Corporate Insolvency Laws

A Stocktake

The View on Chapter 11

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Philosophical and Practical Differences

The fact that in a Chapter 11 the debtor "stays in possession" is the one fact that people home in on more than any other as being the reason why Chapter 11 would not be appropriate for Australia. But in that context I would say two things:

- First, more often than not directors and senior management are replaced pretty early on in a Chapter 11 process; and
- Secondly, I think there is a significantly more fundamental philosophical difference between what we are used to here in Australia and the Chapter 11 regime.

Relative to what we are used to here in Australia there is an incredible amount of Court involvement in the Chapter 11 process. I would suggest that the fundamental reason for this is that whilst directors and management, as it were, stay in possession the creditors need the protection of Court involvement to protect their interests. In Australia I would suggest that the philosophy is that because an independent administrator (or receiver or liquidator for that matter) is appointed that appointment of itself is sufficient to protect creditors interests.

As I said, relative to what we are used to here in Australia, the level of Court involvement in the US is quite incredible. From the very start a vast amount of information has to be put before the Court. The Court not only gets involved in formulating and approving any reorganisation plan but also gets involved in the day to day operations of a company in Chapter 11.

For example, in filing the petition, the petitioner has to provide a list of all creditors, all financiers, all parties with whom the company has a contractual relationship, details of all relevant tax authorities and tax agencies, all employees, all utilities and all claimants generally. Then within 15 days of the petition the following (just by way of example) has to be filed with the Court – schedules of assets and liabilities, details of executory contracts and unexpired leases, a breakdown of creditors and their various rankings, cash flows and statements of financial affairs and lists of shareholders.

Then at a practical and operational level after filing the company would need sanction of the Court to, for instance:

- pay any wages owing for the period immediately prior to filing;
- maintain existing bank accounts;
- acknowledge arrangements with utilities for ongoing service;
- assume commercial leases;
- grant security to obtain credit outside the ordinary course of business.

Then normally within 120 days a reorganisation plan has to be presented to the Court for approval and it is then that the fun really starts! In the larger cases each class of creditors will have its own representation and the right to be appear before the Court. Both in the Court and around the Court negotiation between the various constituent sets of creditor stakeholders takes place as they all jockey for position in the context of agreeing a plan and where they sit within it.

Here in Australia, the administrator has the discretion to do all those things without having to go anywhere near a Court. The philosophy being of course that he or she being independent will act in the best interests of creditors, without the need for Court supervision.

As I mention in the slide the philosophical divide as evidenced by the significantly greater degree of Court involvement in the US would give rise to significant practical problems if such a regime was to be implemented in Australia.

Lawyers and judges in the US have had many many years experience now of being trained in and understanding workouts and reorganisations. As much as I hate to say it we lawyers in Australia are not experienced in formulating the type of documents I just mentioned and presenting them to the Court. Nor are our judges experienced, let alone willing, to get involved in commercial decisions. By way of example during the Ansett Administration, Justice Goldberg who had conduct of nearly all of the Ansett Court applications made it quite clear that it was not for the Courts to get involved in commercial decisions.

He said that it was not for the Court to give its imprimatur to *"a business decision made by the administrators in circumstances where no issue as to power, propriety, reasonableness, or requiring the exercise of judgment on a legal issue, arises"*.

So at a practical level I think it would be very unrealistic for us lawyers and our judges to overnight suddenly be in a position to fulfil the type of role that lawyers in the US fulfil and the role judges in the US Bankruptcy Courts maintain.

Implications for Bankers

Now that I've made those more general observations I shall now comment upon the Report – which as discussed has really knocked on the head, it seems, the wholesale introduction of a Chapter 11 regime. To quote:

> *"The Committee is not persuaded to the view that an insolvency procedure modelled on Chapter 11 of the US Bankruptcy Code is appropriate for the Australian corporate sector. Nor does it consider that wholesale amendments to the voluntary administration procedure to conform with Chapter 11 have the potential to make a significant improvement in outcomes that are presently achievable under the VA procedure."*

Administration Trigger

There are a couple of statements in the Parliamentary Report which certainly seem to have some sympathy with Chapter 11 in the context of contemplating restructurings and reorganisations prior to actual insolvency. Chapter 11 is of course often used as a tool to restructure and reorganise without necessarily the company being either balance sheet or cash flow insolvent. The examples of this I am told are companies such as Dow Corning and Texaco which used the Chapter 11 process to cleanse themselves of prospective and contingent tortious liabilities.

