending to be feasible only for larger companies (not unlike Australian schemes of arrangement), and often not resulting in the rehabilitation of a business but instead, assets are sold through a bankruptcy process (not unlike many Australian voluntary administration and deed of company arrangement outcomes).[18] There is a perception in the USA that it requires review.[19]

As is evident from the above overview, Chapter 11 is a proceeding with numerous complexities.

Nonetheless, there is no reason why, on a helicopter view, those aspects which are positive cannot form the basis for a review of the *Corporations Act* including Part 5.3A (voluntary administration). Given the different policies and culture underlying Chapter 11, whether such features are adopted depends on the extent to which a change in our policy and culture is considered desirable.

Questions which arise for Australia are:

- **Is it desirable to move to a model which gives debtors greater control?**

  MB: In a restructuring scenario, yes subject to assistance from restructuring advisors.

  This highlights a fundamental issue with the existing Part 5.3A framework; upon appointment the directors lose control and the Administrator acts in the best interests of the creditors. There is no one with any power to act in the best interests of the company. It is little wonder, the Part has done little to promote rescue of the company as a going concern (to be distinguished from the fire sale of a business or assets via a deed of company arrangement).

- **Are Australian Courts willing, suitably qualified or constitutionally able to oversee the process, akin to the US system?**

  MB: I expect not; see also the comments of Ray Finkelstein in the ARITA journal April-June 2014, Feature 1 "Q&A with Ray Finkelstein" (page 10). I expect a creditor consent model overseen by a restructuring practitioner, with some Court supervision, would be preferred. A Court model would be unwieldy and expensive, and prohibitive to the SME market.

- **Are we content to restrict creditors' rights to a greater extent and for a longer period of time, whilst a debtor prepares and negotiates an acceptable plan and, if so, for how long and on what basis?**

[18] See ARITA journal April-June 2014, Feature 2 at page 12, "A review of deeds of company arrangement" by Mark Wellard (at page 15).

[19] See http://www.vsb.org/docs/valawyermagazine/vl0710_bk-section101.pdf; see ARITA journal April-June 2014, Feature 4 at page 21, "Chapter 11: Does it Add Up Down Under?" by Peter Gosnell (pages 21-22).

MB: In my view, the answer is yes; I give a possible framework which suggests answers to how long and on what basis in the executive summary under the heading 'The proposed business rescue framework, an overview' on pages 5 to 7 and at Chapter 5.

- **Should there be a power, or a residual power, given to the Court to approve a plan which is not otherwise approved by creditors? If so, pursuant to what criteria?**

  MB: In my view, a creditor consent regime is desirable. However, a residual power granted to the Court to approve a plan which, notwithstanding dissenting creditors, is in the best interests of the company and its creditors as a whole, might be contemplated.

  The Court already retains a power, for example, to overturn the decision of the majority creditors to enter into a deed of company arrangement. I appreciate that such legislation is based on the premise that a minority can be oppressed by the majority. However, as has been seen with Solomon Lew and Clive Palmer, a minority does not always need protecting; indeed the opposite can be true where that minority holds the power to block a majority deal which is otherwise beneficial to the whole.

  If considered desirable, in drafting the criteria on which a Court may approve a plan, careful consideration will need to be had to the extent to which it is intended for restructuring plans to regulated; for example, can two classes of creditors of equal priority be treated differently under a restructuring plan (as is the case in the USA) – is that fair – do we wish to regulate plans to this level of detail? In my view, restructuring plans should not be overly regulated - the best outcome for a particular company will very much depend on a case by case analysis. Inevitably, a body of law will follow to develop a set of guiding principles.

- **Should competing creditor plans be permitted?**

  MB: In my view, no. Creditors should negotiate the terms of the debtor's plan. Inevitably, the plan will be a negotiated document and creditors have the opportunity to propose amendments which in effect turn the plan into a creditors plan. However, having a number of deals on the table being negotiated in tandem is complex, overly time consuming and costly. It too readily provides an opportunity for a stand-off scenario, which is more likely to result in failed rehabilitations.

- **Are we content for a single framework to accommodate all businesses, or do we wish to separate small and large businesses, by what threshold?**

  MB: This will depend on the framework devised; we should in the first instance, agree a framework. I appreciate that it may then be necessary to adjust that framework in specific ways for smaller businesses.

