CLAYTON UTZ

Mr David Murray AO
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Financial System Inquiry
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26 August 2014

Dear Mr Murray,

Financial System Inquiry - Second Round Submission

Clayton Utz welcomes the opportunity to present this submission to the Financial System Inquiry.

Clayton Utz is the leading Australian corporate insolvency law firm. As such, we have considerable experience with the law and practice of corporate insolvency both here and overseas. For that reason, we would like to address some remarks to the Interim Report's request for further information on whether there is "*evidence that Australia's external administration regime causes otherwise viable businesses to fail and, if so, what could be done to address this*".

In particular, we would like to refute the contention that Australia should adopt the US Chapter 11 regime.

Background

It is important to separate out the real issues from the noise when it comes to discussion of Australia's insolvency laws.

Once again, we hear repeated calls for the introduction of Chapter 11 in Australia. This most recently manifested itself (for unexplained reasons) in the Senate report on events at the Commonwealth Bank of Australia:

> "*The committee recommends that the government commission a review of Australia's corporate insolvency laws to consider amendments intended to encourage and facilitate corporate turnarounds.*"[1]

- and in submissions to this very Inquiry.[2]

As this Inquiry has noted, the appropriateness of Chapter 11 for Australia has been extensively considered and rejected a number of times, by both Parliamentarians and specialist advisors. Despite this, the delusion persists that Australian businesses (and, perhaps more importantly, lenders) would embrace a turnaround cultures if only the right legislative regime were in place.

The existing law

Much the same promise was made just over 20 years ago, when the rarely-used Official Management regime was replaced by Voluntary Administration (Part 5.3A of the Corporations Act). It is not necessary

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[1] Recommendation 61.

[2] "External administration: Recycling capital to new businesses".

to dig out the old ALRC report which formed the basis of this change; the purpose of Pt 5.3A is clearly spelt out in section 435A:

> *"The object of this Part is to provide for the business, property and affairs of an insolvent company to be administered in a way that:*
>
> > *(a) maximises the chances of the company, or as much as possible of its business, continuing in existence; or*
> >
> > *(b) if it is not possible for the company or its business to continue in existence - results in a better return for the company's creditors and members than would result from an immediate winding up of the company."*

Because that legislation is now over 20 years old, it is not couched in the more modern language of turnarounds and recovery. Nevertheless, that is clearly what it is intended to achieve.

Existing outcomes

So why are we now facing calls for yet another turnaround/recovery regime? Doesn't Part 5.3A already create a turnaround culture?

The answer to that question, strangely enough, is that no-one knows for sure. There is a lack of hard evidence - and a correspondingly large amount of anecdotal evidence - about what is actually happening under Part 5.3A. However, the recently published Wellard Report[3] does provide some useful pointers.

Perhaps the most interesting of Wellard's findings was that 19 of the 68 DOCAs he examined resulted in *"preservation or rescue of companies or their businesses"*. This compares more than favourably with the success rate for Chapter 11 of between 17 - 33%[4]

On this basis, there appears to be little reason to adopt yet another new legislative regime that would, at best, only deliver results comparable to the current statute.

The scenic route to liquidation

Of equal or more concern, however, is the corresponding fact that 90% of Voluntary Administrations are simply the scenic route to liquidation.[5] Some may argue that it is better to have Voluntary Administrated and lost than never to have Voluntary Administrated at all. However, the contrary view is that:

- even allowing for the cost benefits of having the Voluntary Administrator acting as the voluntary liquidator, the interpolation of administration imposes additional costs and therefore reduces the funds available for unsecured creditors in the consequent winding up;
- as has often been observed, since the decision to appoint an administrator is usually the directors', the fact that 90% of administered companies cannot avoid liquidation strongly suggests that the directors have waited too long before making the appointment.

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[3] "A sample review of Deeds of Company Arrangement under Part 5.3A of the Corporations Act", Wellard, M, 2013 ARITA Terry Taylor Scholarship Report.

