Baker & McKenzie
ABN 32 266 778 912

Level 19
181 William Street
Melbourne VIC 3000
Australia

G.P.O. Box 2119
Melbourne VIC 3001
Australia

Tel: +61 3 9617 4200
Fax: +61 3 9614 2103
DX: 334 MELBOURNE VICTORIA
www.bakermckenzie.com

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Financial System Inquiry
GPO Box 89
Sydney NSW 2001

Dear Sir/Madam

Submission to the Financial System Inquiry - Response to Interim Report released 15 July 2014
Section 3 (Funding) - External Administration

Thank you for the opportunity to provide a submission in response to your Inquiry's Interim Report released 15 July 2014.

1. Introduction

1.1 In response to the Interim Report, this submission responds only to the "external administration" or "insolvency" aspects of the Interim Report. That is, the submission only goes to Section 3 (Funding) - External Administration.

1.2 In part 2 below, we respond to the several questions posed in that Section of the Interim Report. Importantly, however, we also set out in part 3 below some short commentary on the direction that might be taken by the Commonwealth Government in any further consideration of reform to external administration laws in Australia.

1.3 In short, as the Inquiry recognises in its Interim Report, it would be the wrong question to ask "*Should we adopt United States Chapter 11 bankruptcy?*" The correct question to ask is, "*What other alternatives should we consider in order to improve our external administration regime?*" The comments in part 3 below attempt to briefly answer that question.

1.4 The question is relevant to the Inquiry's activities for this reason: In our experience, a restructure or sale of an insolvent or financially distressed company, such that it emerges from insolvency as a "going concern" (as opposed to a terminal liquidation of the company's assets), typically leads to three outcomes:

(a) Increased returns to creditors (including secured creditors) of the insolvent company.

(b) Minimisation of job losses for employees of the insolvent company.

(c) Decreased time and cost, between the commencement of the insolvency procedure and its conclusion.

1.5 Those outcomes are each conducive of the efficient operation of Australia's financial system.

2. Response to Inquiry's questions

2.1 The Inquiry has raised two questions in its interim Report, relevant to this submission. Following are our responses to each of those questions.

The Inquiry would value views on the costs, benefits and trade-offs of the following policy options or other alternatives:

- **No changes to current arrangements.**
- **Implement the 2012 proposals to reduce the complexity and cost of external administration for SMEs.**

2.2 The 2012 proposals referenced in the Interim Report are concerned, in effect, with the regulation and conduct of insolvency practitioners in relation to their remuneration and expenses in conducting an external administration pursuant to Chapter 5 of the *Corporations Act* 2001 (Cth). We will not in this submission comment on matters relevant to regulation of practitioners. We defer in this regard to the input of experienced insolvency practitioners and their industry body, the Australian Restructuring, Insolvency and Turnaround Association ("ARITA").

2.3 As foreshadowed above, however, we do perceive that there are (in the words of the Inquiry's question) "other alternatives" that ought to be investigated in relation to any reform of corporate insolvency laws in Australia. These other alternatives, beyond simply considering United States "Chapter 11 bankruptcy" as discussed in the Interim Report, are discussed in part 3.

The Inquiry seeks further information on the following area: Is there evidence that Australia's external administration regime causes otherwise viable businesses to fail, and, if so, what could be done to address this?

2.4 In our own experience, we have not seen direct evidence of the existing corporate external administration regime causing otherwise viable businesses to fail.

2.5 Related aspects of Australian taxation and corporations laws, however, can tend to result in difficulty when attempting to re-organise a business in financial distress. In short, those aspects are as follow:

Tax liabilities

2.6 First, the Commissioner of Taxation has (since legislative amendments in 2012) enhanced power to make company directors personally liable for certain liabilities of an insolvent company (in particular superannuation and "PAYG").

2.7 Those powers (even before the 2012 enhancements) dis-incentivise otherwise capable company directors from taking a considered risk to trade a business out of financial distress - the risk of that decision to continue to trade ultimately resulting in personal liability for company taxes self-evidently discourages attempts to revive an ailing business and pushes company directors toward a decision to place the company in external administration.

2.8 Of course, it must be recognised that the powers granted to the Commissioner of Taxation are intended to discourage "phoenix company" activity. This is an entirely understandable policy position - company directors who deliberately misuse the corporate form and the concept of limited liability, to the detriment of others, ought to be held responsible. The powers, however, have a much wider application to company directors who, for a proper purpose, attempt to turnaround a business in distress.

2.9 Other powers of the Commissioner of Taxation, such as the power under section 588FGA of the *Corporations Act* to require that the directors of an insolvent company indemnify the Commissioner for any unfair preferences disgorged by the Commissioner to a liquidator, have a similar tendency to increase risk for otherwise competent company directors in control of a financially distressed business.

