Turnaround Management Association of Australia

Submission to Treasury

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Submission
in Relation to Government Options Paper

A modernisation and harmonisation of the regulatory framework applying to insolvency practitioners in Australia

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1. INTRODUCTION

1.1 This submission is made by the Turnaround Management Association Australia, representing legal, accounting and business members.

1.2 The Turnaround Management Association of Australia (**TMA**) is a not for profit organisation providing a forum for professionals practising in the field of "Turnaround Management", which is aimed at restoring value to struggling enterprises and avoiding terminal insolvency. Our membership is made up of professionals practising in turnaround management, law, insolvency, accounting, management consulting, banking, finance and private equity.

TMA's membership base is broad and our members work on turnarounds in large business enterprises as well as SMEs.

1.3 We welcome the opportunity to provide submissions in relation to options outlined in the Government's paper dated June 2011, titled "A modernisation and harmonisation of the regulatory framework applying to insolvency practitioners in Australia" (**Options Paper**).

1.4 In this submission, the TMA outlines some reforms that would be beneficial to improving the turnaround framework in Australia. We believe that these changes will enhance the Government's proposed reform to insolvency laws, so as to assist in the rehabilitation of financially distressed small businesses in a cost effective and efficient manner.

2. EXECUTIVE SUMMARY

2.1 The TMA's vision includes assisting its members restore and create value in distressed businesses.

2.2 Stakeholders need to preserve enterprise value whilst a business is dealing with financial distress. This is often best achieved outside of a formal (administration) process. Administration may be appropriate to deliver a moratorium for enterprises under trading pressure, but is not always the best option for employees, customers and other stakeholders, particularly not in industries with high customer and labour mobility such as retail, technology, resources or industries where such appointments are likely to trigger ipso facto clause default. Moreover, avoiding administration means saving the agency costs of an external party (whatever the vocation of that party), preserving assets which would otherwise have been extinguished in fees for stakeholders. Put another way, the loss of value in an enterprise often comes down to the fact administrators were appointed before all alternates were explored. This comes about because the law protects directors who appoint administrators while transferring risk to directors who try, but fail, to turnaround the fortunes of distressed enterprises (ie: thereby becoming exposed to penalty for trading an enterprise which in hindsight of a failed workout plan was found to have been insolvent).

2.3 The TMA considers that directors should be encouraged to develop and implement workout plans prior to the implementation of a formal external administration. The TMA considers this achievable with the introduction of a business judgement rule defence to insolvent trading liability to assist creditors and directors of small corporations to better engage with the corporate insolvency system. In this submission there are six principal policy reasons advanced as to why there should be a safe harbour defence to insolvent trading liability. They are:

(a) the existing law, without any safe harbour, can impede or prevent proper attempts at informal workouts;

(b) the effect of the existing laws on honest, capable directors, particularly non-executive directors;

(c) the focus of directors of a financially troubled company should primarily be (as it is elsewhere) on the interests of creditors;

(d) the existing insolvent trading law limits the options available to deal with financial distress;

(e) a safe harbour defence would promote the critically important policy objective of obliging directors to obtain early restructuring advice; and

(f) a safe harbours defence reduces the opportunity for unfair manipulation of a workout plan.

2.4 Post external administration – we suggest 3 key changes:

(a) a moratorium on "ipso facto" clauses;

(b) an administrator be permitted to convene a meeting of creditors within 5 business days of appointment to consider a deed of company arrangement proposal; and

(c) a person not be disqualified from being appointed as an administrator by reason only of providing services or advice prior to his or her appointment.

3. PRELIMINARY MATTERS

Importance of restructurings and informal workouts for small businesses

3.1 Generally speaking, a successful restructuring or informal work-out will resolve the financial position of a company through the private agreement of key stakeholders outside of any formal insolvency process. Negotiations may produce a moratorium on repayment of bank or bond debt pending asset sales, injection of fresh capital, or both. Successful negotiations can produce a restructured balance sheet that returns the company to a state of solvency, or otherwise eliminates the question mark over the company's solvency and may thereby preserve enterprise value, employment and the business as a going concern.

3.2 The significance of this for addressing doubtful solvency is threefold:

(a) by avoiding a formal insolvency appointment, the risks of enterprise value destruction are largely avoided or diminished. These risks are identified in paragraphs 3.3 - 3.7, and the importance of them cannot be underestimated;

(b) it is usually the case that the only losses that are experienced are at the banker/bondholder/investor level - ordinary trade creditors will generally get paid in full[1]. This outcome directly contrasts the position in a formal insolvency process where ordinary unsecured creditors rank behind secured and priority creditors and share the deficit equally (and where that deficit may be enlarged should the formal appointment result in a diminution in enterprise value);

(c) counter-intuitively, existing laws may be exploited by hedge funds with vulture profiles which place pressure on directors to either include 'loan-to-own' outcomes in favour of the hedge funds within rescue plans or risk clawback litigation if an alternate rescue plan fails.

Significance of preserving enterprise value

[1] By way of amplification, in an informal work-out of a major corporation, it is usually the case that the claims of its financiers are so significant as a percentage of its total liabilities, that it is in their commercial interests to permit the company to continue to trade under agreed funding arrangements while a restructuring is pursued. In such cases, the business continues to operate and trade creditors are paid in the ordinary course of business during the period of restructuring.

3.3 In a circumstance of financial distress, "enterprise value" may be defined as the value of the company's assets and businesses. Preservation of enterprise value is important for at least three reasons:

(a) it maximises the prospect that a reorganisation, whether in or outside of a formal insolvency process, will be achievable. For example, to the extent that fresh capital might be a solution (either from existing investors or from an external source), the smaller the differential between the enterprise value and company's total liabilities, the lesser the amount of additional capital that would be required to remedy the position;

(b) in the event that the company cannot be saved and its assets need to be sold, the higher the enterprise value, the higher the return to unsecured creditors; and

(c) It preserves jobs. Generally for SME's, the higher the enterprise value, the greater the number of jobs.

3.4 Similarly, where the financial difficulties of the company can be addressed by a reconstruction of the entity's banking facilities or bondholder debt (or by a combination of that and fresh capital), preservation of enterprise value is critical. Again, the smaller the differential between assets and liabilities, the smaller the gap that the reconstruction needs to address.

3.5 For the above reasons, preservation of enterprise value must be an important public policy goal in dealing with financial distress.

