CPA AUSTRALIA

Submission to Corporations and Markets Advisory Committee

Discussion Paper 2003
Rehabilitating Large and Complex enterprises
in Financial Difficulties

4 December 2003

EXECUTIVE SUMMARY

In response to the Committee's invitation, CPA Australia presents its submission generally addressing points 1 and 2 of the matters set out at page X of the Introduction and more specifically dealing with point 3 (also repeated on page 15 at 1.74).

Based on its analysis, CPA Australia disagrees with any proposal for the adoption in Australia of US Bankruptcy Code Chapter 11 type features either applied as a replacement to Corporations Act Part 5.3A Voluntary Administration arrangements or as an alternative treatment for large and complex enterprises in financial difficulty.

CPA Australia's arguments and comments are presented in this submission under two broadly linked themes, the conclusions from which are summarise as follows:

Impact on the rights and insolvency position of unsecured creditors

- The introduction of arrangements which allow in any formal rehabilitation processes a lessening of reference to insolvency, potentially erodes the well defined criteria and basis upon which a directors' duty to creditors will be recognized (*refer 1.2 of submission).*
- A differential in treatment based on size or complexity presents practical problems of definition, may encourage contradictory debtor behaviour and presents real risk of inconsistent outcomes for creditors (*refer 1.3 of submission*).
- Were there to be introduced the extensive moratorium arrangements inherent to Chapter 11, consideration would need to be given to significantly strengthening both the basis of qualification and speed of access to non-standard injunctive type creditor protection (*refer 1.4 of submission*).

Courts' involvement

- Central to Chapter 11 procedures, is the extensive resort to court involvement in both approval and monitoring of corporate reconstructions. This feature does not readily translate to the Australian context. Neither general law approaches to the review of director good faith (*refer 2.4 of submission*) nor specific judicial discretion allowed for in the voluntary administration scheme (*refer 2.5 of submission*) present a ready basis of adaptation to Chapter 11 type arrangements.
- Proposals for the protections of secured creditor rights, whilst unsecured creditor would be subject to more extensive moratorium provision, presents unwarranted shifts in relative creditor value upon corporate debtor insolvency (*refer 2.6 of submission*).
- Any lessening of linkages between the rehabilitation scheme and insolvent trading sanctions will cause undue delay to the censure of director behaviour damaging to both creditor position and the broader conduct of business (*refer 2.6 of submission*).
- The potential for further protection and deferring of review of director behaviour is at odds with various regulatory initiatives presently afoot which are directed at strengthening corporate governance practices (*refer 2.6 of submission*).

1. Impact on the rights and insolvency position of unsecured creditors

1.1 Background

The current case law based understanding of directors' separate duty owed to creditors contingent upon insolvency, contains reference to both common law and statutory protections the balance of which is potentially changed with the imposition of a scheme enabling more extensive moratorium arrangements. Any shift in the status quo may lead to economic / wealth transfers primarily affecting "non-adjusting" unsecured creditors.

In its opening remarks to Chapter 1 the Advisory Committee recognizes the common objective in the design of the rehabilitation systems being compared for financially stressed corporations to be able to reorganise, and if appropriate, to continue as a going concern though each may differ fundamentally in its approach. One such distinguishing point is in terms of applying a necessary moratorium against otherwise available creditor contractual rights. This element primarily leads to the description of US Chapter 11 arrangements as debtor-driven, whilst the Australian Corporations Act Part 5.3A Voluntary Administration scheme is regarded as more creditor oriented (see CAMAC 12 September 2003 Media Release).

Any evaluation of Australia's voluntary administration arrangements should take place in the context of how it functions within the broader scope of the statutory External Administration scheme, and even more generally, how it interacts with other statutory and common law provisions particularly those affecting directors' duties. Such an approach should be applied to the evaluation of the potential effect on the overall cogency of existing arrangements that might ensue from the introduction of alternatives that differentiate between the protection afforded to unsecured creditors in large/complex insolvencies compared to their treatment under existing arrangements irrespective of the scale of the insolvent debtor company concerned.

The Committee notes in the prerequisites for initiating the procedure (page 2) at para 1.12 of the under the heading "*Assessing the tests*":

> " An argument for a financial stress test is that it would overcome any possibility of a clearly solvent company commencing a rehabilitation procedure merely to give itself a temporary immunity from its unsecured creditors."

In addition, the comparative table presented at 1.73 (pp 14-15) of the Discussion Paper notes that the US Chapter 11 procedure is characterised by an automatic moratorium applicable to all secured and unsecured creditors, whereas the Australian voluntary administration provisions which, within moratorium arrangements, enable certain classes of creditor and owners of particular types of property to continue to deal with respective classes of security or property.

