WORK-OUTS — THE CHALLENGES OF THE 90S

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INTRODUCTION

Australia's straitened economic circumstances over the last several years have had their inevitable consequences. Personal bankruptcies have soared, and a number of businesses have entered into insolvency administrations of one form or another.

Businesses that had given security over their assets lost control of those assets as mortgagees or chargees moved into possession, directly or by an agent, or appointed receivers or receivers and managers. In either case the result was almost inevitably 'down-sizing' or 'restructuring' (each of which was a euphemism for a significant divestiture of assets), often to the point of disappearance.

Those businesses that had not given security over a substantial portion of their assets and undertaking could not simply hand control of those assets and undertaking to a key lender and let that lender sort out the mess. More often than not, their fate was the corporate death of liquidation. Some, however, managed to convince their lenders that there would be a way out of the mire, or at least that the lenders themselves would be better off if only those lenders would sit down and negotiate revised arrangements for the money that was owed to them. Indeed those revised arrangements frequently required some lenders actually to increase their exposure.

While such negotiated arrangements were not invented in the late 1980s, they became prominent at that time as a relatively common form of insolvency administration. Their use was not restricted to borrowers that had not granted security: they were also used where security had been given to a number of different lenders and those lenders agreed that a rush to enforce those securities might be better replaced by an orderly restructuring of the borrower's assets and liabilities. In the case of complicated corporate structures, with cross shareholdings and a multiplicity of different lenders at different levels of the corporate group (some secured and others not), a 'work-out' of this type was often seen as the only sensible way to restore order out of chaos, while still preserving for the lenders some hope of recovering at least a part of the moneys that were owed to them.

Work-outs of this nature have been the subject of previous papers at BLA conferences. However, it is appropriate to revisit the topic, first because the rate of new insolvencies seems now to be slowing and, secondly, in order to consider the likely impact on work-outs of Part 5.3A of the *Corporations Law*, once it comes into effect. This paper discusses a number of issues raised by work-outs, and then considers whether the phenomenon is likely to continue into the next cycle of insolvency.

THE VARIOUS FORMS OF INSOLVENCY ADMINISTRATION

Receiver or agent in possession

If a borrower has defaulted in its obligations to its lender, the immediate consequence is likely to be that the lender can cancel its commitment to provide further accommodation, and call up (or accelerate) all outstanding indebtedness. If the borrower has granted security to the lender, the lender might then proceed to enforce that security, either by taking possession of the secured assets itself or through an agent, or by appointing a receiver or receiver and manager. The agent or receiver might seek to trade out of the situation, or might sell all or significant parts of the secured assets in order to pay out the amounts owing to the lender. Yet again, the agent or receiver might simply follow a 'take and hold' strategy, in which assets are held for an indefinite period of time, generally in the hope that the market for assets of that type will improve and a sale might then be effected at a price more likely to return an acceptable proportion of the debt.

Whether or not security has been given, however, there are other options.

Winding up

The lender could move to have the borrower wound up. While the *Corporations Law* also provides for a creditors' voluntary winding up, the more likely course is for the creditor to apply to the court that a winding up order be made. As an interim measure, the appointment of a provisional liquidator might also be sought.

Indeed, it might not even be the lender that applies for winding up. The directors of the borrower may determine that the borrower is no longer able to carry on business without the directors committing breaches of the *Corporations Law* (in particular, under section 592, concerning the incurrence of debts by a company while insolvent). They may therefore arrange for the borrower itself to seek a winding up order.

Official management

Alternatively, the directors might seek to have the borrower placed under official management under Part 5.3 of the *Corporations Law.* (When the *Corporate Law Reform Act* 1992 (the 'CLRA') comes fully into force (which is anticipated to be towards the end of June), the official management provisions will be deleted from the *Corporations Law.*)

Scheme of arrangement

Yet again, if the directors believe that there might be a way for the company to survive its difficulties, so long as its obligations to its various creditors are rationalised, a scheme of arrangement might be proposed between the company and its creditors under Part 5.1 of the *Corporations Law.*

Work-out

Or they could propose a work-out.

Administrator and deed of company arrangement

Once the CLRA comes fully into force, a new form of insolvency administration will be introduced: the appointment of an administrator and the consequent possibility of a deed of company arrangement. The features of this form of insolvency administration are described in greater detail below.

Each of the forms of insolvency administration referred to above, other than the work-out, is founded in or recognised by statute. The work-out, on the other hand, is a consensual arrangement which completely by-passes traditional mechanisms.

GENERAL DESCRIPTION OF A WORK-OUT

A work-out requires the express agreement of each of the creditors to be affected by it. It therefore cannot be put in place overnight. Rather it generally involves a significant period of negotiation between a number of parties, many of whom may have quite disparate interests. So that the debtor's position may be preserved pending agreement on the work-out arrangements, the creditors may enter into interim stand-still arrangements (which might themselves require detailed negotiation). Under these interim arrangements the creditors are likely to agree to continue to make financial accommodation available to the debtor at pre-existing levels, and not to take any steps for recovery of moneys owing by the debtor, to enforce any security, to take steps to wind the debtor up, to place the debtor under official management, or to have a receiver appointed to the debtor.

The formal work-out documents themselves are likely to be developed in discussion between the debtor (or debtor group) and a lead group of creditors. The lead creditors are likely to include those creditors with the largest exposures to the debtor, together (where practicable) with representatives of lending groups with particular interests. If the latter are not involved in the process, it may be hard to convince them that their interests have been appropriately dealt with.

The formal work-out documents will probably be designed to rationalise the debtor's obligations to its lenders, and to provide the debtor with a realistic breathing space within which to restructure its business by selling assets to reduce its debt.

To achieve this, the work-out documents are likely to include provisions to the following effect:

(1) **(Continuation of facilities:)** A commitment by lenders to continue to make financial accommodation available for a uniform agreed period at a uniform interest rate and on common terms.

(2) **(Existing facilities:)** Existing facilities will either be released, or the creditors will agree not to pursue their rights in respect of the existing facilities so long as the work-out continues in place.

(3) **(Further accommodation:)** Where the debtor is unable to fund specific expenditure requirements, or to fund its working capital needs, designated lenders may agree to provide further accommodation for these purposes.

(4) **(Assets disposals:)** The debtor may be obliged to undertake an assets disposal programme.

(5) **(Amortisation of debt:)** Provision is likely for the amortisation of the debt owing to the creditors out of surplus cash flows and the proceeds of assets disposals.

(6) **(Sharing:)** There will be a stipulation of the method by which recoveries from the debtor will be shared between the creditors.

(7) **(Security:)** Details will be set out of the security structure that is to support the work-out.

(8) **(Representations and warranties, etc:)** Representations, warranties, undertakings and events of default will be included of a kind similar to those customarily found in credit facility agreements. Given the factual background against which they are negotiated, these provisions are nevertheless likely to be much tighter in their approach than anything the debtor has previously encountered. A series of mile-stones may be agreed against which the progress of the work-out can be judged. If the mile-stones are not met, the work-out may come to a premature close.

(9) **(Committee of lenders:)** A committee of lenders is likely to be established which will meet regularly to consider the progress of the work-out. The committee is likely to have extensive rights to information and reports, and may have the right to disapprove proposed business plans and budgets. The committee is likely to reflect the composition of the creditor group which negotiated the work-out, and to include the creditors with the largest exposures, together with representative creditors with distinct interests. The committee will act as a conduit between the debtor and the creditors as a whole.

The committee is likely to be chaired by a leading insolvency practitioner. This role is likely to be critical. Not only will the insolvency practitioner be required to provide the creditors with the benefit of his or her extensive experience in the management of insolvent businesses (or businesses that are bordering on insolvency), but he or she will in practice be required to act as a mediator between the creditors in the course of the numerous disputes that they are likely to have as the work-out proceeds. The insolvency practitioner will perform this function best if he or she is possessed of a strong intellect, a large amount of common sense, a persuasive tongue, the patience of Job and an ability to 'bang heads'.

