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Improving schemes of arrangement to better support businesses

King & Wood Mallesons' response to Treasury

10 September 2021

1 Introduction

1.1 Introduction

We refer to the Treasury document dated 2 August 2021 entitled 'Helping Companies Restructure by Improving Schemes of Arrangement' (**Consultation Paper**). King & Wood Mallesons has a specialist Restructuring and Insolvency team which operates nationally, with 10 partners and around 40 lawyers. We have consulted nationally and our response to the Consultation Paper is below.

As a preliminary comment, we note that the Consultation Paper refers to "schemes of arrangement" provided for under section 411 of the *Corporations Act 2001* (Cth) (**Act**). Our firm has a multi-disciplinary team that works on schemes proposed to address members' rights ("members' schemes") and creditors' rights ("creditors' schemes"). We use the terms "schemes", "creditors' schemes" and "schemes of arrangement" interchangeably, but this submission is primarily directed at "creditors' schemes", except in one section where we specifically address "members' schemes."

In summary, we consider that schemes of arrangement work very well to provide restructuring options to companies with unsustainable secured debt burdens where unanimous consent cannot be achieved between the company and its secured creditors.

Schemes of arrangement also provide creative options to address other restructuring-related challenges faced by Australian companies, including in the settlement of mass litigation and in addressing ordinary unsecured creditors' claims.

In terms of the Consultation Paper, our response is focused on two main issues which address the specific questions posed at pages 6 and 7:

Should an automatic moratorium apply to companies that are proposing creditors' schemes of arrangement?

> *On this, we note that there are already two specific types of moratoria which we consider adequate to achieve the restructuring objectives around a scheme of arrangement. We do not consider additional moratoria are needed.*

What other issues should be considered to improve creditors' schemes?

> *We have made a range of comments on this in our submission. For the reasons given, we do not consider that the provisions in the Act governing schemes of arrangement require substantive reform. We think that this discussion is more usefully held in the context of a broader reform of Australia's insolvency and restructuring procedures and outline the issues we believe are relevant below.*

We have also provided submissions on question 8 in relation to the threshold for creditor approval for schemes and question 9 in relation to debtor in possession finance.

The Australian Government has indicated that, following the commencement of the small business reforms, it is exploring further insolvency reform to help larger companies in distress to reorganise

and survive while reducing the regulatory burden for business. In this context, creditors' schemes of arrangement (or **schemes**) conducted under Part 5.1 of the *Corporations Act 2001* (Cth) (**the Act**), have been identified by the Government as one area for improvement.

Specifically, as a scheme can be used to achieve a restructured solvent outcome and does not involve the removal of the board from management and control or the appointment of administrators or liquidators, the impact of the process is less disruptive than voluntary administration and potentially less damaging to the reputation of the company and its directors.

It appears from the questions that are asked in the Consultation Paper that the Government is considering introducing certain features of the United Kingdom's new Restructuring Plan process and also certain features of Singapore's *Insolvency, Restructuring and Dissolution Act 2018* (**IRDA**) and the United States' Chapter 11 process. Therefore, it appears that what is under consideration by the Government in relation to this consultation process for schemes of arrangement is, in essence, the introduction of a debtor in possession (or **DIP**) regime into Australian insolvency law.

In our submission:

(a) such a radical change to Australia's insolvency reform should be undertaken by way of a comprehensive review of Australia's insolvency laws along the lines of Australian Law Reform Commission, General Insolvency Inquiry, Report No 45 (1988) (the **Harmer Report**);

(b) schemes of arrangement serve an important function and are not an appropriate vehicle for such a reform in isolation; and

(c) there are several features of Australia's insolvency laws that should be considered for reform including in respect of some of the questions asked in the Consultation Paper.

2 A holistic approach to insolvency law reform

The Harmer Report, which was published in 1988 after a five-year inquiry and finally became law in 1993 (after some government refinements), is the last comprehensive examination of all aspects of the law and practice relating to insolvency of both individuals and companies. The bankruptcy laws had been last reviewed 25 years earlier by the Clyne Report which led to the introduction of Part X of the *Bankruptcy Act 1966* (Cth).

The Harmer Report was the first review of corporate insolvency law and did not see any overriding need to unify the law relating to individual and corporate insolvency. Given increasing acceptance of business failure, the Harmer Report led to the introduction of voluntary administrations designed to encourage a more swift, uncomplicated, inexpensive, flexible and constructive approach to corporate insolvency with the focus on saving a business and jobs. The need for the Harmer Report arose out of the shortcomings with the law and procedure as a result of significant economic and social changes such as the extraordinary increase in the use of credit since the Clyne Report which led to an increase in the number of insolvencies. In addressing those shortcomings, regard was had to the fundamental purpose of providing a fair and orderly insolvency process by reference to overseas developments. Although the Harmer Report did not lead to the introduction of a United States-style Chapter 11 process, it was highly critical of what was described as the cumbersome, slow and costly scheme of arrangement procedures which were infrequently used and unsuited to the average company in financial difficulty.

