ARTICLE

Voluntary Administration, Deeds of Company Arrangement and Potential Reform of Restructuring Procedures

Matthew Kersey[1], Henry Davis York, Sydney, New South Wales, Australia

Australia's principal formal restructuring procedures for companies are voluntary administration ('VA') and deeds of company arrangement ('DOCA'). After ten years of use, these procedures are under review, together with many other aspects of corporate and personal insolvency. This article considers a number of key features of these procedures and some of the potential areas of reform.

VAs and DOCAs were first introduced in 1992 and are contained in Part 5.3A of the *Corporations Act 2001* (Cth) ('the Act'). VA involves the temporary appointment of an insolvency practitioner to control the company and assess its options. It is a necessary precursor to a DOCA. VAs now form over one-third of all insolvency procedures commenced[2] and are used for companies of all scales. The DOCA is one of three potential outcomes of VA and provides a flexible means for a company to agree a restructuring with its creditors.[3]

Reform is being considered in two fora: first, the Parliamentary Joint Committee on Corporations and Financial Services ('PJC') commenced an inquiry into 'improving Australia's insolvency laws' in November 2002, the scope of which is much broader than VAs and DOCAs. The PJC released an issues paper in May 2003 ('PJC Issues Paper')[4] and numerous submissions have been made to it. The PJC has also conducted a number of public hearings. At the time of writing, it was expected that a report may be released in mid-2004.

Second, no doubt influenced by a number of recent large domestic and international insolvencies, the Corporations and Markets Advisory Committee ('CAMAC')[5] has been asked by the Government to consider and report on:

- Are there particular difficulties in applying Part 5.3A to large and complex enterprises?
- If so, could the Committee recommend the most appropriate course of action to deal with those difficulties? This could include:
  - particular changes to Part 5.3A to better accommodate large corporate rehabilitation cases;
  - particular changes to the rarely used Part 5.1 (arrangements and reconstructions) provisions to accommodate large corporate rehabilitation cases;
  - a new system for corporate rehabilitation, along the lines of Chapter 11 of the United States Bankruptcy Act; or
  - any other action that the Advisory Committee considers appropriate.

CAMAC released a discussion paper in September 2003 ('CAMAC Discussion Paper')[6] and in due course it should release a report with recommendations.

Notes

1 The views expressed in this article are the author's own and do not represent those of Henry Davis York.

2 37% in 2003 and similar in 2002: Australian Securities & Investments Commission *Submission to the Parliamentary Joint Committee on Corporations and Financial Services Inquiry into Australia's Insolvency Laws*, February 2003.

3 Australia also has schemes of arrangement, which are similar to those under English law. Schemes of arrangement are now rarely used due to the cost, time and the requisite court involvement, particularly when compared with DOCAs.

4 A copy may be viewed at <www.aph.gov.au/senate/committee/corporations.ctte/inquire.htm>.

5 CAMAC is constituted under Part 9 of the *Australian Securities and Investments Commission Act 2001* (Cth). CAMAC's functions are set out in section 148 of that statute: '[O]n its own initiative or when requested by the Minister, to advise the Minister, and to make to the Minister such recommendations as it thinks fit, about any matter connected with: (a) a proposal to make corporations legislation or to make amendments of the corporations legislation (other than the excluded provisions); or (b) the operation or administration of the corporations legislation (other than the excluded provisions); or (c) law reform in relation to the corporations legislation (other than the excluded provisions); or (d) companies or a segment of the financial products and financial services industry; or (e) a proposal for improving the efficiency of the financial markets.'

6 Copies are available from CAMAC's website: <www.camac.gov.au>. References to submissions to CAMAC are to submissions which are available on its website.

Objectives of Part 5.3A

Part 5.3A is expressly aimed at rescue and rehabilitation; the objectives are stated in section 435A of the Act to be as follows:

> '[T]o provide for the business, property and affairs of an insolvent company to be administered in a way that:
> (a) maximises the chances of the company, or as much as possible of its business, continuing in existence; or
> (b) if it is not possible for the company or its business to continue in existence – results in a better return for the company's creditors and members than would result from an immediate winding up of the company.'

