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L A W Y E R S

DISTRESSED DEBT TRADING IN AUSTRALIA

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DISTRESSED DEBT TRADING
IN AUSTRALIA

"Distressed" debt trading is big business in overseas markets such as the United States, Europe and Asia. Whilst the market is still underdeveloped in Australia, some recent high profile collapses[1] have seen a large number of foreign debt players[2] enter our market and buy distressed debt with a view to making a return (by on-selling the debt) or a strategic investment (by exerting control over the debtor).

This paper seeks to examine the state of the distressed debt market in Australia, including the possible reasons for its relatively small size and limited number of participants compared to overseas markets and gives some predictions for the future of the market in Australia. In short, for various reasons, the market is likely to become more prominent in Australia with increasing numbers of participants being prepared to engage in trading distressed debts and claims.

The legal principles underpinning debt trading are more complex than they might initially appear to be. The paper also examines some current legal issues associated with the trading of distressed debts and claims.

1. Definitional Issues

1.1 *What constitutes a "distressed" debt?*

The reference to a "distressed" debt is generally a reference to any debt which is owed by a borrower whose credit rating or financial position has deteriorated below a level which the lender finds acceptable. This concept is therefore to be assessed subjectively by reference to the credit standards and quality acceptable to the relevant lender. For example, a financial institution may, under its mandate, only be permitted to hold AAA rated debt instruments. Once the borrower's credit rating drops below this level, this particular financial institution will regard the borrower as distressed and will be required to sell the debt. For other financial institutions, with a heightened tolerance to risk, a credit rating of below investment grade may be quite acceptable.

Quite clearly then "distressed" debt is more than just debt owed by company which is the subject of formal insolvency proceedings (although a formal appointment is often the trigger for the commencement of debt trading).

1.2 *What do we mean by "debt"?*

It is important to remember when dealing with distressed “debt” that, generally speaking, participants in the market are referring to any legal or equitable right that gives rise to a payment obligation, including:

(a) secured debts,

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[1] Sons of Gwalia Limited and Pasminco Limited in particular.

[2] Principally foreign investment banks, so called "vulture" funds and hedge funds.

(b) unsecured debts, including trade debts[3],

(c) liquidated damages claims,

(d) unliquidated damages claims; and

(e) other choses in action.

To use a recent example, following the appointment of administrators to Sons of Gwalia Limited, parties traded everything on offer, including:

(a) bank debt;

(b) bonds issued to parties in the United States;

(c) supplier trade debt; and

(d) exposures under ISDA governed hedging agreements.

For this reason, it is more accurate to describe the market as the distressed claims market. This expanded definition of claims reflects the broad categories of claims provable upon a winding up under s553 of the *Corporations Act*, 2001 (the **Act**) and is also consistent with the United States Bankruptcy Code's definition of "claims".[4]

2. The Distressed Debt Market

2.1 *Why is there a market for "distressed" debt?*

As a matter of market theory, the distressed debt market permits the transfer of credit risk from a seller, who no longer wishes to hold the credit, to a buyer who is prepared to accept a higher level of risk. The emergence of such a market is a hallmark of the increasing sophistication and liquidity of the relevant financial market which gives parties who are not content to accept a particular credit risk the option of disposing of that risk to another party rather than being a reluctant holder of that risk.

The motivations of distressed debt traders are varied but, in general terms, most traders will seek to acquire the secured or unsecured debt of a distressed company for one or more of the following reasons:

(a) To make a profit based upon the trader's view that the debt is worth more than the discounted sale price either by reference to:

(i) the acquirer's view of the value of the company's assets; or

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[3] Arising, for example, from the supply of goods or services to the company.

[4] Under s101(5) of the Code, a "claim" is defined to include the (a) rights to payment, whether or not such right is reduced to judgement, liquidated, unliquidated, fixed contingent, matured, unmatured, undisputed, disputed, legal, equitable, secured or unsecured; or (b) right to an equitable remedy for breach of performance, if such breach gives rise to a right to payment....

(ii) the acquirer's belief that it has credit and turnaround skills that will, through the application of those skills, result in an increase in the value of the company's assets.

(b) As a way of strategically gaining influence or control over the company and decisions relating to its future with a view to effecting a restructuring (be it either formal or informal) or turnaround at some later point in time which will improve the company's financial position (and therefore the value of its debt). Alternatively it may be that the investment has other commercial or strategic advantages for the acquiring party.

