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To Whom It May Concern

Submission on Consultation Paper – helping companies restructure by improving schemes of arrangement

1 Introduction

1.1 Arnold Bloch Leibler (**ABL**) is pleased to provide this submission in response to the consultation paper – *Helping Companies Restructure by Improving Schemes of Arrangement*, dated 2 August 2021 (**Consultation Paper**).

1.2 Terms used in this submission and not otherwise defined have the meaning given to them in the Consultation Paper.

1.3 ABL is a leader in restructuring and has been involved in some of Australia's most complex, significant and sensitive restructures in recent corporate history including the Arrium Group, PAS Group, Axcess Today, Boart Longyear, Oroton Group, Nine Entertainment, Network Ten, Slater & Gordon, Spicers Paper, Adaman Resources and Centro Group among others. ABL has also been at the forefront of reforms and improvements that can be made to restructuring mechanisms in Australia.

1.4 In that context, we welcome the opportunity provided by the Treasury to provide submissions on the important issues raised in the Consultation Paper, and we welcome the opportunity to make schemes of arrangement more efficient and viable recapitalisation options for distressed companies.

1.5 The proposed reforms the subject of the Consultation Paper and this submission are directed to improving creditors schemes of arrangement. Unless expressly noted otherwise, all references to 'schemes' or 'schemes of arrangement' in this response refer to creditors' schemes of arrangement. Any legislative amendments will need to be limited to creditors schemes for debt restructuring purposes (or schemes which are cross conditioned, but include a creditors scheme) as opposed to solvent members schemes of arrangement, with this distinction between the two types of schemes reflected in the amendments to the legislation.

ABL Response

Set out below are our responses to the questions raised in the Consultation Paper, using corresponding numbering.

2 Question 1A:

Should an automatic moratorium apply from the time that a Company proposes a scheme of arrangement? Should the automatic moratorium apply to debt incurred by the Company in the automatic moratorium period?

2.1 In many instances, particularly those in which the counterfactual to the Scheme is an insolvent administration, a moratorium may assist in the implementation of a scheme of arrangement, and in the corresponding restructure of the Company. It allows for the Company to have 'clear air' whilst it pursues its restructure plans and creates efficiencies in not requiring the Company to defend actions which might ultimately be compromised through the scheme of arrangement. A moratorium would also create a more level playing field for all creditors by preventing certain creditors from bringing actions to exert pressure on the Company to extract favourable or preferential treatment.

2.2 Section 411(16) of the *Corporations Act 2001* (Cth) (**Corporations Act**)[1] provides for a Court to restrain (on application by the Company, a member of the Company or any creditor of the Company) further proceedings in any action or other civil proceedings against the Company. In our experience, such stay applications have reasonable prospects of success where the Scheme application has been filed and proceedings are on foot or threatened at the time the Scheme is being propounded. We have also had experience in having such stays recognised in foreign jurisdictions.

2.3 However, we have also had experiences in which an aggressive creditor who may be crammed down by a Scheme seeks to commence proceedings against the Company so as to cause disproportional damage to the Company and a majority of its creditors. Such actions are designed to exert pressure on the Company and its supporting creditors to pay out the recalcitrant creditor (knowing that the Company is not sufficiently along the path to propound a Scheme). There is an unresolved question as to when the Court could grant the Company relief under section 411(16) as the Scheme proceeding could only be commenced with no more than a mere outline of a Scheme and the Scheme could take months to advance.

2.4 If a statutory moratorium is enacted it should be able to be modified or lifted on application to the Court by an aggrieved creditor or other interested party to prevent abuses (which is currently able to be managed via the use of the Court's discretion under section 411(16)).

2.5 Accordingly, whilst we see merit in making such a stay automatic from the date the Company announces that a Scheme will be propounded (as it would provide greater certainty, remove the cost of the summary application and create efficiencies for many schemes), any automatic moratorium that was adopted should include an express power for the Courts to lift all or part of the moratorium, upon application by a creditor or other sufficiently interested person, where it is in the interests of justice to do so. By that, we do not mean that the Court should consider on a creditor-by-creditor basis whether the moratorium is unjust (as a stay will often be considered 'unjust' when viewed in a narrow context), but rather that it must be considered in the context of the scheme of arrangement and the circumstances of the Company as a whole. Relevant considerations may include:

[1] Unless expressly noted otherwise, all legislative references used in this submission refer to the *Corporations Act 2001* (Cth).

