CORPORATE INSOLVENCY - PROPOSALS FOR REFORM

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1. The Insolvency Reference

The scope of this Reference required a review of both the Bankruptcy Act and the provisions of the companies legislation which deal with corporate insolvency.

There has been no previous opportunity in Australia to consider the totality of insolvency law. In particular, the law relating to corporate insolvency has not previously been reviewed in Australia. The succession of legislative devices which ultimately brought about the present system of a unified company law in this country have paid little attention to corporate insolvency.

2. The progress of the Reference

Work on the Reference commenced in July 1984. An Issues Paper was published in January 1985. The response was admirable. From all sections of the community many positive and detailed submissions were received which, apart from their particular value, evidenced the perceived need for substantial reform. It confirmed the view of the Commission that this review of the law relating to insolvency must go beyond merely mending and patching the existing law.

A very wide consultative process has been a feature of the Reference to date. The Commission has the benefit of a distinguished panel of honorary consultants. In addition the Commission has had many discussions with professional, business, government, academic and community groups and representatives both within Australia and overseas. With the benefit of that consultation and the extensive research and inquiry carried out by the Commission firm proposals for reform have been developed.

The Commission is about to publish a Discussion Paper which will set out these proposals and illustrate the manner in which, if acceptable, they might be conveniently translated into the language of the legislature.

The Commission will seek response to the Discussion Paper before presenting a final Report.

3. Corporate insolvency reform

The main thrust of the proposals of the Commission will be in this area. Briefly stated they involve a new approach to director liability based upon the concept of "insolvent trading". It is proposed that the legislation relating to receivers of companies should be strengthened by provisions which will cast a legislative duty on receivers to act with reasonable care in the exercise of their powers and duties; give receivers and others a specific legislative base upon which to seek a declaration that an appointment was or was not invalid; protect receivers who act in accordance with directions of the court; and permit receivers to carry on the business of the company in certain circumstances notwithstanding the winding up of the company.

The avoidance of antecedent transactions will have a specific base in the legislation. These proposals are extensive. They involve a re-statement of the law relating to preferential transactions (including the introduction of a "related person" category of creditor); a new provision relating to transactions at an under-value; a re-statement of the law relating to transactions made with intent to defeat, delay or obstruct creditors; and other provisions designed to avoid or redress other dealings. There are proposals that will intervene upon the endeavour to regulate the insolvency of a corporate trustee, particularly in the area of the private trading trust. The law relating to the involuntary winding up of companies has been redeveloped. It will be proposed that this be the subject of a specific legislative part of the companies legislation.

However, the major part of the proposals with respect to corporate insolvency will involve a fresh approach to the voluntary administration of an insolvent company. It is that area which may be of considerable interest to this audience. thus it is the principal subject of this paper.

4. The voluntary administration of an insolvent company

Submissions to the Commission clearly indicated that existing law and practice as regards voluntary submission to an insolvency administration by a financially troubled company required review. These existing procedures, taken individually, suffer from a number of impediments. The promotion of an arrangement with creditors under the present "scheme of arrangement" procedure is lengthy, complex and expensive. Official management is too rigid in its concept since, in effect, it demands that ultimately creditors be paid in full and that the company be "saved". Creditors were extremely wary of official management. A creditor's voluntary winding up leaves the affairs of a company in a state of flux while the technical requirements of the legislation are fulfilled.

More importantly, however, there is no integration between these alternative means of dealing with the financially troubled corporation. They are mutually exclusive.

In the development of a fresh approach, one objective was to develop a singular as opposed to the existing multi-structured but segregated methods. The other objective was to provide a relatively simple and inexpensive procedure. That, of course, involves a number of considerations. There is a need to balance simplicity with necessary protection. This raised issues such as the extent to which a court should be involved in the process; the responsibility that might be cast on the insolvency administrator; the role of members and creditors of the company; the questions of time and protection of the property of the company from unnecessary and piecemeal salvage operations.

Ultimately the Commission developed its proposals on these criteria:

- the procedure should be capable of quick implementation and be as uncomplicated and inexpensive as possible;
- it should be flexible so as to accommodate alternatives for an insolvent company; and
- there should be provisions for some form of protection of the property and undertaking of the company, at least, while the process toward decision-making was under way so as to provide for an ordered form of administration, whether by way of winding up or under an arrangement.

5. The specific proposals for voluntary administration

The Commission has developed a legislative draft for the proposals. The appendix to this paper has reproduced some, but not all, of the draft legislation. The provisions which are reproduced highlight most of the essential process and procedures.