THE ADVANTAGES OF A WORK-OUT

As will be seen from the above description, a work-out bears a lot of apparent similarities with the type of arrangement which it had once been the habit to implement by scheme of arrangement. For example, some of the most famous insolvencies of the early 1980s, such as Massey-Ferguson and International Harvester, were the subject of schemes of arrangement.

The trend in the late 1980s and early 1990s, however, has been to move to contractual work-outs, rather than schemes of arrangement, where these could be achieved. (Direct enforcement of security, such as by appointing an agent in possession or a receiver or receiver and manager, has continued to be the favoured approach where a dominant lender holds first-ranking security. Liquidation has continued to be the approach adopted where security is not held and where there is no point in attempting to salvage the borrower's business.)

Work-outs seem to have been preferred for the following reasons:

(1) **(Simpler and less expensive:)** Work-outs have been perceived as being simpler to effect and less expensive than schemes.

Schemes of arrangement must be approved by the relevant Supreme Court. They entail applications to the court (at which the Australian Securities Commission has a right to appear and make submissions) and the holding of scheme meetings for the creditors. Where a scheme provides separately for different classes of creditors, scheme meetings must also be held for those classes.

Like any court-related procedure, a scheme of arrangement is inherently expensive. However, it is by no means necessarily more expensive than a work-out.

The major attraction of a scheme of arrangement is that creditors who hold at least 75% of the total amount of the debts and claims of the creditors present and voting at the relevant creditors' (or class) meeting can bind all creditors (or members of that class) in connection with the scheme: section 411(4) of the *Corporations Law*. A scheme can therefore be effected over the objections of minority creditors. This in turn means that it is ultimately unnecessary for consultation with creditors to continue until unanimity is achieved. The cost of a scheme might therefore be less than the cost of a work-out if the process of achieving unanimity in the work-out has become difficult.

(2) **(Confidentiality:)** Schemes of arrangement necessarily involve an element of publicity. Not only is the court process a public one, but a copy of the court's order must be lodged with the Australian Securities Commission.

On the other hand, it is theoretically possible to negotiate and implement a work-out in circumstances of absolute secrecy. Of course, theory and practice often diverge. Where a particular insolvency is sufficiently newsworthy, it is common for the details of private meetings of creditors to be reported at length in the next day's business newspaper: particularly where it suits the agenda of one or other of the participants for this to happen.

(3) **(Flexibility:)** Work-outs give the parties absolute freedom to structure their arrangements as they wish, within the bounds of legality and public policy. On the other hand, a scheme of arrangement must be approved by the court. While the court is unlikely to overturn an agreement of creditors, especially were it to be reached unanimously or by a large majority, it nevertheless remains possible for this to happen. The court will not approve a scheme which is contrary to public policy, even if all creditors are unanimous in their support for the scheme. Furthermore, even if a scheme is not contrary to public policy, the court may withhold its approval if the court considers the scheme to be unreasonable, notwithstanding that the creditors have approved of the scheme.

(4) **(Ease of amendment:)** Changes to work-out arrangements may be effected by agreement of the parties, or by waiver. A change to a scheme of arrangement, to be effective, necessitates a return to the court.

(5) **(Cross-border operations:)** Work-outs are a simpler way of dealing with companies or groups with operations in a number of different jurisdictions. While section 415A of the *Corporations Law* gives Australia-wide effect to Australian schemes of arrangement, the *Corporations Law* makes no special provision for the position of a corporation with operations in overseas jurisdictions as well as Australia. In those circumstances it is likely to be necessary, if a scheme is to be fully effective, to seek parallel protection in those other jurisdictions, where this is possible. On the other hand a work-out, because it is binding in contract, should require no further action for it to be effective in each jurisdiction where the debtor has a presence.

Work-outs also have certain other advantages.

While receivership is generally not an available option to an unsecured creditor, a work-out can be designed to achieve much of what would have been achieved if a receiver had been appointed to the debtor, such as implementation of an orderly divestiture of assets, and the continued ability to trade until the business is in better shape and the depressed market for key assets picks up.

Again, when compared with traditional forms of insolvency administration such as liquidation, or appointment of an agent in possession or a receiver or receiver and manager, a work-out is less likely to trigger defaults in leases, licences and contracts.

THE PROBLEMS OF A WORK-OUT FROM A LENDER'S VIEW-POINT: THE POWER OF MINORITY LENDERS

The need for unanimity

The principal problem with a work-out is that it is impossible to force recalcitrant creditors to participate. A scheme of arrangement can be effected with the consent of creditors who hold at least 75% of the total amount of the debts and claims of the creditors present and voting at the relevant creditors' (or class) meeting. A work-out cannot be effected unless each and every one of the creditors that are to be bound by the work-out agrees so to be bound.

Leverage for small lenders

This in turn gives small lenders a disproportionate leverage in the case of a work-out. Ironically, this leverage is often dealt with by the larger lenders threatening to proceed by means of a scheme of arrangement instead.

A corporation which followed a deliberate practice of divide and rule during the 1980s, borrowing smaller amounts from a large number of lenders, so that it would not be in a position where a small group of large lenders could dictate terms to it, suddenly found that the presence of one or two large lenders with a strong relationship to the corporation, an understanding of its business, and a commitment to its survival was likely to be the difference between corporate survival and liquidation. It suddenly became clear to borrowers why their lawyers had fought so hard to limit the ability of lenders to sell down their participations in large loans to the multitude of financial institutions from all corners of the earth which had appeared, begging to accept an exposure to Australian borrowers.

Of particular concern has been not just the small lender that has no relationship with, and no concern for, a borrower, but the small lender that is owned by a bank in Paris, Rome or Chicago which is itself undergoing economic difficulties and has therefore decided to quit itself of its entire foreign loan portfolio.

One of the many lessons of the late 1980s and early 1990s has been that a borrower which has strong relationships with large lenders that understand the borrower and its business, and that also have a strong desire to be seen to be responsible members of the Australian banking community (and can be relied, where relevant, to respond favourably to a request from the Reserve Bank to act responsibly in the event of a major corporate collapse), is in a much better position to survive insolvency than one that does not.

Special deals

Not only do small creditors have a disproportionate leverage, but so too do those which are the beneficiaries of unique benefits under their existing arrangements with the borrowing group. One of the objects of a work-out is to achieve an equality of treatment among all affected lenders that are in a basically similar situation. This generally entails uniform rates of return, uniform maturities, and 'no special deals'. A lender that was previously a direct creditor of the principal operating company, rather than the holding company, or that also had access to additional security, such as a parent company guarantee or a standby letter of credit, may nevertheless be in a good position to extract concessions when a work-out is negotiated.

A lender might also assert that it is in a particularly favoured position, even though the other lenders cannot be fully satisfied as to this. For example, it is often a condition of a work-out that all committed lines of credit be fully drawn. (This is an aspect of the need for equality of treatment between lenders, and may be insisted on even though the practical effect is to increase the debt service burden on the borrower.) But a particular lender may argue that a side arrangement had previously been agreed with the borrower that its uncommitted exposure could not be drawn against except in certain circumstances which have not occurred.

Even though the other lenders may be unable to satisfy themselves as to the fact of a special arrangement, it may be necessary for them to accommodate that arrangement, or make allowances for it, unless they are prepared to incur the time and potential expense of testing the point.

Commencement of winding up procedures

Not only might a dissentient lender refuse to participate in a work-out (it will usually insist, instead, that its debt be paid out - by the larger lenders if necessary), it may actually commence proceedings against the borrower in order to turn up the heat. Perhaps the most common tactic in this regard is to serve a statutory demand under section 460(2) of the *Corporations Law* for repayment of the debt owing to that lender. Such a demand is theoretically the precursor to the presentation of a winding up petition to the court, and the borrower and its advisers must treat the demand accordingly.

The most effective way of dealing with such a tactic seems to be for the borrower and its advisers, in conjunction with the lenders who are leading the proposed work-out, to prepare the groundwork for an application to the court under section 411(16) of the *Corporations Law*.

Section 411(16) provides that:

> *'Where ... a compromise or arrangement has been proposed between [a company] and its creditors or any class of them, the Court may ... on the application in a summary way of the [company] or of any member or creditor of the [company], restrain further proceedings in any action or other civil proceeding against the [company] except by leave of the Court and subject to such terms as the Court imposes.'*

Winding-up proceedings may be restrained under section 411(16).

