CORPORATE INSOLVENCY LAW REFORM

An Autopsy on the Past and an Anatomy of the Future

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INTRODUCTION

Ron Harmer has conducted his autopsy/anatomy with a focus upon creditor rights, and the new administration procedure. I shall do the same. I propose to make some general comments about 'rescue administrations' overseas, such as they might predict the Australian experience; and to relate some of my forensic experiences in coming to terms with the new legislation.

RELEVANT OVERSEAS EXPERIENCES WITH RESCUE ADMINISTRATIONS

What evidence is there for the success of rescue administration?

A recent survey of Chapter 11 in the US[1] has found that nationwide Chapter 11 filings represent 4% of all bankruptcy filings since 1979. In a more restricted number of Chapter 11 cases surveyed, only 17% made it to confirmation (debtors and creditors bound); of confirmed cases only 60% will ultimately yield consummated plans; and of these approximately 25% will liquidate pursuant to those plans.

The net end result is that only 7.5% of total Chapter 11 cases filed will culminate in a consummated plan and a rehabilitated debtor.

Gratefully the survey reveals that larger debtors will more likely consummate a plan.

Peter Phillips of Buchler Phillips, London, provides these statistics on the use of administrations in the UK:

	1990	1991	half year to June 1992
liquidations	15,051	22,097	11,681
receiverships	2,587	4,100	2,177
administrations	211	206	52
corporate voluntary arrangements	58	137	41

When one takes into account the 25% of consummated plans that will liquidate pursuant to their plans, from the creditors' perspective there is a 10% chance of receiving the distribution promised in a confirmed Chapter 11 plan.

Statistics for the UK[2] also show that administration is resorted to much less than other insolvency administrations.

But when it comes to the crunch, ie the application to the court for the appointment of an administrator, a substantial number of debentureholders in the UK have permitted administration. Thus floating chargeholders consented to the appointment of an administrator by the court in 48% of the cases in 1987, 54% in 1988, 60% in 1989 and 50% in 1990.[3]

Of course in Australia there is no need to apply to the court for an administrator, and the floating chargeholder gets 10 business days to decide whether to appoint his own receiver.

A survey of administrators in the first year of the operation of the UK administrations revealed the following results:

UK: 'first year' study:

1.	restoration of the company to solvency	10	8%
2.	voluntary arrangements and survival of all or part of the business	15	11%
3.	voluntary arrangements as quasi liquidation	2	2%
4.	going concern sale of the business (and liquidation of the original company)	46	36%
5.	break up and subsequent liquidation	56	43%

Finally, the administration process is more formally integrated with the road to liquidation under the Australian forms. Not only has the road to rescue been simplified, but also the road to termination of a company's activities; and this without the necessity, for court intervention.

If indeed large businesses are easier to save than small, there will be plenty of Australian companies who will fail to propose, or to succeed under, a deed of company arrangement under the new procedure, because 82% of Australian businesses employ fewer than 20 employees, and 92% employ fewer than 50.[4]

SOME FORENSIC EXPERIENCES

I will endeavour to keep these in cryptic form. They are given to forewarn you of items which may provide you with little surprises as you inspect the body of a new corporate patient.

a) Secured creditor voting

The draft regulations to the new laws (submissions to change them required by May 19) encourage secured creditors to participate in the administration process by creating special voting rules.

> *Existing regulation 5.6.24 allows secured creditors to vote only to the extent of any shortfall in their security, or alternatively to waive their rights to security in order to vote in respect of their whole debt or claim. However, to import the provisions of regulation 5.6.24 into the voting of creditors at meetings under Part 5.3A would be contrary to the policy of the Part 5.3A procedure that secured creditors be encouraged to take part in the voluntary administration process to ensure its success.*
>
> *Thus, new sub-regulation 5.6.24(4), to be added by proposed regulation 24.3, will provide that regulation 5.6.24 does not apply to a meeting of creditors convened under 5.3A of the Corporations Law, with the result that, where a poll is demanded at a meeting of creditors under 5.3A, secured creditors may vote in respect of their whole debt or claim, without forfeiting their security.*[5]

The whole of regulation 5.6.24 is not applicable to a meeting of creditors under Part 5.3A.

