WORK-OUTS

SOME REFLECTIONS UPON ANOTHER BUSY YEAR OF WORKOUT IN AUSTRALIA

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Mr Chairman, Ladies and Gentlemen.

Let me begin by joining you in noting with some surprise that I was asked to speak on this topic for a second time. Let me assure you that it says more about the penalties imposed by members of the committee of your association on their fellows who are not present when topics for annual conferences are allocated than it does about my knowledge on this topic. I'll try therefore to be brief and to concentrate on one or two aspects only of some of the workouts we have witnessed in Australia since last year's conference. I will then, I'm afraid, be forced to repeat the cry which I made last year, namely that the Australian Government do Australia a service by hastening its consideration of the Law Reform Commission's Report into Insolvency Law Reform. I understand that this is now happening and that we may see a draft bill later this year.

I said last year that a workout delayed may be a workout lost. This was in the context of the Law Reform Commission's proposal that companies be entitled to appoint an administrator without the intervention of any outside party and that the administrator be of the company's choosing. I argued that where these powers lay in the company there was at least a chance that the administrator would be appointed and the workout commenced before it was too late. Regrettably, I think we have seen several examples of companies encountering difficulties in the last year which bear out the truth of my remark.

At last year's conference, David Crawford spoke about the use of a financial advisor technique as applied originally in the case of *Ariadne* and explained some of the reasons for its development. Since then, this technique has been used on a number of other occasions but it has recently been supplemented by an arrangement whereby a recognised insolvency expert is appointed chairman of the bankers' committee.

The precise role played by the chairman of such a committee is, of course, a matter for the members of the committee to decide and to document in individual cases. An examination of some of these indicates that there are some rather grey areas. In at least one case I looked at recently it appeared to me that the chairman of the bankers' committee was being asked to play a more active role in the company's affairs than was the financial advisor.

What is the reason for this development?

It seems to me that what we are seeing here is a development growing out of the frustration banks feel where workouts are attempted without a formal appointment, eg of a receiver, with the result that no-one has control.

Banks have, through the use of the financial advisory role sought to achieve two things. Firstly, they have sought to complete the workout (which may of course be nothing more than a controlled liquidation) in a way which preserves maximum value in the assets. This, it is commonly felt, requires if at all possible that the company be kept out of liquidation. Secondly, they have sought to avoid incurring liabilities as directors.

The major difficulty I see with this is that it is very difficult to have one's cake and eat it. I think a price will be paid for feeling that greater control exists over the insolvency expert if he is chairman of the bankers' committee rather than a financial advisor. It is that members of the bankers' committee will, often against their proclaimed intention, become involved in decision making to a greater degree than the situation can really afford.

In my view, this arrangement is probably the worst of all worlds and is certainly contrary to both the present position in the United States where the debtor in possession retains the initiative subject to the overview of the creditors' committee and the court but with the debtor basically remaining in a key position and the English position whereby once an administrator is appointed he has limited duties to report to creditors in the short term. It is, of course, a response to the unsatisfactory state of present Australian insolvency law.

I should say, in the banks' defence, that in recent cases in Australia they have been faced with the most extraordinary difficult corporate structures with a multitude of creditors interested at different levels of interwoven groups with consequent inevitable conflicts as the impact on different creditors of various reorganisation options become apparent. My point is simply this: The trend in insolvency law reform is to encourage the appointment of an insolvency practitioner to work for the company and to propose initiatives from that side of the table rather than to have him initiate proposals from the point of view of a particular group of creditors. In a word, it is debtor orientated rather than creditor orientated. In my view that is the preferable approach.

I'll come back shortly to a risk which I think the banks run by encouraging the bankers' committee chairman approach.

Another thing we have seen in Australia in the last twelve months has been the inordinate delays involved in putting together contractual moratoria. You have all read about the ***Adsteam*** saga, which has dragged on month after month. I will not hazard a guess at what this delay meant to the fortunes of the various companies involved and their ability ultimately to meet their obligations to their creditors and remain as viable businesses. It is, in my view, quite unsatisfactory that the beginning of some of these workouts has been held up for months by what according to the press was the unwillingness of a small number of creditors owed small amounts of money to go along with the moratorium. The spirit of the law on the matter is clear. It is set out in the sections of the Corporations Law providing for a moratorium to arise as part of a scheme of arrangement. What the present law does not recognise is that a scheme of arrangement in the case of a group such as the Adsteam Group is a mammoth task and that something must be done to keep the patient alive while the operating theatre is made ready. The Adsteam Group has hung together over the past months largely, I suspect, because of its importance to Australia and what in effect has been an informal moratorium while the documents were prepared and efforts made to convince various reluctant creditors to sign them. It could easily have been otherwise. ***Adsteam*** is, of course, an extreme example but we have seen the same type of delays in other moratoria. In my experience, the documentation used for these moratoria is excessive and the level of due diligence done and warranties sought proceed as if emergency funding were first time loans to a new customer. Throughout all this there is the need to fight the PR battle and listen while directors talk earnestly of selling non-core assets. Mr Chairman, the need for law reform is obvious. Something must be done to avoid the delay in getting the patient into surgery.