The years since the Harmer Report have seen many "ad hoc" changes to the law, most recently in response to COVID-19. As well amending the law, of course, governments have responded to COVID-19 by providing financial support to businesses. Along with the economic distortions caused by COVID-19, the overall result is a business/insolvency landscape in Australia - and the rest of the world - that is unprecedented in the 21st Century. After more than 30 years since the Harmer Report, it is submitted that the same reasons for the Harmer Report mean that the time has come for another comprehensive review rather than continued piecemeal reforms targeted at perceived shortcomings with unintended consequences.

We submit that an exclusive focus on schemes of arrangement misconceives:

- the fact that creditors' schemes of arrangement in Australia already operate clearly and effectively to balance debtor and creditor rights based on extremely well-established and understood common law developed over centuries with no meaningful legislative change;
- the importance of the procedural alignment between the Australian and English scheme of arrangement systems, which enables the respective use of Australian and English authorities in the development of that common law, a practice which has continued successfully for many decades and promotes flexibility in the use of creditors' schemes in Australia;
- further, given their inherent cost of preparation and implementation, creditors' schemes of arrangement are exclusively used by large corporations to address highly specific restructuring purposes, in recent years related mostly to the conversion of secured syndicated debt into equity without unanimous consent – that function remains vitally important to the Australian restructuring system, but does not have a particularly wide application to businesses in the Australian economy;
- creditors' schemes of arrangement do have potential uses outside the restructuring of secured syndicated debt, and have been used to implement wide-ranging settlements of prospective litigation (eg, *Opes Prime*) and to compromise wider classes of creditors (eg, Ovato) which demonstrates that they can be adapted for those purposes – however, those situations remain confined to large corporations, again with highly specific restructuring purposes; and
- the fact that there are demonstrable gaps in the Australian restructuring system which could better be served by legislating new restructuring procedures including adopting those successfully legislated and implemented recently during the COVID-19 era in England – rather than meddling with the well-established creditors' scheme of arrangement procedure, which our English brethren wisely did not do.

We consider that a more comprehensive review should consider how the Australian insolvency and restructuring system should operate given important learnings from the COVID-19 era. Even if there were no COVID-19, the Australian insolvency rules are long overdue for a major overhaul. The world of insolvency and finance has moved on a lot in the 30 years since the Harmer Report. Today, there is a strong emphasis on saving companies from threatened insolvency by restructuring them, rather than winding up.

Such a review ought to consider the important questions which are the subject of this consultation paper, namely whether any moratorium protections are required outside of those which are available during the voluntary administration process, whether reforms are required to facilitate rescue financing and whether any additional cross-class cram down mechanisms are required to prevent out of the money creditors undermining a restructure.

However, there are important other issues to consider. Numerous recent high-profile appeal cases questioning well entrenched fundamental insolvency principles (such as the peak indebtedness rule, set offs and trusts to name a few) highlight the current legal uncertainty. The abolition of ownership and floating charge concepts following the *Personal Property Securities Act 2009* and the introduction of the Fair Entitlement Guarantee (**FEG**), Australian Taxation Office director penalty notices, trading of distressed debts / liquidator actions, safe harbour and ipso facto has only added to the complexity. This has led to innovated practices to avoid the legislative intentions such as the 'prepacked phoenix', section 440B consents, featherweight / springing securities, holding deeds of company arrangement, artificial value breaks and entrenched pre-voluntary administration second creditors' meeting funding and sales. As a result, the scale seems to have tipped too far with the more liberal system now open to abuse with associated loss of stakeholder confidence. If we do not commence such a review during the current high priority economic time it may be at least another 10 years before we see any comprehensive reforms given the experiences with the Harmer Report. Finally, we note that the recent reforms to the United Kingdom's insolvency law introduced in June 2020 as a response to the COVID-19 pandemic, including the introduction of the new flexible court supervised restructuring tool that is the Restructuring Plan, had long been planned and consulted upon prior to their introduction. Australia should adopt the same approach to any significant reforms.

It is submitted that such a review should consider the interests of creditors, shareholders, employees, customers/clients, directors of companies and even the interests of society.

3 A look at schemes of arrangement

The Consultation Paper observes that schemes are not often used in Australia relative to other insolvency processes and reference is made to the Productivity Commission recommendations in its 2015 report, '*Business Set-Up, Transfer and Closure'* that the Act be amended to create a moratorium on creditor enforcement during the formation of schemes of arrangement and that this moratorium be aligned with the approach used in voluntary administration and that the Courts be given the explicit power to lift all or part of the moratorium in circumstances where its application would lead to unjust outcomes.