INSOL principles – features that might be adopted in Australia

Given my very positive experience in the UK in consensual restructurings applying the INSOL principles, including across jurisdictions in the USA, Europe, Asia and the Middle East, I would encourage consideration of those principles also in formulating a business rescue culture in Australia.

Features that plainly, ought be embraced in both consensual restructurings and in any legislative framework which seeks to promote restructurings, are:

- **standing still**
- **coordinated creditor response**
- **the provision of new money on a priority basis**

- the concept of equalisation might be considered, as a mechanism to avoid prejudice to creditors who are asked to stand still.

Additionally, the following feature of UK style restructurings, which is not expressly set out in the INSOL principles, but is embedded in the restructuring landscape, ought also be adopted:

- **preparing a restructuring plan**, which addresses both the operational and financial restructuring necessary, and **which is based on a financial forecast which evidences that the company can afford the plan and will be turned around in the stated period**.

5. Australia – a detailed look at what law reform might look like, adopting such features

Part 5.3A of the *Corporations Act* was designed to facilitate businesses being restructured and continuing in existence. In my view, it is a good basic framework which includes, for example, provision for a moratorium, provisions regarding the rights of secured creditors and the basis on which a restructuring plan may be implemented via a deed of company arrangement. That said, it has not been successful in delivering corporate turnarounds. It is part of Australia's insolvency regime.[20]

For simplicity, this paper is craft as a variation to Part 5.3A of the *Corporations Act*, as the concepts under it are generally known to the Australian community. However, once understood in that context, it is probable that a new framework will be required, which could be legislation or a code of conduct.

The framework provides a reorganisation tool which draws on Chapter 11 and my experience in the UK in consensual restructuring transactions.

It does represent a cultural shift. **It assumes that not all companies facing financial difficulties will inevitably fail**, and that **those with viable businesses should have available to them, a clear framework within which to operate, with a view to being turned around**.

Part 5.3A objectives: to amend, to provide for a First Objective and a Second Objective

- The first objective does not, as drafted, speak to business rescue. A company might continue in existence under a DOCA as a shell, without delivering a restructuring; the business might continue in existence under a deed of company arrangement as a sale of business to a new owner; however, in both cases, there is no business rescue and creditors are left behind receiving no or little dividend.
  - To replace with: "**to rescue the company as a going concern**"[21] (the **First Objective**)
- The second objective should be amended, to reflect the amendment to the first objective.
  - To replace with: "if it is not possible to rescue the company as a going concern, to achieve a better result for the company's creditors and members than would result from an immediate winding up of the company" (the **Second Objective**)

[20] Once in voluntary administration, ordinarily a company is placed into liquidation or enters into a deed of company arrangement. According to the study undertaken by Mark Wellard, in 72% of cases, a deed of company arrangement delivers a quasi-liquidation outcome (see his article published in the ARITA journal April-June 2014, Feature 2 at page 12, 'A review of deeds of company arrangement').

[21] This language is taken from paragraph 3 of Schedule B1 of the *Insolvency Act, 1986* (UK).

Notice of appointment: to amend, to refer it to the First Objective or the Second Objective

- The notice of appointment must state whether the appointment is in pursuance of the First Objective or the Second Objective.

Separate frameworks for each objective as follows to be introduced:

- **First Objective**: a substantive amendment, to provide for business rescue, see framework proposed below.
- **Second Objective**: the existing timeline and framework applies, with creditors' meetings and a deed of company arrangement proposal, which provides a proposal for a better result than liquidation, which creditors may vote on or determine that liquidation is preferable. This framework is suitable for the status quo deed proposals including pre-packs, business and asset sales, and third party contributions.

First Objective framework, to vary the existing framework as follows:

Where the notice of appointment refers to the First Objective, it is to be accompanied by:

- a financial forecast for a period which does not exceed [6] months (the **Forecast Period**) which evidences that the company can continue to trade during that Forecast Period, paying interest on pre-administration debt (but not principal) and post-administration trading costs and expenses (including Administrator and advisor costs for the company, and creditor committee fees and advisor costs, which are to be reasonably estimated[22], including interest on proposed post-administration new money borrowings but not principal, and any adequate protection amounts, if any)
- a statement by the directors that there is a reasonable prospect of the company being rescued as a going concern
- a statement by the directors that they will deliver a plan to rescue the company as a going concern for creditors' consideration within [1] month where the Forecast Period is [4] months or less,[23] otherwise within [3] months

A rescue plan is a plan that sets out the proposed terms of a restructuring, accompanied by a business plan/financial forecast for the proposed restructuring period.