3.6 It is the experience of the practitioners and industry participants represented by this submission that formal insolvency appointments can, and often do, cause a destruction of, or diminution in, enterprise value. This can occur in a number of ways, including:

(a) asset sales by an administrator, receiver or liquidator can have connotations of a "fire sale", and this can produce a lower price for those assets;

(b) the ability to hold assets for sale at a later time, perhaps when the market has improved, is more difficult in a formal insolvency administration[2];

(c) the operation of "ipso facto" clauses in commercial agreements can destroy businesses overnight, consequent upon entry into a formal insolvency process, particularly where a business has few if any hard assets, but is dependent on its contractual arrangements. One.Tel is but one example of a company that completely lost its business as a retailer of telecommunications services when its wholesale suppliers of those services relied upon ipso facto clauses to cease providing those services upon the appointment of an administrator. In our experience, the prevalence of such clauses is widespread. Where businesses are, for example, reliant upon leased premises, those leases invariably contain an ipso facto clause permitting the landlord (subject to the temporary moratorium which permits continuing occupancy during the voluntary administration period) to terminate the leases even though rent is up-to-date and there is no default under the lease;

(d) customers may shun a product or brand affected by a formal insolvency when concerned about future servicing or warranty issues. Some recent examples of funds management business have evidenced this adverse impact on 'goodwill' from such formal appointments;

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[2] The *Corporations Act* imposes certain time restrictions on the conduct of an external administration. The voluntary administration regime in Part 5.3A of the *Corporations Act* provides short timeframes for the transition of the company out of administration. Section 477(1)(a) empowers a liquidator to carry on the business of the company, but only insofar as it is necessary for the beneficial disposal or winding up of that business. Also, section 478(1) requires a liquidator to cause the company's property to be applied against its liabilities as soon as practicable after the Court order that it be wound up.

(e) the costs of the insolvency process, including the costs of the appointed insolvency practitioner, and his or her lawyers, can be substantial and need to be met before creditors are paid; and

(f) the crystallisation of contingent liabilities will further reduce the return to creditors.

3.7 In circumstances where it is feasible to overcome a company's solvency difficulties by an informal work-out or a restructuring of its balance sheet, it will in most cases be important for this to occur outside of a formal insolvency process.

Solvency is often a complex issue

3.8 In the experience of the practitioners and participants in the insolvency process represented by this submission, a company's state of solvency is frequently not black and white. The following illustrations provide a few examples of complexities that occur in practice:

(a) when a "mere temporary lack of liquidity" is weighed against the ability to sell assets in the short term, what assumptions may reasonably be made by the directors as to how quickly the assets can be sold (ie what is meant by "temporary"), and the amount that can be realised for these assets. Moreover, how ought directors address them in, say, the circumstances of the recent global financial crisis when there was a question mark over the value of assets, and real concerns about whether the assets could be sold at all or, in present market conditions, where the assets have exposures to southern European and other troubled regions;

(b) where the company has a letter of comfort from its parent that is not legally binding but which has always been supported in the past, is it reasonable for directors to assume that they are solvent if they can only meet their debts by reason of their ability to call on that letter of comfort?

(c) where a company has been trading unprofitably and has only been meeting the claims of its creditors through the financial support of its major shareholder, and where that support has always been forthcoming when called upon in the past, can the directors rely on the shareholder continuing to support the business? What is the position where the directors ask for a legally binding commitment, and the shareholder declines to provide it, but indicates that it is its present intention to continue to support the company?

(d) the Australian subsidiary of an overseas company that is in a formal insolvency process overseas is trading solvently, but its balance sheet identifies a very substantial debt owed by it to its insolvent parent which is payable on demand and which it could not meet if called upon. The parent company's liquidator refuses to give a commitment that it will not call upon the intercompany debt, but has to date not done so;

(e) a large property company's facilities with its foreign banker expire on 1 December 2011, and the bank, which is withdrawing from the Australian market, will not roll the facilities. Other banks so far approached to refinance the facilities have similarly refused even though the company can clearly demonstrate it can service the facilities. It is perhaps clear that:

(i) the company is not insolvent today (i.e. July 2011); and

(ii) the company will be insolvent on 30 November 2011 if not in receipt of a commitment to refinance.

However, when, between today's date and 30 November 2011, does this company change from being solvent to insolvent?

3.9 The above represent a few examples in practice of circumstances facing honest, diligent directors. If the directors appoint administrators they risk destroying or substantially diminishing the value of the business. If they do not call in administrators, they risk incurring personal liability for the company's debts incurred in the future, which would usually mean personal bankruptcy for the directors, if found to be liable.

Comparative analysis

3.10 The laws of other countries do not impede proper restructuring attempts by directors in the way that our insolvent trading laws do. A full comparative analysis of laws is contained in the INSOL publication "Directors in the Twilight Zone", but generally speaking, in a circumstance of doubtful solvency the laws of other countries impose an obligation on the directors to have primary regard to the interests of creditors in actions they take in consequence of the financial distress. This contrasts with Australian law where the overriding insolvent trading prohibition compels directors to place the company into administration where they cannot form the requisite view as to an expectation of solvency, even in circumstances where the interests of creditors might be better served by an informal work-out. There is no flexibility at all in the law as it presently exists.

4. INSOLVENT TRADING LAW – POLICY REASONS TO INTRODUCE A RESTRUCTURING SAFE HARBOUR

First policy reason - The existing law, without any safe harbour, can impede or prevent proper attempts at informal workouts

4.1 No other major Western economy has laws that operate in the same manner, and with the same severity, as Australia's insolvent trading laws.[3] If there are grounds for suspecting that the company is insolvent and the director is unable to form an expectation that it is in fact solvent, the director faces personal liability for all of the company's debts incurred after that date. In almost all cases, this would mean personal bankruptcy for the director. A dishonest breach of the provision renders the directors liable to imprisonment for up to 5 years.

4.2 Faced with these consequences, honest, diligent directors will ensure that they do not breach the law. For the reasons explained earlier in this submission at paragraphs 3.8 - 3.9, the question of a company's solvency frequently is not black and white, particularly with regard to large enterprises. If the solvency of a financially distressed company is uncertain or incapable of precise determination, it follows that it may be difficult for the director to form the necessary positive expectation that the company actually is able to pay all its debts as and when they fall due. Thus, not only will honest, diligent directors of companies that are actually insolvent place them into administration, but also there will be directors who feel compelled to do the same thing where the solvency is simply brought into question, because of the absence of their ability to form their positive expectation of solvency.