If an application has in fact to be made under section 411(16), the work-out will have to be abandoned and replaced by a court approved scheme of arrangement.

Trade debt

It is likely to be essential to the survival of the borrower that its trade creditors are prepared to continue to extend credit to it. The borrower will face an impossible situation if all trade creditors move to a COD basis.

As a practical matter, it will not be possible to include trade creditors as participants in the work-out. They are unlikely to take into account the same considerations as would a bank. Many will be relatively small and unsophisticated. Many will in any event depend on the ongoing servicing by the borrower of its obligations to them if they are themselves to be able to continue in business.

If no security is taken as part of the work-out arrangements, there ought to be no reason why trade creditors should not be prepared to continue to deal with the borrower. They will, after all, rank equally with all other creditors (with limited exceptions for statutorily preferred debts) should the borrower go into liquidation. The work-out itself should be seen as making liquidation less likely.

However, trade creditors are unlikely to be prepared to continue to deal if the lenders have taken substantial security in connection with a work-out. Yet it is common for lenders to insist on all-embracing security as part of a work-out.

In practice, this has tended to mean that notwithstanding that the lenders have taken security, they must agree to subordinate themselves to the trade creditors in the event of a winding up. To a substantial extent, therefore, the lenders' demand for security may be undermined by the need to allow the borrower to continue to trade. This is in turn ironical, since the lenders might have insisted on security as a belated response to a perception that it was the willingness of bankers to lend without adequate security as against other creditors which contributed to the borrower's difficulties.

THE PROBLEMS OF A WORK-OUT FROM A LENDER'S VIEW-POINT: LENDER LIABILITY

A further group of problems concerning a work-out are those that concern lender liability.

In the first place, the lenders and their officers (particularly those who are members of the committee of lenders established under the work-out documents) may be liable as so-called shadow directors of the borrower, or for insolvent trading.

Shadow directors

Section 232 of the *Corporations Law* imposes the following duties and liabilities on an 'officer' of a corporation:

(1) **(act honestly:)** at all times to act honestly in the exercise of his or her powers and the discharge of the duties of his or her office: section 232(2);

(2) **(exercise care and diligence:)** in the exercise of his or her powers and the discharge of his or her duties, to exercise the degree of care and diligence that a reasonable person in a like position in a corporation would exercise in the corporation's circumstances: section 232(4);

(3) **(no improper use of information:)** not to make improper use of information acquired by virtue of his or her position as an officer to gain, directly or indirectly, an advantage for himself or herself or for any other person or to cause detriment to the corporation: section 232(5); and

(4) **(no improper use of position:)** not to make improper use of his or her position as an officer to gain, directly or indirectly, an advantage for himself or herself or for any other person or to cause detriment to the corporation: section 232(6).

For the purposes of section 232, an 'officer' of a corporation includes a 'director' or 'executive officer' of that corporation.

Section 60(1)(b) of the *Corporations Law* defines 'director' to include 'a person in accordance with whose directions or instructions the directors of [the relevant corporation] are accustomed to act'. It is therefore important, if lenders and their officers are to avoid the potential for liability under section 232, that the work-out arrangements be prepared and implemented in a way which enables those lenders or officers to show that they are not in a position to require the borrower's directors to act in accordance with their directions or instructions.

Section 60(2) of the *Corporations Law* provides that:

> *'A person shall not be regarded as a person in accordance with whose directions or instructions ... a body corporate's directors ... are accustomed to act merely because the directors ... act on advice given by the person in the proper performance of the functions attaching to the person's professional capacity or to the person's business relationship with the directors ... or with the body.'*

On the face of section 60(2) it may be open to a lender to argue that it covers the situation where that lender or its officers make certain requirements of the directors of the borrower in connection with the conduct of its business as part of the work-out (for example, they 'advise' the directors to dispose of particular assets, or to conduct the borrower's business in a particular way). However, the better view seems to be that section 60(2) would not remove lenders and their officers from the ambit of the definition of 'director'. Rather, section 60(2) seems to be directed to true 'advisers' such as lawyers, accountants, stockbrokers and investment bankers, rather than those who have a real and immediate power (whether legally enforceable or not) to affect the conduct of the business of the borrower and who exercise that power to direct or instruct the directors of the borrower in the exercise of their duties and discretions as such.

Section 9 of the *Corporations Law* defines 'executive officer' to mean 'a person, by whatever name called and whether or not a director of the [relevant company], who is concerned, or takes part, in the management of the [company]'.

What does it mean to 'be concerned in or take part in the management' of a company?

Section 227(1) of the *Companies Code* (see now section 229(1) of the *Corporations Law*, which is more directly worded), provided that a person who is an insolvent under administration should not be concerned in or take part in the management of a corporation without the leave of the court.

In **Commissioner for Corporate Affairs v Bracht** ([1989] VR 821 at page 830), Ormiston J of the Victorian Supreme Court shed light on the meaning of 'management', in the context of section 227, as follows:

'There must be an element of decision-making, which affects the corporate enterprise as a whole, but those responsible need not form part of the board, nor even need they be executives directly communicating with the board. Nevertheless, in the ordinary course of affairs, it is only in a large company that persons outside this latter category, so far removed from the power of control exercised by the directors, may be engaged in the "management" of a company. In a small company like the present the actions of those directly answerable to the directors may amount to "management", for, even if those people are also engaged in routine activities of a kind not normally associated with management, it is sufficient if powers and functions are delegated to those persons which are likely in their performance to have a significant effect on the business and financial standing of a company. As [section 227] is a protective section, protective at least of the creditors and shareholders, then it must have been designed to prevent the participation in management of those who might put the solvency or the probity of the corporation's administration at risk. Persons not given any significant discretion or advisory role in decision-making could not therefore be intended as an object of the prohibition.

It may be difficult to draw the line in particular cases, but in my opinion the concept of "management" for present purposes comprehends activities which involve policy and decision-making, related to the business affairs of a corporation, affecting the corporation as a whole or a substantial part of that corporation, to the extent that the consequences of the formation of those policies or the making of those decisions may have some significant bearing on the financial standing of the corporation or the conduct of its affairs. It is not necessary for me to reach any conclusion in this case whether that management must be confined to the "central direction of the company's affairs", as appears to have been approved by the Court of Appeal in **Campbell's Case** *(78 Cr App R, at p98). With respect, I would doubt that the term must necessarily be confined in that way. It is the management of the corporation which is the subject of the prohibition. Thus, although the decisions of a branch manager, subject to predetermined restrictions, may not be comprehended, there are those involved in large, discrete parts of a corporation's business, who, although not participating in the central administration of that corporation, nevertheless are involved in its management to the extent that their policies and decisions have a significant bearing on its business and its overall financial health.'*

Ormiston J then went on to discuss the meaning of 'take part in' management, at page 831 of the report, as follows:

'... it is unnecessary to say more, in construing such simple words, than that it both connotes and proscribes the active participation of a prohibited person in the management of a corporation: cf **Marshall v British Broadcasting Corporation** *[1979] 1 WLR 1071, at pp1073-4. Such participation would have to be real and direct, but not necessarily in a role in which ultimate control is exercised, although it would have to be more than the administrative carrying out of the orders of others responsible for a company's management.'*

At page 832, Ormiston J considered the concept of 'being concerned in' an activity, as follows:

'... the concept of "being concerned in" a particular activity connotes participation at a variety of levels and at differing intensities ... as was said by Quilliam J in **R v Newth***, at p761, [the section] prohibits a person "from taking any hand in the real business affairs of the company" ... the level of participation to which the section refers may be relatively modest. In this context I would not consider its meaning to be as wide as "having something to do with" .... On the other hand it should not be construed as requiring some financial interest or material benefit in the corporation ....*

In the present section I would see the prohibition as covering a wide range of activities relating to the management of a corporation, each requiring an involvement of some kind in the decision-making processes of that corporation. That involvement must be more than passing .... It requires activities involving some responsibility, but not necessarily of an ultimate kind whereby control is exercised ....'