Continuous disclosure

2.10 Second, in the case of listed companies, the continuous disclosure laws in section 674 of the *Corporations Act* pose further difficulty for company directors considering a decision between continuing to trade a distressed business or placing that business into external administration.

2.11 That difficulty arises from the potential personal liability of directors for contravention of the continuous disclosure laws - an error or oversight innocently made in the course of updating the market during often tense and complicated negotiations in the course of an attempted turnaround of a distressed business might result in the directors having a personal liability in connection with that error or oversight.

2.12 This source of risk to company directors of personal liability is a further disincentive to making the decision to continue to trade with a view to avoiding external administration.

Insolvent trading

2.13 Third, it may be noted that there is argument in the Australian market that the duty to prevent insolvent trading set out in section 588G of the *Corporations Act* incentivises directors of financially distressed companies to elect to simply place the company into a formal insolvency procedure, rather than exploring avenues to rescue the company - this step is taken, so the argument goes, in order to avoid the risk of personal liability for breach of the duty to prevent insolvent trading.

2.14 There has already been extensive consultation by Government with insolvency market stakeholders about potential reform to the insolvent trading laws. We will not repeat the results of that consultation in this submission.

2.15 In conclusion, while it is beyond the scope of the Inquiry's request for input following issue of the Interim Report, these three ongoing sources of risk for company directors faced with the decision of "trade on" versus external administration do merit ongoing policy review by the Commonwealth Government. The three sources of risk do not directly relate to the external administration regime, however, in our experience, those risks do influence the options available for the successful turnaround of a financially distressed business.

3. Reform of external administration regime - other alternatives

3.1 Moving beyond the three issues identified in part 2 above that are extrinsic to the external administration regime, there are a number of other alternatives for reform of that regime that ought to be considered. Following is a short discussion of those other alternatives.

The difficulty with adopting US "Chapter 11 bankruptcy"

3.2 Before starting that discussion, however, it is important to mention United States "Chapter 11 bankruptcy". As the Inquiry recognises in its Interim Report, a potential adoption of Chapter 11 bankruptcy in Australia raises a number of issues, particularly:

(a) The desirability, as a matter of public policy, of introduction of a "debtor in possession" corporate insolvency procedure. Historically, Australia (along with other Commonwealth jurisdictions, particularly England) has not embraced an insolvency procedure whereby incumbent directors and management of a failed business are given continued control over the business during its formal insolvency - Australia (and England) favours the handing over of control to an external party (in the form of a qualified insolvency practitioner). Any movement away from that policy would require very careful consideration and a clear case in favour of change, which does not presently exist.

(b) The very substantial cost and complexity of the Chapter 11 bankruptcy procedure is such that, in the context of Australia's economy, there would in reality be very few businesses that could justify such cost and complexity. Further, amongst some of those businesses sufficiently large to justify such a procedure, namely banks and insurance companies, there are existing, specialist insolvency procedures already in existence - the *Banking Act* 1959

(Cth) and the *Insurance Act* 1973 (Cth) already provide for judicial or statutory management procedures in relation to those systemically important businesses. Accordingly, the number of businesses for which a Chapter 11 bankruptcy procedure would be relevant may be expected to be relatively small. This tends to support a conclusion that the time required to be spent on adoption of the procedure could be better spent on other initiatives, or on particular aspects of the Chapter 11 bankruptcy procedure that could be adopted.

3.3 It follows that much more work would be needed before a conclusion could be reached that adoption of a Chapter 11 bankruptcy procedure in Australia was a worthwhile exercise that was consistent with Australian policy toward corporate insolvency.

Other alternatives - taking aspects of Chapter 11 bankruptcy and the United Kingdom approach to voluntary administration

3.4 That is not to say, however, that aspects of the Chapter 11 bankruptcy procedure ought not be considered for adoption in Australia, as part of a more general move to consider the question, "*What other alternatives should we consider in order to improve our external administration regime*?" There are a number of aspects of the corporate insolvency regimes in both the United States (particularly Chapter 11 bankruptcy) and England that merit consideration in answering that question.

3.5 Those aspects follow below. Firstly, we deal with other alternatives relevant to the voluntary administration regime set out in Part 5.3A of the *Corporations Act*. Secondly, we deal with other alternatives relevant to the scheme of arrangement regime set out in Part 5.1 of the *Corporations Act* (as it applies to creditor schemes of arrangement only).

