Providing additional flexibility to businesses in financial difficulty – law reform on the agenda

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Introduction

In November 2014, the Treasurer asked the Productivity Commission to undertake an inquiry into barriers to business entries and exits, and to identify options for reducing these barriers where appropriate, in order to drive efficiency and economic growth in the Australian economy. Submissions to the Productivity Commission's *Business Set-up, Transfer and Closure* draft report[1] closed on 3 July, and the final report is due on 30 September 2015.

While the draft report traverses the full life cycle of a business, Australian law firm DibbsBarker made a submission on those aspects concerning corporate restructuring processes. Copies of all submissions are publicly available on the Productivity Commission's website.[2]

The Productivity Commission's draft report raises a number of interesting business restructuring recommendations which are aligned with both the Senate Economics References Committee's call in 2014 for law reform to encourage and facilitate corporate turnarounds, and the topics being considered by Treasury in the context of the Financial System Inquiry's final report (delivered on 7 December 2014). DibbsBarker recently published a series of articles which shine a spotlight on some of the most important restructuring issues to be considered by Treasury, when it comes to determine which recommendations it ought to pursue by way of law reform.[3] Those articles address, amongst other topics:

- the proposal to introduce a safe harbour defence to allow companies and their directors to explore restructuring options without liability for insolvent trading
- the recommendation that ipso facto clauses allowing the termination of contracts solely due to an insolvency event should be unenforceable during restructuring efforts
- the proposal to legislate a framework around pre-packs and pre-positioned sales, being the sale of a company's business or assets which is organised in the period immediately prior to a formal insolvency appointment.

In this paper, I address what I think is one of the more fundamental issues, being the role that culture plays in delivering effective restructurings. I also discuss what banks, their customers and expert advisors can do, irrespective of any law reform, to help struggling businesses get back on track.

[1] The Productivity Commission's draft report is available on the Productivity Commission's website at www.pc.gov.au/inquiries/current/business

[2] See www.pc.gov.au/inquiries/current/business/submissions

[3] The article series was published between 14 July and 11 August 2015, and can be accessed on DibbsBarker's website at http://www.dibbsbarker.com/service/Restructuring_and_insolvency/Recent_news_and_publications.aspx.

The role of culture in delivering more effective restructurings

In reviewing and assessing the effectiveness of the existing insolvency framework in Australia, the Productivity Commission's starting point was to comment on the role and objectives of an insolvency system. The Productivity Commission then questioned the extent to which the Australian approach to dealing with companies in financial difficulty is aligned and where improvements might be made.

In particular, the Productivity Commission found (in draft finding 14.2) that the current culture, incentives and legal framework around voluntary administration inhibit its effectiveness as a genuine restructuring mechanism.

The Productivity Commission has made a number of interesting observations about the role of an insolvency system, reporting:

- Business exits facilitate structural change within and between industries. They also allow entrepreneurs to learn and experiment, transferring skills and information between old and new businesses.
- It is important that an insolvency system facilitates these exits in a structured, predictable and expedient manner to enable learning and adjustment without undue delay or cost.
- The insolvency system should encourage economic activity through the productive use of assets, be it the continuation of existing (valuable) activity, or the rapid and orderly redeployment of employees and assets.
- Wherever there is either continuation of a business or the redeployment of its employees and assets, a number of stakeholders will be affected and not all of their interests will necessarily be aligned with those of secured creditors. This is particularly the case when the business is struggling. In this light, an undue focus on the rights of creditors at every stage of the process (a perceived feature of the current Australian system) can risk diminishing the overall economic value of the process. Instead, a more balanced group-focused process may provide the best opportunity for restructuring and the best overall outcome in the long run.
- It follows that the objective of an insolvency regime should be to provide a genuine opportunity for restructure. If restructure is not possible, the insolvency regime should aim to provide an efficient process for winding up. The regime should foster a coordinated approach to recovery of a company, or if that is not possible, its assets.