In short, therefore, the lenders to a company that is subject to work-out arrangements must take their potential liability as shadow directors very seriously.

This is particularly so in the case of lenders represented on the committee of lenders, for it is in the forum of the committee of lenders that many of the decisions are taken concerning the implementation of the work-out.

Trading while insolvent

Section 592(1) of the *Corporations Law* provides that:

> *'Where:*
>
> *(a) a company has incurred a debt;*
>
> *(b) immediately before the time when the debt was incurred:*
>
> > *(i) there were reasonable grounds to expect that the company will not be able to pay all its debts as and when they become due; or*
> >
> > *(ii) there were reasonable grounds to expect that, if the company incurs the debt, it will not be able to pay all its debts as and when they become due; and*
> >
> > *(c) the company was, at the time when the debt was incurred, or becomes at a later time, a company to which this section applies; any person who was a director of the company, or took part in the management of the company, at the time when the debt was incurred contravenes this subsection and the company and that person or, if there are 2 or more such persons, those persons are jointly and severally liable for the payment of the debt.'*

It will be seen that creditors and their officers might be liable under section 592 in two threshold circumstances:

(1) where they are 'directors' of a borrower; and

(2) where they 'took part in the management of' the borrower.

The above discussion concerning section 60 of the *Corporations Law* is also apposite to whether a creditor or its officers would constitute a 'director' for purposes of section 592.

The decision of Ormiston J in **Commissioner for Corporate Affairs v Bracht** helps show when a person might be said to have 'taken part in the management of' a borrower.

It is significant that section 592 does not extend as far as persons 'concerned in' the management of a company. To this extent, therefore, it is possible that a lender or its officers may be liable under section 232 in circumstances where they have no potential liability under section 592.

Nevertheless, the lenders to a company that is subject to work-out arrangements, and their officers, must also take their potential liability for insolvent trading very seriously.

Insolvent trading under the CLRA

When the CLRA comes into full force and effect, section 592 will be replaced by a different but analogous provision, section 588G, which will impose on a 'director', but apparently only a 'director', a liability for failing to prevent an insolvent company from incurring a debt if the director was aware at the time that the debt was incurred that there were reasonable grounds for suspecting that the company was insolvent, or would become insolvent by incurring the debt or, alternatively, if a reasonable person in a like position in a company in the company's circumstances would be so aware.

In addition, new section 588V will impose a similar liability on a holding company which fails to prevent a subsidiary from incurring a debt in corresponding circumstances.

Liability under other legislation

Liability as a shadow director might also be incurred under other legislation. For example, section 66B of the *Environment Protection Act* 1970 (Vic) imposes a liability on directors and those concerned in the management of a corporation for any contravention by that corporation of the Act or any notice, licence or permit under the Act.

Minimisation of risk for liability as shadow directors or for insolvent trading

The work-out documents themselves should be drafted so as to minimise the possibility that a liability may be held to arise under section 232 or section 592. If the work-out documents specifically empower ongoing active control of the actions of the borrower's directors, or if they specifically empower an involvement in policy and decision-making in relation to the borrower's business affairs, then it will be an inevitable practical consequence that those powers are exercised, with likely adverse consequences under sections 232 and 592.

This leads to a significant practical tension. Part of the reason that the borrower is in a work-out situation is often likely to be that it has suffered poor direction and management. The lenders are unlikely in those circumstances to commit themselves to an ongoing exposure to the borrower only to permit the directors and management to carry on unchecked, as before. Nor are the lenders likely to be able to locate new directors and management of sufficiently high calibre in sufficient time for them to be able to walk in on the day that the work-out arrangements are executed and take over the borrower's affairs.

The lenders are instead likely to have fairly firm ideas on what must be achieved by the borrower from a business view-point, and on how this might be done. Some of those ideas will be legitimately included as ongoing undertakings in the work-out documents. Many, however, will be evolutionary and reactive to the particular business environment in which the borrower operates: they will not be able to be spelt out in the form of specific undertakings. Rather, they will require ongoing input by the lenders into the form of the borrower's business plans and budgets, its approach to its asset sales programme, and its other business decisions.

It is here that the lenders must be particularly careful if they want to avoid liability under sections 232 and 592.

Whether the lenders or their officers will be liable in any particular circumstances under section 232 or section 592 will ultimately be a question of fact and degree. However, the following very broad guidelines may assist in avoiding the liability:

(1) It seems that the lenders and their officers may make suggestions about the options that are available to the borrower and its directors.

(2) It is also likely to be in order for the lenders and their officers to explain the likely consequences if the borrower or its directors were to choose one particular option rather than another. These consequences may include the likelihood that the lenders will decide to exercise a discretion to accelerate the debt and terminate the work-out when next that discretion becomes available to be exercised.

(3) It seems further that the lenders and their officers would be within their rights to explain how they themselves would have acted had it been their decision to take. While they may 'inform' the borrower and its directors of their views on such issues, they may not 'direct' or 'instruct' the borrower and its directors as to how they should act.

(4) The lenders and their officers are entitled to remind the borrower's directors of their obligation to act bona fide in the interests of the borrower as a whole. If the company is insolvent, in the sense that its liabilities exceed its assets, it is also likely that the directors must have regard to the interests of its creditors (see, for example, **Kinsela v Russell Kinsela Pty Ltd** (1986) 10 ACLR 395 and **Walker v Wimborne** (1976) 137 CLR 1).

(5) The lenders are entitled to acquire information concerning the business of the borrower. Appropriate drafting may entitle the lenders to as much information as the directors themselves.

(6) The lenders are entitled to require certain ongoing obligations (and negative obligations) in order to protect their security position. To the extent that these ongoing obligations are typical of those imposed by credit facility documentation on borrowers who are not the subject of work-out proceedings, it is unlikely that they will create a problem. (It may be argued that an obligation not to dispose of or encumber particular assets without the consent of the lenders, or an obligation to enter into contracts with related entities only on arm's length terms for valuable commercial consideration, involves the lenders in policy and decision-making relating to the borrower's business affairs. Yet really such obligations are designed simply to protect the lenders' security position and ought not of their own to give rise to a liability under section 232 or section 592.)

Section 267

Section 267 of the *Corporations Law* imposes an added burden if a shadow directorship can be established in respect of the period during which the work-out documents are under negotiation. (Such a shadow directorship might result, for example, from the arrangements associated with any stand-still agreement.)

Section 267(1) of the *Corporations Law* provides as follows:

'Where:

(a) a company creates a charge on property of the company in favour of a person who is, or in favour of persons at least one of whom is, a relevant person in relation to the charge; and

(b) within 6 months after the creation of the charge, the chargee purports to take a step in the enforcement of the charge without the Court having, under subsection (3), given leave for the charge to be enforced;

The charge, and any powers purported to be conferred by an instrument creating or evidencing the charge, are, and shall be deemed always to have been, void.'

Section 267(3) provides as follows:

'On application by the chargee under a charge, the Court may, if it is satisfied that:

(a) immediately after the creation of the charge, the company that created the charge was solvent; and

(b) in all the circumstances of the case, it is just and equitable for the Court to do so;

give leave for the charge to be enforced.'

Under section 267(7) of the *Corporations Law*, a 'relevant person' includes 'a person who is at the time when the charge is created, or who has been at any time during the period of 6 months ending at that time, an officer of the company'. Under section 82A of the *Corporations Law*, an 'officer' includes a 'director' and an 'executive officer': cf the discussion of section 232 above. Under section 9, a 'charge' includes a mortgage.

It follows that if the lenders or their officers are held to have been shadow directors of the borrower in the period leading up to finalisation of the arrangements concerning the work-out, any security that is taken as part of those arrangements is likely to be void under section 267(1) if, without the leave of the court, the beneficiaries of the security take steps to enforce it within 6 months after creation of the security.

Ancillary liability

Whether or not the lenders themselves (and their officers) have a direct liability for a contravention of section 232 or section 592, or against section 588G when it comes into force, they must also be careful not to incur ancillary liability in connection with that contravention.