For me the probably most important and telling statement in the Report was this one:

> *"The Committee recommends that the threshold test permitting directors to make the initial appointment of an administrator under the voluntary administration procedure be revised in order to alleviate perceptions that the VA procedure is only available to insolvent companies"*, i.e. the procedure is available to solvent companies

To facilitate the change of that perception the suggestion is that the test be reworded to read "the company is insolvent or may become insolvent". That is quite different to "the company is insolvent or likely to become insolvent at some future time". This change in the text could potentially have far reaching consequences and I believe in a general sense could see the advent of financial re-engineering and restructuring along the lines of what is seen in the US. The potential scenarios are endless but, as a topical aside, one could envisage say companies with significant contingent or prospective asbestos liabilities using the administration procedure and a deed of company arrangement to reorganise itself and cleanse itself of the contingent and prospective liabilities – or at least use the procedure to formally come up with a capping mechanism. The existing administration procedure is certainly flexible to allow for that to happen – which of course can happen without any Court involvement. Essentially all that would be required is for the creditors to agree by majority and value in number.

At a more practical level, particularly from a banker's perspective, the change in the text might have other significant implications. In many of the workout situations, a concern sometimes faced (certainly from a banker's perspective) is that directors run off and appoint an administrator prematurely or at an inappropriate time. Many of the larger corporations are run by employee directors who at the end of the day receive a salary and perhaps some options and bonuses. In the context of the large turnover of some of these companies and the debt they incur on a day to day basis – the potential insolvent trading liability is significant if, as it were, directors get it wrong when it comes to determining solvency. Arguably in workout situations some directors feel they take on a far greater risk than they feel they are being rewarded for.

Often we are faced with a situation where directors quite rightly want assurances from their lawyers that there is absolutely no risk whatsoever of insolvent trading, that there is no breaching of duties to creditors. Of course we as lawyers find it hard to give any blanket guarantees. Certainly at the moment I think that most lawyers advise directors that whilst they could conceivably form the opinion that a company is likely to become insolvent in the future and thereby justify the appointment of an administrator - it is not inconceivable that they could be challenged for breaching their duty to creditors by prematurely doing so – particularly if it became apparent subsequently that forming an opinion that a company was likely to become insolvent could not be justified. However, if the text is watered down to "may become insolvent" then the chances of directors being criticised for appointing administrators too early is significantly lessened. There could be the risk of employee directors just saying – I am not going to take on any risk and I'm giving the keys to an administrator.

Often in workout situations bankers very much prefer, for instance, directors to implement asset disposal programs and related debt reduction initiatives with a view to avoiding the uncertainties that receivership or administration might give rise to and potentially the lesser value that might be realised in a context of formal insolvencies. Directors are often happy to go along with this on the basis that it could be criticised for appointing administrators too early in such circumstances. However if the text changes that view might change.

On a more positive note what the change in text might allow for is a greater number of what is often referred to as pre-packaged insolvencies or reorganisations. Once could envisage major creditor stakeholders of a company potentially facing difficulty getting together and agreeing a workout plan which could be effected through a fast track administration. Directors could be made comfortable by those persons ensuring that there is sufficient cash flow support during that planning process. Directors then initiate administration on the basis that the company may become insolvent in the future. Thereafter the plan could be cut and approved in a relatively short period, i.e. through the two sets of creditor's meetings that have to be held within the first month of administration. Again I would reiterate that the administration procedure as it exists is flexible enough to allow for this and perhaps towards the end of this session we can discuss a little more as to how these things might work. But the opportunities would be there!

Implications for Bankers

Uncommercial Transactions

The next recommendation in the Report which I believe could have some implications for bankers is the removal of "insolvency" as a pre-requisite for the avoidance of uncommercial transactions which could be challenged by a liquidator – which transactions are to have taken place during the two year period preceding formal insolvency.

It is worth quickly setting out what one has to have regard to in determining whether or not a transaction is uncommercial. They are:

> *"it may be expected that a reasonable person in the company's circumstances would not have entered into the transaction"*

The matters include also whether any benefit or advantage was obtained by the company from the transaction or whether the transaction caused some detriment to the company that cannot be explained by normal commercial practice. At present the company must also have insolvent at the time of the transaction.

There have been probably only about half a dozen cases on this section of the Corporations Act and in practice that has largely been caused by virtue of the insolvency hurdle that a liquidator would have to overcome or at least demonstrate before getting into whether or not the other matters justify declaration being made. Otherwise you will note how widely drafted the section is. Potentially everything the company will have done over a two year period could be questioned for its reasonableness or as to whether it constitutes normal commercial practice. Further – "transaction" can cover all sorts of things!

If this recommendation is followed it could well result in significantly greater number of actions by liquidators – a lawyers dream! It might also see transactions that might otherwise be challenged under different sections of the Corporations Act being challenged using this section. For instance there is no reason why unfair preferences cannot be challenged using this section. In the context of transactions that financiers are involved with in workout situations I would be enunciate my concern by way of an example.