2.2 *Where it all began – the US Market*

By reason of the size and sophistication of its financial markets, distressed debt trading first became popular in the United States (**US**).

In the celebrated *Texas Hotels*[5] decision of 1936, hotel magnate Conrad Hilton acquired over one third of the debts of Waco Development Company which had filed for Ch 11 bankruptcy protecion under the US Bankruptcy Code. These debts were sufficient to defeat the reorganisation plan proposed by the debtor to attempt to force the sale of the debtor's land. The debtor complained to the District Court which ruled that Hilton's company has acted improperly in buying the claims for the purpose of voting down the plan. This decision was reversed upon appeal by the Fifth Circuit which found that, as the owner of the debt, Hilton was entitled to vote in any way he chose, which effectively cleared the way for distressed debt trading.

Since that time, the US distressed debt and claims market has grown expotentially in size. Some of the reasons for this significant growth are:

(a) Sheer weight of liquidity within the market leading to investment across a range of risk grades with distressed debt becoming a recognised high risk investment class. Many hedge and private equity firms have distressed investment and debt trading mandates.

(b) The emergence of hedge and vulture funds that have specialised in distressed claims trading and have produced excellent historical returns to investors.

(c) The proliferation of intermediaries (typically investment banks) looking to promote trading between debt holders and investors to generate commissions.

(d) The growth of the US bond market which is a significiant source of funding for US and international companies, including Australian corporates.

(e) The requirement that insurance companies and pension funds, which traditionally have funded the US private placement market, are only permitted to invest in low risk grade debt (such as A rated bonds) and must sell those bonds upon a risk downgrade, creating an availability of product for the traders and a ready market.

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[5] *Texas Hotels Sec Corp v Waco Dev.* Co 87 F.2d 395 (5th Cir. 1936)

2.3 *Other markets*

In other markets throughout Asia and Eastern Europe, the growth in distressed debt trading has arisen by reason of uncertain legal frameworks and poor accounting, banking and credit practices, which have resulted in a large volume of non-performing loans (commonly known as NPLs) being held by state owned or controlled banks, imposing significant inefficiencies upon the economies of those countries. This has certainly been the case in each of China and India. The developments in those countries were preceded, of course, by the significant market activity for NPL's in the immediate aftermath of the Asian financial crisis in 1997. One dramatic example of that activity saw the acquisition by a US hedge fund of Korean Exchange Bank.

The typical remedy in such a situation is to put those NPLs up for auction and there are a large number of banks, hedge funds and investment companies willing to acquire the debt at discounted prices with a view to working out the loans with the customers using informal techniques.

2.4 *Recent Experience in Australia*

To date, the distressed debt market in Australia has shown only bursts of activity. Typically these occur when a large listed Australian corporate, funded (at least in part) by foreign bondholders, goes into voluntary administration.

Notwithstanding this activity, the market remains in its infancy and domestic players have not historically participated in it. There are many reasons for this, including the following:

(a) Australia has an efficient legal and financial system which enables creditors to manage and recover their debts with confidence. If a company does become insolvent, there is a highly skilled insolvency industry which will "happily" restructure the company or liquidate its assets.

(b) The domestic banks, which have been the traditional sources of debt funding in the market, have excellent in-house credit skills which they utilise to manage their exposures. The prevailing view has been that, if the bank trades out its position, it will be delivering a profit to the buyer at its expense.

(c) It has been difficult for domestic banks to consider trading their debt by reason of the duty of confidentiality and the borrower's natural reluctance to permit the bank to transfer its rights and obligations to persons unknown.

(d) Credit quality in Australia has been excellent for the last decade with historically low levels of provisioning by the banks, coupled with 13 consecutive years of economic growth. In other words, a benign economic climate in which there has not been much distressed debt around to trade.

(e) Historically, Australian financial markets have been relatively small and insulated from the major international markets where distressed debt trading has been common.

More recent experience suggests that these historical trends will not continue.

In recent years, large listed Australian corporates have raised significant funds in the US under Reg 144A and the private placement market through the issue of unsecured bonds which are comparatively attractive (in terms of tenor, covenant and pricing) to domestic funding.

As we have seen, when a listed Australian corporate which has been funded by US bondholders enters voluntary administration, an immediate market is created in the US for the debt as the bonds are on-sold to traders (typically investment banks or "vulture" funds). This, then, creates a market for the debt of the company and results in traders seeking to acquire other debts and claims, including those held by Australian creditors.

