WORKOUTS

John Stumbles
Partner
Mallesons Stephen Jaques
Sydney

1. Parties involved in a workout

In the absence of fraud, the collapse of a corporate group is often preceded by early warning signals such as a request to waive or ease a borrowing covenant or a request to consent to the granting of a specific security as part of an asset financing.

At this time in a distressed company's life, there may also be differing levels of knowledge amongst creditors as to its financial health. Those financiers which may be closer to a borrower such as a transactional banker may have a detailed knowledge of the company's cashflow and of the cashflow of the group of which that company forms part. By contrast those more distant from the group such as hedge providers or trade creditors are likely to have less detailed information about a borrower or its group. An insolvent borrower[1] or a borrower facing imminent insolvency has to have regard to a wide range of stakeholders each of whom may have varying exposures to the borrower differing in type, amount or tenor and each of which may have distinctive issues which are of particular concern to them.

The composition of the creditors of an insolvent or nearly insolvent company may differ during a workout but at the outset, a typical profile of the creditors of a large distressed company includes the following:

[1] Henceforth unless otherwise indicated, references will be made to a borrower only it being recognised that statements made with respect to a borrower apply equally to companies within the borrower's group.

- institutional banks;
  - hedge providers and holders of credit default swaps;
  - trade creditors; and
  - preferred creditors such as employees and taxation authorities.

If the company has borrowed on the capital markets by means of a bond or note issue, there may also be a trustee for bondholders or noteholders and if the borrower has raised funds by syndicated borrowing, syndicated creditors may be represented by a facility agent.

Debt traders such as US vulture funds may approach institutional banks and offer to buy their debt at a discount. For the institutional bank considering a sale, a judgment has to be made between the certainty on sale of at least some known return on an exposure to a company and if no sale is made, the prospect of a full return over a longer period of time albeit coupled with the allocation of significant management time in the superintending of a workout.

For those institutional banks which stay the vulture funds are often regarded as unwelcome interlopers! The vulture funds may have an agenda very different to that of the institutional banks and preferred creditors. They may be satisfied if the return on their investment is merely 10 cents or some higher figure above the purchase price which they paid for the distressed debt. For them liquidation does not raise any necessary adverse consequences so long as there is some form of return on the initial purchase price for their debt.

Then there are the hedge providers. Their concerns may differ from the institutional banks and other players. Market conditions may result in their exposure being extremely volatile such that their aim would be to cap their exposure by exercising their close out rights and any rights of set off over funds which may have been deposited by the borrower with them.

In a large corporate group the concerns of employees or more accurately, their union representatives also need to be addressed in relation to issues of job security and payment of entitlements.

Last but by no means least are the directors and senior officers of the company. They may be willing to remain albeit reluctantly on the board of the borrower or in senior management positions within the borrower to reduce damage to their personal reputations occasioned by the collapse and so as not to be seen as 'rats deserting a sinking ship'. At the same time, they may be anxious about personal liability for insolvent trading if the company is not put into voluntary administration or liquidation.

In describing the workout of Marconi, a British manufacturer of telecom equipment, the position was described as follows:

> "The old, straightforward clash between a company and its creditors has been replaced by a mish-mash of interests. For example, an investor who bought debt yesterday at 20% of face value might be happy to be repaid tomorrow at 25% whereas another - an insurance company, say, that paid the full price for the bonds as a long term investor - might prefer to recover 75% in 3 year's time. The holder of a creditor default swap might prefer the company to go into bankruptcy. More complicated still, some around the table may be trading in and out of their positions each day, with their motives changing accordingly".[2]

2. Why do a workout?

In Australia & New Zealand companies legislation provides for a range of more formal procedures if a company is in financial difficulty:

- receivership (usually only if security has been granted to creditors);
- administration (Australia only);
- statutory management (New Zealand only);
- provisional liquidation;
- liquidation; or
- scheme of arrangement.

2 *The Economist, May 17 2003, 67.*

A receiver appointed by a secured creditor under a charge has a wide range of powers to satisfy the claims of the secured creditor which appointed the receiver. Although receivership does not result in an automatic stay of proceedings against the company, the existence of the charge over the secured property effectively eliminates other claimants from accessing the secured property. Receivership also reduces the extent of court intervention in the actions of the receiver unlike the case with voluntary administration or liquidation where the courts are often more intrusive. The majority of the candidates for a workout have usually borrowed on an unsecured basis such that receivership is not an available option. Court appointed receivers are rarely used in these circumstances[3].

In contrast to receivership, the procedures of voluntary administration and liquidation result in an automatic stay of proceedings being brought against a distressed company without the leave of the court in the case of a liquidation or without the leave of the voluntary administrator or the court in the case of a voluntary administration. This requirement thus prevents certain creditors from taking individual enforcement action against a distressed company although it would not prevent the service of demand or the close out of certain contracts and the subsequent exercise of a right of set off. Nevertheless, these procedures do provide a degree of protection against blackmail by dissentient creditors who do not wish to agree to any form of moratorium. In addition, a compromise via a deed of company arrangement only requires the consent of a majority creditor in number and value voting at the meeting rather than the consent of all creditors.

Another useful procedure for effecting a workout, and often used in Asia and to a lesser extent in Australia, is a scheme of arrangement requiring the consent of a majority of creditors in number voting at the relevant meeting to approve the compromise where those creditors' debts amount in aggregate to at least 75% of the total debts of the distressed entity.[4]

It is thus legitimate to ask: Why would a company opt for a workout based largely on contractual undertakings amongst creditors when other procedures are available which may impose an interim stay on creditors taking action

3 *Bond Brewing Holdings v National Australia Bank Limited [1991] VR386*

against the company and enable a proposal to be propounded which does not require the unanimous consent of all creditors?

Whilst the particular circumstances of a company may differ, in some cases a contractual workout may be preferred to more formal insolvency proceedings. Formal insolvency proceedings may trigger cross default clauses in a range of other facilities not in default, thereby exacerbating the distress in which the company already finds itself and putting renewed pressure on its cashflow. An appropriately drafted standstill or waiver clause or variation to existing arrangements may avoid this outcome. Secondly, formal insolvency proceedings could seriously damage a company's goodwill and business and again result in the termination of contracts and arrangements (for example supply contracts or distributorship arrangements) which are vital to the ongoing operation of the company's business. Even if those contracts are not terminated, the risk of termination may force the contracts to be renegotiated on less favourable terms. As a variant of the foregoing, formal insolvency proceedings could adversely impact on the terms of trade with ordinary trade creditors and crystallise other liabilities such as bonds for environmental remediation.

The risk of damage to goodwill and business coupled with the exacerbation of cashflow problems occasioned by formal insolvency proceedings have significantly influenced major creditors in opting for a contractual workout in preference to other available procedures. Usually these arrangements are entered into by the major creditors of a borrower. The arrangement stabilises the company such that minor creditors, trade creditors and the like are comfortable to continue to deal with the company in the knowledge that its major bankers have provided the necessary ongoing support.

Unlike formal insolvency proceedings, a workout may also offer more flexibility and less risk of judicial intervention. Since workouts are ordinarily driven by major creditors, the ability of major creditors to focus management on their particular needs rather than the needs of the 'butcher, the baker and the candlestick maker' means that major creditors may exert greater influence on the manner in which the distressed company continues to conduct its

[4] For a recent example of this, see the scheme arrangement in *Re Bulong Nickel Pty Ltd (2002) 42 ACLR 52.*

business operations. Although a workout involves retaining existing management in place to conduct the business of the borrower and although management has to have regard to the claims of all creditors, the concern for other creditors (as distinct from major creditors) is less significant than is ordinarily the case in a voluntary administration or liquidation.