Voluntary administration

3.6 **"Floating charge" receivers**: As part of the reforms introduced in the United Kingdom under the *Enterprise Act* 2002, the ability of a secured creditor with a "floating charge" over the entire assets and undertaking of a company to enforce its security through private appointment of a "receiver and manager" to the company was abolished. In its place, a secured creditor with this type of security was given the right to select the "administrator" appointed to the company, pursuant to an administration regime under the *Insolvency Act* 1986 (UK) (very similar to the Australian voluntary administration regime).

3.7 There has been considerable empirical study done by the UK Insolvency Service in relation to the effectiveness of this reform to UK insolvency regimes - the output from these studies suggests that the reform has increased the prospects of a successful "going concern" sale of a company in administration and, correspondingly, increased returns to unsecured creditors of a company in financial distress.

3.8 In those circumstances, the merits of this type of reform in the Australian context ought to at least be explored by Government. This is particularly given the present frequency of concurrent administration and receivership appointments in the Australian market (whereby a secured creditor appointing a receiver simultaneously appoints an administrator in order to gain the benefit of the moratorium provided by the administration procedure) - the UK approach plainly reduces duplication and may assist in decreasing costs.

3.9 **"Ipso facto" clauses**: A central feature of US Chapter 11 bankruptcy that provides a procedural advantage over the existing Australian voluntary administration regime (set out in Part 5.3A of the *Corporations Act*) is the prohibition on counterparties terminating contracts with the insolvent company solely in reliance on the ground of "insolvency". This prohibition on use of "*ipso facto*" clauses places a more effective moratorium around a distressed company, compared to the Australian voluntary administration regime.

3.10 In doing so, the prospect of a rescue of the company's business as a going concern is increased. That is because the most valuable assets of many businesses are their contracts with customers and suppliers - if that value can be protected during an insolvency procedure, the prospect of a rescue of the business as a going concern, and therefore the prospect of greater returns to creditors, is increased.

3.11 **"DIP" finance**: Another central feature of US Chapter 11 bankruptcy that provides a procedural advantage over Australian voluntary administration, which may be capable of implementation in Australia, is "Debtor In Possession" or "DIP" finance. Effectively, the Chapter 11 bankruptcy procedure enables an insolvent company to obtain new secured debt finance that is "primed" over all other secured (and unsecured) debt of the company, in priority of repayment.

3.12 This enables an insolvent company to obtain new working capital during its formal insolvency procedure. Importantly, the new working capital may be obtained from new lenders, thereby making the market for provision of the new capital more competitive and alleviating reliance by the insolvent company on its existing secured creditors (who may be unwilling or unable to continue to fund the company) for further capital.

3.13 That new working capital aids the company in exploring rescue and turnaround options, which may lead to either a successful restructure or "going concern" sale - such outcomes may be expected to increase returns to unsecured creditors from the insolvency process.

3.14 **"Pre-pack DOCAs"**: Market practice in the United Kingdom has seen widespread adoption of "Pre-pack DOCAs" as part of successful company restructures or going concern sales, through the administration procedure. The Pre-pack DOCA effectively involves a "Deed of Company Arrangement" (effectively the same as a deed of company arrangement under Part 5.3A of the *Corporations Act*) being pre-negotiated between a debtor company and a potential administrator - the early negotiation of the arrangement then leads to very quick execution of that arrangement by the potential administrator following commencement of the administration procedure.

3.15 Recognising the importance of Pre-pack DOCAs in the UK market, the UK Insolvency Service adopted in 2009 "Statement of Insolvency Practice 16" ("SIP 16"). SIP 16 set out the Insolvency Service's expectations of insolvency practitioner conduct when becoming involved in the planning and execution of a Pre-pack DOCA. More recently, the Insolvency Service has conducted ongoing reviewed of the operation of SIP 16 and Pre-pack DOCAs generally, leading to a sophisticated empirical understanding of the practice.

3.16 While Pre-pack DOCAs do happen in Australia, there is no established market practice or regulatory guidance on the practice generally.

3.17 Consideration ought to be given to the policy merits of Pre-pack DOCAs and development of regulatory guidance (by ARITA and by the Australian Securities & Investments Commission) as to how Pre-pack DOCAs may be used in a more directed fashion in Australia.

3.18 **Reducing court involvement**: The need for the voluntary administration regime to add to the workload of the judicial system, as is presently required, may now prove unnecessary.

3.19 Presently, extensions of time to convene the second meeting of creditors required to be held under section 439A of the *Corporations Act* require the intervention of a court. In a more contentious setting, applications under section 445D to terminate deeds of company arrangement or for orders under section 444GA to transfer shares (as part of a deed of company arrangement), which presently must be determined by a court, might be satisfactorily dealt with (at least in the first instance) outside of a court.