General

The draft legislation is in the form of an amending bill to the present Companies Co-operative legislation. The amendments would be incorporated into the Act of the A.C.T. and the Codes of the six States and the Northern Territory by appropriate application of laws legislation under the co-operative scheme. The nature of the co-operative scheme will require reciprocity provisions so that an administration of a company with business and assets in more than one State or Territory can be effectively carried out. This legislation would introduce a new Part into the companies legislation which would be largely self-contained.

The existing provisions for official management and creditors' voluntary winding up would ultimately be repealed. It is

intended to preserve in large measure Part VIII which deals with schemes of arrangements.

The scheme of the legislation

A. It applies to companies with a debt problem. They need not be "insolvent" in the classical or strict legal sense.

B. Such a company may make a declaration of financial difficulty and appoint a registered insolvency practitioner as administrator.

C. The administrator takes full control of the company for a limited period of time which will not normally exceed 28 days.

D. During the "control" period there is a moratorium or stay on action or proceedings against the company and its property. The principal features of the moratorium are:

- it applies to all unsecured creditors;
- it applies to all secured creditors, with limited exceptions;
- it applies to all persons who are the owners or lessors of property possessed, used or occupied by the company.

E. During the period of "control" the directors of the company are required to give the administrator all necessary information and the administrator is given suitable powers to effectively control (to the point, if necessary, of excluding the directors) the property and the continued operation of any business of the company.

F. If the administrator continues with any trading operations of the company he or she will be personally liable for debts or liabilities incurred as a result. However, the administrator is entitled to be indemnified out of the assets of the company. That indemnity postpones unsecured creditors, government creditors and a floating chargeholder (to the extent of permitting the administrator to have access to the assets subject to the floating charge).

G. The administrator is required to convene a meeting. Notice of the meeting is to be given accompanied by a report of the administrator of the business, property and financial affairs of the company together with the administrator's opinion to the creditors as to whether the company should be wound up or make an arrangement with the creditors. If an arrangement is proposed, full particulars are to be given.

H. The meeting is to be convened within 28 days. At the meeting the creditors will determine whether the company is to be would up or make a deed of arrangement.

I. If the creditors resolve that the company be wound up this is accomplished by the filing of a notice to that effect. The company is then wound up in insolvency as if an order of the court had been made on the date that the company became a company under administration.

J. If an arrangement is proposed by the company with its creditors it need not be such that it requires the company to meet its debts in full, nor such that the company should necessarily survive. It could amount to an immediate "straight" composition; a "carry on" of part or the whole of the trading operations of the company until that can be conveniently realised with a composition or winding then to result; or the granting of time to pay while re-financing or the injection of additional capital is negotiated.

However, whatever the nature of the proposed arrangement, the essential terms will be embodied in a short form of "deed of company arrangement". Many parts of the corporate insolvency legislation will apply to such a deed as, for example, the legislation dealing with proofs of debts, avoidance of antecedent transactions, priority payments and so forth.

K. The court is given a general supervisory power throughout all aspects of the procedure. However there is no requirement for any part of the procedure to be sanctioned by the court. The principal powers of the court are to remove an administrator; to give directions as regards meetings; and to avoid or terminate a deed.

6. A consideration of some of the essential provisions

Purpose and application. The proposed sections VA1 and VA2 describe in broad form the purpose of the legislation and companies to which it would be applicable. An arrangement must be for the satisfaction of all debts, either in full or in part with a release from debts unsatisfied in full. It is not intended that the effect of a completed arrangement in respect of a company should leave that company in a continuing state of insolvency.

Initiation. Sections VA5 and VA6 set out the means by which the process is commenced. The essence of these provisions is toward expedition, informality and little initial expense. A declaration in non-formal terms is all that is required.

It will be noted that the members of the company are not involved in this process. The initiative is, as with management generally, reposed with the directors.

The one exception to the initiation of the process by directors is as provided in VA5(3). The holder of a floating charge may invoke the procedure. While this may seem to detract from the

voluntary nature of the procedure, the Commission has taken the view that as a floating charge generally comprehends the whole of the property of a company, including any going concern business of the company, the holder of the floating charge should, if that person is in a position to appoint a receiver, be able to appoint an administrator as an alternative.

The administrator. Section VA10 is designed to achieve the appointment of an objective and impartial administrator. The procedure cannot be initiated without the consent of the person selected to be the administrator of the company. Even though the administrator would normally be selected by the directors, the thrust of this provision is designed to promote and ensure that the administrator is impartial.

The general and specific powers of administrator. Sections VA12 and VA17 outline the position of the administrator and the powers accorded to that person. They vest control of the company in the administrator and prescribe the temporal limits for that period of control. The company remains under administration until one of the events provided for occurs - normally within 28 days of the commencement of the administration.

The administrator is given the right to absolute control over the property and business of the company.