Costs can also be another factor favouring the use of a contractual workout. A voluntary administration or liquidation may involve greater involvement by a professional insolvency firm. Expensive professionals within the firm would be undertaking tasks which ordinarily would be performed by employees of the distressed company. The result is that the management and running costs of the distressed entity could increase significantly. In a workout, although the involvement of the financial adviser is essential, the financial adviser is less intrusive. The existing management continues to perform a greater number of functions than would be the case in the voluntary administration or liquidation.

3. Review of distressed company's circumstances

Before a workout plan is devised, the distressed company (usually in consultation with its major creditors) needs to perform a thorough review of its situation and options available to it. These matters for review are listed below, it being recognised that their importance could well differ with the particular circumstances of the distressed company or of the group of which the distressed company is a member. There may also be issues which are unique to the company.

3.1 Good core business

If a borrower or a corporate group has assets generating in normal times a strong cashflow sufficient to meet the claims of trade and similar creditors, this does provide a basis for a possible debt rescheduling. An important factor in the Burns Philp workout was the strong world class assets which the group had in yeast. True it was that at the time the group went into default it had poorly performing assets such as its herbs and spices business in North America. Nevertheless, its good core business coupled with management changes to the herbs and spices division and planned the sale of certain non-core assets provided a sound basis for working out a business plan and the

basis of a realistic variation of the existing debt arrangements and the rescheduling of that debt.

3.2 Directors and Senior Management

It is equally important that directors and senior management do not take fright because of the distressed circumstances of the borrower. They must also be confident that the workout has realistic prospects of success. At the same time, major creditors must have confidence in management. Sometimes it is possible to retain existing management but more often than not it becomes necessary to appoint an alternative chief operating officer from outside the borrower. The ability to find such a person in whom the market also has confidence also influences whether or not a workout is a viable option.

3.3 Information flow

A key feature which distinguishes companies in distress is poor information systems. Accounts and reports are often in such a mess that it is difficult to ascertain whether or not a particular division is making a profit or incurring a loss. Rescheduling requires trust between management and major creditors. Accurate and timely information flow is a vital element in establishing and maintaining trust. It is also another factor which enables a company and its creditors to determine whether or not a workout is viable.

3.4 Cashflow Projections

A distressed company usually experiences a shortage of working capital. A rescheduling must as far as is possible identify sources of new capital. This involves an analysis of whether the borrower can sustain additional debt and whether there is an alternative source of additional capital. Very often the latter only becomes available once the borrower's circumstances have been stabilised. In the interim, additional funding may be provided by major creditors with large exposures but only on the basis that such funding is secured and is capable of being repaid in full. Financiers would be unwilling to provide such additional funding if it is likely that the additional funding would not be repaid but merely result in an increase in their overall exposure to the borrower.

It is vital that the cashflow projections with respect to the distressed company are accurate. The projections should be run without taking into account any short-term cash preservation measures. Such cash preservation measures

are sometimes not sustainable and can have their own adverse consequences. Cashflow projections, together with a review of the company's latest financial statements, will help the company to determine whether and when, in the absence of such cash preservation measures, a payment default or financial covenant default under a loan contract or material contract will occur. A company's first worst case scenario is usually insufficient. The failure to reflect in a sufficiently realistic manner the company's financial difficulties, can contribute to false starts and wasted time in restructurings. This can occur not only because the company's officers may underestimate the extent of the company's problems but also because of a failure to fully appreciate the general economic environment in which the company operates. For example the price of a product may be experiencing a long term decline.

3.5 Material contracts

Another basic step is to conduct a review of all outstanding loan agreements and material contracts with major purchasers, long-term supply contracts and other critical arrangements. These agreements should be reviewed to identify whether the company's financial difficulties will trigger termination, breaches of financial covenants, cross default and cross acceleration provisions or mandatory pre-payment obligations. The review should also address negative pledge clauses which may prevent borrowing on a secured basis and dispositions of assets by the borrower if the borrower is to sell non core businesses. Particular attention should also be paid to boilerplate clauses such as non-pro rata debt repayments and whether these are affected by sharing clauses. Finally, regard should be had to the necessary majorities required under documents to effect amendments or waivers and the extent to which creditors may have set-off rights under the documentation.

3.6 Other review items

At the same time as the company and its major creditors either alone or together, review the entity's cashflow and material contracts, it will also be necessary to review other matters prior to concluding that the workout is the best available alternative for both the company and those creditors. These will include:

a) liquidation analysis: this will involve an assessment of the amount which creditors are likely to receive on a winding up and whether one or other of the formal insolvency procedures outlined in section 2 above is to be preferred to the workout. This will also involve a proper assessment of the claims of other creditors including trade creditors, employees and taxation authorities and whether these claims are capable of satisfaction without liquidation. If major creditors are supportive of a workout, it is usually possible to deal with the claims of other smaller creditors and obviate the need for them commencing winding up proceedings;

b) tax laws: if the reconstruction is to involve the sale of assets and/or the forgiveness of certain loans, consideration should be given to any adverse tax impact. For example, forgiveness of debt may result in a loss of future tax losses for the borrower. Alternatively, an asset sale may trigger a capital gains tax liability;

c) fiduciary duties of board: if acting for the distressed borrower, it is essential that the borrower and its directors each be separately advised as to their duties to shareholders and creditors and whether they are able to comply with any ongoing duties imposed upon them by special statutes. For example, environmental law may place additional duties on directors of mining companies. On occasion directors of distressed companies in a group which have few assets require indemnities from those companies which have more significant assets. Whether or not these indemnities will be provided, depends upon the actual circumstances of the corporate group, the scope of any existing directors and officers insurance which those directors may have and the importance of retaining those particular directors on the board;

d) insolvent trading: this will also involve an assessment of whether going forward, the directors will have an exposure for insolvent trading. If the directors are uncomfortable about these matters, then they may seek the appointment of a liquidator or voluntary administrator. Either event is likely to seriously prejudice the prospects of a successful workout;

e) financial adviser: in order to provide an independent means of verifying information passing from the distressed borrower to its creditors, it is usual for the company to appoint an independent financial adviser to facilitate this process. Steps should be initiated to identify the proposed adviser;

f) legal counsel for major creditors: at this stage it is also important for the major creditors to appoint a law firm to act for them. The firm will take instructions from representatives of the major creditors (usually via a creditors committee or the chairman of that committee). Their job will be to act for all the major creditors in documenting the workout and in advising on matters related to it. Necessarily that firm will not be able to act on inter-creditor disputes but it can form an important role of honest broker in facilitating the identification and resolution of issues. The terms of appointment will be recorded in a formal letter dealing with scope of retainer and any other conflict issue. Because the legal market in Australasia is comparatively small, it often happens that the law firm selected has already advised one or two creditors in relation to the matter. If this is the case, express consents and waivers should be obtained to reflect the new position. The firm's fees are the responsibility of the appointing creditors but they are usually reimbursed for same by the distressed company.

3.7 Creditor ranking

In a corporate group financiers may have lent at different levels within the group. Those who have lent to entities which own and control the operating assets may consider that they have a claim to payment ranking in priority ahead of creditors who may have lent to an entity at a higher non-operating level within the corporate group. The jostling amongst creditors over this issue may determine whether a workout is a possibility. A typical issue which emerges in these circumstances is whether set off rights should be shared or appropriated by the creditor to satisfy its own debt. Such an issue may also be vital to hedge providers. At the same time, creditors who have financed assets by means of special asset financing arrangements such as equipment leases may also assert a special priority claim on the basis that these assets and their use are vital for the ongoing continued operation of the entity and that they should be paid on a priority basis for the use of that equipment because all other creditors are benefiting from its use.