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[22] I do not in this paper address the question of reasonable fees and costs, nor the basis on which they might reasonably be charged and approved. In the UK, depending on the size of the company, there are market standard coordinating committee fees.

[23] This is intended to provide for smaller or less complex companies, who are able to deliver a business rescue in a short period of time but to do so, need to take advantage of the benefits available under the First Objective framework (such as the broader moratorium). The shorter timeframe will result in a more cost effective rescue. Of course, a longer timeframe will be more expensive. A rescue in such a short period of time is ambitious and assumes 1) a simple business and creditor position, 2) the company has good, accurate financial information immediately available, 3) the company has a strong advisor team well-supported by management, willing and able to act quickly and commercially to isolate the issues and prepare a suitable plan, and 4) the creditors are able to respond quickly and commercially. For a larger company or where complexities arise, I would expect such a short period is not possible. It goes without saying that the more financially troubled a company, the greater the complexities so that by leaving an appointment too late, the company will probably not be able to achieve a rescue in a short period, and will probably not be able to afford a longer First Objective moratorium. As such, a business rescue under the First Objective is unlikely to be available and the company will be more likely to fail.

Section 436F functions of the creditors committee, to amend for the First Objective to include to coordinate a response to the rescue plan

- The primary function of the creditors committee is to coordinate a response to the rescue plan.
- It will be desirable to craft a pro-forma creditors committee appointment letter (perhaps as secondary legislation or an industry code), which in turn may provide for an appropriate coordinating fee to be paid to each such member.
- The UK market standard coordinating committee appointment letter is a good starting point. It provides that the committee is appointed to facilitate negotiations and discussions, but does not act as a fiduciary, does not owe a duty of care, and cannot bind other creditors. The committee is permitted to engage advisors. Creditors may delegate powers to a creditors committee, for example, to approve new money loans during the administration up to a permitted threshold. A creditors committee acts on the unanimous decision of its members.

Division 3 control of company's affairs and director assistance (section 438B): to amend for the First Objective, to provide a model where the primary interest to be served by the Administrator is that of the company and there is greater cooperation between the Administrator and the directors

I do not suggest a debtor in possession legislative framework, as I have experienced restructurings where difficult decisions were not made by the board, adversely impacting the time it took to agree a restructuring plan, the quality of that plan and the prospects of it being successfully implemented.

Additionally, where the debtor remains in control, the debtor is liable for the ongoing trading expenses. In a consensual environment outside of legislation, where creditors are in control of what is agreed, that is appropriate. However, **in a legislative environment where a moratorium is imposed on creditors, in my view, creditors are more adequately protected if the Administrator is liable for the trading expenses.**[24]

It follows, if the Administrator is liable for administration trading expenses, the Administrator needs to retain control.

That said, I recommend a shift in the interests which are served by the Administrator, so that the board and executive management should be engaged and cooperative.

Broadly, I propose:

- **The Administrator is appointed to enhance the value of the company as a going concern.** Whilst this, in general, ought be in the best interests of all of the company's stakeholders, including its members and creditors, **the primary interest to be served is that of the company**.

  This can be justified by reason that under the First Objective the company may not be insolvent or if it is insolvent, the objective is that it return to solvency. An appointee (or someone) needs, therefore, to be acting with the best interests of the company in mind.[25]

[24] Some suggest that there is no reason why an Administrator should take on personal liability, in the case of a viable company subjected to a company-led turnaround regime. Others say that an advantage of the Administrator being personally liable for the administration expenses, is that arguably, the administration will be less open to abuse.

[25] This is an issue with the existing Part 5.3A framework; upon appointment the directors lose control and the Administrator acts in the best interests of the creditors. There is no-one with any power to act in the best interests of the company.

- As the Administrator is personally liable for administration expenses under Part 5.3A, it is appropriate that the Administrator retains control.
- The board remains obligated to assist (section 438B), but should also be subject to the obligation to deliver the rescue plan within the time stipulated in the notice of appointment.
- Given the shift in the interest, the relationship ought to be one of greater cooperation.