Ancillary liability might arise in appropriate circumstances by virtue of ordinary rules of criminal law, such as under section 5 of the *Crimes Act* 1914 (Cth) which provides that:

> *'Any person who aids, abets, counsels, or procures, or by act or omission is in any way directly or indirectly knowingly concerned in, or party to, the commission of any offence against any law of the Commonwealth or of a Territory, whether passed before or after the commencement of this Act, shall be deemed to have committed that offence and shall be punishable accordingly.'*

Again, so far as concerns sections 232 and 588G, ancillary liability may arise under Part 9.4B of the *Corporations Law*, which was introduced by the CLRA: see sections 232(6B) and 588G(3). Section 1317DB, in Part 9.4B, provides that:

> *'For the purposes of this Part, a person who is involved in a contravention of a particular provision of this Law or a corresponding law is taken to have contravened that provision.'*

It seems to follow from ordinary principles of criminal law, and from Part 9.4B of the *Corporations Law*, that ancillary liability could for example arise in the present context where the directors of the borrower conduct themselves in a way which contravenes section 232, 592 or 588G and they do so in response to (and as a predictable consequence of) demands from the lenders or their officers in connection with the work-out.

Consequences of a breach of section 232, 588G or 592

A person directly liable for a contravention of section 592 is jointly and severally liable for payment of the relevant debt.

A person 'involved in' a contravention of section 232 or 588G (including both a person who is directly responsible for such a contravention, and a person who has only ancillary liability in that regard) might be subject to a civil penalty order: section 1317EA in Part 9.4B.

If section 232 or 588G was knowingly, intentionally or recklessly contravened, and was contravened dishonestly, or with the intention of gaining an advantage (whether personally or not), or with the intention of deceiving or defrauding someone, criminal proceedings might be brought for the contravention: section 1317FA in Part 9.4B.

The court that hears an application for a civil penalty order or that hears criminal proceedings for a relevant contravention of the *Corporations Law* may, if the court is satisfied that the relevant corporation has suffered loss or damage as a result of the contravention, also order the person against whom the proceedings have been brought to pay compensation to that corporation: sections 1317HA and 1317HB in Part 9.4B.

Of course, it is not only the lenders and their officers who will need to take special note of Part 9.4B of the *Corporations Law*. It is clearly possible that lawyers and other advisers may also be liable as having been 'involved in' a particular contravention.

The tort of inducing breach of contract

One of the so-called economic torts is the tort of intentionally inducing or procuring a breach of contract. The lenders that are parties to a work-out must bear in mind the possible application of this tort to their arrangements.

For example, it is not uncommon for interim stand-still arrangements to prohibit a borrower from repaying any of its funded debt, pending negotiation and implementation of a work-out. Where a lender's debt has been validly accelerated or is otherwise due and payable, and that lender is reluctant to participate in the work-out, it may seek to hold the lenders who are leading the work-out liable for having procured the borrower not to comply with its obligation to repay its debt.

Again, if the negative undertakings that are imposed on the borrower under the work-out documents are designed to prevent the borrower from implementing certain transactions, and if the lenders are aware that the borrower is contractually obliged to third parties nevertheless to implement those transactions, the lenders could be liable for having procured a breach by the borrower of its obligations to those third parties.

Guarantors

The lenders that are parties to the negotiation and implementation of a work-out are likely to have access to a substantial amount of information concerning the borrower and its affairs.

Care will need to be taken to ensure that a liability does not arise to guarantors, or the providers of third party security, as a result of a failure to pass on material information to them. Care will also need to be taken that such guarantors or providers of third party security are not relieved of their obligations as a result of such a failure to pass on material information.

Banker-customer relationship

The lenders that are parties to the negotiation and implementation of a work-out must also be alert to the obligation of secrecy which the law accepts as a basic term of the banker and customer relationship.

Of course, it is possible that the relationship between a number of the lenders and the borrower is such that, notwithstanding that they are banks, they cannot be said to be in a relationship of banker and customer with this particular borrower. It is almost inevitable, however, that some of the lenders will be parties to such a relationship. Moreover, it is likely that those lenders with the largest exposures to the borrower, and who are leading the work-out, will be among the lenders that have a banker and customer relationship with the borrower. The lenders that are leading the work-out are likely to be privy to extensive information concerning the borrower and its prospects. If they were not, it is unlikely that they would be prepared to participate in a work-out, for a decision to participate in the work-out will almost certainly involve a comparison of the borrower's likely financial condition at the end of the work-out with the likely returns to the lenders on an immediate liquidation.

A lender would be faced with a serious quandary if, because of its banker-customer relationship with the borrower, it is unable to pass on any information which the lender has obtained (or which it might already hold) to other lenders who are to participate in the work-out.

As a practical matter, however, it is likely such a lender will nevertheless be able to establish the implicit consent of the borrower to the passing-on of information, by virtue of the borrower's active participation in developing the work-out arrangements. It would nevertheless be sensible, where practicable, to have the borrower expressly authorise the lenders to pass information on.

Liability for misstatements

Section 52(1) of the *Trade Practices Act* 1974 (Cth) (the 'TPA') provides that a corporation 'shall not, in trade or commerce, engage in conduct that is misleading or deceptive or is likely to mislead or deceive'.

Section 75B of the TPA effectively extends liability for a contravention of section 52 to a person who has aided, abetted, counselled or procured the contravention, or who has induced the contravention, or who has been knowingly concerned in or party to the contravention, or who has conspired with others to effect the contravention.

Sections 11 and 31 of the Victorian *Fair Trading Act* 1985 (and equivalent provisions in the *Fair Trading Acts* of most other Australian jurisdictions) are to similar effect.

Section 82 of the TPA (and section 37 of the *Fair Trading Act* 1985 (Vic) and equivalent provisions in other jurisdictions) allows a person who suffers a loss or damage by conduct of another person in contravention of section 52 (including a person liable for such a contravention by virtue of section 75B) to recover that loss or damage by action against that other person.

Again, under principles founded in **Hedley Byrne v Heller** ([1964] AC 465) and the cases extending from that case, including **Mutual Life and Citizens' Assurance Co Ltd v Evatt** ([1971] AC 793), a person who holds himself out as possessing skill or knowledge relevant to an inquiry will be liable for the consequences of a negligent misstatement in response to that inquiry if it was reasonable for the recipient of the misstatement to rely upon the misstatement and the recipient did so to its detriment.

The lenders who are leading a work-out must therefore be careful in the advice that they give to other participants in the work-out. In the course of negotiating a work-out, there is likely to come a point where the lenders leading the work-out have developed an extremely strong commitment to its implementation. In their quest for the necessary unanimity of lenders for the work-out to be put in place, the lead lenders are also likely to have to cajole other lenders that are less convinced of the benefits of the proposal. (Those other lenders may be faced with relatively insignificant exposures, and may be prepared to write those exposures off in return for putting the whole sorry experience behind them, allowing them to focus on matters which are of greater importance to them. They may view the whole work-out exercise as nothing more than an attempt by the lead lenders to save face by postponing the inevitable results of bad lending decisions taken in times of reckless optimism.)

In trying to persuade the reluctant lenders to join in the work-out, the lead lenders may be inclined to make unduly optimistic statements as to the likely results if a work-out is implemented. They might likewise be inclined to pass on the borrower's own optimistic assessments of its future circumstances if a work-out is put in place. (Such optimism from a borrower is common. The borrower might not have been facing the troubles that it now faces if it had been more realistic in its assessment of its previous business condition and prospects. Having got itself into parlous circumstances, however, it may feel that the only way to ensure its survival is to persuade all lenders to view the future with the same rose coloured glasses.)

If lead lenders make projections in this fashion, or pass on such projections from the borrower, they face the risk of subsequent suit from other lenders if the work-out ultimately fails to improve the position of those other lenders.

While some protection may be obtained by ensuring that all statements to the lenders are coupled with extensively worded disclaimers of liability, it should be borne in mind that the courts are prone to reading disclaimers down in their operation and effect.

Unconscionable conduct

Section 52A of the TPA provides that a corporation 'shall not, in trade or commerce, in connection with the supply or possible supply of goods or services to a person, engage in conduct that is, in all the circumstances, unconscionable'.