[4] Warren, Westbrook, "The success of Chapter 11: A challenge to the critics", Michigan Law Review, February 2009 and earlier studies referenced there.

[5] Either because the creditors vote for liquidation at the second creditors' meeting or because the DOCA which they adopt is, in Wellard's terms, simply a "glorified liquidation" or "settlement DOCA".

Some uncontroversial conclusions can be drawn from these observations.

The first is that, as Wellard has demonstrated, turnaround and recovery is not only achievable under Part 5.3A, but is regularly being achieved at a level commensurate with Chapter 11.

The second is that most of the arguments regularly trotted out in favour of Chapter 11 revolve around the fact that it is a "debtor in possession" model. This is the springboard for arguing that directors are better placed than external administrators to devise recovery plans for their companies. The stark fact, however, is that the directors of 90% of companies that utilise Voluntary Administration do not act until their company is hopelessly insolvent. Given that the appointment of an administrator will, in many cases, have been the last throw of the dice after unsuccessful informal efforts to trade out or restructure debt, these figures do not suggest that directors are always necessarily the best judges of what is in their companies' best interests or have the necessary business skills to rescue their company.

The Field of Dreams

In this regard, one might even go further.

The Senate Committee report quoted above falls prey to the "Field of Dreams" syndrome (if you build it, they will come). Its demand for Chapter 11 *"amendments intended to encourage and facilitate corporate turnarounds"* is predicated on the apparent assumption that any lack of corporate turnarounds in Australia flows from an absence of the necessary amendments. As we have already noted, Wellard's figures show that, in terms of results, Part 5.3A is on a par (at least) with Chapter 11. It follows inexorably, therefore, that adopting Chapter 11 in Australia will not do any more to "encourage and facilitate corporate turnarounds" than is already being achieved by Part 5.3A.

More controversially, the fact that 90% of Voluntary Administrations end up in liquidation is strong evidence what is holding back corporate turnarounds in Australia is not the existing legislative regime, but the attitude and skills of financially-troubled companies and their directors.

Cultural factors

There are also important cultural factors to consider when looking at Chapter 11.

We earlier referred to the possibility that directors are not always necessarily the best judges of what is in their companies' best interests. In doing so, we deliberately adopted the language of those who advocate Chapter 11 and who tend to place their emphasis on the interests of the "company".

The reality, however, is that the "company" is not the only relevant player. In Australian company law (indeed, in most legal systems derived from Britain), the creditors of a company are also important stakeholders. The interests of creditors are reflected in many provisions of the Corporations Act, even outside Chapter 5 (eg s 257A(a)), which only allows share buy-backs which do not materially prejudice the company's ability to pay its creditors).

However, it has long been recognised that, once a company becomes financially stressed, the interests of creditors begin to assume an increased importance. This principle reached its apogee in **Kinsela v Russell Kinsela Pty Ltd** (in liq) (1986) 4 ACLC 215, which appeared to hold that directors of an insolvent company owe a standalone duty to creditors:

> *"In a solvent company the proprietary interests of the shareholders entitle them as a general body to be regarded as the company when questions of the duty of directors arise...But where a company is insolvent the interests of the creditors intrude. They become prospectively entitled, through the mechanism of liquidation, to displace the power of the shareholders and directors to deal with the company's assets. It is in a practical sense their assets and not the*

> *shareholders' assets that, through the medium of the company, are under the management of the directors ..."* (at p 221).

In **Spies v The Queen** (2000) 18 ACLC 727, the High Court rejected the proposition that Kinsela leads to the conclusion that directors owe a duty to creditors that creditors can enforce. Nevertheless, the many provisions in Chapter 5 which restrict an insolvent company's ability to dispose of its assets or conduct its business without reference to its creditors (most notably, the clawback and insolvent trading provisions, the ability of creditors of a company in voluntary liquidation to replace the liquidator and the ability of creditors of a company in administration to decide its fate) reflect the Kinsela view that, once insolvency intervenes or seriously threatens, the interests of creditors in the company's assets become a real and valid concern.

