RECENT DEVELOPMENTS UPDATE

REVIEW OF THE VOLUNTARY ADMINISTRATION PROCEDURE UNDER THE CORPORATIONS LAW

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INTRODUCTION

There is little doubt that what we have now in Australia through the Voluntary Administration procedures ("VAs") under the *Corporations Law*, provides an extremely flexible and creative tool to solve problems arising in the credit industry.

With almost one year of practical application of the new provisions behind us it appears that the objective of the legislation is being achieved. It is a matter for the credit industry to become more familiar with the provisions' flexibility and take a more active role in the procedure to achieve results.

My comments on the paper prepared by Bruce Hambrett are treated in similar order to his and it is my intention to highlight the practical aspects of the legislation.

BACKGROUND TO THE NEW PROCEDURES

As a creditor driven procedure, the aim of the legislation was to fill the gap in procedures available to provide a method of dealing with a company's affairs in a swift, cost effective and flexible manner.

The paper draws from the comments of the Australian Law Reform Commission ("ALRC") and outlines the objectives of section 435A of the *Corporations Law*.

The provisions of Part 5.3A *"Administration of a Company's Affairs With a View to Executing a Deed of Company Arrangement"* were designed to integrate with the directors' positive duty to act in a manner to prevent insolvent trading by a company outlined in section 588G of the *Corporations Law*.

Section 588G

Director's Duty to Prevent Insolvent Trading by Company

588G(a) [Director when debt occurred]

This section applies if:

(a) a person is a director of a company at the time when the company incurs a debt; and

(b) the company is insolvent at that time, or becomes insolvent by incurring the debt, or by incurring at that time debts including that debt; and

(c) at that time, there are reasonable grounds for suspecting that the company is insolvent, or would so become insolvent, as the case may be; and

(d) that time is at or after the commencement of this Part.

588G(2) [Failure to prevent incurring of debt]

By failing to prevent the company from incurring the debt, the person contravenes this section if:

(a) the person is aware at that time that there are such grounds for so suspecting; or

(b) a reasonable person in a like position in a company in the company's circumstances would be so aware.

588G(3) [Civil penalty provision]

This section is a civil penalty provision as defined by section 1317DA, so Part 9.4B provides for civil and criminal consequences of contravening it, or of being involved in a contravention of it.

588G(4) [Pt 9.4B]

The provisions of Division 4 of this Part are additional to, and do not derogate from, Part 9.4B as it applies in relation to a contravention of this section.

One of the defences now available to a director faced with the prospect of breaching this duty under the provisions of Division 3 of Part 5.7B is to take the appropriate action to appoint an administrator (section 588H(6)) and thereby hand control of the company's affairs to an independent person, and allow creditors an opportunity to have input on the future direction of the business.

Section 588H

Defences

588H(5) [Reasonable steps to prevent incurring of debt]

It is a defence if it is proved that the person took all reasonable steps to prevent the company from incurring the debt.

588H(6) [Elements proving reasonableness]

In determining whether a defence under sub-section (5) has been proved, the matters to which regard is to be had include, but are not limited to:

(a) any action the person took with a view to appointing an administrator of the company; and

(b) when that action was taken; and

(c) the results of that action.

Thus the creation of a duty on directors to act positively to prevent further debt being incurred is an important trigger mechanism to the appointment of an administrator.

THE APPOINTMENT OF AN ADMINISTRATOR

Sections 436A, 436B and 436C outline how and who can appoint.

Section 436A deals with the company resolving to appoint an administrator by the board of directors and, as the architects of the new procedures anticipated, this will be the predominant method of appointment, especially in the light of section 588G.

The second and third methods of appointing an administrator are by a liquidator and the "chargee", section 436B and section 436C respectively.

Again the flexibility of the new procedures is demonstrated firstly in the ability to remove a company from liquidation and convert to an administration (with the objective of entering into a deed of company arrangement) and secondly, perhaps the most creative of all, the ability of a charge holder to make the appointment (section 436C).