These disputes often go on behind the scenes. Nevertheless, unless major creditors are able to reach agreement amongst themselves on these matters and stabilise the borrower's financial circumstances, demands by employees and their representatives and other smaller creditors may emerge with greater force. Notwithstanding these disputes, many creditors see the sense in agreeing to share equally in the proceeds from the borrower or the group of which it forms part. They recognise that formal insolvency proceedings will damage the group and reduce the number of cents in the dollar which they may receive from the distressed company. The costs of resolving priority disputes amongst creditors may also be prohibitive and the result may be uncertain. Furthermore, the existence in Australia of class order guarantees (whereby in order to obtain certain accounting relief, each company within the corporate group guarantees the indebtedness of each other company in the corporate group) may render this issue irrelevant since each creditor may access on a pari passu basis the assets of all companies within the group.

Another possible factor is the risk of a pooling order. This may be made if a distressed company is within a group in respect of which dealings within the group have become so intermingled that it is not possible to differentiate between those assets which may belong to a particular borrower and those assets which may belong to other companies within the group. In those circumstances the court may order that the group be treated for insolvency purposes as a single entity[5].

3.8 Major creditor support and dissenting creditors

A contractual workout is only viable if the major creditors are unanimous in support. Communications between banks at the highest level are often used to bring reluctant major creditors to the table. The threat of liquidation may also awaken a recalcitrant creditor to the disadvantages of holding out. Once bound, restrictions on debt assignment (if possible) can lock parties into the arrangement. Structural subordination of unrestructured debt instruments can also be used to make holding out an unattractive option.

[5] For good survey of the Australasian and English law on pooling see *Whelan "Administration of Insolvent Groups - The Present Sate of Pooling (1998) 6 Insolv LJ 107.*

4. The Business Plan

The company should start preparing a draft business plan identifying not only immediate measures to preserve the unnecessary outflow of cash from the entity but also the longer term steps which are to be taken to bring the distressed borrower back to financial health. Ideally, these matters and the matters identified in section 3 above should be addressed prior to the company making a public announcement as to its financial difficulties.

If, as is normally the case, the distressed company needs additional capital, the business plan should also address the means whereby additional capital is to be obtained. If there is a major shareholder or cornerstone investor who perceives value in the core business of the entity, that shareholder or investor may be prepared to subscribe for additional capital in the company. Alternatively, a partial float of part the entity's operations may be considered together with the swapping by major creditors of some of their debt for equity in the enterprise. Consideration of the actual capital requirements of the distressed company should not be deferred for another day in the hope that something may turn up.

In the ideal world, a distressed company would announce its financial difficulties to the world at large and then proceed immediately to announce a plan to remedy same. In the real world, this does not always occur. A company may get into financial difficulties and then contact its creditors who then, in consultation with the company, have to engage in a review and the formulation of a rescue plan. The result is that the announcement, consultation with creditors, formulation of the business plan and its documentation are all running in parallel necessitating a cool head, strong leadership and co-ordination. It is usually those major creditors who have most to lose who take the leadership at this stage. They manifest this support by public statements that they are continuing to support the distressed debtor. Such announcements often pacify the ordinary creditors.

5. Structuring a contractual workout

5.1 Standstill phase

On the assumption that in order to maximise the chances of recovery, major creditors reach a consensus that there is no attractive alternative other than a contractual workout arrangement, an issue then arises as to how best to

document it. This question may arise in a context where there could well be a wide variety of agreements evidencing the claims of creditors including bilateral agreements, syndicated facilities, hedge contracts and trust deeds with trustees for bondholders.

Often it takes a considerable period of time to put these arrangements into place. As an interim measure a standstill agreement is often executed between the major creditors and the distressed company. Under such an agreement and as evidence of their ongoing support, the major creditors agree amongst themselves and with the distressed company to defer exercising rights vested in them under their applicable loan documents. The purpose is to maintain the status quo in order to give the parties time to determine whether or not a workout is possible and to assuage the concerns of lesser creditors. As indicated above, this is likely to require the resolution of a large number of issues between all major creditors and the debtor company as well as issues between creditors. Creditors do not grant such indulgences for nothing. The standstill agreement may well require the borrower to pay additional fees and interest to the creditors reflecting the additional credit risk in being exposed to a company in financial distress.

The standstill may be recorded by an exchange of letters between the distressed company and each of its major creditors or their representatives. If there are a large number of creditors involved from all over the world the obtaining of this consent can sometimes be a significant and difficult logistical exercise. For this reason it is also wise to select at the outset a realistic initial standstill period. If an unrealistic standstill period were selected, this may necessitate the need for the extensions of time which may be difficult to achieve amongst creditors, destabilise the whole process and prejudice the workout's likelihood of success.

At this stage, it is not uncommon for a creditors committee or steering committee to be formed by the major creditors. The creditors committee would identify issues of major concern to the distressed borrower and to its creditors, cajole and guide creditors in reaching a common position on these issues and then communicate such views to the borrower. Their final position could be evidenced by a document similar to a term sheet which outlines the

main parameters of any acceptable long term workout arrangement between the borrower and its creditors.

5.2 Documentation

The workout should then be recorded in and regulated by a more formal document such as a standstill agreement or an override agreement. Whatever the nomenclature, the document (to be signed by the borrower and all relevant major creditors) should aim to address the following matters:

- imposition of a no action clause in respect of all existing indebtedness to the distressed borrower;
- except for transactional banking facilities, prohibit further advances being made to the distressed borrower under existing documentation;
- ongoing funding for the borrower. This is contemplated in the agreement but usually detailed in a separate facility agreement.
- placing all creditors on common terms as regards fees, interest, set-off rights and sharing of moneys received;
- replacing undertakings and covenants and events of default by a common set of provisions applicable to all facilities. This could be achieved by a specific amendment to each underlying facility agreement. In large corporate groups which may have a significant number of such agreements in different continents, this can be impracticable and involve a separate consideration of a large number of individual agreements. As an alternative, an override clause could be inserted into the workout agreement whereby the terms of any existing arrangement would henceforth be replaced either permanently or during the standstill term by the substitute undertakings, covenants and events of default.

The covenants should be crafted in such a way as to accommodate the borrower's existing circumstances and avoid the situation whereby a borrower is in continual default of its obligations to its creditors thereby obviating the continual need for a borrower to approach its creditors for waivers or indulgences. Where the underlying documentation is governed by the law of one country and the

standstill agreement is governed by the law of another, local advice may need to be obtained as to whether, for example, a New Zealand law standstill agreement which overrides existing clauses in a document governed by say the law of New York, would be effective to vary that document;[6]

- asset sales and the sale of non-core businesses;
- application of sale proceeds derived from sales of assets and businesses;
- the creation of a creditors committee as a conduit for communication between the borrower and its creditors and as a mechanism for providing (where necessary) the consent of creditors to actions to be taken by the borrower;
- an ongoing business plan for the borrower and a mechanism for the approval by creditors of that business plan. The approval of the business plan and of any amendments to it is usually given by means of a negative consent viz: the plan is deemed approved unless indicated otherwise;
- the appointment of an investigating accountant to monitor the borrower's cashflows and management generally;
- reporting obligations. Commonly a distressed borrower would be required to report monthly by means of management accounts and quarterly or half-yearly by means of audited accounts.

6. Documentary and related issues

Having briefly outlined the scope of the main clauses which, as counsel for the creditors, one commonly encounters in a standstill agreement, it is appropriate to consider in more detail some of the more (but by no means all) significant legal issues which arise when documenting these matters. Space does not permit an examination of all issues including those peculiar to the borrower, such as obligations to shareholders and of continuous disclosure.