4.3 Moreover, there is a lack of flexibility with the current insolvent trading law. Once the operation of the law is triggered and a director is unable to form a positive expectation that the company is solvent, the director must cease incurring debts, with the likely result that administrators are appointed. This

[3] See paragraph 2.10 of this submission and the INSOL publication, "Directors in the Twilight Zone".

is so even though professional advice suggests it may be in the best interests of creditors that the company explore an informal workout or restructuring. The adverse implications arising from this inflexibility can be illustrated in several ways.

4.4 There are many examples of directors citing the insolvent trading laws as a reason for the appointment of administrators where a restructuring or informal workout was available to be pursued.

4.5 One example is the Henry Walker Eltin group, where the directors, citing concerns regarding insolvent trading liability, placed the company into administration. Ultimately, all creditors were paid 100¢ in the dollar, and the destruction of enterprise value was experienced at the shareholder level.

4.6 In many of the recent spate of corporate failures associated with the GFC, insolvent trading concerns have been cited by directors as a significant or determining factor in their decision to appoint administrators.[4]

4.7 This is not to say that a restructuring would have been feasible in all or, for that matter, most of the matters. That is not to the point. Of significance is the fact that the option of a restructuring or informal work-out is simply not available to be pursued when directors form the view that the insolvent trading law obliges them to make a formal appointment. There are many cases like Henry Walker Eltin where the formal appointment has been considered premature. No doubt in other cases, no attention was given to the issue of a restructuring as this was simply not an option given insolvent trading concerns.

4.8 It is the experience of practitioners and participants represented by this submission that the relevance of the above observations extends to companies of a smaller size as well as large enterprises and public companies.

Second policy reason – the effect of the existing laws on honest, capable directors, particularly non-executive directors

4.9 As indicated above, insolvency is often not black and white. Faced with the severe consequences of insolvent trading, there is a high burden placed on directors when the company enters the "zone" of questionable solvency. In these circumstances, directors, particularly non-executive directors for whom their personal reputation is of paramount concern, may not wish to continue their appointment. Non-executive directors in particular have been observed to resign from a company when its solvency is brought into question. This is to the detriment of the company and its creditors as this is the very time when their skilled, objective input would be highly valuable.

Third policy reason - the focus of directors of a financially troubled company should primarily be (as it is everywhere else in the world) on the interests of creditors

4.10 As indicated in paragraph 3.10, the laws of other major Western countries universally oblige a company's directors to have primary regard to the interests of creditors where the company is of doubtful solvency. As it is the company's creditors that are the stakeholders whose interests are paramount at this point, this is an appropriate policy choice. To the extent that Australian law differs, it is suggested that our laws reflect an inappropriate policy choice.

[4] While it is not appropriate for parties to this submission to identify those companies in this public submission, some of the parties would be pleased to provide further detail in a private meeting with Treasury officials, should this be considered helpful.

4.11 Australian law does differ in this respect as our insolvent trading law, in practical effect, requires the directors to place a trading company that is insolvent into administration (or liquidation), even though this may immeasurably harm the company and its business, and that they are in receipt of professional advice that a restructuring was feasible and to the advantage of creditors. In such a situation, the directors ought to be permitted to take proper steps to pursue a restructuring, as is the case in all other major Western economies.

4.12 This is not to say that a formal insolvency appointment is inappropriate as a general proposition. This is not the case, and an early appointment of an insolvency practitioner to the company will often, perhaps in most cases, be the appropriate course. The problem with the current law is the lack of flexibility for directors to choose the appropriate course in the particular circumstances of the company.

4.13 A safe harbour is needed to provide the necessary degree of flexibility for directors to make that choice.

Fourth policy reason - The existing insolvent trading law limits the options available to deal with financial distress

4.14 Options available to deal with financial distress and which are commonly employed in overseas jurisdictions, are limited by Australia's insolvent trading laws in at least three important respects.

4.15 First, as explained in paragraphs 4.1 - 4.8 above, the achievement of a work-out or restructuring, by private agreement between key stakeholders, is impeded.

4.16 Secondly, a common feature in overseas jurisdictions is the appointment of a Chief Restructuring Officer (**CRO**) by the company, who is a skilled professional in the field. It will be the task of the CRO to perform the following executive tasks so as to advise the company's board of directors on all aspects of the restructuring:

(a) assess the financial condition of the company;

(b) examine restructuring options;

(c) engage with key stakeholders;

(d) negotiate, on behalf of the company, the restructuring with relevant stakeholders;

(e) implement the restructuring.

4.17 In contrast to the position overseas, the appointment of CROs is a very rare occurrence in Australia. Anecdotally, in the limited circumstances in which a CRO has accepted an appointment, enterprises have been saved. These are rarities because most CROs will not accept appointments. This can be seen largely as a product of our insolvent trading laws in two respects.

4.18 The first is that restructurings are less frequently attempted in Australia for the reasons set out above in paragraphs 4.1 - 4.8.

4.19 Secondly, given the professional skills and expertise brought to bear by the CRO, it is anticipated that the board of directors would largely be guided by, and proceed to implement the recommendations of, the CRO. This would likely make the CRO a "shadow director" in accordance with the *Corporations Act* definition of a "director", and would therefore render the CRO personally liable for insolvent trading liability. It is unlikely that many sensible professionals would be prepared to assume that risk.

4.20 Thus, providing a safe harbour defence to insolvent trading liability for proper restructuring attempts would, subject to one qualification, enable Australian companies to enjoy the benefits associated with the appointment of CROs. The one qualification is that a further amendment would need to be made to modify or eliminate, in a restructuring context, the extended definition of a "shadow director". It is therefore very important that legislative attention is given to the definition of "director" so that a CRO, or any other stakeholder, participating in the restructuring process is not taken to be a "shadow director" of the company.

4.21 Finally, a safe harbour to enable proper attempts at a restructuring would enable another commonly used tool overseas to be available in appropriate circumstances in Australia. This is where a formal insolvency appointment will be necessary in order to restructure a company, but it is considered desirable to resolve by negotiation with key stakeholders the material aspects of the restructure prior to the formal appointment. This can enable the formal appointment to be accompanied by the assertion that the appointment has been made in order to implement the reconstruction. This can be a critical element in preserving enterprise value. A recent example is the General Motors restructuring in the United States. The "pre-pack" approach adopted with GM enabled the bankruptcy filing to be accompanied by press reports of "GM saved" rather than "GM goes bust".