  That is, based on strong financial and operational restructuring experience, the Administrator should provide direction to the company. The Administrator will also provide resources where necessary, if the company is under-resourced (for example, its finance team will often require support during a restructuring to attend to the demands of putting together a plan whilst continuing the day to day business).

  However, the Administrator does not replace the company's executive and management team, but draws on their knowledge and expertise, and works with them so far as is possible and in the best interests of the company. This is important, as the objective is that a rescue plan is agreed and the Administrator hands control back to the board (either in its existing form or varied, as required to support a successful rescue plan). For a successful plan, the board and management (either in their existing form or as varied to support the plan) need to have bought into the plan and need to be capable of implementing it.
- That said, the benefit of the Administrator retaining ultimate control, is that if difficult decisions need to be made (eg downsizing, changing management), the Administrator can make them.
- Specifically, the Administrator should:
  - Be assisted by management and the executive in the preparation of appropriate financial information to update creditors and support the rescue plan, including the business plan/financial forecast for the proposed restructuring period (supported by the Administrator's own staff if necessary).
  - Be assisted by management and the executive in trading and other decisions which will improve the company's financial and operational performance during the administration.
  - Assist management and the executive in formulating the company's rescue plan, which the directors are obligated to deliver.
  - Be assisted by management and the executive in communicating and negotiating that plan with creditors.

Section 438A, Administrator to investigate affairs, to be deleted for the First Objective and replaced with an obligation to:

- assist the directors to deliver a plan to rescue the company as a going concern for creditors' consideration within [1] month where the Forecast Period is [4] months or less, otherwise within [3] months
- deliver monthly financial information to creditors, providing a rolling 13 week cash flow forecast and monthly management accounts.

Division 5, second meeting of creditors, to be amended:

- Section 439A(5), the convening period in the case of the First Objective is the Forecast Period
- Section 439A(6), (7) & (8), the company and its creditors may resolve to extend (by the requisite majority), or the Court may extend (on the application of the company), the Forecast Period for up to a further [6] months at a time, up to a maximum [2 years], subject to:
  - delivery of a financial forecast for the proposed extension period which evidences that the company can continue to trade during that extension period, paying interest on pre-administration debt (but not principal) and post-administration trading costs and expenses (including Administrator and advisor costs for the company, and creditor committee fees and advisor costs, which are to be reasonably estimated, including interest on proposed post-administration new money borrowings but not principal and any adequate protection amounts, if any)
  - a statement by the directors that there continues to be a reasonable prospect of the company being rescued as a going concern

It is not intended that the company be penalised for requiring further time; indeed for more complex or larger companies, one would expect that more time might be required. The six-month periods are provided, to ensure that each six months, financial forecasts are prepared which continue to show that the company is able to afford to trade as a going concern during the administration and that the directors are satisfied that there continues to be a reasonable prospect of a rescue plan being agreed. If these two conditions are met, the extension should generally be granted.

Section 439C, to be amended for the First Objective, with creditors asked to vote on whether or not to approve the business rescue plan:

- Creditors can vote to approve the rescue plan (by the requisite majority plus each secured creditor). They are not asked to vote on any other matters.
- If approved, a restructuring agreement (with such other documents as necessary) embodies the terms of the rescue plan. The implementation of the restructuring agreement is the implementation of the rescue plan. Entry into the restructuring agreement brings the administration to an end.
- If it is not approved, the company or other interested party may apply to the Court for the approval of the rescue plan.
- The Court may approve a rescue plan that was rejected by the requisite majority creditors plus each secured creditor, where it is in the best interests of the company and its creditors taken as a whole.
- If the rescue plan is not approved by the Court, the Court may order that a Second Objective s439A creditors meeting be convened within [25] days or if the company is insolvent, that it be wound up.[26]

[26] Providing a process for the Court to approve a deal, is a positive lever to aid an agreed negotiated position, as parties know that if they do not agree a position, they may be subjected to a deal by Court order. See also footnote 3. I prefer a regime where the creditors are voting on a plan, without leverage to vote the company into liquidation which can be misused and is likely to impede a shift towards business rescue. I recognise however a need for 'next steps' if a plan is not agreed or approved.