6.1 Creditors committee

The suggestion to set up a creditors committee or steering committee often arises in the frantic first few days following the revelation by a borrower of its

6 For a consideration of this issue in the context of a scheme of arrangement, see *Re Bulong*

dire financial circumstances. Apart from the desire of all classes of creditors to ensure that they are adequately represented on such a committee, the decision on whether to join the committee is often made without proper thought having been given to the full implications if a creditor were to assume this role. Membership of the committee means that a creditor may have greater influence on the conduct of the workout. As against that membership involves a considerable commitment of time and costs in respect of which a committee member may not necessarily receive proper reimbursement.

a) Agent or mere conduit of information

Members of the creditors committee may see themselves as a vehicle for distilling and passing onto other creditors information given to them about the distressed borrower. In practice a creditors committee does more than this. Depending on the wording of the standstill agreement, the creditors committee may be the vehicle for the provision of consent to the borrower to take certain action contemplated by the standstill agreement. The committee may also be required to grant a negative approval of certain matters such as the borrower's business plan and proposed asset sales. It may grant waivers. It may review draft reports to creditors and comment on them before final reports are settled.

In undertaking these roles a committee member is acting on its own behalf. However the member is also representing those creditors not on the committee who being aware of the responsibilities allocated to the committee in the documentation then proceed to rely upon committee members to properly fulfil their function.

Bowstead on Agency[7] defines an agent as follows:

> "Agency is the fiduciary relationship which exists between two persons, one of whom expressly or impliedly consents that the other should act on his behalf so as to affect his relations with third parties, and the other of whom similarly consents so to act or so acts. The one on whose behalf the act or acts are to be done is called the principal. The one who is to act is called

Nickel Pty Ltd (2002) 42 ACLR 52.

> the agent. Any person other than the principal and the agent may be referred to as a third party".

In the case of *Hospital Products*, Mason J provided the following classical definition of a fiduciary:

> "The accepted fiduciary relationships are sometimes referred to as relationships of trust and confidence or confidential relations ... viz., trustee and beneficiary, agent and principal, solicitor and client, employee and employer, director and company, and partners. The critical feature of these relationships is that the fiduciary undertakes or agrees to act for or on behalf of or in the interests of another person in the exercise of a power or discretion which will affect the interests of that other person in a legal or practical sense. The relationship between the parties is therefore one that gives the fiduciary a special opportunity to exercise the power or discretion to the detriment of that other person who is accordingly vulnerable to abuse by the fiduciary of his position" [8].

Having regard to these principles a creditor assuming the role of membership of a committee acts at least in part as agent for non-member creditors even if in a limited fashion. A member of the creditors committee should also assume that they owe fiduciary duties to non-member creditors. Potential credit committee members should be alert to these issues before assuming that role. It is nevertheless possible for committee members to protect themselves against some of the implications arising from their status and these are discussed further below.

b) Indemnity

At general law an agent has a right of indemnity from their principal in respect of matters undertaken by the agent in the course of the agent's authority. Conformably with this principle, members of the committee should require an express indemnity from all other

---

[7] *Bowstead & Reynolds on Agency,* article 1(1).

creditors benefiting from their exertions as committee members. The indemnity should extend to all liabilities incurred by them as a consequence of the performance of that office save possibly where they have acted fraudulently, dishonestly or with gross negligence[9]. Members of the committee should also be paid for the time and costs incurred by them in acting as committee members.

The indemnity should cover not just responsibilities allocated expressly to committee members under the standstill agreement. It should also cover matters arising from their role and in respect of responsibilities assumed in good faith by committee members but which the drafting of the standstill agreement may not adequately envisage. In practice, it often happens that in emergencies committee members have to make decisions on the run. The decision falls on them and there is simply insufficient time to approach all creditors for their views. Committee members should be protected in this type of situation.

c) Conflict of interest

The standstill agreement should also modify[10] the content of any fiduciary duty owed by committee members to other creditors.[11] For present purposes the duties of a fiduciary would include:

- the obligation to pass through to non-member creditors all information which they receive in their role as committee member to those creditors.

  This may not be possible where for example the borrower is in delicate negotiations concerning a possible asset sale and has conferred with the creditors committee on the terms of such sale. Ideally, the documentation should not require the committee to pass information to all other creditors in that type of situation;

- conflict of interest.

---

8 *Hospital Products Ltd v United States Surgical Corporation (1984) 156 CLR 41 96.*

9 *Cf Armitage v Nurse [1998] Ch 241.*

10 As to modification of the duty, see *Kelly v Cooper [1993] AC 205.*

11 As to the content of the fiduciary duty see the English Law Commission's Report "*Fiduciary Duties and Regulatory Rules*" *HMSO 1992.*

As agents, committee members must act in the best interests of their principals, that is, the non-member creditors. At the same time, committee members are also creditors. How can one reconcile the duty to act for all creditors with their own interest? Again, the documentation should address this issue and state expressly that in making a decision a committee member is fully entitled to act in its own interests without regard to the interests of other creditors and notwithstanding that the decision they make may prejudice the interests of those creditors;

- not to profit from the role as committee member.

A fiduciary may not make a personal profit from the office of fiduciary. The standstill agreement should expressly acknowledge the right of a committee member to receive payment for services as a committee member and also acknowledge the right of a committee member to act in other roles in its dealings with the borrower.

6.2 Insider trading

In any workout it is not uncommon for the borrower to require that participating creditors sign a confidentiality agreement requiring the creditor to keep confidential all information not in the public domain and which they acquire concerning the borrower. This is an issue for all creditors participating in a workout and is particularly relevant for those creditors on the creditors committee.

Some creditors especially the US vulture funds deliberately choose to take a passive role in investments which they make in distressed companies. They refuse to sign confidentiality agreements and ask not to be supplied with information relating to the affairs of the distressed debtor. They do this so that, as far as is possible, they have full freedom to trade their debt and not incur liabilities to purchasers of that debt on the basis of material non-disclosure of matters referable to the distressed debtor.

The issue arises if a creditor or committee member is in possession of confidential information and wishes to exit from the workout by selling its debt

to a third party. A seller of debt may be unable to transfer its debt to a purchaser free of liability as vendor without making adequate disclosure to the purchaser concerning the affairs of the borrower. Yet, proper disclosure may involve a breach of the confidentiality agreement and, it has been argued, a possible breach of duties which creditors in their workout owe to each other on the basis that creditors involved in a workout are similar to participants in a joint venture.[12]

Furthermore, a seller of debt in these circumstances may trigger a breach of the insider trading provisions in the Corporations Act.[13] Section 1043A of the Corporations Act applies not only to dealings in equities but also dealings in debentures as defined in section 9 of the Corporations Act. This raises the question of whether a creditor is free to transfer its debt without breaching the insider trading provisions of the Corporations Act.

Broadly speaking, insider trading is trading by a person who possesses information that is "material" to the price of financial products and which is not already known to other traders in the market.[14] The insider trading prohibitions contained in part 7.10 of the Corporations Act apply only to "Division 3 financial products". The latter term is defined to include securities. The word "securities" is further defined under section 92 of the Corporations Act to include debentures. Under section 9 of the Act the word "debenture" is defined to mean, "a chose in action that includes an undertaking by the body to repay as a debt money deposited with or lent to the body". The definition contains certain exceptions. Relevantly, a debenture does not include:

> "(a) an undertaking to repay money deposited with or lent to the body by a person if:
>
> (i) the person deposits or lends the money in the ordinary course of a business carried on by the person; and
>
> (ii) the body receives the money in the ordinary course of carrying on a business that neither comprises nor

---

12 *cf United Dominions Corporation Limited v Brien Proprietary Limited & ors (1984-1985) 157 CLR 1*

13 The position appears to be the same in New Zealand if the distressed debtor is a public issuer. See the definition of "Security" in the *Securities Markets Act 1988 (NZ)*.

forms part of a business of borrowing money and providing finance;

...

(d) an undertaking to pay money under a promissory note that has a face value of at least $50,000.

..."