This was the recent experience in the *Sons of Gwalia* administration, as it was in the earlier *Pasminco* administration.

In the case of *Sons of Gwalia*, the high level of turnover of debt and claims post administration has had some interesting consequences:

(a) Within a relatively short period of time after the appointment of administrators:

 (i) most of the unsecured bank debt had been traded by domestic banks to US or Singaporean based investment banks and traders;

 (ii) most of the hedge counter-parties terminated their positions and traded out their termination positions to the same parties;

 (iii) many of the acquirers of the debt themselves sold down the debt to investors; and

 (iv) following high levels of competition for the debt amongst traders, the price for Sons of Gwalia debt rose from about fourty cents to a peak of about sixty-five cents in the dollar.

(b) The likelihood of a reasonable dividend then encouraged the Australian based litigation funders, which had started funding class actions for disgruntled shareholders, to agree to fund Sons of Gwalia shareholders to lodge claims for damages for breach of s52 of the *Trade Practices Act* 1974 (Cth) (**TPA**) and related relief under the *Corporations Act* 2001 (the **Act**) for misleading disclosures.

(c) The possibility of claims by shareholders (which total many hundreds of millions of dollars) brought previously unanticipated liabilities into account in that company's liquidation which affected the anticipated dividend with the result that the price of the debt then collapsed back to around thirty cents. This caused general unhappiness amongst traders (particularly US traders) who had paid a higher price not factoring in the possibility of substantial parri passu competing claims by shareholders who, under US bankruptcy law at least, are barred from competing with creditors on any basis.

(d) Following the significant turnover in debt, the committee of creditors became dominated by US based creditors which has acted in ways consistent with US bankruptcy practice, including:

(i) strongly supporting the administrators' challenge to the lodgement of the shareholder proofs relying upon a wide construction of s563A of the Act which postpones debts owed to members "in the person's capacity as a member of the company"; and

(ii) holding meetings in New York;

(iii) retaining separate legal advisers; and

(iv) separately interviewing company management.[6]

2.5 *Impact of Sons of Gwalia decision*

There is no doubt that the principle that, in Australia, shareholders can compete with creditors upon liquidation has not done much for our international reputation, at least amongst the US traders.

The controversy concerning shareholder entitlements has its genesis in the rise of litigation funding in Australia and the progressive whittling down of the traditional prohibitions against maintenance and champerty. In recent years, this has resulted in the bringing of a much larger number of claims for damages by shareholders of listed companies in the event of corporate misadventure or collapse on the grounds of a failure to comply with the continuous disclosure regime under the Act and Listing Rules with consequential misleading and deceptive conduct, under any of the TPA, the Act or the *Australian Securities and Investments Commission Act* 2001 (Cth).

The debt traders who acquired bonds and bank debt after the Sons of Gwalia collapse began to feel nervous when an unsuspecting Finklestein J made an obiter observation in *Re Media World Communications Ltd; Crosbie v Naldoo*[7] that, in his view, the traditional principle[8] that the claims of subscribing shareholders are subordinated to creditors upon liquidation which was enshrined in section 563A of the Act, did not apply to shareholders who had acquired their shares "on market" (**transferee shareholders**) under circumstances which gave rise to a claim under the TPA.

Section 563A of the Act is in the following terms:

> *Payment of a debt owed by a company to a person in the person's capacity as a member of the company, whether by way of dividends, profits or otherwise, is to be postponed until all debts owed to or claims made by, persons otherwise than as members of the company have been satisfied.*

Following some press coverage of the *Media World* decision, and at the direction of the committee of creditors, the administrators of Sons of Gwalia decided to run an urgent test

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6 These activities are common for a US based creditors' committee but are not within the normal functions and powers of a committee of creditors appointed under Australia law.

7 (2005) 216 ALR 105

8 *Houldsworth v City of Glasgow Bank* (1880) 5 App Cas 317; *Webb Distributors v Victoria* (1993) 1789 CLR 15.

case to obtain a binding ruling as to whether such transferee shareholders could prove in competition with ordinary creditors. The litigation funders (which had been active signing up Sons of Gwalia shareholders) offered up a shareholder, Mr Margaretic and a bondholder also joined in.