Divisions 6, 7 and 8, stay and rights of secured party, owner or lessor: a new moratorium division is to be introduced for First Objective appointments which removes the exceptions to the stay in Division 6 and alters the manner in which the Administrator may deal with sale proceeds, to create a UK style standstill

For a business rescue to be effective, the company needs an effective standstill, where creditors genuinely stand still and do not take enforcement action or other action which will prejudice the company's chances of being turned around. *See Executive Summary under 'The moratorium or automatic stay' on pages 6 and 7 for further discussion.*

This is a radical change[27], impacting lenders (and any receivers appointed by them) with security over the whole or substantially the whole of the company's property. However, **in the UK such lenders since 2002 have not been able to appoint administrative receivers,[28] with administrative receiverships being replaced with administration. Likewise, secured lenders in the USA are subjected to the Chapter 11 automatic stay.**

Specific changes required include:

- all creditors, secured and unsecured, are restricted from taking any steps to recover unpaid pre-appointment debt, from terminating contacts by reason of the appointment or taking any other action to enforce rights in insolvency or because of the appointment[29]
- chargees with charges over the whole or substantially the whole property, or perishable property, or where action begins before the administration, can only act with the consent of the Administrator or if approved by the Court
- the Court will only approve such action if and to the extent there is not adequate protection and/or the action would not adversely impact the prospects of rescue – a secured creditor with a fixed charge over property is adequately protected if the value of the security is broadly stable or, by virtue of the continued trade and/or business rescue, likely to increase. In so far as the value might decrease, the creditor will be protected by a new money priority regime in any ensuing deed of company arrangement or liquidation *(see point below next)*
- ordinary course business sale proceeds of retention of title or floating charge property may be used for working capital purposes by the company and do not need to be set aside, subject to the relevant creditor being granted new money priority in any ensuing deed of company arrangement or liquidation for any loss suffered
- the deed of company arrangement and liquidation waterfalls are to be subject to the concept of First Objective administration new money priority – that is, certain claims arising during the administration are elevated in priority, including:
  - claims for losses relating to fixed security, to be paid ahead of employees

[27] The proposed stand still in the context of a legislative framework, which can continue for 6 months or greater, does not have the support of some of the people I spoke with, in particular a bank. There is a real concern the regime would be open to abuse, with creditors' positions deteriorating over time. I appreciate a need for the threshold criteria for maintaining a First Objective appointment to be robust and have suggested that the administrator have the power to end a First Objective appointment if the criteria is not satisfied. I also appreciate the need for the adequate protection measures to be robust, discussed in this section.

[28] Where debenture security, similar to an Australian fixed and floating charge over the whole or substantially the whole of a company's property, is created after the commencement of the *Enterprise Act 2002* (UK), the secured creditor is prohibited from appointing an administrative receiver. Rather, such creditor may appoint an administrator.

[29] 'Restricted from taking any other action because of the appointment' is broad – creditors cannot attempt to re-write contracts. Where suppliers have supplied pursuant to a particular set of terms, including by course of conduct over a period of time prior to appointment, they cannot seek to amend those terms following appointment.

- claims for losses relating to retention of title clauses or floating security, to be paid after employee claims

  For example, where inventory subject to floating security is sold in the ordinary course of business during administration, the proceeds are not set aside. However, if the company fails to approve a plan and is subsequently wound up, then there will be a super priority payment in that liquidation to put the relevant creditor in the position that they were at the commencement of the First Objective administration. If the creditor had pre-administration debt of $200 and inventory valued at $100, but in the liquidation inventory is valued at $50, then they will receive a super priority payment (ranking after employees) of $50.

- new money loans granted during the administration, are to be paid ahead of employees. Such loans are given priority status under any business rescue plan also.

  Given the priority status of new money loans, the quantum of such new money is to be approved by creditors or the Court. If there is an immediate new money need, that should be tabled at the first meeting of creditors for approval. A new money request needs to be supported by the financial forecasts. If further time is required to assess a new money need, the creditors could vote to delegate the decision to the creditors committee within an agreed basket.

  New money loans are not repaid during the administration, other than interest and if it is a working capital facility, out of ordinary course working capital. Flexibility will need to be built into the legislation for a longer administration, to permit the early repayment of new money loans if that is in the interests of the company and creditors overall, and there is adequate cash to do so (eg from an asset disposal).

- The concept of equalisation would also need to be introduced in the event that a rescue plan is not approved, to ensure that creditors are, so far as is possible, in the same position at the beginning of the administration as at the commencement of any ensuing deed of company arrangement or liquidation. For example, if as a result of ordinary course business, a working capital facility liability is less than it was at the commencement of the administration, the relevant lender would be obligated to equalise its position relative to other creditors.