Let me make one or two specific comments about liabilities of particular players in the workout environment which I have had cause to look at in the last year.

The first of these relates to the position of directors during a workout period.

It is accepted, I think, that in a case of an insolvent company the duty of directors to creditors increases. The position is thought to be less clear where the company is in what might be described as the state of marginal insolvency. For example, where a company's existence is in the hands of its bankers but those bankers have given no indication that loans which have now become payable on demand will not be called immediately because they are negotiating with other bankers to attempt to put together a formal moratorium.

The trend of law reform as discussed in papers presented by Alex Chernoff, Bob Baxt and the late Larry Adler at the Banking Law Conference in Queensland in 1988 has been to make life tougher for directors in this situation. This is part of the general "get-tough-on-directors philosophy" which seems to pervade company law to a greater extent every day. Take the situation I have mentioned where it may be in the interests of the company's creditors and shareholders and employees and those who do business with it that the directors keep the business running while the banks argue about a moratorium. It seems to me very tough in these circumstances to say to directors that they will shoulder an increased liability and that the only way for them to protect themselves is to go to the court and seek the appointment of a provisional liquidator. The difficulty, of course, is that they have perhaps momentarily, or perhaps forever, lost control of the company and yet the law says that they must either run the company and accept liability or bring it to an end. I wonder if that is really in the interests of all those who make up the company's community.

A twist to this problem arises where a director has been appointed to the board perhaps during a workout phase at the request of creditors. As we know, the duties owed by a representative of creditors are not altogether clear (see Bob Baxt's paper at the 1988 conference) and so it will be a brave man or woman who, despite his or her experience as a company doctor, accepts appointment to a board during a workout phase. This is especially so where there is a potential conflict amongst creditors. If you wonder whether this is possible then you only need to look at the recent actions by subordinated debenture holders in Australia to understand the concern. I will have something to say on this later.

Let me in this context refer to the issue I raised earlier of financial advisors/members of banks committees/chairman of banks committees being regarded as having become directors of the company and thus liable for this enhanced responsibility.

Ironically, it seems to me that the position where the workout expert sits as chairman of a bank committee, may well ***increase*** the risk that not only the chairman but also all members of the committee are in law directors.

In ***Principles of Corporate Insolvency Law*** at page 196, Roy Goode draws a distinction between what he calls a "***de facto***" director and a "shadow" director. He draws the distinction this way. He says that a shadow director is someone who acts as if he were a director and a ***de facto*** director is someone who, while he does not act as if he is a director, in fact has, if-you-will, the power of a director by acting through the actual directors. Where the insolvency expert sits on the banks' side of the table, as chairman of a bank committee it seems to me that the position both for the chairman of the committee and the members of it, the position may be ***worse*** than if the insolvency expert had become financial advisor to the company. My reason is that the bankers will find it very hard not to initiate proposals for reorganisation, assets sales etc and then possibly "direct" the company with the assistance and leadership of an insolvency expert who is accustomed to "directing" but without a director's liability by virtue of his statutory position. They will often face a board which realises that it has very little room to disagree with the banks. It may be a board of straw! Mr Chairman, I'd be very interested to hear from anyone here today who has been involved in the appointment of such a chairman whether he or she has considered these problems.

I have mentioned the position of subordinated creditors and I would now like to turn to and consider what appears to me to be another recent development in Australian workout problems.

In days gone by when children smiled and the trains were safe and good things came to those who waited, there was a general level of co-operation amongst banks and professional lenders. This was in part because historically all had lent either to the parent company of the group or to a particular financing vehicle and thus had their interests at one common point in the company structure.

With the development of more complex corporate structures for accounting or tax reasons or for reasons associated with controlling a very large number of companies with substantial liabilities through small key shareholdings, the position has changed. Moreover, as many of the major corporate groups in Australia have grown dramatically through acquisition, large sub-groups have their own banking arrangements which are not altered after the acquisition was completed. The result has been that within major groups there is a myriad of borrowers and a myriad of different security arrangements. Very often those dealing with a group from outside had little idea as to the position of individual companies within the group and this led to the introduction of the class order arrangements permitting individual companies to dispense with accounts where cross guarantees or solvency undertakings were given.

The result of this has been in many cases that banks have found themselves at odds with other creditors as to which arrangements ought to be adopted during the work out phase. We have seen brawls over preferential payments, over securities given to support emergency funding and a level of hostility particularly between the major banks and some of the smaller banks.

The only aspect of this that I want to deal with today is claims by the holders of subordinated debt in Australia in the last year.