This is consistent with the new section 444D which states that a deed of company arrangement binds all creditors, but not secured creditors, unless *the deed so provides in relation to a secured creditor who voted in favour of the resolution of creditors because of which the company executed the deed.*

The effect will be to grant considerable voting power to debentureholders and other secured creditors, including the voting power to determine whether the administrator be replaced, and what form the proposal is to take.

This proposal is to be compared with the UK position under an administration. In the UK, voting by a secured creditor to approve an administrator's proposal is based upon the unsecured amount after deducting the value of security. **But** the amount estimated as security does not prejudice recovery by the secured creditor in the event that the ultimate realisation from the secured property exceeds that value.

It is also interesting to compare the new Canadian *Bankruptcy and Insolvency Act* which came into force on 30 November 1992, and contains a new rescue proposal (Commercial Reorganisations).[6] Under that legislation creditors vote by class, but 'the votes of secured creditors do not count for purposes of determining whether the proposal has been accepted but decides whether or not the proposal will be binding upon that class of secured creditors'.[7]

b) Subordinated creditor voting

On the other hand, to avoid *the risk that subordinated creditors may take advantage of the proposed simplified voting procedure to improve their position by using their ability to veto proposals put by the administrator,*[8] they will be prevented from voting in all creditor meetings in respect of external administrations, where *in an instrument creating a subordinated debt or otherwise, [they have] relinquished all or part of* their rights to vote as a creditor.[9]

c) The chairman's 'casting vote'

The draft regulations give a highly unusual casting vote to the chairperson on a deadlock. He or she may now determine the outcome by exercising a 'casting vote' in favour to carry, or against to deny, a resolution which is otherwise deadlocked because a majority in number and value was required, but only one such majority is achieved.

The explanatory statement advises *it is envisaged that the exercise of such a casting vote would be most appropriate in circumstances such as where:*

> the creditors with the majority in value have such an overwhelming interest that it is inappropriate to allow a majority in number, who do not have the same monetary interest, to carry the day, or vice versa.[10]

d) Liquidation commencement and relation back

The date that winding up commences, or begins, has been redefined to the lay meaning. In a notorious example of legislative drafting, four sections are now required to define when a winding up begins, and it is far more difficult to read than before.

I hope you arrive at the same conclusion I do. A winding up will generally 'begin' or 'commence' at the date of a court order/voluntary resolution unless immediately preceded by the administration process, in which case it will begin or commence at the date of administration.

To be distinguished is the new 'relation-back' day, for the purposes of setting aside antecedent transactions, which is either the date of the application to wind up the company (court liquidation), or voluntary resolution, or if liquidation follows the administration process, the date the administrator is appointed.

Preferences (old 565) and dispositions (468) will no longer overlap.

Unfair preferences may be recovered during the six months (related persons 4 years) up to the relation-back day, and after that day up to the beginning of the winding up.[11]

By contrast, dispositions (section 468) may only be set aside if they occur after winding up commences. If there has been no administration, the only dispositions relevant are those that occur after the liquidator is appointed.

If there has been an administration followed by a liquidation, there are potential dispositions after the administration date. But proper conduct of the administration, and the saving provisions of the new legislation are likely to make such recoveries academic only.[12]

e) Transitional provisions

The transitional provisions are something of a nightmare. But it should be noted that the old undue preference section (565), and the old invalid floating charge section (566) continue alongside the new creations, though qualified so as only to apply to transactions that were incurred, or floating charges that were created, before the commencement of the new Part 5.7B.

This hopefully implies an intention that the parallel new provisions cannot be used to set aside transactions that occurred prior to the new provisions operating.

See also similar changes to section 567(5).

Ron Harmer has adverted elsewhere to the possible 'double' retrospective effect of the new law if transactions effected in the past, prior to the operation of the new laws, can be set aside by the application of the new law.[13]

f) Reckless trading

The concept of the director's duty to avoid the company's reckless trading is certainly an improvement. Recovery of proceeds has been 'democratised' by enabling the liquidator to recover for all creditors, and the presumption of insolvency upon failure to keep proper books and records will greatly assist the liquidator.