There are similar provisions in the *Fair Trading Acts* of the other Australian jurisdictions (see, for example, section 11A of the *Fair Trading Act* 1985 (Vic)).

Section 82 of the TPA (referred to above) allows a person to recover any loss or damage suffered as a result of a contravention of section 52A.

The borrower is not, of course, in a particularly strong negotiating position in connection with a work-out. Section 52A is likely to become part of the standard armoury of litigation lawyers in connection with business disputes. It remains to be seen whether borrowers and their shareholders are likely to proceed against lenders for breaches of section 52A in connection with work-outs that have failed (or, indeed, even in connection with work-outs that have succeeded, but where the borrower has been left with a considerably smaller asset base as a result).

Indemnities

It is also important to bear in mind that while a number of lender liability problems might, in a different business context, be adequately dealt with by obtaining an appropriate indemnity from another party to the transaction, in the context of a work-out it is much more difficult to obtain satisfactory indemnities. In particular, the party that one might ordinarily look to for indemnification in connection with a large number of the areas of possible lender liability outlined above would ordinarily be the borrower or its affiliates. But it will be uncertain that the borrower and its affiliates will be able to meet their liability on such an indemnity: if it were otherwise, there would be no need for the work-out. While indemnities might be obtained from the other lenders, this would merely have the effect of spreading the pain. It is unlikely to mean that a lender will be made whole.

A lender might also protect itself against some liabilities (in particular, those to the other lenders and to the borrower and its affiliates) by obtaining suitable releases and waivers as part of the work-out arrangements. The fact remains, however, that it is impossible to protect against every possible liability that a lender might incur. For example, it is not possible to obtain satisfactory protection in the event of an offence against the *Corporations Law*. It is also possible that certain protective measures will in any event be held to be contrary to public policy.

THE PROBLEMS OF A WORK-OUT FROM A LENDER'S VIEW-POINT: MISCELLANEOUS FURTHER PROBLEMS

Estoppel and waiver

In the course of negotiating the arrangements for a work-out, it will be important to the lenders that they preserve their ability to rely on their pre-existing rights, such as their rights to cancel their commitments and accelerate the debt, and their rights to enforce any security which they might hold, if the work-out cannot be consummated.

In particular the lenders must be careful not to conduct themselves in a way which gives rise to an estoppel, or which constitutes a waiver of accrued rights, or which might be said to give rise to an application of the doctrine of laches.

It is possible, for example, that the borrower will subsequently assert that it was led by the lenders' statements to conclude that the lenders were in any event not going to exercise the rights which had accrued to them arising out of earlier defaults, and that the borrower had relied on those statements to its detriment.

It is therefore important that lenders participating in the development of a work-out do so on the express basis that they reserve all rights which they might from time to time have, including the right to require payment of the borrower's debts and the right to enforce any security held in that connection, notwithstanding any intervening discussions on the possibility of a work-out and notwithstanding that they might even agree, so long as those discussions are proceeding satisfactorily in their view, to place their rights in suspended animation under the stand-still arrangements.

Unfair preferences

When deciding whether to participate in a work-out (or indeed any form of insolvency administration other than a liquidation or official management), lenders should take into account whether the borrower might have been party to transactions which would, if the borrower were to be wound up, be able to be set aside: see sections 565 and 566 of the *Corporations Law* as at present in force, and the provisions of Part 5.7B of the *Corporations Law* as they will be once the CLRA comes fully into effect.

If a work-out is implemented, time will continue to run in favour of the beneficiaries of preferential arrangements that may have been previously entered into. Once sufficient time has passed, most such arrangements will be incapable of being set aside. It is therefore important, when determining the likely returns to it under the various alternative possible forms of insolvency administration, that a lender takes into account that in a winding up it will be possible to reverse a recent preferential arrangement, but that a work-out will in most cases lead to the loss of the ability to challenge such arrangements.

Progressive degeneration

A broader, more practical, problem arises in connection with work-outs, and follows from their very flexibility. This is the 'more good money after bad' syndrome.

Because it is comparatively easy to amend the arrangements concerning a work-out, it is tempting for the parties to a work-out which is not succeeding to amend the work-out, bit by bit, as circumstances become worse.

It is likely that those who were responsible for the decisions that gave rise to the lenders' original commitments to lend to the borrower will have departed the scene. It is generally unusual for such people to be charged with determining the best recovery strategy (be it a work-out or liquidation, and so on), since they will have a real interest in covering their earlier mistakes.

However, it is also likely that their replacements will develop an emotional commitment to the implementation of a work-out, assuming that a work-out was at one stage the rationally preferred method of insolvency administration. That emotional commitment may be the product of a number of factors, such as fear of being associated with proven failure, a liking (or at least sympathy) for the borrower's people, an optimism that things cannot continue on as badly as in the past and an unwillingness to take hard decisions.

Unless care is taken to view the situation as a whole, comparing the position now reached with the position immediately prior to the original default, it is possible that the lenders will simply dig a bigger and bigger hole for themselves as each successive request comes in from the borrower for permission to contravene its obligations and for increased funding in order to tide it over supposedly temporary difficulties. Meanwhile, there will be a continuing series of crises of confidence.

Part of the problem may also be due to the fact that the original work-out documents might have been impossibly onerous from the borrower's view-point. This may have been because the work-out documents represented a cumulative catalogue of the requirements of the credit committees of each of the lenders. It may also have been the result of a desire by individual lenders to preserve their right to return to the negotiating table at an early juncture if things continued to get worse.

Sometimes, of course, it is the correct business decision to continue supporting the borrower despite the continued downward trend of its fortunes, notwithstanding that if the borrower had been in its current condition when the work-out was first mooted the lenders might have chosen to have it wound up. In other cases, had the borrower been in its current condition at the time when the work-out was first proposed, there would have been no doubt that it would have been wound up, and that may remain the only sensible option.

PROBLEMS OF A WORK-OUT FROM THE VIEW-POINT OF THE DIRECTORS

Liability for trading while insolvent

The effect of the work-out is likely to be to replace a situation of clear insolvency, in which all or a substantial portion of the borrower's funded debt was liable to acceleration, with a period during which the borrower has renewed commitments of ongoing financial accommodation.

Nevertheless, the directors of the borrower must continue to monitor the borrower's financial position very closely. If they do not do so, they may find themselves liable under the 'trading while insolvent' provisions of the *Corporations Law*: see the previous discussion in this paper of section 592 of the *Corporations Law* and sections 588G and 588V (which will be introduced when the CLRA becomes fully effective).

Furthermore, section 301(5) of the *Corporations Law* requires that the directors' statement to be attached to a company's accounts must 'state whether or not, in the directors' opinion, there are, when the statement is made, reasonable grounds to believe that the company will be able to pay its debts as and when they fall due'.

Section 301(5) is likely to place specific additional pressure on the directors.

The ongoing interest burden on the debt the subject of a work-out might itself be enough to tip the borrower back into insolvency. By the same token, that interest burden is likely to be so substantial that if it can be satisfactorily deferred it may create enough leeway for the incurrence of other debts necessary to maintain the ongoing operations of the borrower, without there being a contravention of section 592 or equivalent provisions. It was in response to this that the Adsteam restructuring was designed so that debt only continued to accrue interest so long as the interest obligation could be satisfactorily serviced. Debt was therefore divided into tiers (depending on whether interest on that debt could be serviced if it were to be payable). Where interest could not, on this basis, accrue, it was replaced by PCORNs (or Perpetual Convertible or Redeemable Notes) which were in effect prospective interest obligations which could only become real interest obligations in circumstances where that interest could be serviced. If they were not to become real interest obligations, the PCORNs would instead be converted into equity in the issuer.

Need to bolster the borrower's balance sheet

In practice, it is possible that notwithstanding any amount of juggling that goes into restructuring a borrower's obligations as part of a work-out, the borrower will still be left with a balance sheet that will make it difficult for the borrower ever to survive.

The directors might at that point have little option but to pursue with the lenders the desirability of converting some at least of their debt to equity.