While it is correct that creditors' schemes are not often used relative to voluntary administration in particular, this is, in our submission, largely due to the success of Part 5.3A of the Act and other aspects of the Act (such as personal liability of directors for insolvent trading) which direct insolvent companies towards Part 5.3A. It is also in part due to the success of consensual workouts which are frequently supported by sophisticated creditors. Indeed, the availability of the scheme of arrangement processes often looms large in creditor negotiations and assists in securing the support of holdout creditors in consensual workouts.

Finally, to focus on the statistics in relation to creditors' schemes ignores the frequent use of members' schemes of arrangement (which utilise the same provisions of the Act as creditors' schemes of arrangement) to effect change of control transactions and to otherwise restructure companies. Over the last 10 years, the use of members' schemes to effect control transactions for listed companies has grown in popularity and now represents approximately half of the control transactions undertaken in Australia over the last few years. There are several reasons for this, including when compared to the main alternative of undertaking a takeover bid under Chapter 6 of the Act, such as:

- the fact that a members' scheme provides certainty of obtaining 100% if the scheme is approved;
- flexibility to incorporate terms that may not be permitted under a takeover bid; and
- a more certain timetable.

While market participants are keen to improve the process for members' schemes, including potentially expanding the remit of the Takeovers Panel to include members' schemes (as foreshadowed by the Treasurer on 30 April 2021[1]), in considering whether to adopt any reforms it will be important to consider whether they could, intentionally or not, have adverse impact on members' schemes.

In our submission, schemes of arrangement are a long standing and important part of Australia's corporate and restructuring landscape and great care should be taken in considering any reforms to the scheme of arrangement provisions in isolation.

3.1 Overview of schemes of arrangement in Australia

Schemes of arrangement are one of the earliest corporate restructuring tools of the common law world. The history of scheme of arrangement legislation in England (and Australia) can be traced back to sections 136 and 137 and sections 159 and 160 of the *Companies Act 1862*.

The earliest schemes were only available for companies in liquidation. This requirement was removed in the *Companies Act 1907* so that a company could make use of the scheme procedure

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[1] The Honourable Josh Frydenberg MP, *Strengthening the Takeovers Panel* (30 Aril 2021), available at: https://ministers.treasury.gov.au/ministers/josh-frydenberg-2018/media-releases/strengthening-takeovers-panel.

while avoiding the risk of forfeiture of leases, concessions, contracts and other rights which occurred in a liquidation then and is still an issue today over 100 years later.

The modern scheme of arrangement allows a company, with the approval of its creditors or members, to effect a reconstruction of its capital, assets or liabilities through a court-approved procedure under Part 5.1 of the Act.[2] A scheme of arrangement requires the approval of 75% in value and 50% in number of each class of creditors (for a creditors' scheme) or each class of members (for a members' scheme) affected by the scheme and present and voting at the scheme meeting and also approval of the Court.[3]

The almost identical formulation of the scheme of arrangement provisions in different jurisdictions means that Courts have the benefit of global jurisprudence when considering the operation of the scheme of arrangement provisions in Australia.

Schemes of arrangement are a flexible tool to allow a compromise or arrangement to be implemented by a company with its shareholders or its creditors or any class of them.[4] Creditors' schemes have typically been used by companies to implement financial restructures (particularly of corporate bonds which can be difficult to restructure consensually). Examples include the Centro Properties[5], Nine Entertainment[6] and Alinta Energy schemes. Any reforms ought to be careful not to reduce this flexibility.

Importantly, a creditors' scheme need not involve all creditors of the company as the scheme can be expressed to bind only particular classes of creditors and schemes of arrangement can take place outside of a formal insolvency appointment. For this reason, creditors' schemes are commonly used to cut out a "cancer" in an otherwise healthy company, for example to restructure specific finance arrangements and to leave the rest of the company (and its creditors) unaffected. Recently, schemes have even been used to restructure trade creditor and employee claims (e.g., the recent Ovato schemes of arrangement).[7]

Finally, as schemes of arrangement are effected by Court order with significant oversight of the corporate regulator, the process is transparent. The Australian Securities and Investments Commission (**ASIC**) has entrenched rights to review the terms of the schemes and make submissions,[8] affected members and/or creditors may also make submissions as part of the Court process and the Court has a discretion whether to ultimately approve a scheme. The Courts have adopted an increasingly flexible approach in relation to creditors' schemes, for example, by permitting variations to the scheme terms after dispatch of the scheme booklet[9] and retrospectively extending the deadlines by which conditions precedent to the scheme had to be satisfied after those deadlines had expired[10]). When it comes to class composition for voting purposes, the Court's approach is to avoid being "too assiduous" in identifying different classes of creditors to avoid a dissenting creditor having a veto right in determining whether the scheme is approved.[11] In our experience, we have also found ASIC to be accommodative of reasonable waivers and

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[2] King & Wood Mallesons, *Australian Finance Law* (Lawbook Co., 7th edition, 2016) [27.90].