4.22 General Motors traded for many months whilst insolvent in order to enable the detailed and complex negotiations with unions, bondholders and the Government to be consummated. A fully negotiated restructure plan was then presented to the Bankruptcy Court at the commencement of the formal process and adopted. Damage to the brand was minimised. In contrast, had this occurred in Australia, Australia's insolvent trading laws would most likely have compelled the directors of General Motors to appoint administrators many months earlier, at a time when there was no agreement with the Government to recapitalise the company, and no agreement with bondholders and unions to convert substantial entitlements into equity. In short, at the time of any hypothetical formal appointment in Australia, there would have been no guarantee as to the company's future and no security to anyone buying a General Motors branded car that there would be service or warranty support in the future. The damage that would have resulted to enterprise value would have increased the amount of equity required from Government and the quantum of concessions required to be made by the unions and bondholders. It would very quickly have rendered any restructuring of the nature entered into in the US increasingly unviable. In short, a restructure of this type almost certainly could not have occurred in Australia.

4.23 The contrast between what was achieved in the US, and what would have occurred in Australia, could not be starker. It is important to record that the difference has nothing to do with the availability of "Chapter 11" procedures in the US; it is a product of Australia's insolvent trading regime.

4.24 While the General Motors example is at one end of the extreme in terms of the size and complexity of businesses, the dynamics in play are no different in principle to companies smaller in size and less complex in structure. There are many examples of pre-negotiated restructure plans of a smaller, more modest size that are being successfully effected in the UK and US. Examples in the UK are Whittard of Chelsea, Mosaic and USC.[5]

4.25 Denying the availability of these restructuring tools in Australia is manifestly to the disadvantage of Australian business and the Australian economy.

Fifth policy reason - A safe harbour defence would promote the policy objective of obliging directors to obtain early restructuring advice

[5] It must be acknowledged that some difficult policy issues exist in this area.. The fact that some regulation may be necessary in the area should pre-negotiated restructure plans become common practice in Australia does not mean that this tool for addressing insolvency should not be available.

4.26 In circumstances where the law provides relief conditioned on the director obtaining professional restructuring advice, the important policy objective of ensuring that financial distress issues are addressed early and with the benefit of professional advice would be served. This is important as early intervention would maximise the prospect of a solution being found. Equally importantly, should a restructuring not be feasible, early action by directors in seeking professional advice would nonetheless identify the need for an appropriate formal appointment at an early stage.

Sixth policy reason - A safe harbour defence makes manipulation by hedge funds less likely

4.27 Hedge funds with vulture profiles actively trade into distressed debt positions. Australian domestic banks are more willing to trade out of senior positions for discount. Subordinated debt, especially international bondholder and investment grade funds, typically trade out of distressed conditions for deep discounts. Incoming hedge funds gain negotiating positions at costs well below par. While it is legitimate for such funds to recover against par, some funds have adopted a very aggressive profile of negotiation for added benefits, failing which those funds are prepared to force on the administration or even liquidation of the enterprises. Because such funds can invest into industry portfolios, the liquidation of one enterprise (and loss of the investment there) can be averaged across other enterprises within the portfolio. The threat of liquidation is real and is often enough to force other asset class holders, whether the enterprise, its equity or financiers, to satisfy the hedge demands in order to save the enterprise.

4.28 Directors faced with such demands are at heightened risk of insolvent trading liability if they continue to implement a workout plan knowing the hedge funds may bring a tactical application to wind up the enterprise.

4.29 Changing the law to allow directors a safe haven in the appropriate circumstances allows directors to concentrate on the workout plan instead of the greenmailing.

5. MORATORIUM ON "IPSO FACTO" CLAUSES

Summary of proposal

5.1 We submit that a moratorium should apply in voluntary administrations to cover the operation and enforceability of ipso facto clauses, with the effect that certain ipso facto clauses cannot be enforced until at least after the end of the voluntary administration process. The rights of chargees acting before the end of the decision period, counterparties to derivatives, swaps, ADIs with set-off, combination, acceleration, other rights under s440JA of the *Corporations Act 2001* (**Corporations Act**), statutory and contractual rights of set off and the operation of the Payment Systems and Netting Act, 1998 (Cth) (**Netting Act**) should remain unaffected by this moratorium.

5.2 An extension of the moratorium against ipso facto clauses which would otherwise alter property rights is highly desirable for financially distressed companies to successfully rehabilitate, the primary object of the voluntary administration process.[6] This is because a company may be subject to a number of key contracts essential to the continuation of its business, including leases and supply contracts. The automatic termination of such contracts upon an administrator being appointed is highly likely to burden the continued operations of that company.

[6] Refer s 435A of the Corporations Act.

Ipso facto clauses

5.3 Ipso facto clauses are contractual clauses that create a default, impose additional or modified obligations or dispossesses a party of a property right on the happening of certain events such as the appointment of administrators, changes to capital structures and renegotiation of material contracts. These steps are usual precursors to a workout. The clauses in issue may also provide for accelerated repayment of borrowed funds. Termination may be automatic or at the option of the counterparty.[7]

The TMA submits that the issue deserves renewed attention in light of the recent spate of failed companies during the global financial crisis, where many companies which otherwise would, in better economic times, have likely continued to prosper after a corporate reconstruction, have rather failed due to their counterparties' insistence on enforcing the ipso facto clause in a contract. We also point to recent discussions in the industry that the law in relation to ipso facto clauses in periods of voluntary administrations is inadequate.

5.4 Ipso facto clauses result in many administrations resulting in realisations being determined on a net asset basis rather than a business value basis because of the lack of contract certainty.

Proposed reform

5.5 The TMA accepts that financial based, or synthetic equivalent, events (eg: non payments, failure to settle deliveries under ISDA derivatives instruments) should, subject to existing Pt 5.3A Corporations Act provisions, still be enforceable after the appointment of voluntary administrators to a company. Similarly, rights of acceleration, combination, set-off and the other rights described in s440JA Corporations Act are not to be subject to the moratorium. The integrity of financial markets requires parties to remain bound by the terms of their financing arrangements.