In workout situations debt might initially be unsecured. Bankers will often insist upon taking security and in doing so will take security for both old and new money. If after having taken security the company does go into liquidation within the following two years it is not inconceivable that a liquidator challenge that security on the basis that it was unreasonable particularly in relation to old indebtedness and, that normal commercial practice would be for security only to be granted for new monies. Of course I can see everyone about to jump down my throat in suggesting that it is perfectly commercial for security to be granted for old debt - to ensure and procure the new facilities. In any event it will be interesting to see whether or not someone might think of bringing such an action should of course this recommendation be agreed to.

Labor's Views

At the end of the Report there are a couple of pages where the minority Labor members of the Committee express certain views. These in a general sense are expressed very vaguely across the board – presumably on purpose.

However in relation to liquidators challenging transactions Labor's recommendation goes a lot further and suggests that a company be presumed insolvent in the 90 day period prior to the commencement of winding up for <u>all</u> voidable transactions not just uncommercial transactions. In other words 90 day presumed insolvency would also, for instance, apply to unpaid preferences.

For the sorts of reasons explained above clearly from a banker's perspective the acceptance of such a recommendation could significantly increase the exposure on banks which will have taken security in the 90 day period prior to winding up - again particularly for security taken for old monies. Of course bankers are already very aware of floating charges only being good for new monies lent if a company goes into liquidation in the six months following. But where acceptance of this Labor recommendation could have a real effect is on the taking of fixed charges.

Implications for Bankers

Secured creditors right to veto administrator

Just quickly I should mention that the Report does not suggest that a holder of security over all or substantially all of a company's assets lose its right to appoint a receiver and manager in the 10 day window following the appointment of administrator.

Clarification of 440B Agreements

As many of you know it is not uncommon for administrators and banks to agree that banks be allowed to enforce security after that 10 day window ends. The Report suggests that the Government clarify one way or another whether or not those agreements can be regarded as effective there being, of course, considerable debate as to whether or not they are.

Implications for Bankers

Maximum Priority Proposal

In October 2001 the Coalition, precipitously perhaps, proclaimed a commitment to "give unpaid employee entitlements ... priority of secured creditors ... when a business becomes insolvent". According to Labor at least, Tony Abbot restated this commitment after the collapse of Coogee Textiles in July 2003. This policy has been known as the Maximum Priority Rule and has been the subject of some debate over the last year or so. In simple terms the suggestion is that employees also be given priority over fixed charge realisations in addition to floating charge realisations. When one looked at the detail of what was being suggested it became quite complex - in that employees would only be entitled to look to fixed charge realisations in the event of a shortfall on floating charge realisations. This would result in an administrative nightmare in the context of large and complex insolvencies, as determining whether or not there might be a shortfall out of floating charge realisations could take some years. In any event the Report has clearly recommended that the maximum priority proposal not be adopted.

In the Labor member's minority Report the Maximum Priority Proposal is not really addressed. The Labor members focused on expanding the GEERS scheme, i.e. the governmental protection for employee entitlements. Essentially Labor proposes that the Government cover all employee entitlements and more particularly, in the context of what is not covered at present, all unpaid superannuation contributions and, most importantly, <u>all</u> retrenchment and redundancy entitlements not just up to 8 weeks. This would have a considerable monetary effect when one takes into account, for example, in a case like Ansett where redundancy entitlements in some cases were up to 102 weeks.

At the very end of the Labor member's minority report some rather vague references are made to the need for provisions enabling recovery of employee entitlements from related body corporates by liquidators, creditors or ASIC in appropriate circumstances. Indeed the actual recommendation suggests that such persons be able to apply to the Court to order a related body corporate to pay <u>any</u> debt of an insolvent company. The detail is unnervingly scant but the minority Report also goes on to recommend that *"intention to avoid liability ought not to be a pre-requisite to the making of such an order".*

Taken to the nth degree implementation of such recommendations could clearly impact upon the very structuring of groups generally, project finance, special purpose vehicles etc etc. Whilst the vagueness of the recommendations clearly demonstrate to me that either they were not necessarily being thought through by the Labor members or purposely left vague. But the recommendations do demonstrate an intent which if poorly implemented by any subsequent Labor Government could have far reaching ramifications.

Implications for Bankers

Section 556 Mandatory in DOCAs

Rather oddly and without any real justification to my mind, the Report suggests that in any deed of company arrangement section 556 be strictly adhered to unless any person or persons who might be effected by a changing in 556 agree to waive their rights.

As you know section 556 sets out the priority of return on a liquidation as between costs of administrators and liquidators etc and, employees. And further, within the context of employees the section sets out a further cascading priority. In other words - unpaid wages and superannuation contributions, annual leave and long service leave and finally retrenchment payments which would include redundancy.

One of the real benefits of deeds of company arrangements are their very flexibility.