The decision of Emmett J in *Sons of Gwalia Ltd (Administrators Appointed) v Margaretic & Anor*[9] to the effect that a claim by a transferee shareholder arising under statute for misleading and deceptive conduct was not caught by s563A came as shock to many of the creditors of Sons of Gwalia (including the distressed debt traders) who did not relish the prospect of the litigation funders supporting a large number of shareholder claims for damages to compete with their claims.

In particular, the US based creditors found the principle difficult to comprehend given that shareholder claims (other than those having no connection to the shareholding) are subordinated to the claims of unsecured creditors under the terms of section 510(b) of the US Bankruptcy Code.

The principle had also been confirmed relatively recently by the US Court of Appeals in *Baroda Hull Investments v Telegroup,Inc*[10] where a challenge by a shareholder to this principle was unsuccessful[11], the Court stating that:

> *We agree that in enacting S. 510(b), Congress did not intend to subordinate every claim brought by a shareholder, regardless of the nature of the claim. We disagree with claimants, however, that the subordination of all claims brought by shareholders is a logical consequence of our holding that claims for the breach of a stock purchase agreement requiring the issuer to use its best efforts to register its stock must be subordinated pursuant to S. 510(b). Nothing in our rationale would require the subordination of a claim simply because the identity of the claimant happens to be a shareholder, where the claim lacks any causal relationship to the purchase or sale of stock and when subordinating the claims would not further the policies underlying S 510(b), which was intended to prevent shareholders from recovering their equity investment in parity with general unsecured creditors.*

Whilst the appeal by the administrators of *Sons of Gwalia* to the Full Federal Court was unsuccessful[12], an application for special leave to appeal has been granted and the matter is to be determined by the High Court shortly[13].

The best arguments available to the administrators are:

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9 [2005] FCA 1305.

10 2002, 3rd Circuit Court of Appeals.

11 It is interesting to note that like s563A of the Act, s510(b) of the Bankruptcy Code is not free from doubt as to its proper construction.

12 *Sons of Gwalia v Margaretic* (2006) 56 ACSR 585.

13 The High Court appeal was heard in Adelaide on 7 and 8 August 2006 with the judgement pending.

(a) the apparent illogicality of the difference in treatment of claims by subscribing and transferee shareholders,

(b) the uncertainty from a corporate funding perspective arising from the prospect of substantial "off balance sheet" liabilities and the extra cost and delays of administrations which would be generated by an upholding of the principle[14]; and

(c) the general principle that equity is risk capital with upside and downside[15].

Notwithstanding these arguments, and even if the appeal is unsuccessful, it is unlikely that the principle will cause the distressed debt traders to bypass Australia in the future. Rather, it is a risk that will be factored into pricing.

Furthermore, as we have seen recently[16], it is one thing for shareholders to allege that they acquired their shares acting in reliance upon a misleading statement or material omission by the company and an entirely different thing to prove it.

2.6 *Prediction as to the future*

The slowness of the Australian market to embrace debt and claim trading probably has much to do with Australia's recent golden economic run together with the relative efficiency and effectiveness of the Australian legal and banking systems. In particular, Australian banks have traditionally been the principal source of funds for Australian corporates and those banks have highly effective and skilled credit and workout teams who are trained at maximising the bank's position upon customer distress rather than cutting and running with the risk of leaving value behind for others.

However, notwithstanding the current unhappiness over the concept of shareholders competing with creditors upon an insolvnecy, it is likely that distressed debt trading will become more common and recognised as one of the legitimate options facing an Australian based creditor looking to manage its credit exposure to a distressed company.

There are many reasons for this but to list a few:

(a) Like all financial markets, the Australian market is experiencing high levels of liquidity with new debt and equity players entering into the market previously dominated by the domestic banks. Many of those new debt players do not have institutionalised credit and workout teams with the capacity and ability to deal with a credit problem.

(b) Many international funds[17] and traders are now familiar with Australia and Australian insolvency practice and procedure and are actively looking to the

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[14] If shareholders can prove for such claims, this will add significant costs to an administration and will delay its finalisation.

[15] This principle often having been cited by US courts to justify the subordination of shareholder proofs.

[16] *Johnson v McGrath* [2005] NSWSC 1183

[17] Based in New York, Hong Kong and Singapore.