There are two cases which have received a good deal of publicity; they involve the Linter and the Fairfax groups.

Let me start with the short point I wish to make and then give you a little detail.

It seems only weeks ago that in a number of transactions I sat across the table from corporate treasurers and listened to speeches about how subordinated debt was in reality equity and ought to be taken into account as such in the otherwise monstrously restrictive financial covenants I (and not even the client) had proposed. We were told over and over again that the only way in which the subordinated lenders could be repaid was after the banks had received every penny of principal and interest.

Let us look first at ***Linter*** and see if this was true.

Following a corporate reorganisation Linter Textiles Corporation Limited issued US$200,000,000 worth of subordinated debentures principally to residents of the United States.

Subsequently receivers and managers were appointed by the Supreme Court of Victoria. Linter Textiles Corporation Limited, its parent Linter Group Limited and many other companies in the Linter Group were placed.

The receivers and managers set about devising a means by which the relevant companies, or alternatively their assets, could be sold, having formed the view that the companies comprising the Linter Group could not continue as going concerns. They proposed a scheme of arrangement and I think it is fair to say all the creditors realised that the value of the group's assets would be diminished if a winding up order was made.

Immediately the decision to try and keep the group out of liquidation was made, the commercial position of the subordinated debenture holders changed. Let me explain why this is so. Traditionally subordination has been achieved by a number of means but all with the effect or intent that the subordination applied with regard to the division of the spoils upon the realisation of the company's assets. Now while I don't think many banks were seduced by the line that subordinated debt equals equity many I imagine felt that there were few (if any) circumstances in which the subordinated lenders could get their money back if the banks had not been paid out in full. This was fine so long as the company proceeded into liquidation.

Where liquidation was not the outcome then the law treats subordinated creditors no differently from other creditors. Their vote is relevant in any decision of creditors to approve a scheme of arrangement which as you know requires the consent of at least 75% in value and 50% in number of the creditors.

It is apparently common practice in the United States for subordinated debenture holders to seek a settlement of their claims as an alternative to taking action to enforce such other rights they believe they might have. In the ***Linter*** case they did just this and the banks took advice on the matter and having been informed that the subordination provisions worked, declined to reach any settlement with the debenture holders. The debenture holders then indicated that they would oppose the scheme of arrangement and argued that they represented a different class of creditors for that purpose. This issue was litigated before the Victorian Supreme Court and his Honour Mr Justice Marks held that they were not to be separate meetings of creditors but that the issue could be re-opened when the matter returned to the court after creditors' meetings.

Shortly before the creditors' meetings took place the banks became aware that whereas previously the subordinated debentures were held in only four names on the register maintained by the trustee, steps had been taken to split the holdings or to transfer holdings presently held in a nominee's name to the names of individual owners. A conclusion which could be drawn from the resultant increase in the number of registered holders of subordinated debentures was that they were seeking to achieve a majority in number of the number of creditors who would be entitled to vote. The effect would be that even at a single class meeting the subordinated debenture holders could block the scheme.

The banks' response to this was to split their debt amongst a number of different companies within each of the major banks with the result that although there were only 28 banks as original creditors of Linter their debt was held by 161 individual corporate entities by the time the meeting came around. By the same date the debenture holders' activities had resulted in the numbers on their register increasing from 4 to 56.

Needless to say the scheme of arrangement was approved and the matter is shortly to return to the Victorian Supreme Court where amongst other things the actions of the banks in splitting their debt is to be challenged.

Quite apart from these steps the subordinated debenture holders have commenced proceedings in New York claiming damages from LTCL as issuer and from some of its subsidiaries and the banks on the basis of alleged breaches of US securities law and breaches of the terms of the indenture. In the case of the subsidiaries and the banks they also claimed tortious interference with the subordinated debenture holders' rights.

The point of these claims is that it may be that if damages are available for breach of contract or tort they will rank equally with the claims of the bank lenders. That is to say that, unlike damages arising from Securities Act violations, they may ***not*** be subordinated against the subsidiaries whose guarantees were given on a subordinated basis and, of course, they rank equally with any other unsecured liabilities of the banks.

In other words, Mr Chairman, the strategy seems to be that one does one's best to pull oneself up by one's boot straps in relation to the issuer and, in this case, the subsidiaries, and thereby gain an enhanced priority and, secondly, one looks around for anyone else who might have been involved to target for an additional claim where subordination is not an issue.

Moreover, whether or not the New York proceedings are successful, because they seek punitive damages it will be very hard for the scheme manager or liquidator to make a pro-rata distribution to creditors on the basis simply of outstanding principal and interest. This possibility of delay gives the subordinated debenture holders further leverage.

It appears that it may not be the case that "once a subordinated lender always a subordinated lender!"

