INSOLVENCY LAW REFORM - MAJOR ISSUES
THE IMPACT OF THE HARMER REPORT ON SECURED CREDITORS

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INTRODUCTION

The Harmer Report proposes a new regime of insolvency administration and recommends sweeping changes to the provisions of the Companies Code dealing with corporate insolvency. The Harmer Committee attempted to justify its specific recommendations by reference to nine fundamental principles:

"(i) The fundamental purpose of an insolvency law is to provide a fair and orderly process for dealing with the financial affairs of insolvent individuals and companies;

(ii) Insolvency law should provide mechanisms that enable both debtor and creditor to participate with the least possible delay and expense;

(iii) An insolvency administration should be impartial, efficient and expeditious;

(iv) The law should provide a convenient means of collecting or recovering property that should properly be applied toward payment of the debts and liabilities of the insolvent person;

(v) The principle of equal sharing between creditors should be retained and in some areas reinforced;

(vi) The end result of an insolvency administration, particularly as it affects individuals, should, with very limited exceptions, be the effective relief or release from the financial liabilities and obligations of the insolvent;

(vii) Insolvency law should, as far as it is convenient and practical, support the commercial and economic processes of the community;

(viii) As far as is possible and practicable, insolvency law should harmonise with the general law;

(ix) An insolvency law should enable ancillary assistance in the administration of an insolvency law originating in a foreign country." (para 33 of General Insolvency Inquiry, Vol 1).

Few of us would quarrel with this litany of general principles so far as they relate to unsecured creditors. Serious problems emerge, however, when one studies the way these principles have influenced the proposals relating to secured creditors.

THE NEW VOLUNTARY PROCEDURE FOR INSOLVENT COMPANIES

The Harmer Report recommends that a company in financial difficulties should be able to initiate, usually through its directors, a scheme of "voluntary administration". The company would simply make a declaration of financial difficulty and appoint a registered insolvency practitioner as its administrator.

The directors are not the only persons entitled to appoint an administrator. A person who is entitled to enforce a floating charge may, if the company has not already been wound up or placed under a voluntary administration, appoint an administrator. The chargee is required to state simply that default has been made in the payment of the moneys secured by the charge. Other defaults by the company will nor entitle the chargee to appoint an administrator.

Whether the administrator is appointed by the company itself or by the chargee, the floating charge will crystallise into a fixed security upon the appointment.

If the company itself makes a declaration of financial difficulty it must notify the holder of a registered charge over all its assets and undertaking. The chargee will then have seven days to decide whether to appoint a receiver or enter into possession personally or through an agent.

The rights of the chargee vary depending upon whether he takes action to enforce his security before or after the commencement of the voluntary administration.

WHERE THE CHARGEE ACTS BEFORE THE COMMENCEMENT OF THE VOLUNTARY ADMINISTRATION

When a secured creditor holding a registered charge over all the property of a company is notified that the company has made a declaration of financial difficulty, he may, within seven days of the appointment of the administrator, take possession of the property of appoint an agent or receiver to take possession of the property of the company.

The principal advantage of acting before the commencement of the voluntary administration is that the chargee can proceed to enforce the charge by entering into possession or by appointment of a receiver, unhindered by the new insolvency regime. This concession to chargees is more modest than it appears at first sight. Only a creditor holding a registered charge over all the property of the company is entitled to be given notice of the appointment of an administrator. Creditors holding unregistered charges which cover only some of the assets of the company need not be notified. Moreover, if a creditor holding a charge over all the property of the company elects not to take possession of the property of the company in the seven day period, he loses the right to intervene. He surrenders the right to control of the company to the administrator. Moreover, even if the chargee elects to enter into possession or appoint a receiver it appears that the chargee or his receiver will not be allowed to exercise a power of sale. Clauses VA 5(4) and VA 22(2) in the Draft Legislation clearly confine the chargee's enforcement rights to taking possession or control. This is an extraordinary restriction upon the normal remedies of a chargee. It is only lifted where a chargee purports to exercise a power of sale of perishable property. (Harmer Report, para 103, App A, Clause VA 22(5)(d)).

The Harmer Report will have an impact on a chargee even if he decides to act promptly to enforce his security. The chargee or his receiver can apply to the court on a specific ground for a determination of the validity of the appointment of a receiver or the entry into possession, as the case may be. This is a useful recommendation, but if the chargee enters into possession himself or assumes control of the property of the company for the purpose of enforcing his charge he must file a report on the affairs of the company within two months of entering into possession or assuming control.