VA provides for a registered liquidator (i.e. the administrator), invariably an accountant, to be appointed to the company. The administrator is required to hold two meetings of creditors and to provide a report to creditors for the second meeting about the company's business, property, affairs and financial circumstances, together with a statement setting out the administrator's opinion on:
(a) whether it would be in the creditors' interest for the company to execute a DOCA;
(b) whether it would be in the creditors' interest for the administration to end;
(c) whether it would be in the creditors' interests for the company to be wound up.

The creditors then vote on the options available to them.

Appointment of administrator and major consequences

The administrator can be appointed in a number of ways:

1. The company may appoint an administrator if the Board has resolved that the company is insolvent, or is likely to become insolvent at some future time and that an administrator of the company should be appointed.[7] The 'likely to become insolvent' limb provides an opportunity for early access to restructuring, although it appears to be used far less frequently than the first limb and directors' resolutions appointing an administrator are often put in the alternative.
2. A liquidator may appoint an administrator, although in practice rarely unless there is a prospect of a DOCA. The DOCA may then provide an exit from liquidation.
3. A chargee may appoint an administrator if they are entitled to enforce a charge on the whole, or substantially the whole, of a company's property and the charge has become enforceable. Secured creditors can therefore precipitate the restructuring of the company rather than simply acting to enforce their security.

The administrator has full control of the company's business property and affairs and may carry on the business, terminate or dispose of all or part of it.[8] The powers of its directors and officers are suspended and any transaction or dealing affecting the property of the company is void unless the administrator enters into it or consents to it in writing.[9]

Moratorium in VA

There is a broad moratorium immediately following the appointment of an administrator so as to enable the company's options to be considered in an orderly fashion. The moratorium prevents: commencement or continuation of proceedings; the recovery of property that is owned or leased by others; enforcement process; and enforcement of charges on the property of the company. These actions are possible with the consent of the administrator or the leave of the court.

The major exception is secured creditors. Secured creditors with security over all or substantially the whole of the company's property have a period of 10 days, referred to as the 'decision period', in which to act to enforce their charge. In this way secured creditors can appoint a receiver and manager, who will then co-exist with the administrator. When this occurs there is often very little for the administrator to do other than comply with his or her statutory duties in completing the VA.

Control of the administrator

The absolute control of the administrator is the major distinguishing factor from a debtor-in-possession system such as Chapter 11 of the US Bankruptcy Code. However, the directors of the company do not automatically lose their position; their powers are simply suspended and executive directors can still serve the company if they and the administrator wish. Employee contracts are not automatically terminated unless they so provide.

Administrators can and often do continue to trade the company. A major determinant will be the avail-

Notes

7 Insolvency is a cash flow not a balance sheet test: see section 95A of the Act.

8 Section 437A of the Act.

9 Section 437D of the Act.

© 2004 Chase Cambria Publishing

ability of assets to meet the costs and expenses of doing so. Administrators are personally liable for any debts incurred in the performance or exercise of their functions and powers for services rendered, goods bought or property hired, leased, used or occupied.[10] They have an indemnity to support that liability and a lien over the property of the company to secure it. The administrator's costs and expenses have a priority over priority creditors, such as employees, and the unsecured creditors.

Timing restraints

A voluntary administrator is subject to a number of strict timetabling requirements:

(a) A first meeting of creditors within five business days of commencement: the administrator may be replaced and a creditors' committee may be appointed;

(b) A second meeting within 5 business days after the end of the 'convening period', which is normally 21 days from appointment. The convening period can be extended by the court on application by the administrator.[11] The second meeting may be adjourned on a number of occasions but no longer than 60 days after the first day on which the meeting was held;[12] again this 60-day period can be extended by the Court.