Australian market for new opportunities. Some have even opened offices in Australia.[18]

(c) Following their experience in the Sons of Gwalia and Pasminco administrations, many Australian banks and other financial market participants are becoming comfortable with the concept of trading out their debt in appropriate circumstances. The concern over leaving money on the table has been replaced by the attractiveness of choice. As has been seen from Sons of Gwalia, in some circumstances, Australian banks will find the offer too good to refuse.

(d) Whereas in the past, banking relationships were long term and personal, Australian banking documents are now being prepared with a view to having the flexibility to sell down or assign loans, particularly upon the occurrence of an event of default.

(e) Changes to provisioning following the adoption by Australia of the International Financial Reporting Standards may also cause lenders to consider trading their distressed debts before reporting dates.

3. Assigning Choses in Action in Australia

3.1 *General Principles*

The following general principles apply to the assignment of debts:

(a) At common law, debts and other choses in action were not assignable, although assignments in equity were recognised[19] with the result that legal title remained with the assignor.

(b) Section 12 of the *Conveyancing Act (NSW)* 1919 (and its equivalents in other jurisdictions) now provides for the legal assignment of debts and legal choses in action[20] if:

  (i) the assignment is in writing and is signed by the assignor; and

  (ii) notice of the assignment is given to the debtor.

(c) Upon the receipt of the notice by the debtor, legal title to the debt or chose in action passes along with all legal and other remedies attaching to that chose in action.

(d) A copy of the written assignment and, if it is ambiguous, the agreement to assign must be given to the debtor to enable the debtor to determine if the assignment is valid.[21]

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18 Eg Fortress Investments.

19 See generally J G Starke, *Assignments of Choses in Action in Australia,* Butterworths, London 1972.

20 The phrase "legal chose in action" covers all assignable legal rights.

21 *Van Lynn v Pelias* [1969] 1 QB 607 at 613; *Geroff v APD* [2003] QCA 187.

(e) Any assignment of debt will be subject to any equities including the defences, set off rights and counter claims held by the debtor at the date of the assignment.[22]

(f) The giving of notice to the debtor also:

(i) stops the accrual of new equities such as set off rights which arise after the notice of assignment[23],

(ii) prevents the debtor from giving a valid receipt and discharge for any purported payment of the debt[24]; and

(iii) can confer priority notwithstanding any earlier assignments of the same debt which are only effective in equity.[25]

(g) Securities should be assigned separately as they do not generally follow the debt.

(h) It is not possible to legally assign part of a debt. It is only possible to assign part in equity.[26]

(i) A cause of action in contract and tort where the assignee has a genuine and substantial commercial interest in that cause of action (which must be present before the assignment) is usually assignable.[27] However there is no champerty involved where an assignee sues to recover a debt which is the subject of a valid and bona fide legal assignment.[28]

(j) It is not possible to assign an action for damages under s82 of the TPA[29] for breach of s52, although the "fruits" of such claims may be assigned.[30]

(k) Unlike the position with voting upon Part X arrangements under the *Bankruptcy Act* (Cth), an assignee is entitled to vote for the face value of the debt or claim assigned rather than the amount paid to acquire it.

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22 *Legal Problems of Credit & Security*, Goode, 2nd Ed p 116.

23 *Equity Doctrines and Remedies*, Meagher, Gummow and Lehane 4th Edn, 6-500.

24 *Brice v Bannister* (1878) 3 QBD 569.

25 The priorities are governed by the rule in *Dearle v Hall.*

26 *Williams v Atlantic* [1933] 1 KB 81, *Norman V FCT* (1963) 109 CLR 9 at 29-30 and *Equity Doctrines and Remedies*, Meagher, Gummow and Lehane 4th Edn, 6-175 – but in Western Australia it is possible to do so by statute.

27 *Trendtex v Credit Suisse* [1982] AC 679.

28 *Camdex International Ltd v Bank of Zambia* [1998] QB 22.

29 This is also the case with any State based equivalents.

30 This is no doubt a disappointing principle for shareholder creditors seeking to rely upon the *Sons of Gwalia* decision, however the litigation funders are always an option.

The above is a summary only of the relevant general principles. When considering the trading of debts and other legal choses in action, it is important that specific consideration be given to the relevant type of debt or claim and the surrounding contractual and fiduciary relationships which may impact upon the assignability of those debts or claims.