The Harmer Report recommends that the court have power to remove a receiver from office or terminate the possession or control of the chargee on the application of the company.

The duties of receivers and chargees have been clarified and extended. The Harmer Report recommends that they be required to take reasonable care in the exercise of their powers, in particular in the management of the property. They should also ensure that the charged property is not sold at a price below the best price reasonably obtainable. An action for breach of this duty can be instituted by the company itself or a guarantor of the company's secured debts. This represents a significant departure from the obligations of a chargee under the general law, which merely requires him to act bona fide in the management or sale of the charged property.

THE DANGER IN DELAY

If the chargee elects not to enforce his charge within the seven day period after appointment of administrator, the administrator will take full control of the company and its property for a period of up to 28 days in the first instance. During this period of control, secured creditors cannot take steps to enforce their securities. Generally, the moratorium will last for 28 days, although it can be extended to 35 days or, with the approval of the court, for a longer period. The moratorium also prevents the chargee from bringing or proceedings any claim against the company or with respect to the company's property.

There are certain exceptions to this moratorium.

1. The chargee can exercise his rights under his security if he obtains the consent of the administrator or a court order exempting him from the moratorium;

2. The moratorium will not apply to receivers or other persons who have entered into possession for the purpose of enforcing a charge <u>before</u> the appointment of the administrator;

3. The moratorium will not apply to a secured creditor who has taken steps to sell the charged property <u>before</u> the appointment of the administrator. In the absence of a court order to the contrary, the chargee can proceed with the sale. A chargee is also permitted to exercise powers under his charge in relation to perishable property, notwithstanding the moratorium. Moreover, the moratorium does not prevent a chargee from giving the company a notice of default under the charge.

Since the company itself, through its directors, can initiate a voluntary administration as soon as the directors believe that the company is in financial difficulty, exceptions 2 and 3 offer little comfort to secured creditors.

How did the Harmer Committee justify this interference with the rights of secured creditors? It cited three principles to justify its so-called "limited interference":

(i) "promotion of an orderly dealing with a company's affairs so as to enable a more beneficial realisation of assets on winding up or possibly the rehabilitation of the business of the company".

This principle begs the question: "beneficial realisation of assets" for whom? It suggests that the charged assets should be realised in the interests of the creditors generally. Yet, once the charge crystallises the assets are treated as belonging in equity to the chargee. At least the chargee's inchoate equitable assignment by way of charge is perfected. To introduce a requirement that promotes a more beneficial realisation of assets on winding up is to erode the chargee's priority in the interests of increasing the return to unsecured creditors. This proposal might have been feasible in the

1860s before the Courts of Chancery recognised floating charges. In the modern commercial world it ignores the primacy of the chargee's priority and destroys a fundamental aspect of the chargee's security, notwithstanding the Committee's assurances to the contrary (para 102).

The reference to the possible rehabilitation of the business of the company are precatory words. Even the Committee itself appears to concede that the proposals might save only a "small percentage of the companies which, under the present procedures, have no alternative but to be wound up" (para 53). In the overwhelming majority of cases, companies which are "going to the wall" hit it! Few insolvent companies are salvaged. This is an unfortunate fact of life which the best of intentions cannot change.

(ii) The second principle cited as a justification for the restriction on secured creditors is "recognition that a debtor continues to have an interest in assets which are subject to the rights of others". In a time when secured creditors are forced to walk away from multi-million dollar losses this is indeed a flimsy justification. The chargee's floating charge usually covers <u>all</u> the assets and undertaking of the company and the company's equity of redemption is almost invariably worthless. This problem is endemic in a financial community which is lending on smaller and smaller margins at spiralling interest rates on the security of assets which fluctuate in value. In truth, the borrower has no real interest in the assets charged because they are mortgaged to the hilt. Why then interfere with the rights of secured creditors who are trying to recover their loans?

(iii) The third principle cited in justification of the moratorium is "recognition that particular assets may be necessary for a reorganisation of the company's affairs". Again, this justification assumes that the company has a future, that it will spin out of its temporary difficulties. It does not justify an erosion of the secured creditor's priority and his right to appoint a receiver when he wishes to assume control of the assets and undertaking of the company primarily in his own interests.