3.20 An alternative to the need for court involvement in these aspects of a voluntary administration may be to confer greater administrative power on the Australian Securities & Investments Commission (as the existing regulatory body) or on a newly-created body akin to the Takeovers Panel (created for purposes of Chapter 6 of the *Corporations Act*).

3.21 The use of administrative decision-making (with appropriate appeal rights to the courts) may avoid unnecessary consumption of judicial resources. As well, an administrative body akin to the Takeovers Panel may, like the Takeovers Panel, be able to deploy a wider base of commercial expertise and personnel in resolving essentially mercantile issues. Of course, under the present system, the judiciary is fundamentally (and very properly) unable to give decisions or guidance premised on "market practice" or "commercial" considerations.

3.22 While this type of reform has not been considered previously, the policy has been deployed in the area of public company takeovers since the 1990s. It may be proper for the same policy to now be considered in relation to at least some aspects of the voluntary administration procedure.

Schemes of arrangement

3.23 Turning to schemes of arrangement, we perceive a potential area for development of this procedure that ought to be considered.

3.24 Before mentioning that matter, it is important to note that schemes of arrangement have enjoyed increased use by the insolvency market over the past five years. The procedure is typically deployed in relation to large, complex corporate groups implementing a restructure or change of corporate control driven by secured creditors of the company.

3.25 **Cram-down**: A present practical difficulty with the scheme of arrangement procedure is its strict requirement that affected creditors vote on a proposed scheme in classes. This requirement of division of creditors into classes leads to a situation whereby senior secured creditors with claims against the company that are impaired may be left unable to properly execute a restructure without permitting "value leakage" to junior-ranking creditors whose claims are effectively value-less.

3.26 This value leakage, in our experience, typically involves simply not compromising the junior-ranking claims at all, as part of the insolvency process.

3.27 In contrast, and while it is complicated, the US Chapter 11 bankruptcy procedure contemplates a "cram-down" of a bankruptcy plan by senior-ranking creditors on junior-ranking creditors. This cram-down procedure, with certain restrictions, can permit not only a compromise of the claims of dissentients within a class of creditors (e.g. a minority senior-secured creditor), but also a compromise of the claims of entire classes of junior-ranking creditors (e.g. ordinary unsecured creditors).

3.28 A cram-down procedure of this kind needs to be approached with great caution - it may conceivably be abused by senior-ranking creditors in order to expropriate to themselves the "value" of claims held by junior-ranking creditors. Nonetheless, it is a potential reform worthy of consideration.

Valuation - administration and schemes of arrangement

3.29 Finally, relevant to both voluntary administration and schemes of arrangement, is the concept of business valuation in an insolvency context. Valuation has the potential to arise in several contexts relevant to the alternatives discussed above, namely:

(a) Pre-pack DOCAs;

(b) Cram-down procedures for schemes of arrangement.

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3.30 The valuation methodology adopted in formal insolvency procedures is also relevant to the current market practice in voluntary administration of using section 444GA of the *Corporations Act* as an aspect of changes of corporate control through court-ordered transfers of shares in a distressed company from an existing holder to a new holder, as part of a deed of company arrangement.

3.31 It is clear that valuation methodology is critical to the operation of insolvency regimes, in a context of the use of schemes of arrangement and deeds of company arrangement - those statutory insolvency plans are able to impose outcomes on minority and junior-ranking creditors, and also on shareholders, in a manner that presumes those stakeholders' claims to be of a particular value. Implementing a methodology to value those claims in a manner that is consistent and predictable is critical.

3.32 The approach adopted by the US legislature and courts in the Chapter 11 bankruptcy context is relatively prescriptive and rigorous. While the discounted cash flow method is widely accepted by US courts as being proper in an insolvency context, the bankruptcy legislation itself and court practice contemplates the use of various valuation methods as part of the valuation evidence produced in connection with the Chapter 11 bankruptcy procedure.

3.33 This requirement has lead to a relatively established and rigorous approach to valuation methodology amongst the US courts - while it may suffer from its own shortcomings, consideration ought to be given to providing Australian courts and insolvency practitioners with guidance (either through regulatory guidance or legislation) on this important developing issue in the Australian insolvency market.

Finally, we note that similar issues to those discussed in this submission are being considered by legal academics in the United Kingdom; Professor Jennifer Payne's article "*Debt restructuring in English law: Lessons from the United States and the need for reform*" (2014) 130 L.Q.R. 282 is an excellent discussion of the issues from the perspective of an English lawyer.

Thank you for considering this submission. If you have any queries arising from the submission please do not hesitate to contact us at the details below.

Yours sincerely

David Walter
Partner

+61 2 8922 5294
David.Walter@bakermckenzie.com

Maria O'Brien
Partner

+61 2 8922 5222
Maria.O'Brien@bakermckenzie.com