Equally significant to an assessment of the potential risk, and in turn cost, associated with the standing of unsecured creditors being altered, is the duration of the moratorium itself. The Discussion Paper at 1.65 (p13) notes the directors' six month exclusive right provided under Chapter 11 to formulate a rehabilitation plan unencumbered by creditors exercising their contractual or property rights. The potential for adverse consequences of such extended duration of moratorium is noted in the Discussion Paper in terms of both "creditors' own solvency" and the resultant disadvantage to the trading position of debtor company competitors.

The consequence and duration of moratorium arrangements is fundamental to triggering of the stage in the demise of a company at which the interests of unsecured creditors is seen to supplant those of the company and its shareholders. As such, the facility provided in s 439C(c) of Part 5.3A enabling the creditors to resolve that the company be wound up plays a vital link to the threshold at which a protection is afforded by statute to creditors separate from any uncertain notion of a directors' duty separately owed to creditors.

1.2 Basis of directors' duties owed to creditors

The development of Australian law in this regard is shaped by a number of cases culminating in *Spies v The Queen*[1] the outcome of which is to specify a well defined but narrow basis of directors' duty to creditors such that the establishing of alternative arrangements specific to large/complex insolvencies which might in specific instances defer recognition of creditor interests should be treated with caution.

Whether directors owe a duty to consider the interests of creditors has been subject to both considerable judicial analysis and academic debate. Certain aspects evolve around consideration of the retrospective

[1] (2000) 201 CLR 603

nature and complexity of proof associated with statutory compensation for creditors[2] and how these shortcomings may to a degree be negated by identification of a separate prescribed duty to protect creditors where a company is financially distressed.[3] Particular analysis of *Spies v The Queen* take the view that it remains uncertain as to whether the duty is fiduciary in nature, indirect arising by way of implication or purely the province of statute.[4] A reasonable conclusion advanced by Professor Keay[5] is that:

said

> "The courts have, in general, preferred to found the duty on a traditional basis in that they have that the duty is owed to the company to take into account the interest of creditors, that is the duty is mediated through the company."

Prior to the High Court decision in *Spies v The Queen* judicial development in Australia has been heavily influenced by the statement in by Mason J in *Walker v Wimborne*:

> " - - - it should be emphasised that the directors of a company must take account of the interest of its shareholders and creditors. Any failure by the directors to take into account the interests of creditors will have adverse consequences for the company as well as for them."[6]

Built on this view, has been the development of the notion that "directors might owe an independent duty to, and enforceable by, the creditors by reason of their position as directors."[7] Their Honours' analysis in *Spies* not only serves as a rejection of this expanded view of directors' duty[8], but tends also strongly toward the view that protection afforded creditors is foremost one of statute.[9] Of some significance to their Honours' conclusion is a short paper by Professor Sealy[10] in which judicial statement seeking to establish a distinct and duty to act in the interest of creditors are described as:

> " - - - nothing more than extraneous words of censure directed at conduct which anyway comes within some well-established rule of law, such as the law imposing liability for misfeasance, the expropriation of assets or fraudulent preference."[11]

and further, at p 177:

> " - - - ill-focused dicta about directors' 'duties' to creditors can be seen as both unnecessary and potentially pernicious."

The means by which the interest of creditors are safeguarded within the broad scheme of Australian corporate insolvency law are therefore quite narrowly defined such that to describe this structure for managing the outcome of an insolvency as "creditor oriented" is to a degree a misnomer.

CPA Australia believes introduction of any measures which further protract the imposition or recognition of these duties available through the 'linkage' established in s 439C(c) of the voluntary administration arrangements between the creditors' decision and the Part 5.7B recovery or compensation arrangements, ought to be approached cautiously to avoid any erosion of protections that precipitate under narrow but well defined circumstances.

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[2] Section 588G Director's duty to prevent insolvent trading by the company and section 588FF Courts may make orders about voidable transactions.

[3] A Keay, "The Director's Duty to Take Into Account the Interests of Company Creditors: When is it Triggered?" (2001) 25 MULR 315, pp 318-319.

[4] McConvill, "Directors' Duties to Creditors in Australia after Spies v The Queen" (2002) 20 C&SLJ 4 at pp 13-14.

[5] A Keay, "The Director's Duty to Take Into Account the Interests of Company Creditors: When is it Triggered?" (2001) 25 MULR 315, p 321. In these terms, whilst directors will not be regarded as owing a fiduciary duty to a creditor, the duty is nonetheless one of an 'imperfect obligation' enforceable only on behalf of creditors though the initiative of a liquidator – see McConvill, "Directors' Duties to Creditors in Australia after Spies v The Queen" (2002) 20 C&SLJ 4 at p 6 and fn. 17 per J D Heydon.

[6] (1976) 137 CLR at 7.

[7] (2000) 201 CLR 603 at 636-637.