[3] *Corporations Act 2001* (Cth), s 411(4).

[4] *Fowler v Lindholm, Re Opes Prime Stockbroking Ltd* (2009) 178 FCR 563 at [67] – [68]. Refer to also the recent Tiger Resources scheme of arrangement (*Re Tiger Resources Ltd* [2019] FCA 2186 and *Re Tiger Resources Ltd* (No 2) [2020] FCA 266) in which the Court took a purposive approach and declined to unduly restrict the type of compromise that a company can propose as part of a creditors' scheme. The approach was consistent with a long line of scheme cases in both Australia and England where courts have declined to restrict "*the nature of the bargain that might be made between company and creditors*".

[5] *Centro Properties Ltd v PricewaterhouseCoopers* (2011) 86 ACSR 584.

[6] *In the matter of Nine Entertainment Group Limited (No 1)* [2012] FCA 1464; *Re Nine Entertainment Group Ltd (No 2) [2013] FCA 40; Re Atlas Iron Ltd* [2016] FCA 366.

[7] *Re Ovato Print Pty Ltd* [2020] NSWSC 1683 and *Re Ovato Print Pty Ltd* [2020] NSWSC 1882.

[8] Section 411(2) of the Act provides that the Court must not make an order convening a meeting of creditors to vote on the proposed scheme unless 14 days' notice of the hearing (or such less period permitted) has been given to ASIC and the Court is satisfied ASIC has had a reasonable opportunity to examine the terms of, and make submissions to the Court in relation to, the proposed scheme and draft explanatory statement.

[9] *Re Tiger Resources Limited (No 2)* [2020] FCA 266.

[10] *Re Wollongong Coal Limited; Re Jindal Steel & Power (Australia) Pty Limited* [2020] NSWSC 614,

[11] *First Pacific Advisors LLC v Boart Longyear Ltd* [2017] NSWCA 116 at [78].

consents requested to facilitate a shortened scheme approval timeline, for example abridging the 14-day review period under section 411(2)(a) of the Act.

Schemes are incredibly powerful. Specifically, they can be used:

(i) to restructure proprietary rights (including the rights of secured creditors, landlords and other property owners and trust creditors);

(ii) to restructure creditors' claims against third parties (e.g., guarantors, directors and officers), which makes schemes of arrangement particularly useful as a tool to settle class actions,[12] mass torts and corporate group restructures;

(iii) to effect a debt for equity swap;[13]

(iv) to amalgamate corporate groups;

(v) to bypass contractual requirements (e.g., the WICET scheme);[14]

(vi) to restructure secondary liabilities under a guarantee;[15]

(vii) to restructure cross-border corporate groups (including foreign law governed debt) (e.g., Tiger Resources);[16]

(viii) to restructure the debts of foreign companies registered under Division 2 of Part 5B.2 of the Act;[17] and

(ix) concurrently with other restructuring / insolvency processes (e.g., liquidation) such as the Opes Prime and HIH schemes of arrangement.[18]

For these reasons, we expect that schemes of arrangement will be an important tool to assist some companies in recovering from the COVID-19 pandemic. The consequence of hibernation and payment holidays for many companies has meant that lease or finance liabilities have continued to accrue and may be unsustainable going forward. Perhaps most relevantly, creditors' schemes can be used to restructure lease portfolios or finance arrangements while avoiding a formal insolvency process. Volatility in economic performance can also result in potential shareholder class actions which may also be proactively resolved by way of creditors' schemes to reduce the costs of litigation.

4 Responses to specific queries in Consultation Paper

The Consultation Paper called for submissions on four main issues in relation to creditors' schemes: (1) Should an automatic moratorium apply from the time a company proposes a scheme of arrangement? If so, what issues should be considered? (2) Is the current threshold for creditor approval of a scheme is appropriate noting the introduction in other jurisdictions of a cross-class

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[12] See for example *Wingecarribee Shire Council v Lehman Brothers Australia Ltd (In Liq) (No 9)* [2013] FCA 1350; *Hall v Slater and Gordon Ltd* [2018] FCA 2071. The binding effect of schemes, stay of proceedings, ipso facto stay and no requirement for insolvency also make schemes a useful tool for settling class actions. In addition, using schemes to settle class actions reduces or avoids litigation funder premiums, expedites payout and certainty and provides the opportunity for direct interaction with shareholder claimants. Schemes were used in a similar way to settle the multiple class actions brought by investors in the managed investment schemes operated by the agribusiness Great Southern group and a potential class action by shareholders of Atlas Iron.

