WORK-OUTS

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I take this opportunity of thanking the Banking Law Association for inviting me to address the Seventh Annual Banking Law Conference and for the splendid hospitality which has been shown to me and my wife. For my part it has always been a pleasure to visit this magnificent country and a privilege to address lawyers and others who have made this country one of the most resourceful and intelligent legal jurisdictions in the world.

Well as Henry VIII said to his wives: "I shan't keep you for very long!" I only just have a few points because as has been said, the secret of walking on water is knowing where the stones are.

In the UK we still have the classic private work-out restructuring "sport" agreement containing freeze on acceleration rights, sometimes new money, sometimes subordination, sometimes conversion of debt, always the comprehensive group currencies backed up by security, and we still have the same difficulties and disadvantages - ie. the inability to hold creditors at bay, the inequality between creditors, the intense inter-creditor competition, the inability to achieve parity between bondholders, suppliers and banks, the hold out bank problem, the delays caused by loss sharing agreements because one bank has a negative pledge; one bank is lending to an operating subsidiary whilst the other to the holding company, and so on. But, the old work-out agreement in England is now a dying contract; and the main inhibiting factor has been the introduction of the concept of wrongful trading.

In earlier times, here certainly, and in most countries, directors were not liable on the "silver lining" test. So long as they could see a light at the end of the tunnel they did not have liability - provided of course it was not a freight train coming the other way. And, if you want to have a veil of incorporation, you test it on insolvency, because it is then you have to decide whether you are going to honour it or not. It is the test, whether the management is liable on insolvency or not. Now to some extent we, in England, have to a degree dishonoured the veil of incorporation by this concept of wrongful trading, because directors are now liable on almost an objective test of mismanagement. If they ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation, then they have liability to contribute tot he assets.

There is a defence of best efforts. But also, there is a very important new technique which saves them. That is why this dishonouring of the veil of incorporation which we objected to so much at the time, is maybe not so bad. Wrongful trading does not apply if the directors put the company into administration - which is a sort of US Chapter 11. But you know it is very different from Chapter 11 and it is very different from the New Zealand Statutory Management concept.

It is a controlled work-out which aims to achieve a balance of power. You are aware whether the debtor has got the money or not, and therefore is in a very powerful position comparatively speaking as vis-a-vis the creditors. The debtor has all the aces, whereas the creditors only have twos or threes - sometimes supported by their contracts; by their security, they can move themselves up to five or six. The chief features of our administration are it keeps the creditors at bay by freezing proceedings. There is a limited interference with creditor rights - not too much, I will explain later. If one interferes too much with creditor rights on rehabilitation, more, if you put the debtor in a better position than he would be when solvent there is the risk that these rehabilitation proceedings can be used to get as much as possible out of the creditors and then liquidate - in other words evade all the protections which are given to creditors on a liquidation.

Next, our scheme is not distributive, that is the administrator has no power to agree claims and pay dividends. It is not a composition. It cannot involve debt forgiveness or creditor voting. Creditor voting introduces huge unpredictabilities into commercial relationships because you never know whether or not you are going to be out-voted in your transaction.

Finally, it is a very open procedure - you know there are no rules. When it was first introduced the government said: "We don't know how this is going to work. All we will do - we will put a fence around creditor actions and we'll see how it goes." It is not a formal procedure; there are no tough time limits except on important things. It relies on negotiation and the balance of power between creditor/creditor and debtor. It only applies to UK companies by the way, not foreign companies. I think that is probably another difference between it and Chapter 11. The US law, tends to reduce some of the confrontations between jurisdictions, but not of course the question of confrontation over foreign assets.

It is a surprise proceeding. All insolvency proceedings of this sort have to be ambush. They only work that way. Creditors cannot get advance notice if it is to work.

There is a general freeze on creditors' rights on the usual lines - no winding up orders, no proceedings, no enforcement of security, and this also applies to the treatment of hire purchase, chattel leases, and retention of title. The sham forms - fancy dress security - are treated as security and are therefore frozen. The object being that the administrator should be able to use the assets of the company in the meantime and sell them in his own time. The actual impact upon security is in fact quite limited and has not as it turns out notwithstanding our initial protests been too bad. The administrator's only powers are to sell the security, so the result is that the holder of the security loses the timing of the enforcement, but he does not lose the ability to compel an enforcement at some point, and he does not lose the return of the proceeds of sale.