In order for the charge holder to act in this way section 436(1) stipulates:

- The charge holder must be entitled to enforce a charge.
- The charge must be on the whole, or substantially the whole of a company's property.
- The appointment must be in writing.
- At the time of the appointment the charge had become and was still enforceable.

COMMENTS ON THE STATUTE AND THE SUCCESS OF THE PROCEDURE

The paper attaches statistics published by the Australian Securities Commission and identifies that VAs have increased in popularity at the expense of the court liquidations, a result which is in line with one of the objectives of the new provisions, being speed and cost effectiveness. The surprising result which is identified is the increase in the number of creditor voluntary liquidations.

Given the speed of appointment of a voluntary administrator, compared to a liquidator appointed at a meeting of shareholders under the Creditor Voluntary Winding Up provisions of the *Corporations Law* I believe this trend will change. Where it is clear that no deed of company arrangement is contemplated, the recommendation by the administrator under section 438A(b)(iii) would be that it is in the interests of creditors for the company to be wound up. This eliminates the difficult hiatus period of 14 days from when directors resolve to enter into a voluntary winding up and the convening of the shareholders meeting where the control of the company remains with the directors.

IS THE NEW PROCEDURE MEETING EXPECTATIONS?

The paper effectively focuses on the connections between the intention of the legislation and the results to date. The provisions of the voluntary administration procedure do not fail if an administration does not enter into a deed of company arrangement. As indicated above, the speed, flexibility and lack of court involvement lends itself to a more orderly regime to wind up companies. This is highlighted by the results of questionnaires referred to in the paper carried out by the Australian Society of Certified Practising Accountants ("ASCPA"). In particular, the result that creditors' dividends are likely to be higher than dividends if the company went into liquidation recognises the benefits.

Other interesting results stem from the survey conducted by the ASCPA and I comment as follows:

A) "Eighty one percent (81%) of the administrators believe the 5 day period for the first meeting is too short."

Comment

This opinion of practitioners is based naturally on the notion of calling a meeting to report to creditors. However the objectives of the first meeting are really to meet the administrator and either endorse his appointment or appoint another; and more importantly, to give creditors the opportunity to participate in the administration through the committee of creditors.

The functions of a committee of creditors are defined in section 436F as follows:

(a) To consult with the administrator about matters relating to the administration; and

(b) To receive and consider reports by the administrator.

Section 436F(2) prevents the committee of creditors from giving directions to the administrator, but they can "reasonably" require the administrator to report to the committee about matters relating to the administration (section 436F(3)).

B) "A very high proportion of administrators believe the second meeting period is too short."

Comment

Again we must look to the objectives of the legislation and remember it is creditor driven. Unless there are good reasons to defer the second meeting (by court application) this meeting must be held within the prescribed period. A more effective way of dealing with the shortage of time is to hold the meeting as contemplated and attach the administrator's report as required under section 439A(4) outlining the shortcomings in the investigation and request an adjournment pursuant to section 439B(2) which provides for no more than an additional 60 days to consider the fate of the company. This way creditors are **informed** and more than likely will rely on the committee of creditors elected at the first meeting under section 436E(1) to look after their interests. It is clearly against the spirit of the legislation to leave creditors "in the dark" for lengthy periods.

C) "A significant number of companies that enter into deeds of company arrangement trade on."

Comment

This result is to be expected since it preserves the value of a business but highlights the great risk for the administrator in respect of personal liability.

D) "The second survey stated that, where a secured creditor was involved 57% supported the appointment of the administrator, 11% of secured creditors appointed their own (presumably receiver) while 18% remained 'passive'."

Comment

With over half of the secured creditors in the survey supporting the administrator (previously appointed under section 436A) the results are encouraging.

My experience is that secured creditors will be influenced by the reputation of the administrator appointed by the directors and will act accordingly. Again, coming back to the fact that these new procedures provide for increased creditor involvement, it is of paramount importance to notify the secured creditor of the directors' intention to appoint a voluntary administrator before it actually takes place. This will result in the secured creditor having an opportunity to assess the situation and understand the purpose of the action. The secured creditor will either co-operate or immediately appoint their own administrator or receiver and manager. Either way it is preferable to have the position known at the outset rather than have a receiver/manager appointed 10 days into the administration creating further confusion to creditors and additional expense.