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These observations reflect a significant change in the way that Australia has traditionally viewed the role of an insolvency system, revealing a new emphasis on the recovery of the company (that is, a turnaround), with an orderly wind down where that is not possible.

The Productivity Commission cites the main reasons for business failure as inadequate cash flow or high cash use, poor strategic management of the business, and trading losses.

This suggests that the primary role of the turnaround practitioner is to provide expert advice to companies about managing cash flow, improving business strategies and identifying and fixing items in the income statement that are causing recurring losses. Stakeholder management and contingency planning are also important.

If companies become more accustomed to engaging turnaround practitioners who provide this type of expert advice, then we should expect greater facilitation of structural change within companies on a going concern basis, and a decreased reliance on insolvency solutions.

An Australian debt restructuring protocol

In my view, to reach a position where this type of advice is routinely sought, there will need to be a cultural shift that begins with redefining what we mean by turnaround expert advice. If the market continues to associate this expertise with insolvency, then companies will not engage experts soon enough. Further, the experts that *are* engaged will tend to provide insolvency advice that is focused on exit solutions via (or immediately prior to) insolvency mechanisms.

To assist the cultural shift, a protocol should be established to facilitate these turnarounds in a structured, predictable and expedient manner. The benefit of such a protocol is that it mitigates the risk of uncertainty and inconsistency, which exhibits itself in delay, cost and execution risk.

An example of an effective debt restructuring protocol is the London Approach followed by market participants in the UK. There is also a better-known global protocol, known as the INSOL principles, which is similar to the London Approach. The London Approach evolved in the UK in the 1990s with the support of the British Banking Association and the Bank of England. It provides a set of guiding principles for banks and other financial creditors in dealing with customers in financial difficulty. It is so consistently applied by banks that it has become market standard conduct in the UK.

To preserve the good standing and reputation of the banking industry, and based on the fundamental view that it yields better returns than individual action to enforce rights in insolvency, the tenets of the London Approach include the following:

- lenders adopt a reasonable and supportive attitude towards companies experiencing financial difficulty, to which they have been willing lenders in the first place
- lenders stand still to provide the company with a stable platform and time to put in place a sensible restructuring plan
- where there are multiple lenders to the company, lenders share information and work together to a collective view.

Key principles of an effective protocol

Applying learnings from overseas protocols like the London Approach, as well as from successful turnarounds conducted domestically, there are five key principles which, if routinely applied, will maximise the prospects of turning around a financially troubled company. These five principles might therefore form the basis of an Australian protocol aimed at encouraging and facilitating corporate turnarounds. The principles are:

- creditors remaining supportive when they receive bad news
- creditors agreeing to stand still and not take enforcement action or exercise rights triggered by insolvency
- the company preparing a plan which addresses financial *and* operational sustainability
- the plan being supported by accurate, reliable financial information about the company, which is shared equally with creditors (ie those whose agreement to the plan is sought)
- creditors coordinating their response to the plan.

Currently, Australian companies tend not to prepare a plan based on accurate information which will deliver a lasting turnaround. There may be no plan at all, or one that is based on poor quality financial information and overly optimistic forecasts. Additionally, plans can be superficial and incapable of delivering anything more than a short term band-aid solution. To be viable, a company's plan must outline the financial *and* operational changes that will be made to return the company to sustained improved performance over the medium term.

Likewise, creditors in Australia are less familiar with the concept of coordination outside of a financial syndicate or where they share rights and obligations pursuant to a like framework. By coordination, I refer to 'working together to a collective view', led by a coordinating team if the size and complexity of the matter warrants it. The creditors who stand still and coordinate their response to the troubled company's plan will necessarily be those who are asked to compromise or vary their claims. These will ordinarily be financial creditors although key suppliers, alternate providers of debt capital and other stakeholders might also be involved.

There are a number of benefits to coordination. As described by Chris Howard and Bob Hedger in their text *Restructuring Law & Practice*[4], coordinated collective action between a group of creditors helps to avoid duplication of cost. Additionally, if parties work together to create the same pool of information, this should help the collective decision making process and can ensure that the implications of certain actions, if taken, are fully explored and understood.