(a) the nature of the proceedings (for example, whether they are seeking to stay a secured creditor, or a creditor with such voting power that its consent is required for any scheme success);

(b) whether the proceedings would interfere with or jeopardise the proposed scheme;

(c) whether the claims the subject of the proceeding are intended to be compromised by the proposed scheme and more appropriately dealt with in the context of the scheme approval process; and

(d) whether the claim is insured.

3 Question 1B:

*Should the automatic moratorium apply to debt incurred by the Company in the automatic moratorium period**?***

3.1 A scheme is, by its nature, a public process due to the requisite Court applications and publication requirements. Creditors dealing with a Company that is propounding a scheme should be aware that it is subject to a scheme process (and perhaps the ASIC register should be obliged to be updated with this information, akin to the current notification obligations when entities enter external administration).

3.2 Nevertheless, we are of the view that any automatic moratorium should not apply to debts incurred during the scheme period. This is necessary to protect creditors who continue to trade with the Company whilst it is undergoing a scheme process (and who are currently subject to the ipso facto stay on exercising contractual rights pursuant to section 415D from when the Company publicly announces its intention to make an application under section 411).

3.3 By way of contrast, in voluntary administration creditors are encouraged to continue to trade with company because:

(a) the administrator is personally liable for debts incurred during the voluntary administration period with that liability supported by a statutory lien over the company's assets (per Division 9 of Part 5.3A); and

(b) debts paid during the administration period with the authority of the administrator cannot generally be impugned as unfair preferences if the Company later goes into liquidation by reason of section 451C.

3.4 Creditors trading with a Company propounding a creditors' scheme may be vital to the continued viability of the Company. Given those creditors do not have the benefit of the personal liability and lien provisions that apply to trading debts incurred in voluntary administration, we consider that they should be able to take steps to recover debts incurred during the scheme period, subject to any specific Court ordered stay that is available under section 411(16).

3.5 Having regard to the recent introduction of the ipso facto stay, it may also be appropriate to include an analogous provision to section 451C to protect creditors from unfair preference claims in respect of trading debts incurred during the scheme period (if the Company subsequently goes into liquidation). A balance needs to be struck between giving the Company 'breathing space' during the scheme process (which can be protracted) and not discouraging ongoing trade creditors continuing to trade with the Company. Such creditors are often fundamental to the Company's ongoing viability.

4 Question 2:

Would the moratorium applied during voluntary administration be a suitable model on which to base an automatic moratorium applied during a scheme of arrangement? Are any adjustments to this regime required to account for the scheme context? Should the Court be granted the power to modify or vary the automatic stay?

4.1 As explained above, the protections afforded to creditors who trade with a Company during voluntary administration in Division 9 of Part 5.3A do not apply to creditors' schemes. Accordingly, the moratorium that applies in voluntary administration should be tailored to the scheme context, including in the manner discussed above with respect to debts incurred during the scheme period.

4.2 To protect the Company from distraction, costs and 'greenmail' attempts during the scheme period, an automatic moratorium should include:

(a) a stay on proceedings against the Company, including arbitration proceedings; and

(b) a stay on enforcement processes against the property of the Company.

4.3 The stay would however be subject to being lifted by the Court on the application of a creditor.

4.4 In addition, section 411(16) could be adjusted to allow the Company to apply for a wider range of orders staying:

(a) enforcement and recovery actions by secured creditors or owners of leasehold property;

(b) the enforcement of guarantees;

(c) winding up applications;

where the proposed scheme will compromise secured creditor rights and claims if passed and provided that adequate protections are implemented to protect the interests of secured creditors and owners of property.

5 Question 3:

When should the automatic moratorium commence and terminate? Are complementary measures (for example, further requirements to notify creditors) necessary to support its commencement?