AN ALTERNATIVE TO RECEIVERSHIP/WORKOUT?

With the flexibility of the new procedures I see great benefit to the secured creditors taking action to appoint an administrator under section 436C, although I am not aware of this having taken place to date.

By taking the initiative to appoint an administrator rather than a receiver and manager, secured creditors avail themselves of the ability to deal with unsecured creditors, an advantage hitherto not available.

So often the result following the appointment of a receiver and manager is the unsecured creditors receive no distribution and the secured creditor suffers a shortfall. In essence it is the prospect of unsecured creditors seeing a dividend in an administration that gives the secured creditor the competitive edge in an administration where they participate actively. Unsecured creditors will compromise their debts and allow a company to trade on under a deed of company arrangement if the alternative is no dividend. In the process the secured creditors improve the value of their security, especially if changes to the management are made by the administrator and profitability increases as a result.

Active participation therefore includes attending the first meeting of creditors and voting, election to the committee of creditors, and involvement with the administrator in exploring the options available.

In effect, being a party to a "workout team" as contemplated by section 436F (Functions of Committee of Creditors) is a sure way of maximising the return for all creditors. The additional benefits which I would highlight as beneficial in particular to an effective "workout" are contained in Division 6 of Part 5.3A - *Protection of Company's Property During Administration.* Section 440B prohibits a person enforcing a charge on property of the company unless the administrator consents in writing or the court gives leave. There is a great benefit in a "workout" where Retention of Title claims exist on stock or assets. Naturally the administrator will be required to account for the sale of the stock if the Retention of Title claim is valid, but it affords the opportunity to continue the business without interruption for the benefit of creditors. Similarly section 440C prevents the owner or lessor of property used in a business from being removed unless the court intervenes or the administrator consents.

Regulation 5.6.24 of the *Corporations Regulations* governs how secured creditors vote at meetings generally. The architects of the voluntary administration procedures have provided an **exception** to the normal rule of voting for the balance of the debt after deducting value of the security or surrendering the security if voting for the full amount of the debt.

Regulation 5.6.24(4) **specifically excludes** this regulation for meetings convened under Part 5.3A meaning secured creditors have the same voting rights as unsecured creditors, a change which provides a bias towards the secured debts voting power in addition to normal legal entitlement. If such an advantage is exercised properly the outcome should be in the interests of all parties concerned, including directors (with guarantees) and employees.

The definition of "creditors" in this context includes a debenture holder (Regulation 5.6.21(5)).

A resolution to accept a deed of company arrangement requires 50% of creditors voting in favour by value and 50% voting in favour by number, a contrast to the provisions under Part X of the *Bankruptcy Act* where the percentages are 75% and 50% respectively.

Regulation 5.6.21(4) provides the administrator with a casting vote if no result is realised and I suggest that this means of breaking a deadlock should be carefully exercised bearing in mind the dollar value of claims in the vote.

THE POSITION OF THE DEPUTY COMMISSIONER OF TAXATION

The aspect of carried forward losses should be viewed in proper context and the paper deals with the morality of this issue. It would not be surprising if the Commissioner of Taxation proposed legislation to limit carry forward losses so that the quantum carried forward equated with the actual dividend received by creditors.

As with any successful reconstruction of a company's affairs, the provision of a tax benefit due to carried forward losses should not be the sole purpose of the exercise, but nonetheless a consideration to have in mind as a benefit if continuing to trade under a deed of company arrangement.

SUMMING UP

Unlike similar legislation in the United Kingdom and the United States we have a set of procedures designed to avoid court involvement and provide flexibility. Creative use, in the right hands, will improve the return to creditors and I urge all secured creditors to examine the benefits which flow from intelligent application of this new law.

Never before have we had laws which create a moratorium in respect of a company's affairs for a short period to enable **independent** assessment of the financial position with a view to improving the return to creditors.

"Tread carefully but think laterally!"