5.6 The US Courts have recently recognised that counterparty positions in ISDA derivative instruments may be characterised as ipso facto clauses if rights to participate in cashflow waterfalls automatically swap to different parties on the bankruptcy event triggering[8].

5.7 Accordingly, the TMA proposes that the limited extension of the moratorium be dealt with as an extension of s437D of the Corporations Act, in which case the Netting Act will continue to provide the framework for credit exposure netting in swaps, derivatives and similar instruments[9]. The PPSA requirements remain unaffected by this proposed extension.

5.8 As a result, the moratorium extension shall be limited to deal with those enforceable ipso facto clauses that genuinely affect, alter or modify property rights of the company simply by reason of the appointment of a voluntary administrator. The counterparty would be unable to terminate, modify or collect any contracted property held by the company under administration. To balance rights, the counterparty may rely upon the administration as an event of default (avoiding complications concerning mutuality and crystallisation when dealing with contractual set-off rights) and may, subject to PPSA restrictions, enforce the operation of the ipso facto clause only with the consent of the voluntary administrator or the court.

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[7] Ipso facto clauses are valid, and were upheld by the High Court in *Pan Foods Co Importers & Distributors Pty Ltd v ANZ Banking Group Ltd* (2000) 74 ALJR 791.

[8] Lehman Brothers Special Financing, Inc. v. BNY Corporate Trustee Services, Ltd (25 January 2010). The PPSA expressly excludes from registration requirements netted out arrangements under the Payment Systems and Netting Act, possibly including ISDA securities lending and repurchase arrangements. Other re-crystallisation arrangements (eg: ownership swapping back to seller on default under an ipso facto clause will not be covered by the Netting Act, so would need to either be registered under the PPSA or come within the perfected registration provisions.

[9] Refer sections 5, 14 of the Payment Systems and Netting Act, 1998.

5.9 This would preserve entitlements of set-off (and combination in the case of ADIs), while also preserving both accrued and crystallised claims. Provisions regarding mutuality and set off in insolvency (s553C) occur automatically, so remain unaffected by the proposed extension of the moratorium to non-financial ipso facto clauses.

5.10 We submit that the total prohibition on enforcing ipso facto clauses, excepting those described in s440JA Corporations Act, without court or administrator approval will appropriately facilitate the rehabilitation of companies whilst protecting the interests of creditors. The TMA proposes that the rights of a counterparty would only be affected to the same limited extent as lessors and owners under the current regime. The voluntary administrator shall, if they continue with the relevant contract, be liable to perform the contract and assume the usual payment obligations referrable to the benefit derived by the company in continuing the contract, with rights of indemnity to meet such liabilities under s443D of the Corporations Act.

Reasons for our submissions

Impediment to the rehabilitation of the company

5.11 The key reason for imposing a restriction on the enforcement of non-financial ipso facto clauses during the voluntary administration process is that automatic termination of obligations, merely because the company appoints an administrator, has the potential to impede significantly on the ability of the administrator to take steps towards the rehabilitation of the company.

5.12 Such clauses are likely to operate as a burden to maintaining the trading operations of the company at a time when the continuation of the company's business is paramount to its survival. It can effectively obliterate the business of the company overnight as it leaves open the risk of counterparties terminating key agreements essential to the continued operation of the company. For example, it would be extremely difficult for a company to continue operating if, for example, its key lease or supply contracts are terminated.

5.13 In turn, this has the real potential to complicate negotiations with stakeholders and therefore creates significant reduction in enterprise value. It considerably reduces the opportunities an administrator may have to negotiate a sale of business and/or assets, and may leave companies and any proponents of a deed of company arrangement with less scope in formulating an attractive (or even effective) rehabilitation proposal.

5.14 By way of illustration, the appointment of voluntary administrators to One Tel Limited (**One Tel**) in 2001 resulted in the immediate termination of One Tel's reseller contracts with Optus and Telstra, which was a major factor in its eventual demise.

5.15 This effect may be exacerbated if the ipso facto clause contains accelerated payment terms, effectively giving rise to a large and unexpected debt against the company. (For example, a company with 20 years of its lease remaining may be obliged to, under accelerated payment terms, pay for the remaining 20 years' worth of lease payments without having actually utilised the property for a large portion of that term).

5.16 Extending the moratorium in this manner may also help to stabilise the asset base of a company (by avoiding a sudden crystallisation of the company's contingent or prospective liabilities) once it goes into voluntary administration.

Encouraging early intervention for rehabilitation

5.17 A prohibition on enforcing non-financial ipso facto clauses (with the exception of court or administrator approval) may encourage financially distressed companies to enter into earlier

negotiations with their creditors on a possible voluntary administration, or some other form of reorganisation.[10] This is because the risk of a counterparty enforcing an ipso facto clause upon the appointment of an administrator operates as a deterrent to companies entering into voluntary administration for fear of their major contract(s) being terminated. Such earlier negotiations are highly desirable. Indeed, one of the key issues discussed in the JPC Paper, and also raised in the CAMAC 2003 Paper was the need for early intervention for rehabilitation.

5.18 This may also lead to companies seeking appropriate advice from specialist insolvency practitioners in a timely manner, thereby avoiding further financial decline.

Prejudice to creditors as a whole

5.19 It cannot be disputed that the interests of creditors is a primary concern of the voluntary administration process. Overall, the interests of creditors as a whole may be prejudiced by the enforcement of ipso facto clauses. This is because it leaves the fate of the company (and thus many creditors' debts) in the hands of the one party. It is the primary interest of the creditors to be repaid the full amount of their debt, and in many instances, this is most likely to occur if the company continues as a going concern. It is certainly not likely to occur if an ipso facto clause contains accelerated payment terms creating a large, unexpected debt for the company.

Freedom of contract

5.20 At the centre of the lack of a prohibition over the enforcement of ipso facto clauses is the concept of 'freedom of contract'. It has been argued that a counterparty's decision whether or not to exercise the ipso facto clause should be left to the individual to determine in light of their and the insolvent company's circumstances. If a counterparty forms the view that the company can be turned around, they may not exercise their ipso facto rights. It has also been said that market forces should determine whether companies are permitted to continue to trade, rather than administrators and the courts.