[13] *Nine Entertainment Group Ltd, in the matter of Nine Entertainment Group Ltd (No 1)* [2012] FCA 1464 and *Nine Entertainment Group Ltd, in the matter of Nine Entertainment Group Ltd (No 2)* [2013] FCA 40.

[14] *Re Wiggins Island Coal Export Terminal Pty Ltd* [2018] NSWSC 1342; *Re Wiggins Island Coal Export Terminal Pty Ltd* [2018] NSWSC 1434 and *Wiggins Island Coal Export Terminal Pty Ltd, Re* [2019] NSWSC 831.

[15] *Tiger Resources Limited, in the matter of Tiger Resources Limited (No 2)* [2020] FCA 266.

[16] See eg *Tiger Resources Limited, in the matter of Tiger Resources Limited* [2019] FCA 2186 (debts governed by English law); *Re Bulong Nickel Pty Ltd* (2003) 21 ACLC 191, *Re Glencore Nickel Pty Ltd* (2003) 44 ACSR 210, *Re BIS Finance Pty Ltd* [2017] NSWSC 1713 (debts governed by New York law).

[17] Section 411(1) of the Act relates to a "Part 5.1 body". This includes an Australian company and a registrable body that is registered under Division 1 or 2 of Part 5B.2 of the Act (which includes a "registered foreign company").

[18] *Re Opes Prime Stockbroking Ltd (No 1)* [2009] FCA 813; *Re Opes Prime Stockbroking Ltd (No 2)* [2009] FCA 864; *HIH Casualty & General Insurance Ltd, Re* (2005) 215 ALR 562 and *HIH Casualty and General Insurance Ltd, Re* (2005) 56 ACSR 295.

cram down mechanism? (3) Should rescue or DIP funding be considered in the creditors' scheme context? (4) What other issues should be considered to improve creditors' schemes?

4.1 Automatic moratorium

In our submission, an automatic moratorium is not appropriate for creditors' schemes of arrangement generally. As noted above most creditors' schemes of arrangement which have been proposed over the last 20 years have involved only limited classes of creditors and have rarely involved any compromise of trade creditor claims outside of a liquidation process. An automatic moratorium was not required in respect of those creditors' schemes and may have served to undermine creditor confidence in the companies which were the subject of those schemes which would have been counterproductive to their restructuring efforts.

There are already two important forms of moratoria which apply to companies that are proposing creditors' schemes of arrangement which serve important purposes:

First, the ipso facto regime implemented in 2018 already provides an automatic moratorium for companies proposing creditors' schemes of arrangement (refer to section 415D of the Act). This moratorium extends to the enforcement of rights under contracts which arise solely for the reason of the proposal of a creditors' scheme of arrangement which are stayed during the creditors' scheme procedure.

Second, the Court already has the power to order a moratorium where a creditors' scheme has been proposed if required (refer to section 411(16) of the Act). Under that provision, the Court has a reasonably wide discretion to make orders which are complementary to the proposal of a creditors' scheme of arrangement.

In considering amendments to the creditors' scheme procedure, we submit it is necessary for the legislature to carefully consider these existing legislative moratoria. Given its recency, the ipso facto moratorium has not been subject to any reported Court decisions. We do note that there are several exceptions and "carve outs" to the ipso facto moratoria which restrict its application. The most obvious example is the exception to enforcement by secured creditors holding a security interest over the whole or substantially the whole of the company's property. This is an endemic exception which applies throughout Australian restructuring law, which in fact was strengthened in the ipso facto reforms, which included receivership as one of the applicable procedures which benefits from ipso facto protection. We expect that it is beyond the intention of the existing reform proposal to interfere with those secured creditor rights (although we would expect them, along with the other exceptions and "carve outs" to the ipso facto moratoria enacted in 2018, to be re-visited as part of any more comprehensive reform exercise as recommended in this submission).

The section 411(16) moratorium is within the discretion of the company proposing the scheme to seek, and the Court to grant, where applicable in the circumstances of the creditors' scheme at issue. We note that this provision has been used successfully in the past to support companies seeking to restructure using the creditors' scheme procedure and has been endorsed by academic commentary with which for the purposes of this submission we broadly agree.[19] We submit that it is not necessary to broaden this discretionary moratorium for the purposes of better achieving the objectives of the creditors' scheme procedure. We note that in 2017, Singapore introduced amendments to the *Companies Act 1967*, that introduced several new features to the insolvency regime in Singapore, which has subsequently been incorporated into the *Insolvency, Restructuring and Dissolution Act 2018* (**IRDA**) including introduction of an automatic moratorium (for 30 days after filing of an application) (cf. 120 days under Chapter 11) for those companies who *intend* to propose a scheme,[20] and an application can be made for the moratorium to be worldwide (cf.