3.2 *Bank Debt*

The historical reluctance of the domestic banks to sell their debts is partly attributable to the nature of the banker and customer relationship which, whilst contractual in nature, has long had an implied covenant of secrecy and confidentiality; see *Tournier v National Provincial and Union Bank of England.*[31]

In order to interest a third party in acquiring the debt, it is reasonable to expect that the bank will be required to disclose to that third party financial information relating to its customer. It is of course difficult to reconcile this with the duty of confidentiality.

However, the Court in *Tournier* recognised a series of exceptions to the duty, one of which is disclosures made with the implied or actual consent of the customer.

It has increasingly become the practice of financiers to seek to negotiate an agreed regime to sell down or transfer their facilities to third parties (or a defined category of them) in certain prescribed circumstances.

In particular, it has become common[32] to include an agreed ability for a lender to transfer all or part of its rights and obligations to "another bank or financial institution" without the borrower's consent, upon the ocurrence of an event of default. Such an ability to transfer is also coupled with a right to disclose information relating to the customer to potential buyers of the debt. Provisions of this kind, obviously, assist banks to trade out of their positions in a distressed scenario in the future.

Even more helpfully, the English Court of Appeal has recently handed down judgement in *Essar Steel Ltd v The Argo Fund Ltd*[33] and gave a broad interpretation to the meaning of "financial institution" in the context of an agreement restricting transfers by syndicate lenders in a loan agreement to "a bank or other financial institution".

In *Essar* the Court found that a transfer by the bank to a Cayman mutual fund investment company was a transfer to a "financial institution", those words only conveying the requirements that:

(a) the transferee was an entity having a legally recognised form or being,

(b) it carried on business in accordance with its laws of incorporation; and

(c) its business concerned commercial finance (even if that did not involve the lending of money).

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31 [1924] 1 KB 461.

32 See the standard AMPLA terms relating to changes to parties.

33 [2006] EWCA Civ 241

The borrower in Essar had been proposing a debt restructuring program to its existing lenders following the occurrence of various events of default and was unhappy that one of the banks transferred its loans to a Caymans hedge fund which then promptly demanded repayment of the loans.

If the loan agreements prohibit assignment without consent, one other option is to arrange for a sub-participation with another party. Such arrangements usually take the form of a contract between the financier and the sub-participant whereby the participant takes on some or all of the economic risk of the loan by paying an agreed sum in return for a right to receive some or all payments made by the borrower to the financier. Such arrangements do not ordinarily require the consent of the borrower.[34] They do, however, require the financier to continue to manage the loan[35] and enforce any relevant rights, including voting rights as it remains the legal owner of the debt. Furthermore, the sub-participant will have not set off rights against the borrower, nor benefit from any gross-ups or increased cost provisions as it is not the lender under the loan agreement. Care should also be taken with the duty of confidentiality as there is unlikely to be any express permitted disclosures for sub-participations.

3.3 *ISDA agreements*

When trading counter party positions under ISDA agreements relating to commodities or interest rates, it is important that parties understand that most agreements will not permit a counter-party to assign an open position to a third party without their consent.

Rather, upon default, the non-defaulting party will have the option of terminating the agreement and then the parties are required to follow the contractual regime for establishing the positions upon a close-out of the agreement. These arrangement can involve the obtaining of expert market maker quotes to value the underlying positions and there is scope to challenge the process if it is not undertaken properly.[36]

In the *Enron*[37] decision, the non-defaulting parties failed to properly assess their final close-out positions following termination (the reference market makers having applied the wrong method of assessing the market value of the terminated trades). If those parties had traded out their termination positions prior to the liquidator's successful challenge to the calculations, those parties would have had substantial issues with the purchaser of those debts.

When trading "debts" under such agreements, vendors should be careful to ensure that they have correctly terminated and closed-out their positions leaving an unliquidated amount due which can then be traded with minimal risk of a future challenge.

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[34] Unless participation is expressly prohibited by the loan agreements.

[35] Albeit that the bank can agree to act upon the instructions of the sub-participant.

[36] *Enron Australia Finance Pty Ltd (In Liq) v Integral Energy* [2002] NSWSC 753

[37] above

3.4 *Insolvency Issues impacting trading*

When dealing with unsecured claims following the commencement of a formal administration it is necessary to have regard to the provisions of Division 6 – (Proof and Ranking of Claims) of the Act[38] to determine how the unsecured claim will be assessed and admitted to prove.

In particular regard should be had to:

(a) Section 553(1) which, subject to section 563B(1), limits provable claims (including interest claims) to those arising or accrued at the relevant date.[39]

(b) Sections 553A and 563A which limit certain shareholder claims.