[8] (2000) 201 CLR 603 at 637 – "they are contrary to principle and later authority and do not correctly state the law."

[9] This decision gives considerable credence to prior academic comment, see for example Yeo and Lin, "Insolvent Trading: A Comparative and Economic Approach" (1999) 10 AJCL 217 where it is stated: " - - - it is highly unlikely for any common law based doctrine of directors' duties towards creditors to develop further having regard to the legislative development on the matter."

[10] "Directors' Duties – An Unnecessary Gloss", (1987) 47 Cambridge Law Journal 175 at 175.

[11] This latter aspect is extensively covered in Part 5.7B of the Corporations Act "recovering Property or Compensation for the Benefit of Creditors of Insolvent Company"

1.3 Equality of treatment of creditors

Significant also in the paper by Professor Sealy referred to by their Honours in *Spies* is the comment:

> " - - - if such a rule is to give some creditors remedies in an insolvency which are denied to others, the fundamental principle that all creditors participate *pari passu* in the bankruptcy is undermined."[12]

This theme was restated by EM Heenan J in *Geneva Finance Ltd v Resource & Industry Ltd*[13] as part of an extensive reference to the authority established by the High Court in *Spies*. The continuing recognition given here to the fundamental principle of pro rata equality of standing amongst equally ranking creditors strongly suggests the need for considerable caution in the preservation of safeguards that would protect unsecured creditors in the development of alternative insolvency procedures that would provide differentiated avenues of resolution between large/complex enterprises and other corporations.

Similarly, the notion of *collectivism* which forms a related cornerstone to the design of insolvency systems needs to be considered in the context of developing alternative paths of insolvency administration. The compulsory nature of collectivism serves an important function of "ensur(ing) that there is a co-operative system which is orderly"[14].

As between differentiated arrangement operating in parallel within the one jurisdiction, CPA Australia suggests there would likely need to be established procedural rules that prevent 'procedure-shopping' amongst participants to achieve an advantage. Similarly, the idea of debtor company scale and complexity, rather than contractual dealing, as the criteria for determining creditor outcomes is potentially distorting.

1.4 Access to non-standard injunctive type relief

Professor Keay noted that in the United States, the law has developed such that whilst similar to Australia a general duty towards protecting the interests of creditors is not formally established, there can however be discerned a greater sympathy towards allowing company insolvency to form the basis of a distinct duty[15]. As such, were Australian corporate regulation to adopt Chapter 11 type moratorium protections available at the initiative of directors, close attention would need to be given to ensuring the protection of creditors additional to that critically predicated on the liquidation procedure.

In this regard, the Discussion Paper at 1.23 (page 5) makes note of the capacity of creditors in Australia, similar to arrangements provided under Chapter 11, "to apply to the court to halt an asset sale." Specific reference is made in the Discussion Paper by way of footnote (no. 23) to the injunctive relief predicated on conduct (past, actual or prospective) which contravenes the Corporations Act afforded by s 1324 of Part 9.5 (Powers of Courts).

Essential to the operation s 1324 is its interaction with the substantive provisions of the Act and who might be granted standing as an affected party. The case law which has developed around s 1324 affirms creditor standing[16] in relation to the discharge of a director's duty of good faith. Within the leading case on this matter (decided in relation to an alleged contravention of s 232 the precursor to current s 181) *Airpeak Pty Ltd v Jetstream Aircraft Ltd*[17] the following significant authority of Hayne J in *Allen v Atalay*[18] is provided:

> " - - - it is in my view very arguable that a creditor having a right to prove in a liquidation of a company may be a person whose interests are affected by a contravention which is alleged to have lead to the diminution in the value of a claim against the company."

This authority clearly associates a director's duty to creditors in the context of a liquidation though prospective, however some doubt has been raised in the light of the *Spies* decision in terms of a necessary nexus between statutory duties, such as s 181, and creditor standing to seek enforcement:

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[12] "Directors' Duties – An Unnecessary Gloss", (1987) 47 Cambridge Law Journal 175 at 177.

[13] (2002) 20 ACLC 1,427 at 1,438.

[14] A Keay, "The Recovery of Voidable Preferences" in *Restitution and Insolvency*, F Rose ed. (2000 Mansfield Press UK) p 240.

[15] A Keay, "The Director's Duty to Take Into Account the Interests of Company Creditors: When is it Triggered?" (2001) 25 MULR 315, p 321 and fn. 47.

[16] HAJ Ford, RP Austin & IM Ramsay, Ford's Principles of Corporations Law (11th ed 2003 Butterworths) 11.310

[17] (1997) 23 ACSR 715.

[18] (1993) 11 ACSR 753 at 757.

> "- - - the scope of s 1324 and the ability of creditors to use this remedial provision in order to protect and enforce their rights and interests, will depend on whether the statements in Spies are considered as merely obiter or binding authority."[19]

This uncertainty aside, the absence of reported cases decided around s 1324 subsequent to *Airpeak* may indicate the existence of issues of speed and cost of access amongst unsecured creditors.