(c) If creditors resolve at the second meeting to execute a DOCA, it must be executed within 21 days after the end of the meeting or the company goes automatically into liquidation[13].

Accordingly, the VA can be over in a month, although it regularly takes significantly longer. The time period to call the second meeting can be very restrictive in the event that there is any size and/or complexity to the affairs of the company. The administrator is required to form an opinion on which of the three potential outcomes is in the creditors' best interests. That will often require an assessment of the benefits of litigation available in a liquidation (where antecedent transactions and insolvent trading by directors can be pursued) and a comparison of the benefits between the DOCA and liquidation options.

Significant flexibility is afforded by section 447A of the Act, which provides the court with power to make such orders as it thinks appropriate about how Part 5.3A is to operate in relation to a particular company. The courts have used section 447A for a wide variety of purposes, often curative, to such an extent that they have attracted the criticism of commentators.[14]

The DOCA

The DOCA binds all unsecured creditors insofar as claims against the company arising on or before the specified date (usually the date of the appointment of the voluntary administrator). The vote requires 50% in number and in value of creditors voting, with a casting vote for the administrator. Secured creditors and owners and lessors of property are not bound except insofar as the deed so provides and if they voted in favour of it. The court can, however, make orders limiting the rights of secured creditors, owners or lessors, if their interests are adequately protected.[15]

With the important caveat of treatment of secured creditors, owners and lessors, the DOCA provides broad scope for restructuring a company's debt. There are, however, some important limitations:

(a) A DOCA can be terminated by the courts and the company placed into liquidation if it is oppressive or unfairly prejudicial to or unfairly discriminatory against one or more of the creditors of the company or contrary to the interests of the creditors of the company as a whole;[16]

(b) It is generally accepted that the priority of employee entitlements over claims of other unsecured creditors should not be disturbed;[17]

(c) The DOCA can discriminate between creditors, at least in relation to unsecured creditors, if that is justified in order to achieve one of the objects of Part 5.3A. Discrimination is commonplace in DOCAs which seek rehabilitation: some creditors are necessary to the future of the business and must be treated well to ensure their continued support. Unfair discrimination is a ground for termination by the Court, and this has been interpreted to mean that no creditor should receive a distribution lower than they would be

Notes

10 Section 443A of the Act.

11 Section 439A(6) of the Act.

12 Section 439B of the Act.

13 Section 446A(1)(b) of the Act.

14 See e.g. O'Donovan, *Company Receivers and Administrators* (2nd ed.) para 17.340.

15 Section 444F of the Act.

16 See section 445D(1)(f) of the Act

17 In a liquidation of the company, employees enjoy a priority in relation to unpaid wages and superannuation contributions, injury compensation, leave of absence and retrenchment payments: Section 556(1) of the Act.

© 2004 Chase Cambria Publishing

likely to receive in a winding up.[18] A favourable comparison with returns under a winding up, however small, is often used to justify DOCAs which simply seek to achieve a winding up without liquidation, for example with a distribution fund enhanced by director and related entity contributions. If a proposed DOCA provides for a distribution which amounts to a bribe or inducement to a creditor or class of creditors, it will be susceptible to termination by a court.[19]

DOCAs have been used in creative ways when seeking rehabilitation. Many companies consider that there remains a stigma in being subject to a DOCA, and they are required by the Act to disclose all company documents that they are so subject. It is possible to apply to court to drop the requirement to use that label.[20] Techniques for achieving a similar result include providing for a transfer of assets and creditor claims into a related company, also subject to a DOCA, where creditors are entitled to participate in consideration for releasing their claims against the first company.

A similar result is possible through the use of a creditors' trust, whereby the trust is used to receive the distribution fund and make a distribution to creditors. In some instances, particularly with publicly listed companies, the only asset available to enable a distribution to be made to unsecured creditors is the insolvent corporate shell itself, and techniques such as set out above enable the shell to be rid of its debt, enabling a sale of the shares, or a recapitalisation of the company, to take place. However, any such interference with equity presently requires consent of shareholders or a shareholder meeting.

