CORPORATE INSOLVENCY - PROPOSALS FOR REFORM

PHILIP FOX

Madden, Butler, Elder & Graham
Solicitors, Melbourne

The legislation proposed by the Law Reform Commissioner is terrific from the insolvency practitioners' point of view, it is really their dream come true. But it also has, I think, far reaching ramifications from the secured creditors' point of view. One's view of the proposed legislation depends on who you are acting for. I will therefore present a banking point of view as to how I see this legislation affecting the secured creditor. Whilst there are safeguards built into the legislation it really does cut into what a secured creditor can and cannot do under his typical floating charge.

I think the reason for the difficulty here is that it puts the insolvency administrator in a position of conflict. He cannot act for both secured and unsecured creditors, their interests are diametrically opposed and yet this legislation will give the administrator the power <u>and the duty</u> to look after both sets of people. The administrator cannot resolve that conflict, although for a time the interests of secured and unsecured creditors may coincide.

Look at what happens in the first 35 day period, because it is in fact 35 and not 28 in most circumstances which will be the initial moratorium. This moratorium comes into effect instantly a director and the administrator sign the relevant yellow form which in due course will be lodged with the Corporate Affairs office. As it take effect <u>on signing</u> one can perceive of an easy situation whereby this form will be kept in the bottom drawer to be pulled out when your Receiver walks through the door. He will have to go away simply because there is a yellow form which will prevent him from doing anything for a period of time. So that is the first thing from a secured creditor's point of view - it is very easy for a company which may be in difficulty which if it does not want to have a receivership can prevent it very quickly. It can keep its options open by hanging on to the form until such time as it wants to rely upon it.

From the instant it is signed it takes effect and binds everyone immediately. The form is then required to be lodged forthwith at the Corporate Affairs Office whatever that may mean and whatever

protection that may give. An analogy is, I understand, taken from the execution of an authority under Part X of the Bankruptcy Act but execution of such an authority under that Act has none of the consequences proposed by this legislation. Specifically it does not bind a secured creditor or a lessor of plant and equipment or creditor under a "Romalpa" contract of sale.

Then we have a situation where in the period of the next 28 days (which can extend to 35) the administrator has to work out what he is going to do with the company and has to call a meeting of creditors. The legislation I think is VA26 which appears on page J - an administrator shall within 14 days after the effective date convene a meeting to be held within 28 days. Well in most situations it is impossible to work out either what the real state of affairs of the company are or what an appropriate proposal may be to put to creditors within that 14 day period. It is inevitable therefore that the administrator will seek to rely upon the subsequent provisions in that section which gives him power to apply to the court and ask for an extension of that moratorium period. And that can be extended for whatever time he can prevail upon the court to impose it. In Victoria we are not sure who will be hearing applications like this but it is a matter of conjecture as to just what information the court will be given, as to how it is to determine whether to extend that moratorium period. One presumes that if the administrator says it is necessary to extend it the court will go along with that view, so it will not be too hard for the administrator if he is of that view to simply seek an extension of the moratorium and in that period of time of course the secured creditor still cannot enforce his security, he will just have to wait and see what happens. Perhaps he can come along to court and argue against any extension and again one imagines that if there is going to be an argument of that sort, the court will take the view that it is all too hard, it will extend the moratorium in the meantime until further argument at some other stage and on it will go. So we have got the thin edge of the wedge creeping in as to what is initially a short moratorium. The moratorium will, I think, rapidly extend if the administrator is of that view.

Then we come to the question of voting when the meeting finally takes place during this moratorium period. The secured creditor can come along and vote at this meeting if he wishes, but I think it puts him in some difficulty. If he votes will he be deemed to be abandoning his security? That is if he votes for the full amount of his debt? On the other hand if he values his debt and votes for the balance he will have a fairly ineffective voice at that meeting for voting purposes. So I can see a conceptual problem as to what should happen at the meeting. Is the secured best advised to ignore it altogether? Should he vote and if he does vote what should he do about valuing his security? Maybe it does not matter in the end. Maybe he hopes that after the meeting is over the moratorium will come to an end. But these are problems which will require constant monitoring from the secured creditor's point of view.

