

# EXPOSURE DRAFT EXPLANATORY STATEMENT

## *Corporations Act 2001*

### *Insolvency Practice Rules (Corporations) Amendment (Restricting Related Creditor Voting Rights) Rules 2018*

Schedule 2 to the *Corporations Act 2001* (the Act) regulates the external administration of companies to give greater control to creditors. Section 105–1 in Schedule 2 to the Act provides that the Minister may make rules providing for matters required or permitted by the Schedule to be provided, or necessary or convenient to be provided for carrying out or giving effect to the Schedule. These rules are contained in the *Insolvency Practice Rules (Corporations) 2016* (the Rules).

The purpose of these amendments is to prevent related creditors facilitating illegal phoenix activity by unduly influencing the removal or replacement of external administrators. This will reduce the incidence of illegal phoenix activity and its effect on creditors, and help ensure external administrators are independent and act in the best interests of creditors generally.

The amendments commence on the day after they are registered and apply in relation to creditors' meetings convened on or after commencement.

#### **Context for the amendments: external administration and creditors' meetings**

A company is under external administration if the company is under administration, is the subject of a deed of company arrangement or has had a liquidator or provisional liquidator appointed.

The external administrator of a company may convene creditor or company meetings at any time (section 75–10 in Schedule 2 to the Act) and must convene them in particular circumstances (sections 75–15 and 75–20), for example when directed to do so by certain creditors or by ASIC. Under Chapter 5 of the Act, there are other instances in which an external administrator must hold a meeting.

The external administrator of a company must have regard to directions given to the administrator by a creditors' meeting but is not obliged to comply with those directions (section 85–5 in Schedule 2 to the Act).

Creditors may replace the external administrator of the company (section 90–35 in Schedule 2 to the Act). Creditors may use this mechanism if they are concerned about an external administrator's independence.

Requirements for convening and holding meetings (including notice, agenda, quorum, voting on proposals and costs) are set out in the Rules. Voting entitlements are outlined in sections 75–85 to 75–100 of the Rules. A creditor who has a debt admitted by the administrator or who has provided particulars of their claim to the meeting is generally entitled to vote.

The Rules do not prescribe the level of proof required before the person presiding at the meeting may admit a claim for voting purposes. As a result, claims are not scrutinised to the same extent as when the external administrator pays a dividend.

Resolutions can pass at a creditor's meeting on the voices (section 75–110 of the Rules) or by a poll (section 75–115). To pass, a resolution to remove an external administrator generally requires a majority vote of the creditors voting and a majority in value of creditors voting.

### **Related creditors**

A related creditor is a related entity and also a creditor of the company under administration (subsection 75–41(4) in Schedule 2 to the Act). A related entity includes company members and their relatives.

The current law recognises related creditors may have an incentive to control the administration in a way that is personally beneficial but detrimental to unsecured creditors as a whole. Another creditor may apply to the Court to overturn a decision of a creditors' meeting if related creditor votes were determinative (section 75–41 in Schedule 2 and section 415A of the Act). The Court must consider whether the decision was contrary to the interests of creditors generally or a class of creditors, or has unreasonably prejudiced the interests of other creditors before setting the decision aside.

This court process may not prevent related creditors who are colluding with illegal phoenix operators from influencing the external administration process and frustrating the interests of other legitimate creditors (including other related creditors) who are not colluding. It may also be costly for unrelated creditors to pursue court action in relation to an improper vote. This is a particular concern to the Government in the context of illegal phoenix activity as a related creditor may use their influence to keep in place an external administrator who is complicit in the illegal phoenix activity, or replace an independent administrator with a complicit administrator.

An external administrator may be actively complicit in the illegal activity or turning a blind eye in carrying out their duties, in particular their duty to investigate and report misconduct to the regulator.

### **Stacking of related creditor votes**

A company and its related creditors may enter into arrangements designed to increase the value of related creditors' voting rights. An example of such an arrangement is where a related creditor accepts an assignment of a debt for less than its face value. In the context of illegal phoenix activity, having obtained an ability to vote for the value of the entire debt, these creditors can collude with an external administrator and the directors of a company when voting on certain resolutions to achieve an outcome that facilitates the illegal activity and disadvantages legitimate creditors.

### **The amendments**

Item 3 in Schedule 1 limits related creditors' voting rights to the value of the consideration they paid for an assigned debt when conducting a poll for a resolution concerning the appointment or removal of an external administrator.

To support this amendment, items 1 and 2 apply when there is to be a resolution for the appointment or removal of the external administrator. These amendments require external administrators to ask creditors (whether the creditors are related creditors or not) to provide evidence in writing in relation to any assigned debt and the consideration provided for the assignment.

The amendments commence on the day after they are registered. Item 4 provides that the amendments apply in relation to creditors' meetings convened on or after commencement.