In some instances, the borrowing vehicle in a large corporate group is a trading company with the result that the borrowing of money does not form part of the ordinary course of its business. If those circumstances subsist, the first exception to the definition of "debenture" may apply with the result that the insider trading provisions have no application. However, it would not be possible to rely upon this exception where a large corporate group borrows money through a special subsidiary whose only purpose is to borrow money and then on lend it to other companies within the group. In those circumstances it is difficult to say that business of that special subsidiary is not the borrowing and provision of finance. As an alternative, it may possible to evidence the then crystallised debt obligations by means of promissory notes of a value of $50,000 or more thereby relying upon the second exception stated above.

If it is not possible to fall outside the definition of "securities" and if it is not possible to rely upon the statutory exceptions for Chinese wall arrangements contained in section 1043F of the Act, the creditor who wishes to exit from a workout may be confronted with some potentially significant practical difficulties if that creditor is in possession of inside information.

As part of the sale process and assuming any existing confidentiality agreement to which the vendor is a party permits it, the vendor may make a disclosure to the purchaser concerning the debt which it is selling and contemporaneously require the purchaser to enter into a confidentiality agreement whereby the purchaser undertakes to keep that information confidential and not to sell the debts the subject of the sale until that inside

[14] *Corporations Act, section 1043A* together with the definition of "inside information" in section 1042A.

information becomes public. Such an approach would prevent the vendor breaching the tipping provisions contained in section 1043A(2) of the Act on the assumption that the debt is not traded on a financial market in the jurisdiction.

These arrangements may not however, avoid a breach of the dealing and procuring prohibitions contained in sections 1043A(1)(c) and (d) of the Act. Provided the vendor made adequate disclosure to the purchaser, it would have a defence to any criminal proceedings instituted on the basis of a breach of section 1043A.[15]

If a breach were established, however, a seller and purchaser of the debt would still be exposed to the risk of a compensation order under section 1317HA of the Act on the application of a disadvantaged third party. A court *may* relieve the seller or purchaser of debt from liability to a civil penalty provision or obligation to compensate the third party in relation to a contravention of the insider trading provisions if it appears to the court that both parties to the acquisition of the debt or agreement for acquisition of debt knew or had reason to have known the relevant information before entering into the transaction or agreement. The relief is discretionary and not available as a matter of right.[16] There is no legislative guidance or case law as to the circumstances in which that discretion will be exercised by a court. It is considered that the absence of dishonesty in the conduct of the seller or purchaser of debt will tend to favour the exercise of the discretion in favour of relief although the result cannot be guaranteed.

If relief is not granted then the seller and the purchaser of debt may be liable to a civil penalty of up to $200,000 and other consequences of breach of the financial services civil penalty provision. The seller may also be liable to compensate a potential purchaser and any third party who suffers loss as a result of the contravention. Conversely, a purchaser may also be liable to compensate the seller and any third party who suffers loss as a result of the contravention. In principle, neither the seller nor the purchaser should suffer loss as a result of the relevant contravention when each has the same information at the time of the relevant agreement or transaction. However, a

---

15 *Corporations Act, section 1043M(2).*
16 *Corporations Act, section 1043N.*

speculative claim might be brought by a party to the transaction or a third party if it suffered loss for other reasons arguing that the loss would not have occurred if the transaction had not proceeded.

It is also possible for a separate claim to be brought under section 1043L of the Corporations Act as to which there is no specific provision for relief from liability. Again it would be difficult to see a basis for a loss if the vendor and purchaser had equal degrees of knowledge. However, a speculative case might be brought by a party to the transaction if suffered loss for other reasons arguing that the loss would not have occurred if the transaction had not proceeded.

6.3 Shadow directorship

It is inevitable that creditors associated with a workout become involved in the affairs of a distressed borrower to a greater extent than would ordinarily be the case in the typical debtor/creditor relationship. A standstill agreement imposes significant restrictions on the freedom with which the borrower may deal with and manage its own assets. In this situation creditors especially those on the credit committee are acutely aware of the risk of becoming a shadow director of the borrower. The question is often asked: How far may a creditor go in imposing conditions on a distressed borrower as to the conduct and management of its business without crossing the line from being a mere creditor to becoming a shadow director?

Section 9 of the Corporations Act 2001 defines a "director" to include (for most purposes):

> "a person who is not validly appointed as a director if... the directors of the company or body are accustomed to act in accordance with the person's instructions or wishes".[17]

Of particular concern to a bank involved in a workout will be the bank's potential liability - by virtue of shadow directorship - if the company is later found to have engaged in insolvent trading in contravention of section 588G of the Corporations Act 2001. In certain circumstances, a company's liquidator or creditors may recover compensation from the company's *directors* for debts incurred by the company in contravention of section 588G,

and a bank, if found to be a shadow director, is likely to present a very attractive target. It is equally relevant if directors of a company are held personally responsible for breaches of occupational health and safety laws or environmental laws.

a) ***What is required to constitute one a shadow director?***

The state of the law in Australia regarding shadow directorship is presently quite uncertain, due to the relative paucity of judicial consideration of the issue. In the past ten years, there have been only two significant Australian decisions, both made by single judges of Supreme and Federal Courts. However, English and New Zealand decisions relating to essentially similar legislation are useful for supplementing the Australian case law, and a number of elements can be elucidated.

b) ***Control and decision-making***

In *Standard Chartered Bank of Australia v Antico*,[18] Hodgson J considered the key issue to be whether the alleged shadow director showed "a willingness and ability to exercise control, and an actuality of control, over the management and financial affairs" of the company, one manifestation of which would be that the directors of the company "simply accepted the decisions which had effectively been made by" the alleged shadow director. Finn J in *ASC v AS Nominees Ltd*[19] considered the crux of the issue to be: "Where for some or all purposes, is the locus of effective decision making?".

c) ***"Accustomed to act"***

In *Re Hydrodam (Corby) Ltd*,[20] Millet J (as he then was) was of the view that what is required to constitute a shadow directorship is "a pattern of behaviour in which the board did not exercise any discretion or judgment of its own, but acted in accordance with the directions of others".

The requirement is for a "pattern of behaviour" or a "course of conduct", which means that occasional instances of compliance will not be sufficient. The decision in *AS Nominees Ltd* illustrates that the

---

17 The definition of "director" in section 126 of *the Companies Act 1993 (NZ)* is to a similar effect.

18 *(1995) 38 NSWLR 290.*

19 *(1995) 13 ACLC 1822.*

converse is also true. In that case, Finn J held that there was such a pattern of compliance and that the occasional exercise of independent judgment by the board did not excuse the shadow director.

It should be noted that this element does not require that the alleged shadow director provide directions or instructions on all matters. Rather, it requires that as and when the directors are directed or instructed, they are accustomed to act in accordance with those directions or instructions: *AS Nominees Ltd.*

d) Attaching conditions to the continuation of financial support

In corporate workout situations, it is arguable if the directors have any real choice in deciding whether to accept the conditions a bank demands in return for the continuation of its support. At first glance this might appear to be a clear example (in substance) of directors "acting in accordance with the instructions or wishes" of the bank, pursuant to which the bank could attract shadow director status. However, the imposition of conditions in such circumstances has been the subject of specific judicial comment which tends to suggest the contrary. For example, in *Antico*, Hodgson J stated that:

> "...it is not uncommon for lenders to impose conditions on loans, including conditions as to the application of funds and disclosure of borrower's affairs; and it is even less uncommon for lenders to require security for a loan, and then to require the sale of property over which the security is given. Certainly, these factors on their own would not amount to assuming the position of a director, or taking part in the management of a borrower company".