5.1 If implemented, the automatic moratorium should commence at the same time the ipso facto stay takes effect in accordance with section 415D (i.e. upon public announcement) but with an ability for the Company to make an urgent application to the Court to have it heard earlier should circumstances warrant. In terms of duration, we are of the view that the automatic moratorium should end on the earlier of the date on which:

(a) the Company withdraws the scheme and/or the scheme ceases to be propounded;

(b) the Company fails to obtain orders from the Court convening a meeting of creditors at the first Court hearing and the Company is not granted leave to re-apply at the first hearing;

(c) the scheme is not approved by the requisite majority of creditors;

(d) Court rejection of the scheme at the 2nd hearing; and

(e) lodgement of the Court orders approving the scheme with ASIC, such that it becomes effective.

5.2 As noted above in paragraph 3.1, we think there is merit in requiring ASIC's records to be updated when an application is made under section 411 to note whether a Company is propounding a scheme of arrangement, such that this status would then become apparent from a search of ASIC's records, so as to allow for greater transparency with all creditors.

6 Question 4:

How long should the automatic moratorium last? Should its continued application be reviewed by the Court at each hearing?

6.1 We refer to the above question at paragraph 5 in relation to when the automatic moratorium should terminate.

6.2 We do not think it should be considered by the Court at each hearing during the scheme process as a matter of course (as this would burden the Company and propounding creditors to deal with such applications on a repeating basis), but that the Court be granted the power to hear an application by a creditor or other interested person for an early lifting of the moratorium if it is in the interests of justice to do so.

7 *Question 5:*

Are additional protections against liability for insolvent trading required to support any automatic moratorium?

7.1 Given that schemes are essentially a 'debtor in possession' model without the same protections afforded to creditors who trade with the company during the scheme period that apply in voluntary administration, the general legal framework in relation to directors' duties during the twilight zone of insolvency and insolvent trading (including any safe-harbour protections and other general law and statutory defences) should apply.

7.2 We note the adequacy and effectiveness of the provisions relating to insolvent trading (and the safe-harbour protections) are currently the subject of separate consultation and review.

8 Question 6:

What, if any, additional safeguards should be introduced to protect creditors who extend credit to the Company during the automatic moratorium period?

8.1 We refer to our comments under question 1B above at paragraph 3.

9 Question 7:

Should the insolvency practitioners assisting the Company with the scheme of arrangement be permitted to act as the Voluntary Administrators of the Company on scheme failure?

9.1 We are the view that a commercial approach to 'independence' of practitioners needs to be applied (and we have welcomed recent judicial authority on this point in a voluntary administration context).[2]

9.2 There are circumstances where, if a scheme of arrangement fails, it will be efficient and in the best interests of all creditors, that the incumbent insolvency practitioners continue on as voluntary administrators. However, in such circumstances, it is likely that a 'special purpose' insolvency practitioner be appointed to consider such issues such as preferences and insolvent trading.

10 Question 8: *Is the current threshold for creditor approval of a scheme appropriate? If not, what would be an appropriate threshold?*

10.1 The threshold for creditor approval has two main aspects. The first relates to the formation of the class or classes, and the second is the actual votes required for each class to approve the scheme. Separately, there is also the issue of cross class cram downs.

Formation of Classes

Schemes of arrangements are currently incredibly time consuming and costly. The risk of a particular "class" of creditor vetoing a scheme also limits their utility as explained by one commentator as follows:

> *One of the issues that presents difficulties for using schemes for restructuring is the requirement to compose separate classes of creditors, and the need to obtain approval from each class, which may create opportunities for greenmailing lenders which can result in value leakage to subordinate creditors.*[3]

Accordingly, their use in a distressed company context has substantially diminished in recent times.

10.2 Where they have been used, the impact and applicability of "classes" has become less relevant, and less recognised by the Courts (that is, there has been a trend to create broader more inclusive class groups). We have welcomed this interpretation by the Courts, as (on the whole) it reduces greenmailing risk and allows for more a streamlined process.

10.3 However, the concept of a class of creditors still creates a significant gateway issue to the utility of a creditors' scheme of arrangement, and creates greater implementation risk than other alternative transaction structures (such as a deed of company arrangement, for example). If a creditor forms a different class, they effectively have a veto right against any scheme that seeks to compromise them, and therefore can obstruct an informal restructure or make it more costly, regardless of the extent of their economic interest. On the other hand, this possibility needs to be balanced with the reality that a creditors' scheme of arrangement is a powerful tool which can not only compromise existing claims, but can change future contractual rights. To remove the concept of classes in a manner that allows for differential treatment between creditors, without needing approval from the affected groups, may allow one group of creditors to exploit another.