EFFECT ON PRIOR SECURITIES

The rights of secured creditors against one another are also affected. A receiver or other person who has entered into possession or assumed control of the property of a company for the purpose of enforcing a charge may apply to the court for an order authorising the sale of property subject to a <u>prior</u> security. The receiver would have to establish that:

(i) The property in question is subject to a fixed charge which takes priority over the floating charge under which the receiver has been appointed;

(ii) The sale of the property would be in the interests of the company and its creditors;

(iii) A sale of the property would be unlikely to realise sufficient to discharge the debt for which the property is security;

(iv) The receiver has taken reasonable steps to obtain the consent of the chargee of the property to the sale of the property and has been refused or cannot conveniently obtain the consent; and

(v) The rights of the chargee will not be substantially prejudiced.

The court will be able to impose conditions to protect the rights of the holder of the fixed charge.

At present a secured creditor can "stand outside the winding up" and rely on his security. The Harmer Committee recommends that the court be given power, on the application of the Committee, to restrain the secured creditor from enforcing his security.

THE RIGHTS OF SECURED CREDITORS IN THE LIQUIDATION OF THE COMPANY

The Harmer Committee has recommended that a liquidator should have power to apply to the court for an order to restrain a secured creditor from realising or otherwise dealing with the secured property.

The court would have regard to the conduct of the parties, proposals for the continued performance of any agreement between the company and a secured creditor and the degree of prejudice likely to be suffered by the company or its creditors generally. The court would have power to impose terms as to costs and to award damages for the period during which the exercise of the secured creditor's rights is restrained. Naturally, this right to damages will be illusory in most cases because the company will be insolvent.

The liquidator of the company will be given the right to inspect any books, securities, or other documents relating to the company's dealings, transactions, property and affairs. In particular, the liquidator will be authorised to have access to and to take copies of any books in the possession of secured creditors.

The powers of a receiver of a company in liquidation will be extended to include a power to carry on the business of the company as agent of the company after the commencement of winding-up with the consent of the liquidator or the approval of the court. This is a sensible proposal which will make it easier for receivers to realise the assets in an orderly manner. At present, a receiver is not entitled to carry on the business of a company in liquidation as agent of the company. If he attempts to carry on the business of a company in liquidation he will be unable to create debts or liabilities which are provable against the company in liquidation. Under the general law, he will be taken to be acting on his own behalf or as agent of the chargee.

In the liquidation of a corporate trustee, the liquidator's right of indemnity will be subject to the order of a court. This means that the right of a secured creditor who has appointed a receiver under a mortgage debenture can be protected by the court.

In the liquidation of a company, the court will have power to re-open transactions and make various orders for relief from transactions where the court is satisfied that the interest charged in respect of the loan or any amount charged in relation to the lending of the money was unfair having regard to the commercial risk, the value of any security taken for the loan, the time of repayment, the amount of the loan and any other relevant circumstances. This general jurisdiction to re-open extortionate transactions is similar to provisions in the moneylenders legislation.

PREFERENCES

It will be more difficult for a "secured creditor" to deflect a challenge by a liquidator that his security was granted at a time when the company was insolvent. The Harmer Report recommends that there be a rebuttable presumption that the company was insolvent at the time of any transaction which occurred with a period of ninety days before the commencement of the winding-up. This reverses the onus of proof of insolvency and makes it much easier for the liquidator to establish that a preference has been conferred.

The secured creditor will be able to retain the benefit of a preference if he can establish that he did not have reason to suspect that the company was insolvent. The normal protective provisions have been replaced by this single test. It appears, however, that there will be no preference where the secured creditor merely suspected a possible, as distinct from actual, insolvency. To this extent, the case law is preserved with all its attendant problems.

A three year limitation period is recommended for preference proceedings. The present limitation period is six years.

Secured creditors will derive some benefit from the proposed amendments to s.452. The exemption contained in that section will be extended to cover moneys paid at the direction of the company, as well as moneys paid to the company. Moreover, the exception will apply to floating charges which secure payment of the amount of any liability under a guarantee.

THE GOOD NEWS

(i) Group tax

Not all the news is bad. The Harmer Report recommends that the Commissioner of Taxation's priority under s.221P, 221YHJ, 221YHZD and 221YU of the Income Tax Assessment Act 1936 (Cth) should be abolished. This echoes the recommendation of the Missen Committee in 1978. It is unlikely that this recommendation will be adopted. In any event, in recent years the courts have emasculated s.221P and its counterparts.