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[19] Timothy Bost, 'Smooth Sailing for Directors: Using the Safe Harbour to Restructure Insolvent Companies in Australia' (2020) 28 *Insolvency Law Journal* 69, 90.

[20] Section 211B of the Companies Act, re-enacted as section 64 of the IRDA.

automatic worldwide application under Chapter 11).[21] However, the scheme of arrangement plays a different role in the restructuring landscape in Singapore as compared with Australia. Schemes of arrangement have been widely used for many years and have been the favoured method of restructuring under the Companies Act (the other being judicial management and otherwise out-of-court consensual workout).[22] In contrast, in Australia, the scheme of arrangement is not an insolvency process and, in that context, the rationale for the introduction of an automatic moratorium is less clear.

In contrast to Singapore, in its recent reforms, the UK has preserved its scheme of arrangement provisions and introduced in 2020 via the *Corporate Insolvency and Governance Act 2020* (UK) (**CIGA**), two new tools to its insolvency arsenal, being a "moratorium" and a "restructuring plan". A company in the UK can now apply to the court for a 20 business day moratorium, which requires the directors to make a declaration that it is likely to become insolvent *and* an independent monitor (an insolvency practitioner) must also confirm that the moratorium would result in a rescue of the company as a going concern, following which the court can make orders for a moratorium if it is satisfied that a moratorium for the company would achieve a better result for the company's creditors as a whole than would be likely if the company were wound up. This moratorium is entirely separate from the scheme of arrangement process.

Therefore, to the extent that it is concluded that some sort of additional flexible moratorium is required in the Australian context it is submitted that there are existing moratoria which are sufficient to achieve the objectives of the creditors' scheme procedure. As part of a more comprehensive review of the ipso facto and broader Australian restructuring procedures, consideration could be given to additional moratoria. However, this should not be limited to the quite confined ambit of creditors' schemes which for the above reasons we consider are adequately served by the existing moratoria.

4.2 Change to current creditor voting thresholds – cross class cram down?

In our submission, the current voting thresholds for creditors' schemes (namely 75% in value and 50% in number of each class of creditors bound by the scheme) are appropriate. The current voting thresholds for creditors' schemes have been in place since 1907, are consistent with the voting thresholds that apply in members' schemes and those that apply in the UK.

An interesting feature of Singapore scheme landscape is that a scheme may be approved by the Court despite a class of creditors not approving the proposed scheme by utilising the cross-class cramdown mechanism. A cross-class cramdown is permitted where:

(i) a majority in number of the creditors to be bound by the arrangement and who were present at the relevant meeting agree to the arrangement;

(ii) the majority in number of creditors represents 75% in the value of the creditors meant to be bound by the arrangement; and

(iii) the court is satisfied that the arrangement does not discriminate unfairly between two or more classes of creditors and is "fair and equitable" to each dissenting class (by reference to what they would otherwise receive in a winding up).[23]

The advantage of the cross class cramdown is that it ensures that creditors whose economic interests are not being prejudiced by the scheme cannot hold other creditors to ransom and prevent the approval of the scheme. We also note that the exercise performed by the Court in respect of the Singaporean cross class cramdown is very similar to that performed by the

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[21] Section 211B(5) of the Companies Act, re-enacted as section 64(5) of the IRDA. For a fuller discussion of the extraterritorial application of Singapore's debtor-in-possession regime, see White & Case Alert, 'Recent Singapore Case Highlights Considerations Relating to Worldwide Moratorium' (15 April 2019).

[22] Wai Yee Wan, Casey Watters and Gerard McCormack, 'Schemes of Arrangement in Singapore: Empirical and Comparative Analyses' (2020) *American Bankruptcy Law Journal* (forthcoming).

[23] Section 211H(3) of the Companies Act, re-enacted as section 70(3) of the IRDA.

Australian Courts in respect of applications pursuant to section 444GA for Court approval in respect of the transfer of shares as part of a deed of company arrangement.

A cross-class cramdown is also now a feature of the UK's new Restructuring Plan regime. Under a restructuring plan, both secured and unsecured creditors are bound, dissenting classes can be crammed down (with a 75% threshold and court approval), and shareholder/member rights (such as rights of pre-emption etc) can be compromised by the court. This new regime was successfully used by Virgin Atlantic to restructure its debts in response to the disruption caused by the COVID-19 pandemic (although a cross-class cramdown was not required on that occasion).[24] Since then however, the Court has exercised its discretion to sanction a restructuring plan utilising a cross-class cram down.[25]

It is less clear that a cross class cramdown is required in relation to Australian schemes of arrangement owing to the pragmatic approach adopted by the Australian courts in avoiding the creation of additional classes of creditors (refer to [3] above). The consequence of this approach is that most creditors' schemes of arrangement in Australia have very few classes of creditors. Further, cross class cramdown is already permitted in creditors' schemes of arrangement in respect of shareholders' claims (including shareholder class actions) by reason of the operation of section 411(5A) of the Act.[26]