5.21 However, the operation of market forces have always been subject to legislation and the courts where this is desirable for public policy reasons. The moratorium restricting the enforcement of creditor claims (including after a breach by the company of its obligations) during the period of voluntary administration is an example of this. It is only a small extension to make to widen this moratorium to also temporarily suspending a counterparty's freedom to enforce its rights under an ipso facto clause.

5.22 In addition, the need for some sort of moratorium has previously been recognised through the enactment of s 301 of the Bankruptcy Act, which provides that an ipso facto clause trigged upon an individual becoming bankrupt or committing an act of bankruptcy, or the execution of a personal insolvency agreement in the Bankruptcy Act, is void. That section also applies to contracts entered into or granted before the commencement of that Act.

5.23 We do recognise that concepts of freedom to contract need to be balanced against the objects of the voluntary administration process and the high desirability of affording distressed companies the opportunity to rehabilitate. We note that other contractual rights are available and should be sufficient to protect the solvent party, and that the voluntary administration process operates only for a limited duration, after which ordinary rights of enforcement will be re-instated.

6. SHORTENING TIME PERIOD FOR DEED OF COMPANY ARRANGEMENT & ADMINISTRATOR'S INDEPENDENCE

[10] This was recognised in the CAMAC 2003 Paper at paragraph 2.203.

Summary of proposal

6.1 This submission considers whether the time period for conducting a voluntary administration should be abridged to accommodate the expedient restructure of financially distressed companies in appropriate circumstances. This would enhance the ability of a company, prior to entering into an external administration, to formulate an agreement or compromise aimed at rescuing it from financial distress or maximising returns to members and creditors. The rescue plan may then be implemented quickly through the external administration process so as to minimise loss of value to the business.

6.2 Under the current law, an administrator must comply with the strict time periods imposed by the Corporations Act. Compliance with these time periods often has the unintended effect of protracting the process of an insolvency process, thereby undermining its commercial benefit and making the strategy outlined in the paragraph above difficult to achieve.

6.3 In this submission, we propose that a mechanism be put in place which allows a deed of company arrangement to be proposed and approved by creditors at an early point in time.

Current provisions that impact on proposal

6.4 The Corporations Act imposes a strict timetable for the conduct of a voluntary administration. The administrator must convene a first meeting of creditors within 8 business days after the commencement of the administration in order to determine whether to appoint a committee of creditors and to allow creditors to replace the administrator. Following the first meeting, the administrator must convene a second meeting of creditors, ordinarily within 15 to 25 business days after the commencement of the administration, at which the creditors may resolve:

(a) that the company execute a deed of company arrangement;

(b) that the administration end; or

(c) that the company be wound up.

6.5 While the Court may extend the time period for convening the second meeting of creditors, there is currently no ability for the Court to shorten the convening period if the circumstances so require. Hence if an administrator wished to implement a sale or restructure almost immediately after appointment through a deed of company arrangement, he or she would need to wait at least 15 business days after the commencement of the administration before putting the proposal to creditors.

6.6 One of the major attractions of announcing a relevant sale or restructure immediately or very soon after the commencement of a formal insolvency process is the creation of certainty for suppliers and customers. The benefit of this is that enterprise value is preserved during the administration period, thereby reducing job losses and increasing the likely returns to creditors. Such measures, effected within moments of, or even simultaneously with, the commencement of an external administration process avoids a rapid destruction in goodwill, customer base and other business assets during the course of the administration and helps preserve business value.

6.7 Consequently, at present, the mandatory time periods in the Corporations Act do not allow the full commercial benefit of formal insolvency processes such as voluntary administration to be realised in Australia.

6.8 It would seem theoretically possible, on the current state of the law in Australia, for an administrator to implement a rapid sale of assets without having to wait for the second creditors' meeting. Section 437A(1)(c) of the Corporations Act provides that while a company is under administration, the administrator may terminate or dispose of all or part of the business of the company and may dispose of any of the company's property. It has been held that this provision empowers an

administrator to dispose of all the company's business and property without the need to obtain the consent of members at a general meeting, provided that it is the appropriate course of action to take in the circumstances.[11] However, in practice, it would be unlikely that an administrator would effect a rapid sale of the business or assets without creditor approval.

6.9 A simple sale may not be the best means of protecting and even enhancing the business and/or deriving value for creditors and other stakeholders. Rather a more extensive restructure, including of the company's capital composition, may deliver a significantly better outcome.

6.10 The existing mechanism in the Corporations Act for effecting such a restructure of a company in administration is through a deed of company arrangement. One notable benefit is the release or compromise of creditors' claims, which can only be achieved through a deed of company arrangement. Proceeding by way of deed of company arrangement would enable a more extensive restructure of the existing entity as opposed to a mere asset sale. That, of course, requires the holding of the second creditors' meeting.

6.11 Accordingly, absent the proposed reforms, it is not possible for a company to implement a comprehensive restructure by way of deed of company arrangement without it first languishing in formal administration for a few months. This is the case even where agreement on the restructure has already been agreed by the vast majority of creditors.

International experience

United States

6.12 In the United States, Chapter 11 of the Bankruptcy Code makes special provisions for expediency in formal insolvencies. In order to appreciate the significance of these concessions, it is important to first note some key features of Chapter 11 of the Bankruptcy Code, which differs in crucial respects from the voluntary administration regime in Australia. Ordinarily, a Chapter 11 bankruptcy commences by the debtor company filing a bankruptcy petition with the Court. The filing of a petition is followed by an immediate and automatic stay on the enforcement of judgments, collection activities, foreclosures and repossessions by creditors. The debtor then must file with the Court a plan for reorganisation. The Court conducts a hearing and if it forms the view that the company has provided adequate information for the creditors to properly consider the merits of the proposed plan, creditors vote on whether or not to accept it.

6.13 Chapter 11 allows for procedural shortcuts in certain circumstances. For instances, a plan for reorganisation can be filed at the same time as the petition. It is possible under Chapter 11 for the support of creditors to be secured even before the petition is filed. .

United Kingdom

6.14 In the UK, sales of assets and business often proceeds as a management buy-out of the company's business. The business is then transferred to a new entity usually operated by the previous management, and the proceeds of the sale are applied to discharge the liabilities of the debtor company.

6.15 In *Re Transbus International Ltd (in liq)* [2004] 1 WLR 2654, it was held that it is permissible under the Enterprise Act 2002 for administrators to execute a business sale without the sanction of a creditors' meeting or directions from the court.