In an article in *Insolvency Practitioner*, Millet J (as he then was) suggested:

> "The fact is that a bank has no business to be managing its customer's affairs, but it is entitled to attach conditions to the continuation of its support. So long as it does nothing that a bank does not normally do in telling its customers what it requires if it is continuing banking facilities, and leaves the

20 *[1994] BCC 161.*

> decision to the customer whether it will comply or not, in my view it cannot be held to have become a shadow director."[21]

Millet J considered typical conditions to be:

- sending in an investigating team;
- demanding a reduction in the overdraft;
- demanding security or further security;
- calling for information, valuations of fixed assets, accounts, cash flow forecasts, etc;
- requesting the customer's proposals to reduce the overdraft, including a business plan;
- advising on the advisability of restructuring management, seeking fresh capital, etc.

However, as has been pointed out elsewhere,[22] these conditions do not appear to give the bank any *ongoing* involvement in the management of the company's affairs, but are essentially 'once-off' concessions by the board. In such circumstances, Millet J's argument that the bank is entitled to exert legitimate commercial pressure to protect its own interests and is therefore not a shadow director is entirely apt. But given the ultimate questions of control posed by the Australian authorities (see above), extending that argument to conditions which afford the bank continued involvement in the company's management becomes problematic: it is not so much the imposition of the conditions that is significant, but the nature of those conditions. As Markovic has noted:

> "...when the conditions imposed by a bank in a business workout... effectively result in the bank having the final say with respect to [certain] management decisions, then the bank in reality is controlling key aspects of the affairs of the company and as such there must be a risk of shadow directorship notwithstanding that the conditions imposed by

[21] *Millet, "Shadow Directorship - a Real or Imagined Threat to Banks" Insolvency Practitioner (Winter/January 1991) 14.*

[22] *Markovic, "Banks and Shadow Directorships: Not an 'Almost Entirely Imaginary' Risk in Australia" (1998) 9 JBFLP 284; Turing, "Lender liability, shadow directors and the case of re Hydrodam (Corby) Ltd" [1994] 5 JIBL 244.*

> the bank may be considered to be legitimate commercial pressures in a business workout situation."[23]

On this analysis, conditions that could potentially be found to amount to a 'usurpation' of the directors' decision making powers might include:

- the board agreeing to implement all business recommendations made by the bank, or one or more of its employees or nominated third party advisers[24];
- a requirement that the bank's consent be obtained in relation to certain business or management decisions, such as payments, investments, capital expenditure, dividends, staffing, etc. (ie positive consent);
- the bank having a veto power over such management decisions (ie negative consent);
- the bank becoming a signatory on the company's accounts.

A creditor's monitoring of company accounts and control of company payments was found by the English Court of Appeal in *Re Tasbian Ltd (No 3)*[25] to raise "at least an arguable case" of shadow directorship, although the more recent decision of *Re PFTZM Ltd*[26] was of the view that the requirements that creditor approval be obtained for company payments and that company revenue be paid into a creditor-controlled account were insufficient to disclose a prima facie case that the creditor was a shadow director.

In finding a lender parent company to be a shadow director of its borrower subsidiary, the court in *Antico* considered relevant the condition that no new financial commitments were to be entered into by the borrower subsidiary, or payments made, without the lender parent's consent, although it must be noted that other instances of interference in the subsidiary's management were found (of a kind that could probably be classified as a greater usurpation of the

---

[23] *Markovic, ibid at 302.*

[24] For the bank to be liable in the last-mentioned case of an appointed third party adviser, it would be necessary for the liquidator to demonstrate that the adviser was acting as the bank's agent; see *Stoney, "Borrower Companies Approaching Insolvency - The Potential Liability of the Lender as a De Facto Director" (2000) 8 InsolvLJ 192 at 199.*

[25] *[1992] BCC 358.*

[26] *[1995] 2 BCLC 354.*

subsidiary's management discretion), and given also the relationship of parent-subsidiary, it is therefore unclear whether the financial control alone would have been sufficient to constitute the parent a shadow director. In *PFTZM* weekly meetings were held between the debtor and creditor which reviewed the previous week's trading activities. Funds from the creditor-controlled account were only released for purposes identified in the proof at these weekly meetings. Creditors determined who received payment and how much they were to receive.

e) Exercise of influence

Given the Court's statement in *Antico* that what is required is an *actuality* of control, it is possible that an unexercised veto power attached to a workout finance arrangement (ie a negative consent condition) may not be sufficient on its own to make a bank a shadow director. In such circumstances the bank is not directing or instructing the board - the board continues to exercise its own discretion and thus may be said, in the words of Finn J in *AS Nominees Ltd*, to remain the "locus of effective decision making".

f) The 'advice' exception

The definition of "director" in section 9 of the *Corporations Act 2001* makes it clear that merely giving advice "in the proper performance of the functions attaching to the person's professional capacity or to the person's business relationship with the directors" does not make one a shadow director, even if the directors are "accustomed to act" in accordance with those "wishes". The purpose of the exception is to provide for the common situation where advice is proffered to the board but, importantly, the board gives proper consideration to the advice and remains free to exercise its discretion whether to follow it or not; in such a case it can truly be said that the "locus of effective decision making" lies with the directors, not the adviser.

What of banks then in a workout situation, who often wish to guide the company out of trouble? In addition to the imposition of various express conditions in return for financial support (already dealt with above), banks may also take a greater 'non-contractual' interest in management decision making, such as attending board meetings or appointing a third party consultant to give business and management

advice to the borrower. In many circumstances, the lender may rightfully argue that such guidance is a proper function of its business relationship with the borrower in a workout situation. However where the board's obedience to the bank or its nominated consultant is tied to the banks continued support (expressly or impliedly), there is a serious danger that the bank will have gone beyond simply giving advice pursuant to the normal lender-borrower relationship, and will have begun, willingly and actually, to exercise effective control over the company's affairs - the directors merely acquiescing in the usurpation of their authority - thereby taking it beyond the 'advice' exemption.[27]

As Vinelott J noted in *Re Tasbian Ltd (No 3)*: "The dividing line between the position of a watchdog or adviser... and a de facto or shadow director is difficult to draw..." and much will depend on the particular facts of any given arrangement.

g) Conclusion

Regardless of how its influence arose - be it contractual or merely a matter of practice - a bank involved with company management in a workout situation would do well to heed Lord Millet's caveat that "a bank has no business to be managing its customer's affairs". The two key sources of potential liability are, first, the imposition of conditions for the continuance of financial support *where the nature of those conditions* is such as to give rise to a significant ongoing decision making role for the bank in the company's affairs, and secondly, the method whereby the bank conveys its opinions about how the company's management decisions should be made such that board becomes accustomed to "simply accept the decisions which had effectively been made"[28] by the bank.

Although such English authorities as *Re PFTZM Ltd* and Lord Millet's extrajudicial writings suggest that a bank is perfectly entitled to apply legitimate commercial pressure and attach whatever conditions it likes to the continuation of its financial support - all of which may be said to be justified by a public policy interest in banks actively assisting in rescuing troubled companies - ultimately one must return to the

27 Stoney, op cit n 11 at 194.

28 *Standard Chartered Bank of Australia v Antico (1995) 38 NSWLR 290.*

purpose of the shadow director provisions: those who actively participate in company decision making, for whatever reason and however that participation comes about, ought to be subject to the same obligations as properly appointed directors.

In practice, this issue is never resolved for creditors in a completely satisfactory fashion. The best advice is to be constantly alert to this issue in all oral and written communications with the borrower. It is suggested that to reduce the risk as far as is possible, the use of a negative consent procedure is to be preferred. Conditions for continuing support could be structured around a high level business plan which, together with any amendments thereto, set the framework for the various decisions to be made by the borrower's directors in the workout. The business plan is accepted unless the creditors indicate otherwise. If they do so indicate, the borrower is required to submit a further plan. If the lenders do not indicate that they disapprove of the plan, then the plan becomes the regulatory document. It is then up to the directors to determine how and with whom the plan will be implemented. As a further form of protection, minutes and/or file notes should be kept of meetings between representatives of the distressed company and its creditors. If an allegation of shadow directorship is made, such records will become vital evidentiary tools for a creditor in disproving the existence of shadow directorship.