It should also be noted that a type of cross class cramdown is already available in Australia pursuant to Part 5.3A in that all creditors of a company vote together as one class in respect of any proposed deed of company arrangement. While secured creditors and property owners are traditionally not bound by deeds of company arrangement without their consent, this position can be altered by the Court pursuant to sections 444F or 447A of the Act or by way of an extension of the Part 5.3A moratorium (refer to the extensive orders made by the Federal Court of Australia to support the restructure of the Virgin Airlines group).[27]

In light of these matters, further consideration should be given to whether a cross-class cramdown is required in Australia and what form that should take (ie. modification to creditors' schemes of arrangement provisions, introduction of a new regime akin to the UK restructuring plan or modifications to Part 5.3A). However, it is important to give careful consideration before implementing any such reform which has the potential to impact on availability of finance and to cut across important proprietary and security rights.

4.3 DIP funding

It is submitted that the availability of rescue financing is important to many operational and financial restructures and that this is a matter which ought to be a focus of reform efforts.

We note that the Singaporean scheme of arrangement provisions provide for super-priority for debts incurred by the company in respect of "rescue financing" that is necessary for the survival of the company that obtains the financing of the company as a going concern, or is necessary to achieve a more advantageous realisation of the assets of a company than would be realised in a winding up;[28]

There are a number of challenges associated with DIP funding during the Australian voluntary administration process. Presently, pursuant to s 443A(1)(d) of the Act, administrators are

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24 *In the matter of Virgin Atlantic Airways Limited* [2020] EWHC 2376 (Ch).

25 *Re Virgin Active Holdings Ltd & Ors* [2021] EWHC 1246 (Cth).

26 The 2015 Atlas Iron restructure by way of a scheme of arrangement with its lenders also compromised potential shareholder claims resulting from representations made in previous capital raisings and also for any breach of continuous disclosure obligations. Since the estimated return to such claimants in a winding up of Atlas Iron was nil, the shareholder claimants were not entitled to vote on the scheme by reason of the operation of section 411(5A) of the Act.

27 See, for example, *Strawbridge, in the matter of Virgin Australia Holdings Ltd (administrators appointed)* [2020] FCA 571, The full suite of orders made is available at https://www.fedcourt.gov.au/services/access-to-files-and-transcripts/online-files/virgin-australia.

28 Section 211E(9) of the Companies Act, re-enacted as section 67(9) of the IRDA.

personally liable for "the repayment of money borrowed". This prescription has effect "despite any agreement to the contrary" (s 443A(2)).

As a result of his unlimited liability, prior to loaning funds administrators will typically seek orders from the court limiting their liability to the assets the subject of the administrators' s 443D statutory right of indemnity.

The requirement to seek judicial relief from the default unlimited personal liability for funds borrowed, imposes not immaterial additional costs on administrators (ultimately borne by creditors) and is also an unhelpful distraction for administrators at the start of an administration, when their energies are better directed more important and value accretive tasks, including business stabilisation, value preservation, and key stakeholder management.

Due an oversight in the drafting of s 588FL of the Act, security interests created post-administration, even with the administrators' consent, automatically vest immediately upon creation (s 588FL(4)(b)). As a result, when seeking finance, administrators are required to seek orders under s 588FM extending the time for registration for the incoming financier's security interest. As with the limited recourse order referred to in the row above, this is an unnecessary distraction and cost in administrations. It is proposed that s 588FL be amended to allow administrators to consent to the creation of security interests post-administration.

Therefore, further reforms to support DIP funding should be considered more holistically and not just in the context of creditors' schemes of arrangement.

4.4 Any other improvements to schemes of arrangement?

In our submission, one of the most significant barriers to the use of the scheme of arrangement provisions are the onerous procedural and evidentiary requirements of the Act which do not reflect modern commercial practice (especially during a pandemic). These other improvements that could be made to schemes of arrangement in Australia to reduce unnecessary costs and to improve efficiency include:

- Provision for electronic scheme booklets. This saves costs and has environmental benefits.
- There could be a process for a simplified scheme booklet, as there is often a significant cost associated with this part of the scheme process.
- Provision for scheme meetings to be entirely virtual (not just during the pandemic). This would save on venue hire costs.

4.5 Broader insolvency reform

In our submission, the other aspects of Australia's insolvency regime which warrant comprehensive review and potential reform are as follows.