Of course, it may be difficult to convince the lenders to agree to such approach. Among other things:

(1) it will mean that the lenders are postponed to all creditors to the extent of their equity investment;

(2) assuming that they convert their debt into redeemable preference shares, the lenders will have to be convinced that there is a realistic prospect at some stage of sufficient profits being generated to enable the shares to be redeemed or that there is some other way in which they can be taken out of their investment;

(3) if the debt is to be converted into redeemable preference shares, it is possible that this will nevertheless have no practical effect on the borrower's gearing (the Australian Accounting Standards Board's exposure draft 59 reportedly proposes that redeemable preference shares be treated as debt, rather than equity);

(4) where the lenders include a number of foreign owned institutions, difficulties might be created under Australia's foreign investment rules;

(5) there may be possible prospectus-type concerns in connection with the issuance of the shares; and

(6) the lenders will need to be satisfied that the transaction is not voidable as a preference, should liquidation supervene.

Need to discharge their duties properly

The directors must, of course, continue to discharge their statutory and common law duties properly. In particular, and as discussed above, they must continue to act bona fide in the interests of the company as a whole.

This may make it difficult for directors of companies in a large and complex corporate group to co-operate in the implementation of a work-out affecting another member of the group.

After all, not all members of the group will necessarily be in the same desperate condition.

The directors of a company which is in relatively good condition may find it difficult to justify a decision to provide guarantees or security in connection with a work-out affecting an affiliate of the company which is in a less robust financial condition, particularly where they are not both wholly owned members of the same shareholding interests.

VOLUNTARY ADMINISTRATION OF INSOLVENT COMPANIES UNDER THE CLRA

The CLRA will introduce into the *Corporations Law* a new Part, Part 5.3A, which is headed 'Administration of a company's affairs with a view to executing a deed of company arrangement'. The new procedure has similarities to the Chapter 11 procedure in the United States and the UK administration procedure, and follows on the report of the Australian Law Reform Commission in its General Insolvency Inquiry (the Harmer Report).

Purpose

The purpose of the administration proposals is to provide a breathing space in which a company's financial problems can be faced and dealt with in the best interests of all creditors. The proposals introduce the concept of a 'deed of company arrangement' which is something less formal than a court approved scheme of arrangement. In effect this represents a statutory recognition of the common practice for companies in financial difficulty to enter into contractual work-outs.

According to the Explanatory Memorandum to the Bill, the contents of a deed of company arrangement are expected to vary according to the needs of the particular company and its creditors, though it might often provide for some form of compromise of debts, such as a repayment of debts by delayed instalments. In exchange, the activities of company management might be subjected to supervision by the creditors.

Appointment of an administrator

Under section 436A, if the directors of a company consider that it is or is likely to become insolvent, the company may appoint an administrator by instrument under its common seal.

An administrator may also be appointed by a liquidator or provisional liquidator, or by the holder of an enforceable charge over the whole (or substantially the whole) of a company's property: sections 436B and 436C.

The administrator must be a registered liquidator: section 448B.

Directors of an insolvent company will therefore no longer need to seek the appointment of a receiver by a secured creditor, or to apply to the court for the appointment of a provisional liquidator or court-appointed receiver, if the company has become insolvent. They will instead have the immediate and direct power to initiate a voluntary administration.

The course of the administration

The administrator effectively takes control of the company and its affairs, subject only to the powers of secured creditors: Division 3 of Part 5.3A. The administrator will even have the power to remove and appoint directors: section 442A.

The administrator acts as the company's agent, and the powers of all other officers of the company are suspended except to the extent that the administrator otherwise consents: sections 437B and 437C. Only the administrator has power to deal with the company's property: section 437D.

The following steps are contemplated in a voluntary administration:

(1) **(Initial meeting of creditors:)** Within 5 business days, a meeting of creditors must be held to determine whether or not to appoint a committee of creditors: section 436E. (Such a committee, if appointed, would consult with the administrator and receive and consider the administrator's reports: section 436F.)

(2) **(Directors to provide information:)** The directors must hand over the company's books to the administrator, or tell the administrator where they are: section 438B(1). Within 7 days after commencement of the administration the directors must give the administrator a statement, and must give the administrator such information as he or she reasonably requires, with respect to the company's business, property, affairs and financial circumstances: section 438B(2).

(3) **(Investigation and recommendations by administrator:)** Under section 438A, the administrator must investigate the company's business, property, affairs and financial circumstances and form an opinion on each of the following:

   (a) whether it would be in the creditors' interests for the company to execute a deed of company arrangement;

   (b) whether it would be in the creditors' interests for the administration to end; and

   (c) whether it would be in the creditors' interests for the company to be wound up.

(4) **(Administrator to report offences and misconduct to the ASC:)** Under section 438D, if the administrator believes that:

   (a) an officer or member of the company has been guilty of an offence; or

(b) a person who has taken part in the formation, promotion, administration, management or winding up of the company may have misapplied or retained, or become liable or accountable for, the company's property, or been guilty of negligence, default, breach of duty or breach of trust in relation to the company,

he or she must report the matter to the Australian Securities Commission.

(5) **(Report to creditors and creditors' meeting:)** Under section 439A, within a specified period of from 21 to 28 days the administrator must convene a creditors' meeting, which must be held within a further 5 business days. The notice convening the meeting must be accompanied by:

(a) a report by the administrator about the company's business, property, affairs and financial circumstances;

(b) a statement of the administrator's opinion on each of the matters referred to in (3)(a), (b) and (c) above, together with the administrator's reasons; and

(c) if a deed of company arrangement is proposed, a statement setting out details of the proposed deed.

Of course, this effectively means that the administrator does not have long to investigate the company's business, property, affairs and financial circumstances, and to form a view on whether a deed of company arrangement should be entered into, or whether winding up is a more appropriate course. Just how an administrator of a company in the Adsteam group, for example, could have done this is difficult to see. Section 439A(6) provides that the court may extend the period, but this gives dissentient creditors an early forum.

(6) **(Decision by creditors:)** At the creditors' meeting, the creditors may resolve (see section 439C):

(a) that the company should execute a deed of company arrangement as specified in the creditors' resolution;

(b) that the administration should end; or

(c) that the company be wound up.

The administrator is liable for the debts, liabilities and obligations incurred by the administrator in the course of the administration, but is entitled to be indemnified out of the company's property for those debts, liabilities and obligations and for the administrator's remuneration (as fixed by the creditors or by the court): Division 9 of Part 5.3A.

The effect of administration on creditors

The administration of a company would usually continue during the period from the appointment of the administrator until a deed of company arrangement is executed, or the creditors resolve that the administration should end or the company should be wound up. The court may, however, intervene to vary this period.

During the administration:

(1) **(No voluntary winding up:)** The company cannot be wound up voluntarily: section 440A(1).

(2) **(Limitation on court-ordered winding up:)** If the court is satisfied that it is in the creditors' interests for the company to continue under administration, the court will not order that the company be wound up or that a provisional liquidator be appointed: section 440A(2).

(3) **(Enforcement of charges suspended:)** Except where a relevant charge is a charge over the whole, or substantially the whole, of the property of the company and the chargee enforces the charge with respect to all the property the subject of the charge, and except to the extent that a relevant charge is over perishable property, a chargee cannot enforce a charge on the company's property during its administration except with the consent of the administrator or the court: sections 440B, 441A and 441C. For these purposes (and all other purposes of the *Corporations Law*), the term 'charge' also includes a mortgage. If enforcement proceedings had commenced before the company went into administration, the chargee is nevertheless permitted to honour its obligations in respect of a previously committed dealing with the company's property: section 441B. Where a chargee holds a charge over the whole, or substantially the whole, of the company's property, the chargee has a window of 10 business days within which to proceed to enforcement. If it does not do so, then it will be unable thereafter to enforce its charge during the course of the administration.

(4) **(Owners and lessors not to retake possession:)** The owner or lessor of property used or occupied by, or in the possession of, the company cannot retake possession of the property during the administration except with the consent of the administrator or the court: section 440C.

