WORK-OUTS
AUSTRALIAN POSITION

DAVID CRAWFORD

KPMG Peat Marwick
Chartered Accountants, Melbourne

INTRODUCTION

Insolvency is a topical issue in Australia at the moment, with a number of high profile corporate collapses distinguishing themselves by their magnitude, complexity, and the size of the resulting deficiencies. There has already been some focus on the causes of the problems, which note in particular poor management, speculation rather than solid productive activity, and the sudden increase in funds available to business as a result of the intense competition in the banking industry following deregulation in the 1980s. There are obvious lessons to be learnt from the current situation both by the immediate losers including lenders, management and shareholders, and the regulatory authorities.

However, an aspect which does not appear to be receiving the critical attention it deserves, is the state of insolvency law and practice in Australia and the inflexibility of that law and practice in dealing with actual or potential insolvency. The current collapses have emphasised the need for insolvency law reform to provide a more flexible method of dealing with potential company failures so as to encourage early recognition of a problem and the ability to take action in a quick and timely way which can significantly reduce the ultimate loss that might be incurred. Creditors, through their willingness to consider participating in "work outs" or contractual rescheduling have shown that the current statutory remedies available to creditors are considered to be inadequate.

The following is an outline on the options available in Australia, which are dealt with by discussing the advantages and disadvantages of each. The formal Australian options are very much a parallel of the earlier English system. Australia does not have any equivalent of the United States Chapter 11 procedure, the New Zealand statutory manager procedure or the United Kingdom administration order procedure.

The Australian possibilities are:

Statutory:	Provisional Liquidation/Liquidation Receivership Scheme of Arrangement Official Management
Contractual Work-outs:	Lender forbearance, moratorium deed, deed of compromise, or other compromise such as debt for equity.

PROVISIONAL LIQUIDATION

The increasing awareness of directors about their potential personal liability should they allow a company to incur further credit when it is insolvent means that applications by the borrower company itself for a provisional liquidator to be appointed are becoming more common. Another contributing factor is the extent of major unsecured lending which took place in the 1980's. This has meant that in some corporate collapses there has been no major secured creditor to take the decision out of the hands of directors when loan defaults occur.

Advantages of Provisional Liquidation

- Immediate, provided the court can be persuaded that assets need protection until a winding up application can be heard.
- Provides an effective moratorium on creditor claims.
- Gives control over assets.
- Allows continued trading without further risk of liability for directors.
- Gives a breathing space to allow investigation of alternatives of arrangement.

Disadvantages of Provisional Liquidation

- Carries very negative connotations generally, with a potential for unfavourable impact on the company's trading businesses.
- Requires a winding up application be lodged with the court which implies that the applicant believes the company should be wound up - otherwise it would be an abuse of process.
- Can trigger "escape" clauses on leases, licences and other contracts essential to continued trading.

- Does not encourage early action by directors since they lose control of the company. In general it is only a last resort for directors. The chances of an effective solution to the problems are therefore significantly less than if less drastic and earlier action had been taken.

- May require concurrent action in other group companies and other jurisdictions to ensure adequate control over assets.

RECEIVERSHIP BY SECURED CREDITOR APPOINTMENT

Here we are not talking about the appointment of a receiver by court order. Receivership by court order is more a remedy for a dispute over assets rather than a remedy for insolvency problems, although of course insolvency problems often also involve disputes over assets.

Receivership by secured creditor appointment is a simple procedure.

Advantages of Receivership

- Immediate, provided default has occurred and any necessary notice periods have been complied with.

- Provides a moratorium on debt.

- Removes control of the company from the directors.

- Allows continued trading.

- Relieves directors of further liability for trading whilst insolvent.

Disadvantages of Receivership

- Requires the existence of a major secured creditor prepared to make the appointment. (As seen in many of the large corporate collapses in Australia recently there may be no major secured creditor to take effective action).

- Although the receiver has a duty to all creditors his main function is to recover the debt owed to the appointing secured creditor.

- Does not give effective control over the company where a large number of secured creditors hold security over different assets.

- Can trigger "escape" clauses on leases, licences and other contracts which may be essential to the company's capacity to continue to trade.

- Does not encourage early action by directors, since they lose control of the company, and they may not be confident that the secured creditor and/or receiver will act in what the directors believe to be the best interests of the company.

- Leaves the future of the company unresolved should there be sufficient funds to pay out the secured creditor.

An alternative to the appointment of a receiver by a secured creditor is that of appointing an agent for a mortgagee in possession. This form of administration is chosen because it is perceived to remove the priority claim of the Taxation Department as against a secured creditor. However, where continued trading of the company the subject of the security is required, there are increased risks for both the secured creditor as mortgagee in possession and his agent.