The effect on floating charges, on partial floating charges, is disastrous - they are completely wiped out. For example, the administrator's contracts are a prior charge on floating charge assets. So now in England the partial floating charge is quite useless - for example, the floating charge on securities on a portfolio of securities.

So there you will see there is a general freeze which reminds me a little bit of the remark of Dorothy Parker when she was watching a dress rehearsal of a dance act and the producer leant across the very amply endowed dancer and said: "Don't you think it would be a good idea if the dancer wore some upper restraints?". Dorothy Parker remarked: "Oh, you've got to have something in the show which moves!" And indeed in our administration there are some things which still do move. There are creditors' rights which are not affected, and I think these are very important. Set offs are still possible, therefore banks can settle, markets can close out. If that were not possible there would be a major threat to the operation of financial markets.

It is still possible to accelerate loans and to accelerate equipment leases. It is not possible to take the security, nor is it possible to get the equipment. It is still possible rescind the executory contract - again, I think that is very important in relation to sale of goods and perishable assets. There are no powers of disclaimer.

Some denuding of the property of the insolvent is still possible. Thus, one has to strike the balance between protection of creditors and the need to promote recovery.

So far as management is concerned, the administrator has overall management control - he can hire and fire directors - we do not have the concept of the debtor in possession. He has to be a licensed insolvency practitioner and in practice we have not had real difficulties over conflicts of interests. He is not personally liable, but his engagements post-administration are a prior charge - they have super priority. In practice it has been possible for the administrator to raise new money, which is of course always an essential feature of any work-out.

The proposals have to be put to a creditors' meeting within three months. They must be approved by majority creditors - not the courts; shareholders are not interested. They involve the usual issues - new management, closures, disposals, hive downs, conversions, rights issues, and so on. But, creditors are not bound. That is why it is just a forum, an arena for a work-out. It is possible to bind creditors by the administrator using an alternative procedure of a voluntary arrangement, whereby 75% voting can bind bind dissentient creditors. But this has in fact not been used very much. It tends to be used by administrators more as a threat to creditors to bring them into the scheme.

Creditors have a protection which again has not been used much - that they can apply to the court on grounds of unfair prejudice. And it just says "unfair prejudice"; it leaves that to be worked out on a case by case basis. As I said, it is a very open procedure.

The administration order can be blocked. This is very odd in a way - it is rather like the inventor who patented a teaspoon with a bent handle so that it wouldn't poke in your eyes while drinking tea! If a bank has a comprehensive floating charge and appoints a receiver before the administration order, that blocks the administrator, because obviously you can't have two people running the business at the same time. So the main purpose of the floating charge as the omnibus universal security is still preserved.

I suppose that the test of any insolvency law of this type is whether it works. Well, we have not enough experience yet of really major administration with two or three going at the moment - Atlantic Computers and Drexel, from which we are likely to derive certain interesting results. But at the moment we do not really know. There is a feeling though, and there has been a survey which showed that about 50% of these "schemes" have resulted in survival of at least some part of the business, usually by a sale.

Now in Australia you are faced by the question of which to go. My own view is that you have to make a decision about who you back - the debtor or the creditor. On insolvency that is the testing time. You cannot back both. You have to back one or the other. What it comes down to is whether you want to back the financial institutions or the rest. The key indicators in the world's jurisdictions of whether a country is debtor orientated or creditor orientated, are whether it allows set off, how many creditors, preferential creditors rank ahead of fixed security, the length of the preference periods, the degree of the dishonour of the veil of incorporation, and whether or not there is a stay on the rescission of executory contracts. If you take those indicators, then on a scale of ten, you would put Australia, Canada, Germany and the Scandinavian countries at about two on the scale, Japan and Korea would finish at three, England would be about four and drifting out to sea, and round about five you find New Zealand. You would put the United States, which is tugged both ways, at seven - it is a very divided and rich jurisdiction from that point of view - it does not have a common culture, a common direction, from the point of view of its insolvency laws. Round about nine or ten you would put France, Belgium, and Luxemburg. You must decide which way to go.