Coordination does not mean agreement on every term. Disparate creditors can coordinate a response to a company's plan to deliver a holistic solution. That response will almost certainly involve a degree of compromise across the board, but that is not to suggest that it is unreasonable for an individual creditor to insist on certain terms. Depending on the circumstances, such terms might be applied to all creditors to ensure fairness, or alternatively to the individual creditor to respect pre-existing rights.

Banks helping struggling customers get back on track

Banks and other financial creditors have vast experience in assessing and monitoring customer risk, and usually have rights under loan documentation to request additional information where there is a concern about the customer's financial position. Banks and other financial creditors are therefore in an invaluable position to assist a customer experiencing financial difficulties, particularly where the customer is relatively unsophisticated.

Below I provide a short list of actions which, if taken in the spirit of the key turnaround principles outlined above, are likely to further increase the prospect of a struggling customer getting back on track:

- Accurate financial information is critical. If a customer is not equipped to deliver such information, they ought to be encouraged to engage a suitably qualified person to assist. Where the accuracy of information is a concern, a carefully prepared suspension, deferral or request in connection with a review event will not only incorporate the key information requirements, but will also be conditioned on the process requirements to ensure that the information delivered is accurate (for example, to evidence the existence of adequate systems and personnel, or advise what steps will be taken and when, to deliver accurate information).
- Financial information that is delivered to support an early stage waiver tends to be superficial and optimistic. The customer should be encouraged to sensitise such financial information and remove the hope ('the market will turn'), to ensure that any new financial terms which might be agreed are realistic, and to avoid a breach occurring again in the very near term. If the customer lacks the skills in-house, again, they should be encouraged to engage a suitably qualified person to assist, and ideally one who has experience in turnaround situations.
- A customer may not see the need for – and may not wish to incur the cost associated with – preparation of a turnaround plan, particularly where the customer indicates that the financial issues are a 'short-term hiccup' and it is simply requesting a short extension of time. Both lenders and customers need to understand that the process need not be overly complex or costly at this point in time, but the benefits are potentially significant. Critically, by seeking out accurate financial information and a plan, the lender and the customer can test the very proposition that the issues are short-term. The information will also assist to assess what new financial terms are realistic. Again, if the customer is not equipped to prepare a plan, it should be encouraged to engage a turnaround practitioner and in appropriate cases, any deferral or suspension may be conditioned on such an appointment. There is no question that if the

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[4] LexisNexis, 2nd ed (revised), 2014 at 1.34

parties wait, the undertaking will be more complex and costly down the track, and in the worst-case scenario, an investigative accountant will almost certainly be more costly with less favourable outcomes for both parties on offer.