As a postscript to the above analysis, reference should also be made to the recent decision of *Emanuel Management Pty Ltd (in liquidation) & Ors v Foster's Brewing Group Ltd.*[29] In that case, the liquidator of an insolvent property group which had defaulted under its loan arrangements with the Elders Finance Group brought an action against Foster's Brewing. Elders Finance was part of the Foster's Group. Following the original loan default, officers of Foster's Brewing had engaged in lengthy negotiations with the plaintiff as part of a workout. In performing this activity, the liquidator alleged that the employees became de facto directors of the relevant insolvent companies and that as a consequence, their employer Foster's also became a de facto director. The liquidator sued Foster's for amongst other things breach of their fiduciary duties as directors, compensation

for insolvent trading and for misfeasance. The trial judge canvassed the authorities referred to above and other cases referred to in those authorities. After a careful review of the minutes of meetings between representatives of Foster's and the distressed company, His Honour concluded that the distressed debtor companies did not become accustomed to act in accordance with the instructions or wishes of Foster's employees. In reviewing the evidence, it was also notable that His Honour took a practical approach to requests from the creditors for the distressed borrower to take certain action. He noted that in many cases these requests were ignored and that there was no evidence of a "regular or common or habitual deference" to Foster's requests. Concluding that shadow directorship was not made His Honour said the following:

> "This is not to say, of course, that a mortgagee can never come to the situation where it is controlling so much of the activities of a mortgagor company that it becomes *de facto* director. The reasons described by Millett J in his article show that that situation will not ordinarily arise where the mortgagee is engaged in a 'workout' with its mortgagor with a view to maximising the return on mortgaged property for the mutual benefit of both."[30]

h) Occupying position of director

For completeness, brief reference should be made to the risk that a creditor or creditors committee actually acts in the position of director rather than being the mere puppet master who pulls the strings. Part of the plaintiffs' case in *Emanuel* alleged that this other limb of the definition of director was also made out. This allegation was rejected, His Honour opining that there was no evidence that the creditors were involved in senior management decisions within the plaintiff group. Nevertheless, the fact that the allegation was made in *Emanuel* (albeit unsuccessfully) is a warning for creditors to leave management decisions in the hands of the officers of the distressed company. The use of a high level business plan is one strategy to facilitate this result.

---

29 Supreme Court of Queensland, 17 July 2003 per Chesterman J.
30 at para 380 of the judgment.

6.4 Acting as officer of company

Creditors should also consider the extended definition of "officer" in the Corporations Act which is defined to include the following:

> "(b) a person:
>
> (i) who makes, or participates in making, decisions that affect the whole, or a substantial part, of the business of the corporation; or
>
> (ii) who has the capacity to affect significantly the corporation's financial standing; or
>
> (iii) in accordance with whose instructions or wishes the directors of the corporation are accustomed to act (excluding advice given by the person in the proper performance of functions attaching to the person's professional capacity or their business relationship with the directors or the corporation);"

The issues associated with paragraph (iii) above are similar to those which arise in the context of shadow directorship. In addition to this concern, creditors in a workout should also consider whether they make or participate in the making decisions that "affect the whole or a substantial part of the business of the corporation" or whether those decisions have the "capacity to affect significantly the corporation's financial standing". These issues were recently considered by Santow J in *Re HIH Insurance Ltd (in prov liq) and anor; Australian Securities and Investment Commission v Adler*[31]. Rodney Adler was a director of HIH. He also sat on that company's investment committee, the terms of reference of which included amongst other things the approval of investments made by companies within the group. One such company included HIH Casualty and General Insurance Co Ltd. In acting as a member of the investment committee, the issue was whether Adler was also thereby rendered an officer of the subsidiary company. Because of the intrusive manner in which the investment committee determined investment

[31] (2002) 41 ACSR 72.

strategies of companies within the group, Justice Santow had no hesitation in concluding that Adler was an officer by virtue of sub-paragraphs (i) and (ii) respectively of the above quoted definition. If a creditors committee becomes too intrusive, it is easy to see how its members and possibly the other creditors on whose behalf it acts could also be officers as so defined. An officer (as distinct from a director of a company) is not liable for insolvent trading under section 588G of the Corporations Act, but an officer is subject to the obligations of care and diligence and good faith contained in sections 180 and 181 respectively of the Corporations Act.

6.5 Preference risk and old money

Commercially, creditors may require that the respective debts owed to them by the borrower are on identical terms and conditions so that there is no differential in trading price if a creditor wishes to trade its debt. To achieve this result, a suggestion is sometimes made that all old debt be repaid and that this be funded by a separate new advance under a new secured facility. It is then argued that the debt would be on the same terms and is secured and because the security secures new money, the security would not be subject to avoidance as a preference.

Creditors should proceed with caution in this area. If a borrower becomes distressed, it is generally safer to work with existing rights rather than create new rights in return for the surrender of existing rights. Although in reliance on the cases concerning running accounts, there is an argument that repayment and a readvance effects in substance no depletion in the economic circumstances of a borrower and thus does not constitute a preference, there is always a lingering concern with double exposure. If the borrower ultimately has to go into liquidation then unless the original loan was properly secured, a liquidator may attempt to claw back the original repayment on the basis that it was preferential. If the liquidator were successful, a creditor would then be left with proving for its old money as well as for any new advances. Directors of the borrower may also have concerns that they may be exposed under section 588G of the *Corporations Act* for insolvent trading if they authorise the drawdown of new funds to effect repayment of old money when the latter was borrowed in circumstances where the borrower was in a healthier financial condition. As mentioned

above, the same result may be achieved by means of an override arrangement without these possible disadvantages.

6.6 Preference risk and new money

The position with new money may be contrasted with that old money. As mentioned earlier often borrowers in distress require additional funding to keep going. In these circumstances, financiers always lend on a secured basis and require priority ahead of all old money. This requirement is not disputed. There is also no issue of preference in respect of fresh advances being made to a distressed company on a secured basis.

In the negotiation on the terms of the new money facility, a tension may emerge between the creditors advancing the new money and those creditors with old debt especially if the respective groups of creditors are not identical. Generally, the former will require the right to call a default under the new money facility without reference to existing creditors it being recognised that creditors advancing new money thus have the right to force the hand of old creditors in a default situation. Sometimes this right is attenuated to some extent by provisions requiring that the new creditors give notice to old creditors or requiring some form of consultation between new creditors and old creditors before action is taken. Creditors providing new money will also wish to ensure that to the maximum extent possible their debt is secured by means of a fixed charge or legal mortgage thereby preventing the dilution of their security rights by preferred creditors.

If fresh advances are to be made it is important that the directors of the distressed entity are confident that the debt represented by the new money is capable of repayment and that they are not engaging in insolvent trading.

6.7 Voting entitlements

In the crafting of the workout, careful consideration should be given to those decisions which the distressed company is free to make without reference to creditors and those actions which it is required to take subject to obtaining the consent of creditors. As is the case with syndicated facilities, it is preferable that only a narrow range of decisions should require the consent of all creditors. The bulk of decisions should be subject to the consent of the majority creditors (which traditionally may be defined as anything ranging from 50.1% to 66.66% of creditors). Furthermore, the consent mechanism

should be carefully structured (for example by reference to a business plan) so as to reduce the likelihood that the provision of consent does not constitute creditors shadow directors.