But recovery is still based upon the company incurring a debt, and the measure of damage or compensation is based upon the loss or damage suffered by the creditor(s) with whom the debt(s) was incurred. So we are still linked to the concept of incurring debts, which for the moment is hidebound to the earlier decisions where judges have struggled with the meaning of debt for the purpose of the predecessor reckless trading section, and have amongst other things, not been prepared to take into account accruing periodical liabilities.[14]

This would seem to mean that once insolvency is demonstrated (and all other elements of the case) then absent a distribution by dividend to unsecured creditors, the amount of loss to be recovered will only be the sum total of what the court perceives to be 'debts' incurred after that date and not for example accrued rent or interest or lease payments, etc.

g) Accountability for property of others

There is some disquiet about the opportunity that an administrator has to realise or deal with property secured (and for that matter property owned by others and used by the company during the administration period), without recourse by the secured creditor or owner. The source of disquiet is section 442C(2)(a) which permits a disposal in the ordinary course of business.

That power is desirable to preserve the company's business while the administrator is forging a proposal.

The scheme of the legislation is to impose a moratorium on action by secured creditors and owners and lessors for an interim period only. Then unless they are bound by a proposal, the moratorium comes to an end for them.

The scheme of the legislation is also to make the administrator personally liable for debts incurred, for services rendered, goods bought or property hired, leased, used or occupied (443A) and to impose personal liability for relevant amounts payable after 7 days, if the company continues to use or occupy or be in possession of property of which someone else is the owner or lessor (443B).

Given provisions of section 443E, a floating chargeholder is unlikely to have recourse against the administrator for property the subject of that floating charge which was so disposed of.

But a fixed chargeholder, or the supplier of goods under a valid retention of title clause would regard the administrator as having at least tortious liability (conversion) if the administrator disposed of his property and did not account once the moratorium had expired.

FOOTNOTES

1. 'Do confirmed Chapter 11 plans consummate? The results of a study and analysis of the law' Susan Jensen-Conklin, *Commercial Law Journal*, Commercial Law League of America Vol 97, No 3, 4 1992, p297 ff.

2. Source: Peter Phillips, Buchler Phillips, London, in a paper delivered to INSOL '93 Congress in Melbourne in March 1993.

3. From research carried out by Harry Rajak, Senior Lecturer and Director of the Insolvency Research Unit of Kings College Law School, London, and provided in a paper presented to the 5th International Insolvency and Banking Law Seminar held in Hong Kong during March, 1993.

4. Statistics provided by Rebecca Fruchtman in a paper entitled 'Corporate Law Reform Act, 1993: Australia's Voluntary Administration Scheme' made available at INSOL International Congress, March 1993 in Melbourne.

5. From the Explanatory Statement to the Draft Regulation, paragraphs 102-103.

6. 'Canadian Bankruptcy Reform: The move from liquidation to rehabilitation' - Derrek C Tay, published in *International Insolvency Review*, Spring 1993, Vol 2, Issue 1, p44 ff, at p50 (see also p53 which alludes to the secured party's role in a proposal).

7. 'Canadian Bankruptcy Reform: ...' *ibid*.

8. The Explanatory Statement, paragraph 89.

9. The Explanatory Statement, paragraph 87.

10. The Explanatory Statement, paragraph 95.

11. New sections 588FA and 588FE.

12. See new sections 451C, 437D and 437E.

13. Corporate Insolvency Law Reform Seminar, 21 April 1993, Blake Dawson Waldron, paper by Ron Harmer on Avoidance of Antecedent Transactions, p2.

14. See **Russell Halpern Nominees v Martin & Anor** (1986) 4 ACLC 393; **John Graham Reprographics Pty Ltd v Steffens** (1987) 5 ACLC 904; **Hussein v Good** (1990) 8 ACLC 390; **Jelin Pty Ltd v Johnson** (1987) 5 ACLC 463; **Castrisios v McManus** (1991) 9 ACLC 287 and **Bank of China v Hawkins** (1992) 10 ACLC 588. See also article by Andrew Brown in *Company & Securities Law Journal*, February 1993 at p34.