One could envisage circumstances where creditors and indeed secured creditors and banks generally have their interests better protected if section 556 did not have to be necessarily adhered to.

Many deeds of company arrangements will envisage handing back the company to its directors and existing shareholders without the need to pay out employee entitlements nor, indeed, for them to crystallise.

To impose section 556 mandatorily would effectively give employees as a class greater leverage in the context of approving a plan - because they could refuse to waive their rights if the plan suggested their employee entitlements not be crystallized and paid or otherwise adequately protected.

Further there may be perfectly equitable reasons for changing 556 priority. For instance there may be a fair number of senior management who are on long fixed term contracts which would allow for retrenchment payments of effectively say, 1, 2 or 3 years pay which again would have to be acknowledged in any deed of company arrangement. It might be perfectly reasonable to expect these entitlements to be extinguished in the context of the resuscitation and survival of a company.

Implications for Bankers

Ipso Facto clauses

As Steve Sherman has discussed at some length during this session one of the provisions of the US Bankruptcy Code that appears to have considerable support is that provision which prohibits creditor counterparties terminating contractual arrangements solely by reason of the filing of Chapter 11.

The Report does not go that far and recommends that administrators be given the power to apply to the Court in such circumstances and for the Court only to have the power to prohibit termination. In doing so the Court would determine whether or not the counterparty was otherwise adequately protected.

My view on this is that if counterparties are still in a position to avail themselves of other termination provisions in the contract, eg. for non payment, they are otherwise adequately protected. Put another way if the insolvent debtor in administration is otherwise and generally in a position to perform the obligations under a contract then surely it should be allowed to continue. I am not sure I would go so far as to say that counterparties are obliged to continue contracts if only future payments for services are secure – in other words for as long as an administrator could assure a counterparty that it would be paid going forward. As a matter of policy, the real issue would be whether the administrator should need to make arrangements to make payment for any unpaid old debt to ensure continued supply. At the moment the Corporations Act does prohibit utilities terminating supply for non-payment of old debt on the basis that they provide essential services. Of course in reality many companies essential services are greater than those which utilities provide, i.e. more than just electricity, gas and telecommunications.

Chapter 11 in Australia

Filing for Chapter 11 by Australian Corporates

For an Australian company to file for relief under Chapter 11 it must have either a place of business in the United States or have assets in the United States. The US Bankruptcy Courts have even exercised jurisdiction in circumstances where the Australian companies had no more than a bank account in New York. In what has now become an old example of this was the filing for Chapter 11 by one of the Australis/Galaxy pay TV companies back in the mid 90's which Steve Sharman and I were both involved with. At the time it was used as an attempt (albeit unsuccessful) to encourage US noteholders are a number of movie studios to agree on a restructure.

The nexus with the US is ever increasing. Not only is there an ever increasing number of US companies establishing in Australia, but many in the room will know 2003 was a record year for 144A issues and private placements by Australian Corporates into the US.

I think it is only a matter of time before we see filing for Chapter 11 by Australian corporates as part of the armoury in restructurings and workouts.

To date we haven't really seen Australian subsidiaries being part of a Chapter 11 filing but to my mind it is only a matter of time before we see more of it. If a multi national company based in the US is going through a major workout or restructuring it is more likely than not that it would seek to have that done on a global basis and indeed it might be in everyone's interest, whether it be US creditors or the Australian creditors of the Australian subsidiary to be part of the Chapter 11 reorganisation. All of this of course will give rise to complex and interesting conflict of law issues and to varying degrees will involve cooperation between the Courts both in the US and Australia. There is some precedent in such restructurings between the UK and the US and those precedents have certainly not been straightforward.

From a strict legal perspective, it is worth noting in the US a "representative of a foreign entity" such as an administrator appointed in Australia can seek a dismissal of a bankruptcy proceeding under the Bankruptcy Code. In deciding whether or not to dismiss the US Court would look at the interest of creditors vis a vis a timely distribution of assets, the convenience or difficulty in establishing claims against the debtor in the foreign proceeding, the prevention of preferences and fraudulent conveyances and the distribution of priorities in the foreign regime. The US Court can however allow for the application of, for instance, Australian insolvency laws relating to such matters as preferences, fraudulent conveyances and setting aside transactions to apply in the US.

Section 304 Applications

Section 304 of the Bankruptcy Code allows for Australian corporates subject to a formal insolvency to apply for relief. The type of relief that can be sought includes obtaining injunctions to prevent creditors in the US from seizing assets in the US. The method by which that would happen could either be by way of a direct application from an insolvency practitioner or if felt more appropriate, pursuant to an application by an Australian Court under Section 581(4) of the Corporations Act to the US Court. This method might be more appropriate if a workout or restructure was to involve more than just seeking particular types of relief that section 304 of the Bankruptcy Code allows for.