The PJC Inquiry

The PJC is considering a wide range of issues relating to insolvency, both corporate and personal. Particular issues highlighted in the PJC Issues Paper relating to VAs and DOCAs include:

(a) Concerns as to the impartiality of administrators. The vast majority of administrator appointments are by the board of directors. Directors may be tempted to choose an administrator who they consider less likely to investigate their conduct and who may be sympathetic to a DOCA which works most advantageously to the directors. Likewise there is a concern that administrator impartiality may be compromised by desire to obtain appointments. This perceived lack of independence may be more apparent than real.[21] The PJC has called for further comment on the need to strengthen the independence of administrators and measures to do so, such as a code of ethics similar to that under Canadian legislation.

(b) Concerns about the quality and content of the report provided by administrators to creditors prior to the second meeting. There is little guidance in the Act as to the content of the report, and the timetable within which to produce the report makes any detailed assessment of the company's position difficult, particularly in large complex insolvencies and where any potential litigation in a liquidation exists.

(c) Aligned with issue (b), calls to lengthen the period of time before the second meeting to enable a more detailed assessment of potential future strategies to be made and restructuring plans formulated. The counter-arguments include that costs will increase; the VA regime is intended to be short and imposes a significant restriction upon creditors' rights as it is. If it is necessary to extend the period of time for convening the second meeting, the administrator already has the ability to apply to court.

(d) Whether there should be a new form of debtor-in-possession business rescue model along similar lines to Chapter 11 of the US Bankruptcy Code. The PJC noted that CAMAC is considering this issue in some detail and some relevant issues are referred to further below. One submission has commented that a major shortcoming of the VA procedure is that it relies on some form of financial engineering or sale of assets within a period of about a month to revive a company, and, in most cases, VAs which are successful involve creditors agreeing to forgive a substantial portion of their debts.[22] The same submission made the observation that a greater appreciation of business turnaround and reconstruction services is needed.

(e) The PJC has raised the issue of discrimination in DOCAs between creditors of the same class. The Australian Tax Office submitted that distributions to creditors pursuant to DOCAs should not depart from the principle that all debts in a winding up should rank equally.[23] This is not surprising given

Notes

18 See e.g. *Molit (No. 55) Pty Ltd v. Lam Soon Australia Pty Limited (administrator appointed)* (1996) 19 ACSR 160.

19 See e.g. *Young v Sherman* [2002] NSWCA 281.

20 *Re Brashs Pty Limited* (1994) 15 ACSR 477.

21 See paras 1.4 of the PJC Issues Paper and the submissions referred to in it.

22 Para 1.79 of the PJC Issues Paper.

23 Paragraph 1.136 of the PJC Issues Paper.

© 2004 Chase Cambria Publishing

that the Australian Tax Office is regularly a victim of discriminatory deeds. There is some force in this submission where a DOCA is not used to enable the business to continue trading. Where, however, a rescue is a positive alternative to a winding up, discrimination may be a useful means to ensure that the rescue has prospects of success, as long as it does not deliver to any creditors any lower dividend than their worst case scenario.

We await the report of the PJC with great interest as the potential exists for wide-ranging recommendations for change across not only Part 5.3A but the entire spectrum of Australian insolvency law.