And during this period of time we come to the question of the personal liability of the administrator. It appears at VA19. What the section says is that the administrator is only liable for the debts of the company incurred during the administration to the extent that the company has received a benefit. Further down in sub-section (5) you will see that the administrator gets a free ride for the first seven days, he is not liable for anything which occurs during that period of time, if he so chooses not to pay creditors.

But from the secured creditor's point of view I cannot see any liability here under any of these sections to require interest to be paid. Conceivably the company is not getting the benefit of its dealings with the secured creditor, that has long since passed and it would appear that the administrator is not obliged to pay interest during that period or perhaps any other period.

But finally, the most important section of all is VA30 which appears in pages M and N. Look at sub-section (3) on page M which deals with the effect of a deed once it is adopted by creditors. Now remember that the creditors will be mostly unsecured and of course no doubt they will be resolving for an orderly administration and they will want a trade-on situation and of course will want to bind the secured creditor. They will want to run it their way, they will want to trade on so they get the benefit of profits in due course. Even though conceivably the secured creditor will rank first, nevertheless it will be in their interests for a lengthy trade-on period with a view that ultimately enough profits will be made to pay back something for them.

But whilst in theory the secured creditor will not be bound by such a resolution of creditors when the meeting finally takes place there is provision for it to bind the secured creditor if the administrator and most creditors so resolve. True it is that a court application must be made in that regard but under the legislation the court is obliged to have regard to a number of factors and the most important one of these is that the enforcement of the charge or the taking of possession would defeat or materially prejudice the purpose and object of the deed. (See sub-section (c), page N.) Now quite clearly a resolution of creditors to trade on with a view to making profits for their benefit would be defeated if the secured creditor says no, we do not want a lengthy trade on situation, we want out money back quickly and we want to run our receivership, get it up and running and run it our way.

You have two diametrically opposed views and yet under this section the court is <u>required</u> to have regard to the fact that the interests of unsecured creditors would be defeated or materially prejudiced. Clearly that will happen and in view of the criteria which the court <u>must</u> have regard to it would seem that in those circumstances the court would have no alternative but to grant an application by the administrator to bind the secured creditor and

have it sit back and await the outcome of the adminstrator's dealings with the company.

So in these circumstances whilst from the unsecured creditors' point of view the legislation is most effective and most desirable, from he secured creditors' point of view there is a lot to look at, a lot to monitor, and a lot I think to be wary of. We do not know where it will all go to and perhaps one of the ways out will be to insist that potential borrowers trade personally where security can be enforced without hindrance and, in Victoria anyway, without registration.

Over recent years there has been a fascinating development in both the enforcement of securities and the law as a result whereby the rights of priority and preferential creditors are sought to be modified or postponed in various ways for the purposes of recovering for the secured creditor the full amount of his debt.

An administration under insolvency will destroy these techniques, and once again the rights of preferential and priority creditors will be payable in full to the detriment of the secured creditor. However that consequence is of a relatively insignificant nature compared to the overall significance of the proposed destruction of the basic rights of secured creditors.

The proposals overall are to be commended. The costs of schemes of arrangement have in many instances become prohibitive and the time taken to satisfy the statutory obligations which are imposed by the *Companies Code* render schemes entirely unsatisfactory where a moratorium is proposed. However I would have thought that if the interests of creditors are best protected by a moratorium the answer would have been to simplify and streamline the provisions relating to schemes. This could have easily been achieved coupled with the addition of a form of appointment of a provisional administrator in addition to the mechanism for the appointment of a provisional liquidator without the necessity to cut across the rights of the secured creditors.

The evils surrounding the enforcement by secured creditors of their rights, I think, are more imaginary than real and I fear that this legislation goes too far in attempting to balance the rights of secured and unsecured creditors.