The ***Fairfax*** case is slightly different involving an action based on s52 of the Trade Practices Act. The bondholders alleged that valuations of company assets information as to offers the company had received to purchase some of its assets, particulars of projected capital expenditure, projections as to revenue and statements about guarantors in the Information Memorandum were misleading or deceptive or likely to mislead or deceive.

The bondholders alleged in their statement of claim that ANZ and Citibank participated in the arrangements for the issue of the bonds, specifically participating in the preparation, drafting and approval of the Information Memoranda. Accordingly, it was said they ought to have known of the alleged deceptive and misleading information.

The ANZ for its part responded by telling the Federal Court that if it were found liable under a s52 action it would seek to rely on representations made to it by the same entity as is now advising the bondholders.

I have not been able to ascertain whether the bondholders argue that if they do succeed in recovering damages then those damages will be unsubordinated. Perhaps someone here today knows. If so, I would be very interested to hear. In any event, of course, there remains the action against the banks which in unaffected by concepts of subordination.

One final point about ***Fairfax*** and it is this. As you know, the receiver has recently sought expressions of interest in relation to the purchase of the Fairfax Group and its assets. I understand there are certain tax losses available which would make the purchase of the corporate structure attractive. To purchase the corporate structure, of course, brings with it the subordinated bondholders. Presumably, therefore, anyone interested in responding to the receiver's invitation will make a calculation as to the value of the tax losses as opposed to purchasing the assets and not having to come to grips with the bondholders. It is another example, I think, of the power of bondholders where there is a reason for not liquidating the company.

Mr Chairman, the point of these two stories is to raise a caution to those who consider subordinated debt provides some comfort to senior lenders. At the very least I suspect it will be necessary to undertake a very rigorous analysis of any future issue of subordinated US paper by an Australian company. Banks will need to be absolutely satisfied that there are no breaches of US securities law, no misrepresentations in the issuing documents and no subsequent breaches of them if they are to be assured that damages claims will not be argued even if only as part of an ambit claim. One can imagine the face above the smile of the corporate treasurer when you tell him that there will be a slight additional disbursement on the banks' Australian lawyer's account for the cost of involving US counsel in giving comprehensive opinions on these matters.

The second thought I leave with you is this. Is there a way of binding subordinated debenture holders to surrender certain rights in relation to their debt?

Some years ago I considered something like this in relation to an Australian company which was raising debt in the United States. Although we battled for six months to retain the restrictions we were eventually met with objections from the SEC as to their novelty and the need to make specific disclosures which would affect the ability to sell the debentures. The banks, faced with this, withdrew their insistence on the provision.

What we prepared was a provision in a deed regulating priorities between the senior bank debt and the subordinated debenture holders to the effect that the subordinated debenture holders would not obstruct or hinder any action taken by the senior debt to wind up the company. The clause (a draft of which was all I could find) is set out in the attachment.

As I have said, the proposal was ultimately dropped by the banks following discussions with the SEC - so much for my bright ideas.

Not all subordinated debt, however, is raised either publicly or in the United States and there may be room to move in Australian financings. I wonder how far one could go in dealing with a scheme of arrangement. Presumably, a subordinated creditor couldn't surrender his right to vote on a scheme. Section 510 of the Corporations Law speaks of "creditors" and presumably this means all creditors just like s555 refers to all debts leading to the techniques commonly used to achieve subordination.

For example, could one contract with a trustee to vote debentures in a particular way or provide for the granting of proxies to senior lenders?

Mr Chairman, recent developments in work outs involving subordinated debenture holders have posed new problems for both bankers and lawyers and needless to say, for insolvency practitioners. It is appropriate, I think, that we record these difficulties as they come to our attention so that when in 5 or 10 years time we are hearing the same speeches, about subordinated debt being the same as equity, from a different generation of company treasurers we can take steps or at least advise our clients to take steps, to achieve more effective subordination. In particular, we should try to deny subordinated creditors key rights which can be exercised in a way to improve their subordinated position to the detriment of non-subordinated lenders.

ATTACHMENT

"3. WINDING UP

3.1 Trustee or Holders of the Securities not to obstruct or hinder dissolution or winding up

(a) If any action is being taken by or on behalf of the holders of Senior Debt to bring about the dissolution or winding up of the Company neither the Trustee nor the Holders of the Securities shall do or cause to be done any act, matter or thing which has the purpose or effect of obstructing or delaying such action by or on behalf of the holders of Senior Debt.

(b) Without limiting the generality of paragraph (a) of this Clause, the Holders of the Securities shall not:

(i) seek any order for a stay (either indefinitely or for a limited time) or termination of a winding up of the Company;

(ii) dispute the entitlement of the holders of the Senior Debt or their agent to seek the appointment of a liquidator; or

(iii) seek any order for the prevention or setting aside of any appointment of a liquidator or for the removal of any such liquidator."