- Any new funding need should be clearly identified and explained. A customer should satisfy its lender that it will exhaust all existing sources of working capital (taking into account proposed cost-cutting and streamlining), and that the new funding need is realistic and critical. If existing stakeholders are not willing to provide any new funding, think strategically about who might contribute such funding and the conditions on which any permission to that funding might be agreed. For example, new private equity or debt capital with a strong turnaround plan, including to bring strong management to the table, could be desirable, so long as any inter-creditor matrix works.
- There are increased capital costs and profit-and-loss considerations associated with distress. These economics, coupled with a lender's business model and governance relating to the lender's risk management framework, will impact on how the lender is able to respond to the distress. In considering the economics of a turnaround, there is no question that the earlier the customer can be turned around, and ideally ahead of any default, the lower the costs and so the more affordable the restructuring for the customer. This itself increases the prospects of the turnaround being successful. Review events are invaluable triggers which enable early (proactive and supportive) intervention by banks. Where the lender is exposed to a capital cost, it may be possible to offset the cost by a variety of restructuring techniques incorporated into the amended financing arrangements. The lender benefits from the incremental recovery on the loan over time, coupled with the improving risk profile (in turn, decreasing the holding cost of the loan). The potential write-up in the event that the turnaround is successful (assuming an earlier write-down) might also be factored in. The prospects of success can be de-risked by involving practitioners experienced in delivering turnarounds.
- Lenders are properly concerned during the restructuring efforts, not to be so involved as to be directing their customers. A customer should take control of its own future and lead its own turnaround. If it lacks the sophistication or expertise to do this, lenders can outline both the benefits to the customer of engaging in an effective debt restructuring early, and the detriments of not doing so. Lenders can condition any waiver on the delivery of certain information, the engagement of a reputable turnaround practitioner and the delivery of a turnaround plan. Ultimately, however, a lender should not see its role as persuading a customer to do things and make changes at an operational level that the customer is not prepared to do and, in those cases, the lender should not mandate them. In my experience, such mandates leave the lender exposed or the customer inevitably defaults on the obligation. It is such customers that, unfortunately, readily move from being viable to non-viable and find themselves in formal workout. Lenders and their advisers want to be sure, ahead of that outcome, that they are satisfied they did all they could to avoid it.
- Finally, a common question asked in the context of a more severely distressed customer is: how do you know whether or not the company is viable and therefore, whether or not to support it through a turnaround strategy? Viability is a complex issue in the context of a financially troubled firm. At its simplest, viability depends on a key question: is the firm able to attract sufficient capital to continue as a going concern, both in the short term and the medium to longer term? This in turn depends on whether:
  - there is a core business that generates positive cash flow or is able to generate positive cash flow at some future point in time, and
  - the firm's creditors and other key stakeholders, existing or new, are willing to support the firm on terms that enable the business to generate that cash either now or in the future.

That is, a firm might be able to generate sufficient cash in the future and be viable in the meantime, because of the support of certain creditors on certain terms. In that regard, a financially troubled firm is not dissimilar to a start-up. Ultimately, viability depends very much on creditor and other key stakeholder support and the terms required to obtain that support. If a creditor is not willing to support a firm on certain terms, but the firm is able to garner such support on terms acceptable to others, then the firm is viable, so long as the firm is also able to agree the terms on which the existing creditor remains or exits. When the issues are understood in this way, the significance of the role of stakeholder coordination, communication and the sharing of accurate information becomes clear. A firm can fall into external administration if just one stakeholder takes an individualistic stance that, from the perspective of the other stakeholders, is unreasonable.

Conclusion

It is clear from the work and recommendations of the Senate Economics References Committee and the Financial System Inquiry, as well as the ongoing work and recommendations of the Productivity Commission, that Treasury has a number of important issues to consider in a restructuring context. I am hopeful that these government-led initiatives will ultimately lead to law reform which enhances the performance of businesses and drives economic growth in Australia, both in a restructuring context and more broadly. In the meantime, I encourage financially troubled companies, their bankers and expert advisors to actively pursue turnaround initiatives and in doing so, participate in a cultural change in the way that Australia approaches financial underperformance.

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About the author

Macaire is a Restructuring Partner with Australian law firm DibbsBarker.

Macaire has 18 years of experience in the restructuring and insolvency industry, including three years in Europe and the Middle East with Allen & Overy LLP, London. Macaire's credentials include acting in London for bank co-ordinating committees including the restructure of US$5 billion owed by a Middle Eastern construction company. She acted on the reorganisation of the Bank of Cyprus and the Co-operative Bank's recapitalisation plan. Such matters have allowed her to develop a strong foundation in advising clients on a broad range of restructuring solutions.

Macaire is an active advocate of encouraging and facilitating corporate turnarounds. In addition to having made submissions in response to the Productivity Commission's draft report on Business Set-up, Transfer and Closure (July 2015), Macaire has made submissions to the Financial System Inquiry in relation to its Interim Report (August 2014), to Treasury in relation to the Senate Economics Reference Committee's recommendation 61 in its report on the performance of ASIC (August 2014) and the Financial System Inquiry's Final Report (March 2015).

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