(c) Section 553C which permits certain types of set-off.

(d) Subdivision B which sets rules for the computation of uncertain or future debts and foreign currency obligations.

(e) Section 556(1) which sets out the priority of payments.

(f) Section 563B(1) which subordinates claims for interest post the relevant date.

(g) Section 563C which provides that debt subordination agreements are enforceable in certain cases.

These provisions do not impact upon a secured creditor to the extent of the value of its security. However, if a secured creditor is unsecured by reference to the value of the security, the claim, to that extent, will be treated as unsecured.[40]

4. The Terms of Trade

It is not surprising to note that when dealing with acquisitive US hedge funds and investment banks looking to acquire Australian distresed debt, they seek to impose standard US terms of trade upon Australian vendors.

Bodies such as the US Loan Syndications and Trading Association have issued standard terms of trade for use in the US which have become accepted by the market. Obviously such standard terms of trade need to be amended to recognise at least Australian insolvency law and procedure.

So far as the substantive terms are concerned, the key issue of concern to vendors is the fact that, notwithstanding the assignment and the fact that the purchaser is taking the risk on the level of return, the vendor remains at risk for the claim. Accordingly, if the claim is

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38 These provisions apply to liquidations and are ordinarily incorporated into deeds of company arrangement.

39 The relevant date is generally either the date of the appointment of the administrators to the company or the date of the winding up order; see s513A,B and C.

40 Section 554E(5)

rejected in whole or in part by the liquidator or if a substantial set-off or equity is raised by the debtor, the vendor will be liable to make good the difference to the purchaser together with an accruing interest component.

By reason of the purchaser's relative lack of knowledge of the details underlying the loan and any applicable equities or set offs, it is very uncommon for a purchaser to agree to accept the risk on the face value of the claim.

Typically the purchaser will seek representations, warranties and indemnities from the vendor in relation to these issues.

In addition to these protections, the agreement will usually contain:

(a) key terms such as the face value and nature of the debt, the price payable and the name of the debtor;

(b) terms requiring the vendor to account for any dividends received post assignment,

(c) an agreement by the vendor to deliver all relevant documents to the purchaser together with a continuing obligation to provide assistance in relation to proving the debt;

(d) further assurances from the vendor to assist to perfect the assignment, including an agreement to give formal notice of the assignment to the debtor and not to participate further in the administration;

(e) if there are litigation rights attaching to the debt (ie an action for breach of contract or misrepresentation), details as to whether those rights are also assigned; and

(f) an acknowledgement that the purchaser may have non-public material information and that the vendor has no recourse against the purchaser for this.

Where the vendor is aware of a potential claim or set-off which, if successful, could reduce or eliminate its proof, it would be normal to negotiate a right for the vendor to take over any subsequent litigation given that it will be on risk.

5. Procedural issues

5.1 *Proving and voting for assigned debts*

Consistently with the long history of claims trading in the US, the US Bankruptcy Code has developed a streamlined procedure[41] for the recognition by debtors of the assignment of claims.

The claims' agent (usually appointed by the Court) is required to maintain a register of claims. Upon a claim's transfer, the transferee is required to file a "Notice of Transfer of Claim" form with the Bankrutpcy Court clerk. Separate notice is not required to be given to the debtor or the trustee.

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[41] Rule 3001(e) of the Bankruptcy Rules.

There is no requirement to specify in the notice the detailed terms of the trade or the price paid. In the absence of an objection from the transferor, the claim will then be registered in the name of the buyer.

In addition to these formal bankrutptcy rules, the US based Bond Markets Association has developed a set of practice guidelines for trading in distressed bonds.[42] The common practice of US traders is to issue a confirmation containing the key terms of the trade before a more formal assignment document is entered into.

In Australia, the practice is less developed and recent experience in *Sons of Gwalia* has confirmed that the following approach should be adopted by parties acquiring debt of a borrower that is in administration or liquidation:

(a) The terms of the assignment should be formally agreed in writing[43] between the transferee and transferor.

(b) Written notice of the assignment should be given to the administrator or liquidator which constitues formal notice to the debtor and ordinarily has the effect of transferring legal title in the debt or claim to the transferree. It may be necessary to submit the assignment agreement in support of the notice.