Effect of appointment. Section VA18 is an important section. It is designed to put the company under a fairly wide moratorium. The intended scheme of the operation of the moratorium is as follows:

1. The period. The restraints operate from the effective date (the making of the declaration by which the company is placed under administration) until the company ceases to be a company under administration. This will normally occur before the expiry of 28 days from the effective date. Within that time, the administrator must call a meeting of creditors. That meeting will usually have the result that the company ceases to be under administration for one of the following reasons.

   (a) The creditors accept an arrangement in which case unsecured creditors and, in some circumstances, secured creditors will be further restrained from taking action against the company, as long as the terms of the arrangement are complied with.

   (b) The creditors resolve that the company be wound up, in which case the winding up provisions will apply including those provisions which effect a stay on unsecured creditors.

   (c) The creditors resolve that the company cease to be under administration.

If none of these events occur, the moratorium will, nevertheless, come to an end after the expiry of 35 days from the effective date even though the company may continue to be under administration (e.g., if the meeting is adjourned beyond that time). There is provision, however, for the period of restraint to be extended by order of the court.

2. The persons affected. The restraints apply to the following general categories of persons:

   (a) all unsecured creditors;

   (b) all secured creditors;

   (c) all persons who are owners or lessors, of property in the possession, use or occupation of the company. This would embrace, for example, lessors of real estate, plant and equipment or personal property and persons who claim title to property through "retention of title" contract provisions.

3. The nature of the restraints.

   (a) Unsecured creditors are restrained from taking or continuing with any action or other civil proceeding against the company or with respect to property of the company.

   (b) Secured creditors are restrained from taking steps to enforce a charge over property of the company.

   (c) Owners or lessors of property in the possession, use or occupation of the company are restrained from taking steps to take possession or recover such property.

4. Exceptions to the restraints.

   (a) All persons affected have a general right to be exempt, either with the consent of the administrator or by order of the court. An order may be made subject to conditions.

   (b) A specific exemption applies to an application for the winding up of the company. There is nothing which prevents the making of such an application during the period of restraint or from furthering the cause of such an application made prior to the effective date.

   (c) A specific exemption applies to a receiver appointed over property of the company prior to the effective date. The receiver's powers and functions may be exercised without restraint unless the administrator obtains an order for the stay of the exercise of all or any of such powers.

(d) A specific exemption applies to the giving of notice in consequence of a default in respect of a charge over property or under any agreement relating to property possessed, used or occupied by the company. Thus, for example, a secured creditor or an owner of property leased by a company may, short of enforcing their full rights, put themselves in a position where, at the end of the period of restraint, they may take further steps in consequence of a default.

It is to be noted, however, that this exemption does not apply to the giving of notice by which a charge, effective as a floating security at the effective date, might be converted into a specific charge as provided for in a proposed s.204A(1)(b) (see legislative draft of this provision - attached).

The intention here is that, if the charge conferred a floating security at the time of its creation and remained floating at the effective date, the moratorium would prevent its conversion to a specific charge. As a consequence, the property which is subject to the floating charge may be dealt with by the administrator during the period of administration and will constitute property of the company to which the administrator is entitled to have recourse for remuneration and by way of indemnity for debts and liabilities for which the administrator is personally liable.

(e) The restraint does not, unless the court otherwise orders, apply where, prior to the effective date, a secured creditor has, in the exercise of the rights of security of that creditor over the security property, either:

(i) made a binding agreement to sell the property or

(ii) caused the property to be offered for sale by public auction, where the auction is to be held not more than 28 days after the effective date.

This exception appears to be necessary to avoid abuse of the procedure by the company and prejudice (particularly to third parties) or the waste of time and expense where, clearly, prior to the effective date significant steps have been taken to realise a security property.

Personal liability and right to indemnity of an administrator. Section VA19 is also a vital provision. Its design is to encourage the continued operation of the business or trading activities of the company (whether in part or in whole) in an appropriate case. To achieve that it is necessary to impose some degree of personal liability on the administrator so that persons

with whom the company deals while under administration may do so with some degree of confidence.

However, to balance or redress that exposure to liability the administrator is to have a right of indemnity (supported by a statutory lien). The provisions dealing with the indemnity have the following features.

1. The administrator's right to indemnity is ranked ahead of the claims of all unsecured creditors.

2. The legislative draft, if enacted, would amend the companies legislation in force in the Australian Capital Territory. It would apply to the States and Northern Territory by virtue of other elements of the co-operative scheme. The use of the words "including debts or liabilities under a law in force in the Territory" would give the administrator's indemnity priority over that possessed by the Commissioner of Taxation in respect of, for example, group tax under s.221P of the Income Tax Assessment Act. For the administrator's priority to be effective throughout all the participating States and Territories, it would be necessary for s.221P to be suitably amended. Nevertheless, there is a clear intention that all unsecured creditors, including the government, should be postponed.