Administrator's independence

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[11] *Brash Holdings Ltd v Shafir* (1994) 14 ACSR 192 per Beach J

6.16 As noted above, an administrator can in theory dispose of the assets of the company immediately upon (or soon after) appointment. However, in practice, it would be unlikely that an administrator could, bearing in mind his or her duties, effect a rapid sale of the business or assets without properly investigating the affairs of the company, familiarising himself or herself with the proposed plan, and being satisfied as to the proper value of the business or assets to be sold.

6.17 Therefore, for an expedient sale or restructure to work most effectively, the administrator would ideally need to have had some previous involvement with the company and its directors so as to acquire the requisite degree of knowledge about the company's financial circumstances and the proposed sale or restructure prior to his or her appointment. However the current laws and regulations concerning the requisite independence of an administrator could potentially preclude an insolvency practitioner who has provided prior professional services to a distressed company from being appointed as an administrator of that company.

6.18 In *Bovis Lend Lease Pty Ltd v Wily* (2003) 45 ACSR 612, Austin J held that administrators are bound by three separate duties of independence and impartiality:

(a) administrators must be, and be perceived to be, independent of the company, its directors and shareholders, and individual creditors;

(b) administrators must act, and be perceived to act, impartially in discharge of the duties and responsibilities of their office; and

(c) administrators must ensure they do not place themselves in a position where there is, or might be, a conflict between their duty to creditors and their personal interest.

6.19 A prior association with the company will not, of itself, infringe these requirements of impartiality and independence. However substantial involvement with a company prior to administration will, generally speaking, disqualify a person from appointment as an administrator: see *Re Central Spring Works Australia Pty Ltd; Tubemakers of Australia Ltd v McLellan* (2000) 34 ACSR 169. In *Re Monarch Gold Mining Co Ltd; Ex Parte Hughes* [2008] WASC 201, Sanderson M commented at [19] that where an administrator has provided professional services to the company prior to the administration, the issue to consider is whether the services were of such a degree of magnitude to the company over a long period and of such a nature as to put in doubt their capacity to independently discharge their office.

6.20 Further, the Insolvency Practitioner Association Code provides that practitioners must not take an appointment if they had a professional relationship with the insolvent company during the previous two years, unless certain exceptions apply. The exception to pre-appointment advice is quite confined.

6.21 We submit that the Act be amended to clarify that an administrator cannot be disqualified simply by virtue of the fact that they provided prior professional services to the company to assist in preparing and implementing a sale or deed of company arrangement proposal to be effected through the administration of the company.

6.22 The interests of creditors may be balanced against this concession by ensuring that the administrator provide full details of his or her prior involvement and the proposal that is to be voted on by creditors, including:

(a) a detailed disclosure of the administrator's prior involvement with the company;

(b) the alternative courses of action that were considered by the administrator;

(c) a detailed analysis of the proposal, including why the proposal is appropriate;

(d) consultation with creditors if any;

(e) the identity of the proposed purchaser; and

(f) details of relevant relationships between the company and its management and that of the purchaser.

Suggested reform

6.23 We propose that consideration be given to amending the Corporations Act to provide that:

(a) An administrator be permitted convene a meeting of creditors within 5 business days of appointment, to consider a deed of company arrangement proposal, upon satisfying certain notice requirements to creditors. At this meeting, the administrator can propose a deed of company arrangement or other relevant proposal that has been negotiated prior to his or her appointment. Creditors at that meeting would be able to choose:

(i) to accept that deed of company arrangement and end the administration period; or

(ii) to continue the administration process as is currently prescribed under the law.

(b) A person will not be disqualified from being appointed as an administrator by reason only of providing services or advice prior to his or her appointment in relation to an asset or business sale or deed of company arrangement proposal to be effected through the administration process.

6.24 The TMA would not be advocating any change to the voting requirements under the Corporations Act.

6.25 Nothing in the proposal would affect the current duties of an administrator.

7. ADDITIONAL ISSUE FOR DISCUSSION: RECEIVERSHIP & VOLUNTARY ADMINISTRATIONS

7.1 Given the similarities and overlapping professional costs incurred where there is a simultaneous voluntary administration and receivership of a company, the TMA feel it would be prudent for the government to consider the interaction between the two regimes as part of its review of the current insolvency laws aimed at enhancing Australia's corporations law to assist with successful corporate rehabilitations.

Current relevant provisions

7.2 Pursuant to section 440B of the Corporations Act, during the administration of a company a person cannot enforce a charge on the property of the company unless the administrator has provided its written consent or the court has granted leave. However, section 441A provides that where the charge is over the whole, or substantially the whole of the property of a company under administration, the secured creditor may, within 13 business days, elect to enforce the charge. Such a decision to enforce the charge overrides section 440B and allows the secured creditor to appoint a receiver for the purpose of realising the security.

7.3 The effect of section 440B is that from the commencement of the administration of the company, a secured creditor has 13 business days in which to decide whether they will appoint a receiver. If the secured creditor elects not to appoint a receiver within this time period, they are then prevented from doing so during the course of the administration (without the consent of the administrator or leave of the Court).

7.4 Recent amendments to UK insolvency law have seen secured creditors lose the ability to appoint a receiver to companies which have entered the equivalent of voluntary administration. This is further discussed below. It was suggested that the purpose of that reform was to shift the emphasis onto the corporate recovery of the company in voluntary administration and allow for the interests of all creditors to be considered.

7.5 One of the main concerns regarding the appointment of a receiver by a secured creditor is that the appointment may not in all the circumstances produce a result which maximises the enterprise value of the company for the benefit of all stakeholders. A receiver owes its primary loyalties to the secured creditor appointing them.[12] The predominant goal of a receiver is to recover the secured property for the benefit of the secured creditor, which is some instances, but certainly not all, can conflict with the objectives of the voluntary administration regime.

7.6 Section 435A of the Act provides that an administration is to be conducted in a way that maximises the chances of a company recovering and, if that is not possible, to ensure a better return to all the company's creditors and members than would result from an immediate winding up. Some commentators have raised a concern that a concurrent appointment of a receiver and an administrator can stifle the performance of an administrator's duties.

7.7 However, the right of a secured creditor to appoint a receiver reflects the significant exposure of major financiers. It is a natural right that flows from the fact that the secured creditor has from the time it takes senior security over all or substantially all assets of the company, a clear interest in, and a degree of control over, the secured assets for repayment of its debt.