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[2] See for example *Re Korda, Ten Network Holdings Ltd (Administrators Apptd) (Recs and Mgrs Apptd)* (2017) 252 FCR 519.

[3] Jason Harris, 'Class Warfare in Debt Restructuring: Does Australia Need Cross-Class Cram Down for Creditors' Schemes of Arrangement?' *University of Queensland Law Journal* (2017) Vol 36(1) 72 at 73.

10.4 There is also problematic uncertainty in propounding a scheme as to class composition. As explained by Finkelstein J in *Opes Prime*:

> *If a judge is too assiduous in identifying classes, it is possible to end up with any number of classes. In the end, schemes of arrangement are propounded in a business context. The judge should adopt a practical business-like approach to the issue, as would the creditors if they were to decide the matter*.[4]

10.5 Whilst we think the concept of classes should remain, we are the view they should be limited to two classes (secured creditors and unsecured creditors), given the ultimate protection that all creditors have that the scheme ultimately must be viewed by the Court as fair and reasonable in order to be approved. All votes should be tagged and recorded by person, and the judge can take into account unfair discrimination in the second (approval) hearing by reference to the comparative liquidation return. This reflects the circumstances that apply under voluntary administration law,

<u>*Voting thresholds*</u>

10.6 We are of the view that, in the context of a creditors' scheme, the most important threshold is the value threshold (75% by value), and that the continued inclusion of a "by number" test has the potential to distort the voting within a class. The Court should be empowered to approve a scheme despite the majority (by number) of creditors not approving that scheme, provided:

(a) it has been approved by creditors representing 75% or more in value; and

(b) the Court considers that the scheme is otherwise fair and reasonable compared to a liquidation counterfactual.

10.7 Empowering the Court to intervene in such cases will limit the opportunity for 'out of the money' creditors to prevent a solvent scheme from being implemented.

<u>*Class cram downs*</u>

10.8 When a Company is distressed, it nearly always has seen a value shift from members to creditors (and usually to certain classes of creditors, whether that be secured senior lenders, or bondholders or a mixture of the two). In our view, the creditors whose vote should carry the most weight in a distressed scenario, are those creditors who have a remaining economic interest in the Company.

10.9 Accordingly, cross class cram down should also be considered to avoid a separate class that is out of the money 'greenmailing' a restructure. This could be introduced by empowering the Court to approve the scheme despite a class of creditors not approving it where at least one class has voted to approve the scheme and the court considers that the scheme is otherwise fair and reasonable compared to the liquidation counterfactual.

11 **Question 9**: <u>*Should rescue, or 'debtor-in-possession', finance be considered in the Australian creditors' scheme context?*</u>

11.1 A debtor-in-possession finance (**DIP Finance**) regime would further enhance the flexibility and utility of schemes as a restructuring mechanism in Australia.

11.2 Given the risks involved to DIP financiers, the potential prejudice to existing creditors, especially secured lenders, and the potential to influence or control the scheme process, any DIP Finance regime should be subject to court approval to avoid abuse and ensure adequate protection to existing creditors. Section 364 of Chapter 11 of the

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[4] *Re Opes Prime Stockbroking Ltd* (2009) 179 FCR 20 at [85].

US Bankruptcy Code provides an instructive example of a court approved DIP Finance model.

12 Question 10: *What other issues should be considered to improve creditors' schemes?*

12.1 We have set out the main issues in our answers to the preceding questions above.

13 Question 11: *Are there any other potential impacts that should be considered, for example on particular parties or programs? If so, are additional safeguards required in response to those impacts?*

13.1 Schemes of arrangement should be considered as just one of the mechanisms available to companies to restructure - the amendments to schemes should be considered holistically with broader restructuring and insolvency reform.

ABL welcomes the opportunity to provide further submissions and participate in any discussion on the Consultation Paper and subsequent recommendations.

Yours sincerely

Arnold Bloch Leibler

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