A minority of creditors (in reliance on the principles of fraud on the minority used in shareholder disputes) may from time to time complain about decisions forced upon them by majority of creditors and threaten to institute legal proceedings. Provided in exercising their voting power the majority of creditors acted in good faith and without fraud and provided there is no evidence that the resolution was passed with the object of oppressing the minority or depriving them of their rights, the decision of the majority should prevail even if in the result the minority is subject to a form of discrimination.

This principle has been recently illustrated in the decision of *Redwood Master Fund v T D Bank Europe Limited & Ors*[32]. In that case, Redwood and other US vulture funds challenged a corporate workout the essential terms of which were that providers of undrawn facilities (tranche A) should permit drawings under that tranche in order to reduce the drawn component of another part of the facility (tranche B). A majority of creditors had obligations under both tranche A and tranche B. However, Redwood and certain other creditors only had obligations under tranche A. The result was that Redwood and a group of similar funds would be forced to advance up to US$30.8 to the borrower (UPC) so that it could repay its other creditors.

Relying on the decision of *British America Nickel v M J O'Brien*[33] that "the power given [under majority voting provisions] must be exercised for the purpose of benefiting the class as a whole, and not merely individual members only", Redwood argued that the vote was voidable because it did not take into account the interests of all the creditors and discriminated against tranche A obligors. The judge found that the workout was negotiated in good faith and concluded that a creditor could vote in its own self interest and rejected that challenge: "By signing up at the outset, each lender submits to the decision of the majority lenders at important forks in the road. The decision of the majority to allow the company to trade would be exactly the

---

32 *[2002] EWHC 2703 (Ch).*
33 *[1927] AC 369.*

type of decision that the [majority voting] clause was directed at enabling the majority lenders to make".[34]

The decision is a welcome reaffirmation that such clauses mean what they say even if a certain group of creditors may be disadvantaged by an application of the clause. It is recognised however that these matters are dependent on their facts and in the instant case dependent on the judge's conclusion that the parties were not acting in bad faith or misusing the voting clause.

6.8 No action clauses

Under these clauses, the creditor undertakes that it will not institute proceedings to wind up the company or purport to challenge the workout documentation. On occasions such clauses are qualified and permit action if the majority of creditors consent.

A question which is regularly asked is the extent to which no action clauses are effective particularly where the clause operates to prevent a creditor bringing proceedings to wind up a corporate borrower. In Australia, the matter is not completely free from doubt. The current edition of *McPherson, The Law of Company Liquidation (4th edition, 1999)* concludes (as it has done in previous editions) that there is "little reason for doubting" a covenant not to bring proceedings to wind up a company "would offend against the policy of the Corporations Law".[35] The High Court of Australia decision of *Community Development Pty Ltd v Engwirda Construction Co*[36] expressly leaves the question open. However, the judge at first instance in the latter case opined that the earlier English case of *In Re Peveril Gulf Mines Limited*[37] was not authority for the proposition that covenants not to wind up a company were ineffective on public policy grounds[38]

---

[34] *Redwood Master Fund v TL Bank Europe Limited & Ors [2002] EWHC 2703 (Ch)* at para 98 of judgment. In reaching his conclusion Rimer J relied on the leading Australian case on fraud on the minority: *Peters American Delicacy Company Limited v Heath (1938-39) 61 CLR 457*. Compare this with *Sydney Land Corporation v Talon Pty Ltd (No2) [1998] 16 ACLC 95 540* where a creditor successfully argued that a deed of company arrangement was voidable on the basis that it was oppressive to its interests.

[35] At page 53.

[36] *(1969) 120 CLR 455-460.*

[37] *[1898] 1 Ch 122.*

[38] *Re Community Development Pty Ltd (1969) QDR 7* (per Lucas J).

In the Western Australian case of *TBGL Enterprises Ltd v Belcap Enterprises Pty Ltd*[39] Master Bredmeyer assumed without comment that such clauses were valid. By contrast in the decision of *A Best Floor Sanding Pty Ltd v Skyer Australia Pty Ltd*[40] Justice Warren of the Victorian Supreme Court concluded that an arbitration clause in a joint venture agreement was null and void insofar as it purported to subject the parties to an arbitration with respect to matters concerning the dissolution or winding up of the company. On the latter point, this case is probably distinguishable from the earlier decisions.

By contrast in England, the effectiveness of such a clause was upheld without qualification by Justice Jacob in a document governed by the law of New York. The issue came before His Lordship in *Colt Telecom Group PLC*[41] following an application by another vulture fund, Highberry, to put Colt into administration so as to accelerate the repayment of certain bonds ordinarily repayable between 2005 and 2009. Highberry was unsuccessful in its application under section 8(1) of the *Insolvency Act 1986* because it could not establish either a cashflow or balance sheet insolvency.

As part of the decision Jacob J also had to consider a no action clause which stated that an individual bondholder such as Highberry would be unable to bring action in an English court unless amongst other things the holders of at least 25% in aggregate in the principal amount of the outstanding notes instructed the trustees for the bondholders to do so. After taking expert evidence as to the effect of New York law, Jacob J concluded that the clause was effective to prevent Highberry from beginning administration proceedings. Highberry then argued that in any event such a clause was void as against the English public policy because the effect of the clause was to prevent a creditor applying to put Colt Telecom into administration or to wind it up.

His Lordship held that a contractual restriction on an ability of a creditor to petition for the winding up or administration of a company was not offensive to public policy. Such a clause was not a fetter on the rights of the company but only on noteholders' rights. Their rights were based on contract not

---

[39] *(1996) 14 ACLC 205.*
[40] *[1999] VSC 170.*
[41] In the matter of Colt Telecom Group Plc [2002] EWHC 2815 (Ch).

statute. Accordingly, the clause was valid.[42] It is hoped that this decision will be followed in Australasia.

6.9 Asset sales and application of proceeds

The business plan associated with the standstill agreement would normally include provisions dealing with the sale of assets and the application of sale proceeds in reduction of facilities. As a starting point, all creditors should agree that their facilities are to be reduced proportionately. A determination of proportions may require some discussion about payments received by way of the exercise of set off rights. This is a matter of negotiation as in some instances payments received by way of the exercise of a right of set off are shared whilst in others they are appropriated to the benefit of the relevant creditor alone especially if in the latter case that creditor is a hedge provider. Once the asset sale has been completed, the proceeds are deposited into an account over which the lender's representative has control. An order of payment clause then determines how these funds are allocated. After satisfying the claims of costs, outgoings and expenses, the indebtedness to all creditors is reduced proportionately. This can give rise to difficult drafting issues where the debtor company may wish to appropriate the sale proceeds in satisfaction of one facility but where by virtue of agreement amongst creditors the proceeds are to be shared amongst all of them. Usually separate indemnities between the obligors and the creditor and amongst creditors are effective in achieving equality of treatment amongst creditors and at the same time enabling the reduction of facilities of the borrower's choosing.

7. Conclusion

A contractual workout is only ever possible if the major creditors of a borrower all conclude that such a procedure is the best way for maximising repayment of debt by the distressed borrower. In large groups, a workout involves bringing together a wide range of differing creditors who may change over time and who may have individual agendas. An essential prerequisite for a workout is a satisfactory business plan which grants the deferral of immediate payment of existing debt and other waivers in return for new promises by the

[42] In reaching this conclusion, Jacob J dismissed the doubts raised in *McPherson's Law of Company Liquidation (1997 3rd edition)* and the 2001 English edition of the same text. His Lordship

distressed company to restructure its existing business. The use of a contractual workout presents significant legal issues for the distressed borrower and its creditors. These issues should be fully thought through before this strategy is adopted and compared with liquidation and other formal insolvency procedures.

---

also concluded that the decision in the New Zealand case of *Peter Dynes (1986) 4 NZ CLC 64, 906* was not relevant to his decision.