Chapter 11, by contrast, has an entirely different focus by virtue of being a debtor-in-possession model with the ever-present threat of a court-imposed creditor cram-down in the interests of the survival of the company. By providing for Voluntary Administration, the Corporations Act gives eligible companies the chance to "sell" a restructure to its creditors, but does not privilege the company's continued existence over the creditors' desire to recoup their losses. Even leaving aside its (very doubtful) benefits, the introduction of Chapter 11 into Australia would run counter to the whole philosophy underpinning both Chapter 5 and the Corporations Act as a whole.

The businessperson as company

The introduction of Chapter 11 would also, we suggest, encourage the further development of an extremely unhealthy phenomenon in Australian business: the inability of many directors, particularly at the SME level, to differentiate their personal interests from those of their company.

This inability can be both malign (as in the well-known phenomenon of phoenixing) and passive (as is commonly found by liquidators whose investigations reveal that directors have been using company property as personal property simply because they cannot distinguish between their personal interests and the interests of the company as a separate legal entity). This situation was undoubtedly exacerbated by the First Corporate Law Simplification Act 1995, which abolished the requirement that a company had to have at least two shareholders. The advent of the "one man company" may have removed the need to have a nominal second shareholder, but by doing so, it also removed an important signal that the company was not simply an extension of the businessperson who had founded it.

There can be little doubt that this is, in part, responsible for the fact that 90% of companies going into voluntary administration have no hope of rescue. Because the company's only shareholder regards the company as merely an extension of him- or herself, he or she often cannot take an objective view of the company's prospects. Restoring the requirement for a minimum of two shareholders would go some way towards mitigating this effect.

The costs of courts

Finally, we would note that Chapter 11 is a process which is heavily dependent upon court involvement. It is, therefore, inherently expensive.[6] From this, it follows that:

> (a) given that the overwhelming majority of corporate insolvencies are in the SME sector, there is little likelihood that, even if it were on the statute book, Chapter 11 would be much utilised;

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[6] A point recognised in both the 2004 CAMAC report on Rehabilitating large and complex enterprises in financial difficulties and this Inquiry's own Interim Report (at p 2-70).

(b) even in those situations in which the insolvent company is in a position to pay a partial dividend to creditors, the court costs of Chapter 11 would in most cases reduce the return to creditors even further.

Despite these realities, it is undeniable that external administration is currently a political topic. As a result, it is not beyond the bounds of possibility that Parliament may legislate to adopt Chapter 11. If that were to happen, it is essential that access to Chapter 11 be restricted to those insolvencies in which the cost of the Chapter 11 processes does not materially prejudice the interests of creditors. For that reason, access to Chapter 11 would have to be subject to a financial threshold. That threshold could take one of two forms:

(a) a threshold based on expected return to creditors (for example, an accountant's certificate that, as at the date of the application, the company assets and debts were such that unsecured creditors were expected to receive a dividend of more than 50 cents in the dollar); or

(b) a broader-brush financial test, perhaps barring Chapter 11 access for small proprietary companies (ie those with less than $25 million annual revenue, gross assets of less than $12.5 million and/or fewer than 50 employees).

Both of these tests would, of course, require evidence in the form of properly-kept financial records. It goes without saying that a company which could not produce those records would not suggest itself as a serious candidate for Chapter 11 restructuring in any event.

Conclusion

There is, we submit, no convincing argument for - and several strong arguments against - the introduction of Chapter 11 into Australia.

However, should that come to pass, it is essential that:

(a) nothing should be allowed to derogate from the longstanding principle that creditors' legitimate interests need to be protected once a company enters the insolvency zone; and

(b) the high costs of the Chapter 11 machinery should not prejudice creditors' interests - an outcome preferably achieved by restricting the types of companies which could access it.

Yours sincerely

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