  The equalisation obligation could be limited to distributions received under a deed of company arrangement or liquidation.

- The concept of permitted payments would need to be introduced. For example, payment of pre-administration principal debt is not permitted, other than in respect of continuing working capital facilities paid in the ordinary course of business.

Division 10, execution of a deed of company arrangement, to be modified to provide for execution of a restructuring agreement

- In the case of a First Objective appointment, it is a restructuring agreement (supported by such other documents as necessary) that embodies the terms of the rescue plan.
- There is no requirement for an Administrator to administer the restructuring.
- Ideally, the terms of a restructuring will not be regulated, other than where necessary, for example, to embody the principle of new money priority for new money loans made during administration. It is a matter for the company and its creditors to agree what the restructuring will entail.

- Generally, however, one would expect the agreement to provide the terms of the financial restructuring and the operational restructuring. If new money is being injected via debt or equity, there will be documents to reflect those arrangements.

Division 14, qualifications of Administrators; a First Objective Administrator is to be suitably qualified to deliver a business rescue plan

Whilst aligned, the skills and knowledge required to deliver a business rescue are different to the skills and knowledge required of a liquidator. In the UK, none of the financial advisors and CROs that I dealt with were registered liquidators (albeit they did not have control of a company, but rather advised the board). Liquidations and administrations were dealt with by separate practitioners.

I do not agitate for the registration of such persons. The critical factor is that the right people with the right skills are brought to the table. That said, I appreciate that given the degree of control and personal liability in any legislative framework, it is probable that registration would be agitated in Australia. This would be consistent with the call for greater supervision of such persons.

In my view, the ideal position is that restructurings are achieved outside of any formal framework. Registration of persons permitted to undertake formal business rescue (if so required), should not preclude others in the market giving restructuring and turnaround advice to companies outside of formal frameworks. Such advisors should also be entitled to take CRO appointments and advise creditors.

Section 449CA, DIRRIs; a First Objective Administrator may act where they have acted in a professional capacity prior to the appointment, including to give restructuring and turnaround advice before their appointment.

Indeed, it is desirable to retain such an Administrator. Ideally, a company will have attempted a business rescue outside of a formal framework, or alternatively, will have engaged an advisor to assist them with their financial forecast, business plan and business rescue plan, ahead of a First Objective appointment. The relevant person will be an ideal candidate to continue the work in a formal appointment, given their background knowledge of the company.

Moreover, as the Administrator is appointed to assist the company, with the creditors advised separately, independence should not be an issue.

Whether the Administrator could take a Second Objective appointment, which followed a First Objective appointment where the First Objective failed, would need to be considered.

Additional changes

Not every necessary change is addressed above. Of course, if there was a desire to amend the legislation along the above lines, there is another layer of detail that needs to be explored. There are concepts that I have mentioned only briefly, such as equalisation and requisite majority, that would need further consideration. Other concepts not mentioned, such as turnover, would need to be considered.

Such concepts however, and the proposed changes, all arise from entrenched practices in the UK and the USA. As such, there is much overseas precedence to be guided by.

Legislative regime or code of conduct?

This paper provides an outline of a possible legislative framework. If a code was the preferred course, some aspects would need to be revisited. For example, I anticipate the directors would remain in control and any agreement would require the unanimous consent of creditors.

Legislation is desirable, for example, where the company requires a comprehensive standstill across a complex matrix of creditor groups. I have been involved in a very complex restructuring where the standstill took almost a year to negotiate during which time the financial position of the company deteriorated and the relative positions of creditors moved significantly. This resulted in a significantly more complex restructuring negotiation. It was clear to me in that case, that a legislative moratorium would have been beneficial. Legislation also provides an avenue for agreeing a deal with less than unanimous consent.

A code of conduct is sufficient where the creditors the subject of the restructuring are less complex, for example, a restructuring agreed with one or a few financial creditors whilst trade creditors are paid in the ordinary course. A code of conduct allows creditors greater flexibility to agree specific terms bespoke to the particular company and creditors being restructured. Where the financial creditors are members of a syndicate or noteholders, there may be a mechanism for less than unanimous consent on some aspects of a restructuring, although more commonly, unanimous consent will be required. A code is only effective if broadly adopted by debtors and creditors.