3. As far as secured debts or liabilities are concerned, the indemnity will not take priority over debts secured by fixed or specific securities. The indemnity will also not take priority over a debt or liability secured by a floating charge where a receiver was appointed under the terms of that charge before the administrator was appointed and the receiver has continued in office. However, if a receiver is appointed under the terms of a floating charge after the appointment of the administrator, the administrator's indemnity will take priority over the secured debt in relation to debts or liabilities incurred before the appointment of the receiver.

   The definition of floating charge contained in s.5 of the Companies Act will apply so as to include charges which were floating at the time of their creation but which have since become fixed. Thus, despite the fact that the charge may have automatically crystallised, it will still be regarded as a floating rather than a fixed charge for the purpose of giving priority to the administrator's indemnity. That priority will only be disturbed by the appointment of a receiver.

4. The administrator is given a lien over the property of the company as one means of securing the indemnity.

Duties of administrator and meeting of creditors. Sections VA25 and VA26 provide for a meeting of creditors at which to consider the options available to them.

Winding up. Section VA27 provides for the winding up of a company to occur as an immediate consequence of a resolution of the creditors to that effect.

Deed of company arrangement. Section VA29 deals with the process should the creditors resolve for the company to make an arrangement and section VA30 details the effects of the deed, again providing for some important provisions relative to secured creditors.

Section VA29 gives a basic outline of the procedure which is to be followed where the administrator proposes and the creditors accept a deed of arrangement.

The creditors exercise control not only by their collective power to accept or reject a proposal for an arrangement, but also by their right to appoint the administrator of the deed. This administrator may, but need not necessarily, be the administrator appointed by the directors.

The basic elements which a deed should contain are specified in sub-section (3). The sub-section also refers to provisions which are to be included in a schedule. The schedule will cover such matters as proof of debts, priorities on distribution of property, avoidance of antecedent transactions, calling of meetings, the remuneration of administrators and the powers and duties of administrators.

Some of these matters, such as proof of debts and recovery of antecedent transactions, are at present dealt with in corporate insolvency by way of cross-reference to the Bankruptcy Act. However, it is proposed that such provisions be comprehensively and explicitly introduced into the companies legislation.

The schedule will thus largely consist of references to various sections of the companies legislation dealing with aspects of corporate insolvency and stating that they apply to a deed of arrangement. It will be permissible to exclude, modify or add to these standard provisions.

Section VA30 sets out the consequences for creditors of the execution of a deed of company arrangement.

1. The nature of the restraint. The deed is basically intended to bind all creditors including secured creditors. However, secured creditors and creditors or other persons who own or lease property which is possessed, used or occupied by the company are not bound in relation to the property over which they have security or which they own or lease unless they agree or the court orders them to be bound.

   Creditors who are bound by the deed may not, except with leave of the court

- make or proceed with an application for winding up of the company,

- enforce a remedy against property of the company or property possessed, used or occupied by the company, or

- commence or continue with a legal proceeding against the company.

2. Limited application to secured and other like persons. Secured creditors are not to be bound automatically to the deed either by a vote of all creditors or a vote of some class of secured creditors. There are at least two reasons for this. First, it is difficult to regard different secured creditors or persons having an interest in property possessed, used or occupied by a company as having such a community of interest as would justify requiring them to vote as a class. Secondly, it is desirable to minimise any interference with the rights of such creditors.

   Therefore, unless a secured creditor or like person agrees to be bound by the deed (in which case it is at least logical that the person should be bound even if there is no consideration in contractual terms) such persons may only be bound by order of the court.

3. Basis for a court order. Provision is made for the company to apply for an order binding a secured creditor or the owner or lessor of property possessed, used or occupied by the company with the same restrictions as apply to creditors generally by virtue of sub-section (2). The order may be made where the exercise of the rights available to those classes of persons would defeat or materially prejudice the purpose and object of the deed.

   The court may take into account

   - the conduct of the parties,

   - proposals for the continued performance of the agreement between the company and the secured or other like creditor, and

   - any prejudice likely to be suffered by the company and its creditors generally and by the particular creditor.

   The position of the secured or other like creditor is further protected by the court's power to impose terms as to costs and damages in relation to

   - the period for which the exercise of rights is restrained and

   - the consequences of any further or other default by the company.

Power of court to terminate or avoid deed. Section VA33 and VA34 gives the court power under various circumstances to terminate or avoid a deed and represents the controlling power or overriding power of the court in relation to a deed of company arrangement.

Modification of deed. Section VA36 permits a deed to be modified in the circumstances mentioned.