(ii) The Commissioner's statutory charge

Of more significance is the recommendation relation to s.218 of the Income Tax Assessment Act 1936 and s.38 of the Sales Tax Assessment Act (No 1) 1930 (Cth). Essentially, the sections require third parties who owe moneys to the company to pay the Commissioner of Taxation instead. In this way, they assist the Commissioner to recover income tax owing by the company. Under recent case law, the Commissioner of Taxation's claim under those sections takes priority over a chargee whose floating charge had not crystallised before the notices under those sections were served on the company or the third parties within the purview of the sections.

The Harmer Report recommends a modification of the priority conferred by the sections. If the company concerned becomes subject to formal insolvency proceedings within six months of the receipt of the funds in question by the Commissioner of Taxation, the Commissioner will be obliged to repay the amount recovered to the insolvent estate. It is not clear whether the funds recovered in this way would be available exclusively to the secured creditor or generally for the benefit of the unsecured creditors in the winding up; presumably they are intended to swell the general pool of assets available to the unsecured creditors.

(iii) Reservation of title clauses

The Harmer Report also addressed the vexed question of Romalpa Clauses. A receiver and manager appointed by a chargee often finds that goods in the possession of the company are subject to a reservation of title clause under which the supplier can claim title for the goods notwithstanding their delivery to the company. The Harmer Report recommends a system of registration of agreements for the sale of goods providing for reservation of title to the goods pending payment. Secured creditors will be able to search the register to ascertain what goods in possession of the company are subject to reservation of title clauses.

(iv) Public utilities

One of the common problems faced by receivers and managers is an inability to obtain continuing supplies of goods and services such as gas, electricity, water or telephone services without paying the outstanding charges claimed by the public utilities. The Harmer Committee recommended that suppliers should not be able to make it a condition of supply that outstanding charges be paid. It did, however, recommend that the supplier be allowed to demand personal guarantees for the payment of the charges for subsequent supplies. This seems a reasonable compromise.

CONCLUSION

The Harmer Report is a bold and serious attempt to deal with corporate insolvency in a manner which promises a fairer return to unsecured creditors, but at the expense of secured creditors and revenue authorities.

It poses a substantial threat to secured creditors who stand to lose the benefits of their security during the moratorium period and any extension thereof by the court as well as their right to control the insolvency administration. The relative certainty of the time-honoured remedy of receivership will be displaced by vague restraints of indefinite duration. The legal and economic justification for this interference smacks of populist sentiment and naivety. If it were 1869 instead of 1989, the Harmer Proposals would be more realistic. But the advent of the floating charge changed the face of corporate insolvency. It is too late to turn back the clock. It is too late to deprive secured creditors of the comforts they have enjoyed for 120 years.

It is a pity that on the Harmer Committee did not learn more from the Cork Committee (Insolvency Law and Practice). Credit is absolutely essential in a modern industrialised economy. As the Cork Committee recognised, there is a direct link between every credit transaction and the health of society: "A sound banking and financial system is essential to the prosperity of the nation. It facilitates the exchange of goods and services and enables the most efficient use to be made of human and material resources. The provision of credit for trade and industry stimulates production and encourages enterprise as well as helping individuals and businesses over difficult times. These factors must in turn be matched by an acceptance by all involved that the sanctity of the contract is fundamental to the existence of business relations."

The debt-to-equity ratio in Australian companies has increased dramatically over the past 20 years. At the same time, the capacity of these companies to service their commitments is deteriorating. This is the root cause of many company failures in Australia. Pressures on profitability, irregular cash flow, relatively high inflation, spiralling interest rates, increasing demand for short-term finance - <u>all</u> these factors contribute to illiquidity and company failures. If lenders were discouraged from continuing to support small business or if lenders were compelled to raise interest rates even by one percent to compensate for the erosion of their securities, our economy would decline sharply. For these reasons, any proposals to curtail secured creditor's rights and remedies should be viewed with extreme caution.

The Harmer Committee is to be commended for its clear and comprehensive review of our insolvency law. Much more work needs to be done in this area but at least the Harmer Committee has clearly drawn up the lines of battle!