SCHEME OF ARRANGEMENT

Schemes of arrangement provide the statutory method by which a company can reach a compromise with its members or creditors or with particular classes of its members or creditors. The legislation does not detail the objectives of a scheme but, typically, a scheme involves either a moratorium under which creditors' claims are frozen and the business continues with a view to ultimately paying pre-existing debts in full or, secondly, a compromise where creditors agree to accept a lesser sum than is owed by the company because creditors have been convinced that that will lead to a better distribution than if the company was liquidated.

Schemes of arrangement are not very common because of the initial delays (generally two to three months) and the legal and accounting costs involved. For a formal scheme of arrangement to take place, it is necessary to apply to the court for consent to convene a meeting of creditors to vote on the proposed arrangement, and presuming that creditors do agree to the scheme, to again apply to the court for approval of the scheme. The proposed scheme documents must be submitted to the court with the original application, and must also be submitted to the regulatory authorities. The court will not approve schemes which are against public policy, regardless of creditor support. The scheme documents are usually complex and the legal costs can be substantial.

The delays and cost involved will not always prevent a formal scheme of arrangement being an appropriate solution, particularly where a provisional liquidation, receivership or commitment of lender support is already available to give the necessary breathing space to enable the scheme to be put in place.

Advantages of Scheme of Arrangement

. Can result in the continued existence of a company and its business.

. Can allow a more flexible solution than liquidation - for example different classes of creditors treated in different ways.

. Can allow shareholder as well as creditor compromise.

Disadvantages of Scheme of Arrangement

. Slow and costly, and no guarantee that it will receive court or creditor approval.

. Does not by itself resolve the problem of funding continuing trading while the scheme is put in place.

OFFICIAL MANAGEMENT

Official management is now very uncommon and it is not generally seen as a solution to insolvency problems.

Advantages

. Provides the potential to place management of the company in the hands of a professional.

Disadvantages

. Must result in all creditors being paid in full or the official manager must convene meetings to initiate a creditors' voluntary winding up.

CONTRACTUAL WORK-OUTS

"Unofficial" schemes or work-outs are possible without reference to the court or the *Companies Code*, but they cannot bind any creditors against their will. They usually involve an attempt by a company to reach a variation as quickly as possible to its normal contractual obligations with significant creditors. In many cases, the existence and details of the proposal are kept confidential. Contractual work-outs normally take the form of an initial period of lender forbearance or temporary funding, followed by a moratorium deed, a deed of compromise or some other compromise such as a debt for equity conversion.

Advantages of Work-Outs

. If agreement can be reached, the company can be restructured with a better result for all than would be achieved compared to a statutory insolvency administration.

- Can accommodate the problem of multiple asset owning companies spread across interstate and international borders.

Disadvantages of Work-outs

- Will not succeed without realism and co-operation from management.
- Typically requires confidentiality and co-operation by a number of lenders, which can be difficult to achieve and maintain.
- Is vulnerable to challenges by individual creditors using the threat to wind the company up.
- Does not protect directors from further liability for insolvent trading.
- Often involves continual crises of creditor confidence through inability to meet sale deadlines or incapacity to produce credible up to date financial information.
- Does not stop the clock for preference recovery actions.

CONCLUSION

In Australia in the vast majority of cases, insolvency problems are not recognised until far too late, with the state of the company so parlous that there is no prospect of an adequate return to creditors regardless of how good a job is done by the insolvency practitioner. Part of the reason for this is that the available mechanisms for dealing with insolvency problems do not encourage early action by directors. Opportunities to salvage companies or at least mitigate the effects of corporate failure are missed.

This problem was identified in the 1988 Report by the Law Reform Commission on its Inquiry into Insolvency Law in Australia. One of the proposals made in that report was for a new voluntary procedure which would involve the appointment of an administrator to investigate the affairs of a company during a moratorium period, and make a recommendation to creditors at the end of the period. The proposals as drafted are capable of quick implementation for a company in financial difficulty and they provide the mechanism for all of the benefits of a scheme of arrangement without the significant down-side of time delay, cost and difficulty of continuing trading pending court approval. The Law Reform Commission recommendations have not to date, been adopted. Insolvency law reform does not appear to have priority in the minds of the legislators.

In the meantime the increasing willingness of major creditors to consider proposals for contractual work-outs reflects the fact

that this often has the potential to produce better results for all concerned than the available statutory insolvency mechanisms.

If problems are recognised early enough by directors (or by quality loan monitoring by lenders) then a contractual work-out may offer the opportunity to salvage the company. Even where the compromise does not result in salvaging the company, the various businesses operated by the company may be continued by sale to other parties, and the return to creditors is improved by the orderly realisation of assets. There is very little to be lost in investigating the possibilities of a work-out, and in some cases, there is a great deal to be gained. Until such time as we do introduce more flexibility into the statutory insolvency options, we are likely to see an increase in the incidence of attempts to solve problems by contractual work-outs.