The CAMAC Inquiry

The scope of CAMAC's inquiry is more limited than that of PJC, focussed on rehabilitation and large and complex enterprises. Some have questioned whether there is an underlying unproven assumption that the current system might somehow have produced a better result if the Australian regime was more like Chapter 11.[24] The inquiry has provoked the response from the former administrators of Ansett, an airline and one of the largest insolvencies in Australia in recent years,[25] that a Chapter 11 type arrangement would not have 'saved' Ansett, but that Part 5.3A could be enhanced to provide better prospects of rehabilitating the larger enterprises.[26]

The CAMAC Discussion Paper identifies a number of principles for effective corporate rehabilitation[27] and addresses both adjustments to the existing regime and considerations on whether to introduce a new form of insolvency regime modelled on Chapter 11 in light of those principles. There is an element of crossover as many potential changes to VAs and DOCAs would bring Part 5.3A closer to Chapter 11. There are many fundamental differences between VA and Chapter 11.[28] Some of the those differences are:

(a) Chapter 11 leaves the directors in control during the moratorium period. This has cost and continuity benefits and may be more likely to promote use of a rescue process. Critics say that it leaves the very people who presided over the company's failure in charge and is less likely to promote trust with key creditors such as banks. A balancing influence in Chapter 11 is the greater involvement and control of the Court and the committee of creditors, who have no real decision making power under VA. One would expect that availability and cost of finance would be strongly influenced by the introduction of Chapter 11, particularly if the other aspects affecting secured creditors are also introduced.

(b) The necessary Court involvement with Chapter 11 makes it more expensive and unwieldy to commence: in that respect it is similar to creditor schemes of arrangement under Part 5.1 of the Act. In Australia, the interrelationship with director liability for insolvent trading, one of the strictest regimes in the world, would need careful consideration. Commencement of VA brings potential liability for insolvent trading to an end. The cost issue is not entirely one-sided: VA unavoidably imposes the professional fees of the administrators and their staff.

(c) Chapter 11 is generally less friendly to secured creditors: the moratorium is broader than under VA, where secured creditors have the opportunity to continue enforcement action already started and have a brief opportunity to appoint a receiver and manager. Secured creditors can be bound to a restructuring plan under Chapter 11 and can lose their priority to those offering financing for the restructure. Under VA it is possible to obtain a Court approval to restrict secured creditor rights to enforce their security if their position is 'adequately protected'.[29]

(d) VA is required to move faster than Chapter 11, although large and complex VAs routinely seek Court assistance to extend the numerous deadlines. Section 447A provides flexibility to tailor Part 5.3A to the exigencies of large and complex insolvencies.

Notes

24 See e.g. the submission of RW Harmer dated 23 September 2003.

25 42 companies, 15,000 employees and over a $1 billion worth of assets: KordaMentha, *Rehabilitating large and complex enterprises in financial difficulty*, December 2003, page 1.

26 Ibid.

27 The principles identified are:
- the earlier a company responds to its financial difficulties, the better may be its prospects of successful rehabilitation;
- the prospect for a financially distressed company being rehabilitated may be improved if it can be encouraged to enter into discussion with its major creditors as early as possible on how best to rectify its financial position;
- a company may have a better prospect of successful recovery if it can obtain new loan or equity finance during the rehabilitation period;
- the procedural timetable needs to be sufficiently flexible to adjust to the needs of particular companies;
- the process of rehabilitating a corporate group may be assisted if that group can be dealt with collectively, rather than on a company by company basis.

28 For a useful comparative table, see the CAMAC Discussion Paper, page 14.

29 Section 444F(3) of the Act.

© 2004 Chase Cambria Publishing

(e) It has been argued that Chapter 11 would relegate employee priorities in a way that may not be acceptable in the Australian environment.[30] If, however, the prospects of continuing to work are enhanced, and employees continue to work and be paid rather than receive a priority redundancy payment, that policy concern may not be as relevant.

A more fundamental concern is that Chapter 11 gives an unfair trading advantage to inefficiently run companies, particularly if it enhances opportunities and conditions upon which to obtain finance. Chapter 11 also should be seen as a system both internally and in the way it interacts with its environment: ad hoc pasting of features, such as the debtor-in-possession aspect, into Part 5.3A would be very difficult.[31] Further, one must question whether there is sufficient evidence that Part 5.3A has failed large and complex enterprises to warrant importing a new and significantly different system in whole or in part.