(5) **(Dealing with property subject to a charge:)** Where the property of the company is charged under a floating charge which has since crystallised into a fixed or specific charge, the administrator may nevertheless deal with that property as if it were still subject to a floating charge: section 442B. The administrator may also dispose of charged property in the ordinary course of the company's business: section 442C. The administrator's ability to deal with property in this way is nevertheless subject to the powers of a chargee that has moved to enforce a charge over the whole, or substantially the whole, of the property of the company: section 442D. (The ability of an administrator to deal with property the subject of a charge is an area of potential concern to lenders, and may be a fertile source of litigation until the precise scope of the new provisions becomes clearer.)

(6) **(Civil proceedings and court enforcement processes suspended:)** Civil proceedings against the company are stayed, and court enforcement processes are suspended, except with the consent of the administrator or the court: sections 440D and 440F.

(7) **(Directors' guarantees unenforceable:)** Guarantees by a director of the company, or a spouse or relative of a director, cannot be enforced: section 440J.

Deed of company arrangement

If the creditors resolve that the company should execute a deed of company arrangement:

(1) **(Administrator of the deed:)** The administrator will (unless the creditors appoint someone else) be the administrator of the deed: section 444A(2).

(2) **(Formal instrument:)** Under section 444A(4), the administrator of the deed must prepare an instrument setting out the terms of the deed, including such matters as:

(a) the property to be available to meet creditors' claims;

(b) the nature and duration of any moratorium;

(c) the extent of any release of debts;

(d) the duration of the deed;

(e) the order in which any proceeds of realisation of the company's property are to be applied; and

(f) the date on or before which claims must have arisen to be admissible under the deed.

The deed will be taken to include certain prescribed provisions, unless it provides otherwise: section 444A(5). The deed must be executed within 21 days after the creditors' meeting or such longer period as the court allows: section 444B.

(3) **(Binds all creditors except non-consenting secured creditors:)** Once executed, the deed binds all creditors of the company so far as concerns claims that arose on or before the date referred to in (2)(f) above: section 444D(1). The deed will not, however, affect a secured creditor's rights to deal with its security unless it voted in favour of the creditors' resolution which led to execution of the deed, or unless the court intervenes: section 444D(2). Similarly, a deed will not affect the rights of an owner or lessor of property unless it voted in favour of the creditors' resolution that led to execution of the deed, or unless the court intervenes: section 444D(3).

(4) **(No winding up or other proceedings:)** Under section 444E, once a deed is executed, the persons bound by it cannot:

(a) apply for, or proceed with a pre-existing application for, winding up of the company; or

(b) except with the leave of the court, bring or pursue any proceeding against the company or in relation to the company's property, or proceed with any court enforcement process in relation to the company's property.

(5) **(Termination:)** Once executed, a deed continues until terminated in accordance with its terms, or until the creditors resolve that it should terminate: section 445C. The court may, however, order that a deed be terminated: section 445D. The grounds on which the court may do so include where the resolution that the company execute the deed was based on materially false or misleading information, or there has been a material contravention of the deed, or effect cannot be given to the deed without injustice or undue delay, or the deed or any of its provisions, or anything done or omitted under the deed, is oppressive or unfairly prejudicial to, or unfairly discriminatory against, one or more creditors or contrary to the interests of the creditors as a whole: section 445D(1). A dissentient creditor can therefore seek the termination of a deed which it considers to be oppressive or unfairly prejudicial to it, or unfairly discriminatory against it.

(6) **(Creditors' power to wind up:)** It is possible for the creditors of a company that has executed a deed of company arrangement to cause a creditors' meeting to be called and to resolve that the deed should be terminated and that the company should be wound up: section 445E.

(7) **(Variation:)** Provisions are included for the variation of a deed during its life: section 445A.

ADMINISTRATION VERSUS WORK-OUT

The procedures to be introduced by Part 5.3A are likely to provide a more workable alternative to work-outs than that currently provided by schemes of arrangement.

Dissentient creditors can be bound

The fact that it is likely only to require a simple majority of creditors for a deed of company arrangement to be adopted means that dissentient creditors are likely to have much less leverage than they currently have in a work-out. This should in turn result in a much quicker process of negotiation than possible in respect of a work-out.

No need for equality of treatment

It will not be essential for creditors to be treated equally before a deed of company arrangement will have any hope of success. Part 5.3A contemplates that all creditors will vote as a bloc. Where different classes of creditor are dealt with differently under a deed of company arrangement, there is no right for those classes to vote separately on the deed (cf the position in respect of schemes of arrangement).

Trade creditors can be protected

Because different classes of creditor can be treated differently under the deed, it is possible for trade creditors effectively to be preferred over other creditors, thereby securing a continuity of supply without the need for separate subordination or other arrangements. During the administration itself, trade creditors will presumably be willing to continue supply since the administrator will be liable for most debts incurred in the course of the administration: section 443A.

Limited scope for termination

Creditors or groups of creditors who feel disadvantaged by a deed of company arrangement may apply to the court for an order terminating the deed. However, the order is unlikely to be made (absent a material contravention of the deed) unless the aggrieved creditors can establish that the information given to creditors when they resolved to execute the deed was materially false or misleading, or that effect cannot be given to the deed without injustice or undue delay, or that the deed or any of its provisions, or anything done or omitted under the deed, would be oppressive or unfairly prejudicial to, or unfairly discriminatory against, one or more creditors, or contrary to the interests of the creditors as a whole.

A deed that is fair and reasonable, even though it does not provide for strict equality of treatment between creditors, seems unlikely to be terminated by the court.

Winding up proceedings cannot be pursued

It will be much harder for dissentient creditors to gain an advantage by threatening winding up proceedings or other proceedings once an administration has commenced. Moreover, such proceedings cannot be commenced once a deed of company arrangement has been executed.

Liability for information, or breach of confidence

Part 5.3A contemplates that the administrator will control the gathering and dissemination of information during the administration and leading up to consideration by creditors of a deed of company arrangement. Individual creditors are therefore likely to have much less exposure for liability for a failure to inform others, or for misleading others, or for negligent misstatements to others. Of course, if an individual creditor chooses to volunteer information or opinions to others, it will remain potentially liable for that information and those opinions.

Unfair preferences

The 'relation-back day' for purposes of the voidable transactions provisions that are to be introduced by Division 2 of Part 5.7B of the *Corporations Law* (once the CLRA comes into full force and effect) will be, in the case of a company that was under administration or operating under a deed of company arrangement immediately before the company was ordered to be wound up, the day on which the administration (or the administration that preceded that deed of company arrangement) began: sections 9, 513A and 513C.

If a company enters into administration, therefore, creditors will no longer carry the risk that as each day passes previous preferential transactions will no longer be able to be set aside.

Liability as a shadow director, and liability for insolvent trading

The administration and deed of company arrangement provisions would not protect creditors or their officers against liability as shadow directors, or against liability for insolvent trading. This is therefore a risk that creditors must continue to bear if they choose to structure a deed of company arrangement in a way that seeks to give them a say in the business decisions of the company.

It might incidentally be noted that an administrator, or an administrator of a deed of company arrangement, will be specifically included as an 'officer' for purposes of section 232. Query whether he or she will also be a 'director' for purposes of insolvent trading.

Progressive deterioration

The administration and deed of company arrangement provisions also would not protect creditors from being sucked into the vortex of a company's declining fortunes, if they are incapable of standing back and assessing proposals for variation of a deed of company arrangement realistically and of objectively comparing the company's current situation with the situation which prevailed when the deed was first entered into.

Will Part 5.3A replace voluntary work-outs?

It follows that there seem to be a number of reasons why an administration and deed of company arrangement will be more attractive to lenders than to proceed by way of voluntary work-out.

Time alone will tell, however, how rapidly lenders are prepared to venture into this new area.

Of course, lenders might choose to take the different option of henceforth insisting on fixed and floating charges over all a borrower's property as a condition of any lending (to help avoid difficulties under section 442B, such charges should, to the maximum extent practicable, be fixed charges), and thereby preserve to themselves the option of standing outside an administration and deed of company arrangement or, alternatively, of triggering an administration themselves under section 436C.

The days of large scale negative pledge lending may never return.