No	Potential area for reform	Observation
1.	**Persons providing finance to administrators can agree to limited recourse loans**	Presently, pursuant to s 443A(1)(d) of the Act, administrators are personally liable for "the repayment of money borrowed". This prescription has effect "despite any agreement to the contrary" (s 443A(2)). As a result of his unlimited liability, prior to loaning funds administrators will typically seek orders from the court limiting their liability to the assets the subject of the administrators' s 443D statutory right of indemnity. The requirement to seek judicial relief from the default unlimited personal liability for funds borrowed, imposes not immaterial additional costs on administrators (ultimately borne by creditors) and is also an unhelpful distraction for administrators at the start of an administration, when their energies are better directed more important and value accretive tasks, including business stabilisation, value preservation, and key stakeholder management.
2.	**Administrator can consent to the creation of new security interests**	Due an oversight in the drafting of s 588FL of the Act, security interests created post-administration, even with the administrators' consent, automatically vest immediately upon creation (s 588FL(4)(b)). As a result, when seeking finance, administrators are required to seek orders under s 588FM extending the time for registration for the incoming financier's security interest. As with the limited recourse order referred to in the row above, this is an unnecessary distraction and cost in administrations. It is proposed that s 588FL be amended to allow administrators to consent to the creation of security interests post-administration.
3.	**For larger administrations, time for holding second meeting of creditors be extended to 3 months from the appointment date**	Administrators have just 20 business days (or 25 if Christmas holidays or Easter intervene) to convene the second meeting of creditors. The meeting is then required to be held within five business days of being convened. In larger and more complex administrations, it is inevitable that extensions are sought to the time for convening the second meeting. These applications are invariably granted by the courts. In view of this, it is proposed that in the case of companies whose debts exceed AUD$10m or which have more than 100 creditors, the time for holding the second meeting of creditors be extended to 3 months from the appointment date of administrators. Whether a company satisfies this test would be determined by the administrators based on their review of the company's books and records and consideration of proofs of debts received from creditors.

		Administrators who required additional time could approach the court for appropriate orders further extending the convening period.
4.	**Ability to hold creditors' meetings at any time**	Section 439A(2) of the Act currently requires that creditors' meetings be held "within 5 business days before, or within 5 business days after, the end of the convening period". This limitation on the power of administrators to hold the second meetings of creditors at a time of their choosing is unnecessary and in our experience is regularly removed by courts when granting extensions of the convening period. It is proposed that administrators be permitted to hold second meetings at any time during the administration, or within 5 business days of the conclusion of the administration (noting that administrators are required to provide creditors with at least 5 business days' notice: rule 75-225 Insolvency Practice Rules (Corporations) 2016 (Cth)).
5.	**DOCA gets ipso facto protection**	Ipso facto protection is extended by the Act to administrations, but not deeds of company arrangement (DOCAs). This oversight means that a fresh and unconstrained termination right arises from the execution of a DOCA, providing contractual counterparties of a company in administration with considerable leverage, even if the company is otherwise fully compliant with the terms of the contract. This in turn can complicate restructuring efforts, particularly where the contract in question is a key source of revenue. Given that a fundamental purpose of the ipso facto reforms was to assist the restructure of companies, this is a material oversight and should be remedied and ipso facto protection extended to rights triggered by reason of the execution of a DOCA.
6.	**Clear laws against DOCA 'vote-buying' by preferring certain creditors**	In our experience, there is a growing trend of DOCAs discriminating against particular creditors or classes of creditors. While this may be acceptable in certain limited circumstances (e.g., ongoing business-critical suppliers receiving a superior outcome), it appears to be increasingly used to entice creditors with smaller claims (e.g., under $10,000) to vote in favour of the DOCA proposal in order to secure the requisite 50% of votes by number (with approval of the DOCA proposal then assured either via related party votes or the administrator's casting vote). It is proposed that the Act be amended to expressly prohibit discrimination between unsecured creditors absent the administrators being satisfied that there was a clear commercial benefit to the company (e.g., securing ongoing supply from a business-critical supplier). Further, this benefit would need to be expressly disclosed by the administrators to creditors in the creditors' report.

7.	**Improved powers to unwind DOCAs with creditors' trusts**	A DOCA coupled with a creditors' trust provides administrators with an important restructuring tool which can be deployed to unlock significant stakeholder value, especially in the case of listed companies. However, the ability to immediately effectuate a DOCA and settle the deed fund within a creditors' trust for distribution to admitted creditors, also presents challenges. In particular, Part 5.3A of the Act presently lacks any mechanism for dealing with these structures, because the DOCA will have been fully performed and terminated and the deed administrators retired, creating jurisdictional and practical difficulties in unwinding the DOCA if considered appropriate by the court. It is proposed that Part 5.3A be amended to include express powers for the court to make appropriate orders to regulate and potentially unwind creditors' trust DOCAs to ensure a clear avenue of recourse for any creditors who may wish to seek the court's assistance in relation to these types of DOCAs.