Small to medium enterprises

There will be a question as to the suitability of the proposed framework for smaller business. As is the case with Chapter 11 in the USA, certain adjustments will be appropriate to ensure the regime is available to those businesses. Some I have mentioned, such as a shorter Forecast Period. Others aimed at managing the associated costs and fees will be desirable.

Critically, however, smaller enterprises will benefit from a cultural change which is led from the top. As a business rescue culture evolves which changes behaviours when faced with distress, all business both large and small will benefit.

6. More immediate law reform that would assist

Insolvent trading

Our insolvent trading laws constrain a free market

In a free market, directors of companies negotiate freely with their creditors to resolve credit issues. In Australia, section 588G of the *Corporations Act* is a form of regulation that greatly inhibits a director's conduct – and that of anyone concerned with being a shadow director – such that no-one is free to advise on and take decisions with respect to more serious credit issues in a trading context, other than to not incur debt and/or appoint an administrator.

The argument that a free market permits companies that are broke to fail might be true; but misses the point that we are not that free market. That is more aligned, for example, to the position in the UK, where parties are able to attempt to negotiate a turnaround, but if they cannot, the company fails.

It is readily agreed that Australia's insolvent trading regime, although not the harshest, is far tougher on directors than is the case in many of our economic trading partners, particularly the UK and the USA.

Some say that the risk of insolvent trading is overstated. However perception is reality

I was involved in the *Hall v Poolman & Ors (in the matter of Reynolds)* insolvent trading claim as solicitors for the liquidator. Irrespective of actual liability, there is no question in my mind that the perceived risk of bearing personal liability for debts is sufficient to influence behaviours, in a way that frustrates a productive turnaround culture in Australia.

A troubled company's executive team and board, key advisors and stakeholders, will be reluctant to engage in turn-around attempts and advice, due to the perceived risk of personal liability if those attempts fail.

Proposed defence

- In 2007 and again in 2010, it was proposed by many in the industry, including the Australian Restructuring, Insolvency & Turnaround Association, that a business judgment rule be introduced by way of defence to s588G of the *Corporations Act*.[30] There is no reason to further delay introduction of that defence.
- Alternatively, a defence could be developed along the lines of the UK law, whereby directors who act reasonably to avoid liquidation are not liable personally.

[30] See http://www.arita.com.au/in-practice/insolvency-law-reform/corporate-insolvency-law-reform/2010/01/18/corporate-insolvency-law-changes-783 under the heading 'Insolvent Trading'

7. Why change?

Transformational change

There will be arguments for and against the existing system. The evidence will vary.

Most will say that there is no burning platform, without which there will be other priorities for government.

What is proposed, however, is transformational change that alters our business landscape, providing greater scope for innovation and entrepreneurship, including in the face of failure.

There is a need today, given the difficulties faced by a number of Australia's traditional industries including the automotive industry, mining services and agribusiness, to consider change. Perhaps also, we should be concerned about the systemic risk in a nation heavily indebted to banks reliant on strong property prices and relatively low interest rates. We are vulnerable to a significant adverse movement in either of those factors.

However, there are the potentially far more significant and today, unquantified, threats of digital disruption. With the onset of online courses, universities face greater competition and likely lower revenues. 'Whats app' is threatening traditional telecommunications company revenue. The 'Uber' app is threatening traditional taxi company revenue. Google, Coles and pay pal are reported to be positioning themselves to take a slice of bank market share.

There is no guarantee that companies who perform well now, are shielded from underperformance in the future.

A robust legal system can support those companies through future change.

The Senate Committee is right, based on my experience, to look overseas for guidance on what changes we could make to deliver such a legal system to corporate Australia.

Benefits

Law reform which encourages and facilitates corporate turnaround will bring many benefits to Australia:

- As a developed economy, there is untapped potential in existing business – realising that potential lies in our ability to support their continuous revival and transformation.
- Our superannuation is heavily invested in existing business – we need to think more carefully about how we manage that value.
- The cost of business failure is not simply financial. The cost of associated mental health issues and divorce is also to be taken into account.
- It will address an imbalance in the existing landscape, which prefers creditors and disadvantages companies.
- We will better attract and retain quality directors through periods of change and financial vulnerability.
- We will better encourage collaborative innovation through periods of change and financial vulnerability.
- We will be more aligned to our global trading partners, and their approach to corporate turnaround.

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