Interaction between receiver and administrator

7.8 A receiver and an administrator are often granted similar powers. An example is the power to manager and control the business of the company. Sections 437A(1)(a) and (b) of the Corporations Act provides that while a company is in administration, the administrator has control of the company's business, property and affairs and may carry on that business and manage that property and those affairs. As to a receiver's power, most charges expressly provide receivers with the power to carry on the business of the chargor company. In addition to any express power that may be included in the charge instrument, section 420(2)(h) of the Corporations Act provides that a receiver may carry on any business of the company, provided that this is done for the purpose of attaining the objectives for which the receiver was appointed. In this example, there is an obvious potential conflict between the administrator's power and that of the receiver. The conflict is resolved in favour of the secured creditor and its receiver by section 442D(1) of the Corporations Act, which provides that where a secured creditor enforces its charge during the "decision period", the administrator's functions and powers are subject to the functions and powers of the chargee and any receiver appointed for the purpose of enforcing the charge.

7.9 Another example is the power to retain the books and records of the company. Receivers are usually granted a power under the charge to retain any documents that are necessary to support the chargee's title. Further, it is generally accepted that the chargee's proprietary interest gives the receiver a general law right to access the books and records of the company: see *Re Geneva Finance Ltd; Quigley v Cook* (1992) 7 WAR 496 at 513-514. As to an administrator's right of access, section 438C of the Corporations Act provides that a person is not entitled, as against the administrator of a company, to retain possession of the company's books. This does not apply to a secured creditor entitled to possession of the books.

[12] Re B Johnson & Co (Cuilders) Ltd [1955] 1 Ch 634; Downside Nominees Ltd v First City Corporation Ltd [1993] AC 295

7.10 In practice, these problems arise quite often. As explained above, the general rule is that a secured creditor cannot enforce its charge during the administration without the written consent of the administrator or leave of the Court. The exception is where the creditor holds a charge over all, or substantially all, of the company's property. In practice, it is common for creditors to take comprehensive security over all of the company's assets to safeguard their position in a voluntary administration (such as taking a "feather-weight" floating charge).

Overseas experience

7.11 In 2002, the *Insolvency Act 1986* (UK) was amended (by insertion of section 72A) to restrict the ability of a floating charge holder to appoint a receiver during the course of an administration. Section 72A(1) provides that the "holder of a qualifying floating charge in respect of a company's property may not appoint an administrative receiver to the company". "Qualifying floating charge" is defined in the Act as including the common form of a charge which purports to grant the chargee power to appoint a receiver over the whole or substantially the whole of the company's property.

7.12 The amendment was enacted following proposals made by the Government in its White Paper "Insolvency – Second Chance", published on 31 July 2001. The White Paper explained the policy behind the amendment at [2.5]:

"The Government's view is that, on the grounds of both equity and efficiency, the time has come to make changes which will tip the balance firmly in favour of collective insolvency proceedings – proceedings in which all creditors participate, under which a duty is owed to all creditors and in which all creditors may look to an office holder for an account of his dealings with a company's assets. It follows that we believe that administrative receivership should cease to be a major insolvency procedure…"

7.13 The amendment carves out a number of exceptions to the general prohibition, which apply to specific kinds of transactions such as capital market arrangements, public-private partnerships, project financing and urban regeneration projects.

7.14 While the UK legislation precludes the holder of a floating charge from appointing a receiver during an administration, it does not abrogate or prejudice the chargee's proprietary rights. Paragraph 70 of Schedule B1 to the *Insolvency Act* provides that the administrator of a company may dispose of or take action relating to property which is subject to a floating charge as if it were not subject to the charge. However where property subject to a floating charge is disposed by an administrator, the holder of the floating charge shall have the same priority in respect of acquired property as he had in respect of the property.

7.15 In Australia, sections 442B and 442C of Corporations Act provide that where a charge was a floating charge at the date of creation but has subsequently become a fixed or specific charge, an administrator may dispose of the relevant property in the ordinary course of business. There is no express provision in the Corporations Act which provides that the administrator must distribute any proceeds from the realisation of floating charge property in the order of priority which would otherwise be afforded by the charge. A provision to this effect would be important from the perspective of a secured creditor. It would ensure that the interests of secured creditors are not unfairly prejudiced and the secured property is protected or at least realised in the interests of the secured creditor. Any change towards a collective insolvency approach should not result in the erosion of the rights of secured creditors over secured property.

Issues for discussion

7.16 If any thought is given to adopting the approach of permitting only a single appointment during the external administration of a company, we consider that any such change should ensure that:

(a) proceeds from the realisation of secured property, including floating charge property, must be used to repay the secured debt in accordance with the terms of the relevant charge and subject to any employee entitlements payable out of floating (circulating) charge assets;

(b) fixed charge assets may only be realised with the consent of the secured creditor;

(c) a secured creditor may always be entitled to appoint a receiver if:

(i) creditors vote that the company be wound up

(ii) the secured creditor does not vote in favour of a deed of company arrangement proposed after the appointment of a voluntary administrator.

7.17 The secured creditor should also be entitled to replace the relevant appointee, at its sole discretion, within 13 business days, except in circumstances where the secured creditor is a related party.

8. Concluding remarks

8.1 The TMA supports the introduction of a safe harbour defence for insolvent trading and suggests the following 3 key changes to post external administration:

(a) a moratorium on "ipso facto" clauses.

(b) an administrator be permitted to convene a meeting of creditors within 5 business days of appointment, to consider a deed of company arrangement proposal.

(c) a person not be disqualified from being appointed as an administrator by reason only of providing services or advice prior to his or her appointment.

8.2 The objectives of the proposed reforms are to help provide greater returns to creditors and shareholders of a small business before and after administration. This may be achieved through a regulatory framework which creates greater certainty as to the value of a business and fosters an environment which allows stakeholders to reach agreement in a timely manner.

8.3 The result of these changes will be that troubled companies are able to attract capital or sell assets, even when financially distressed. It will also allow directors to properly perform their duties in the comfort that provided they adhere to the required procedures, they will have an appropriate defence to an insolvent trading claim. This will give directors the opportunity to pursue a successful turnaround of the business thereby increasing the probability of creditors and employees achieving a better return and maintaining their employment.