There are nevertheless numerous proposals of more of a fine-tuning nature for making the VA procedure more likely to result in rehabilitation of large and complex enterprises. Each has a cost which must be balanced against the likely benefits of rehabilitation. Three particular proposals have significant appeal:

(a) At present, it is difficult for an administrator to raise finance for continuing the business in VA until the best option for the company is identified. The limited 'guarantee' of personal liability for debts incurred by the administrator (backed by the indemnity against the company's assets) does not expressly extend to funds borrowed. The administrator could act only as the company's agent in borrowing funds, which would give rise to a debt incurred after the date on which the winding up would be deemed to be commenced (i.e. the date of the appointment of the administrator) if VA resulted in a liquidation. Such a debt would not be provable in the liquidation and would therefore effectively be subordinated to the claims of unsecured creditors. The alternative is rarely available: to take a loan secured on the company's assets. Extreme cash pressure, often exacerbated by the present ability of banks to set off credit balances against unsecured liabilities owed to them after the appointment of an administrator, can remove the option of continued trading under VA. That present set-off right may also be under threat.

    Extending the present personal liability of administrators to funds borrowed would have the practical effect of allowing administrators to borrow on company assets not subject to fixed charges, with a priority for repayment over floating charge holders and unsecured creditors. Providing for such a priority would seem to have the same net effect on the company's pool of assets as the current priority for purchase of goods and services. This would appear to further weaken the position of the floating charge, and may therefore affect the cost of finance. There is a question whether it would be realistic to impose personal liability on the administrator for such borrowings where large and complex enterprises are concerned. This may be a necessary safeguard against reckless use of the ability to raise finance. However whether this would encourage voluntary administrators to take risks is questionable with large enterprises. The express ability to obtain court approval may be an alternative, for example over a certain level of borrowings.

(b) At present, there is no prohibition on parties to contracts with the company terminating those contracts upon the occurrence of administration, if the contract provides a right to do so. Many submissions to CAMAC agree that the counterparty to the contract should be unable to terminate or modify the contract, or repossess any property to which the contract relates, without the consent of the administrator or the court. This would extend to all contracts the incursion e.g. into landlords' rights which current exists. If there is protection for the other party to the contract in the form of the current personal liability of the administrator to pay for amounts payable by the company, with an option period for the administrator to disclaim the contract, this proposal has merit.

(c) Administrators and creditors, through a DOCA, are currently unable forcibly to interfere with the rights of shareholders without their consent. Greater flexibility to compel changes to existing shareholdings or to consolidate existing shareholdings (most appropriately under a DOCA) may enhance the ability of the company to raise equity finance for restructuring. In circumstances where the shares are effectively worthless, the need for shareholder protection must be diminished.

An associated issue is in relation to debt for equity swaps and whether the deed administrator should be exempt from prospectus-type disclosure statements under Part 6D.2 of the Act, Product Disclosure Statements under Part 7.9 of the Act and from the takeover provisions of the Act. The CAMAC Discussion Paper considers these issues

Notes

30 KordaMentha, *Ansett, Part 5.3A and Chapter 11*, June 2003, page 1.

31 Ibid n.23 at page 3.

© 2004 Chase Cambria Publishing

in some detail,[32] using the example of the experience of the administrators of Pasminco in failing initially to get an exemption from the takeover provisions from the Australian Securities and Investments Commission. Schemes of arrangement are already exempt from Part 6D.2 and the takeover provisions although it might be considered that Court involvement is a necessary protection. Whether any such changes are made must depend on whether there are sufficient protections for shareholders in the existing reporting requirements of administrators.

The issues raised above in relation to both the PJC inquiry and the CAMAC inquiry are only a fraction of the issues which are addressed in their respective discussion documents and the numerous submissions on them. Each have provided a valuable forum to consider Australia's rehabilitation procedures in detail. It may, however, be some time before the recommendations emerge and any reform occurs.

Notes

32 See paras 2.134–2.160.

© 2004 Chase Cambria Publishing