(c) Alternatively, it may be that the loan agreements specifically provide for a transfer regime which must be followed.

It is within the discretion of the administrator or liquidator to recognise assignments effective only in equity (such as an assignment of part of a debt only), although there may be some concern over "double voting" in such cases.

Where a party has acquired an interest as a sub-participant only, no assignment has occurred and the debt continues to be held by the the creditor.

5.2 *Stamp Duty considerations*

The state of incorporation of the Australian company determines the situs of the debt for stamp duty purposes.

Most Australian jurisdictions do not impose stamp duty upon the assignment of debts or other transactions in the secondary dealers market such as assignments of security interests. However, for example, Sons of Gwalia was incorporated in Western Australia which does impose duty upon assignments evidenced in writing. Attempts have been made to avoid duty in relation to such assignments by adopting a written offer/verbal acceptance approach.

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[42] The guidelines are available at: www.bondmarkets.com/assets/files/practice_guidelines_for_trading_in_distressed_bonds.pdf

[43] Subject to any stamp duty considerations.

6. **Insider trading**

An interesting question arises as to the extent to which the insider trading provisions of the Act apply to debt trading.

Obviously, in the context of an active market for distressed debt, having better information about the company's prospects than other parties in the market is a significant advantage. From a policy perspective insider trading in distressed debt seems equally objectionable to insider trading in shares. But is it the case that in this market there is no regulation on trading on inside information?

In the US and the United Kingdon, currently[44] the insider trading laws do not apply to debt securities. However, the members of US creditors committees are recognised as fiduciaries of the company and their ability to trade their debt is generally very restricted except where they obtain a Court ordered exemption.

The position in Australia depends upon the definition of "Division 3 financial products" under the Act.

The prohibition upon insiders is set forth in subdivision B of Division 3 of Part 7.10 of the Act. In summary, the Act prohibits an insider who holds "inside information" from:

(a) acquiring or disposing of a Division 3 financial product (s1043A(1)),

(b) procuring another person to do so (s1043A(1)); or

(c) passing inside information to another person who is likely to acquire or dispose of a Division 3 financial product (s1043A(2)).

A Division 3 financial product is defined by s1042A to, inter alia, mean a "security" or other "financial product which is traded on a financial market".

It is beyond the scope of this paper to analyse these definitions in detail but it is relevant to note that a "debenture" being a chose in action that includes an undertaking to repay money falls within the definition of "securities" under s92 of the Act.[45]

It seems at least uncontroversial that a listed debt security[46] would fall within this definition as it is a financial product which is traded on a financial market. It also seems clear that debt provided by a party conducting business as a financier is exempted from the definition of "debentures".

Even to the extent that the insider trading laws do not apply to a particular form of distressed debt, it is likely that such conduct may breach other contractual, statutory or

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[44] The US at least is reviewing its position in this regard.

[45] There are a number of exceptions to the definition, including a promissory note with a face value of greater than $50,000.

[46] For example, the FIELDS issued by Delhi Petroleum Pty Ltd which are listed on the ASX which have been the subject of much recent press speculation.

fiduciary duties owed by the insiders (who typically would include directors and bankers) to the company or its creditors.

Such duties and obligations include:

(a) The banker's duty of confidentiality.

(b) Contractual and fiduciary duties imposed upon syndicate agents and members of any steering committee which is overseeing an informal restructure.

(c) The terms of confidentiality agreements executed by members of a committee of creditors or a committee of inspection in the contenxt of an administration or liquidation.

(d) The position of members of a committee as fiduciaries to the company.[47]

(e) The statutory and common law duties owed by an officer[48] to the company.

Great care should accordingly be taken by parties possessing inside or non-public information when contemplating trading in the distressed debt market. Similarly, administrators and liquidators should control information very carefully throught the use of confidentiality agreements for committees and purchasers of assets.

7. Conclusion

For the reasons identified, it seems likely that the market for Australian distressed debt market is going to increase in size with a number of new domestic and foreign players being prepared to participate in it. In doing so, those players must understand that whilst Australian insolvency and banking law is similar in many respects to US and English law, there are also some material differences and it is important to bear in mind the need to transact in this market bearing in mind those differences.

This increasing level of liquitity in distressed debt markets adds a further level of sophisticiation and efficiency to the Australian financial markets which is to be encouraged.

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47 Section 551 of the Act.

48 The definition of "officer" included an administrator, receiver or liquidator of the company.