If Chapter 11 type arrangements were adopted in Australia, CPA Australia suggests consideration would need to be given to both clarifying and strengthening their standing in relation to s 1324.

In addition, Einfeld J's judgment in *Airpeak* contains the cautionary comments concerning the strict bounds within which injunctive relief might be availed of:

> "The concern that shareholders or creditors should not be allowed through litigation to interrupt the proper running of a company is certainly valid."[20]

Therefore, one means by which the legislation guides how a duty of 'imperfect obligations' is transformed into a direct enforceable duty is through the subsequent reference in s 1324(1A), to amongst other contraventions, share capital reductions not to prejudice the ability to pay creditors. The substantive operating section here is s 256B(1)(b) which states that a company may reduce its share capital in a way that is not otherwise authorised by law if the reduction does not prejudice the company's ability to pay its creditors. Again this feature of the legislation does not appear to have been extensively litigated, and therefore perhaps not widely availed of by creditors[21].

Nonetheless, if an Australian corporate rehabilitation scheme modelled on Chapter 11 was to be developed, CPA Australia suggests one avenue of creditor protection worthy of consideration could be in relation to the adaptation of s 1324(1A) to a broader set of restructuring circumstances along with the establishment of more facilitative procedural arrangements.

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[19] McConvill, "Directors' Duties to Creditors in Australia after Spies v The Queen" (2002) 20 C&SLJ 4 at p 24.
[20] (1997) 23 ACSR 715 at 721.
[21] The CCH Australian Corporations & Securities Law Reporter at 75-200 cites only two older cases in this regard *Re Fowlers Vacola Manufacturing* [1966] VR 97 and *Re Convalescent Services Ltd* (1971-1973) CLC both of which deal with priority competition between the interests of shareholders and secured creditors. Other cases in this area deal with schemes of arrangement, though particularly from the perspective of s 256B(1)(a) 'fair and reasonable to the company's shareholders as a whole': *Re Advance Bank Australia Ltd (No 2)* (1997) 15 ACLC 248.

2. Courts' involvement

2.1 Background

Central to the Chapter 11 procedures is the extensive resort to court involvement in both approval and monitoring of corporate reconstructions. Traditionally Australian courts (specifically in voluntary administration cases and more generally in considering such matters as directors duties or shareholder rights) have expressed an unwillingness to deal with commercial matters except to the extent of any supervisory role allowed for in the legislation or where the dealings between the parties offends an established principle. To this extent CPA Australia believes the US model does not apply readily to the Australian context.

Closely allied to this issue is the consideration which would need to be given to the legislative establishment or a judicially developed criteria by which the Part 5.3A alternative or substitute procedure might be invoked. By way of comparison and illustration of the potential difficulties, consideration is given in CPA Australia's submission to the Committee to the courts' well established measure of solvency.

No doubt a change in orientation necessitated by the adoption of a "debtor-driven" regime may well be within the competency of many members of the Australian judiciary dealing as they do with a vast array of commercial issues. Nonetheless, the evolution of judicial approaches to corporate insolvency is characterised by a qualified concern for creditor interests once insolvency is apparent or impending, underpinned by reference to aspects of commercial morality and the safeguarding against abuse of the corporate form.

2.2 Determining appropriate threshold criteria

The comparison Table provided at 1.73 (pp 14-15) of the Discussion Paper presents a useful contrast of key design elements of the respective Australian voluntary administration and US Chapter 11 schemes.

The contrasting threshold prerequisites enabling a company to come within the respective schemes are insolvency, on the one hand, and good faith on the other. The latter approach necessarily involves a substantial role for the court in facilitating the commencing of the procedure and approving the plan, whereas under the Australian scheme the courts' role is primarily by way of a supervisory jurisdiction.

The good faith basis for availing of the Chapter 11 facility would seem to necessitate the court's participation to evaluate the bona fide of such a submission – bona fide in turn invites an investigation of a director's business judgement in terms of the good faith basis for seeking a restructure. The review of business judgements of directors and their exercise in good faith are matters which Australian courts have traditionally shunned except under well defined circumstances. Therefore it is worth considering how these approaches might be adapted to deal with financial difficulty induced corporate restructure compared to the somewhat more objective judicially articulated criteria of insolvency.

2.3 Applying accepted fiduciary standards to the wider context of corporate rehabilitation

The strength and extent of judicial reluctance to impose or substitute their views for those of directors in whose hands shareholders have placed responsibility for the management of the affairs of an incorporated commercial undertaking, can be found in statements such as:

> "Directors in whom are vested the duty to decide where a company's interests lie and how they are to be served may be concerned with a wide range of practical considerations, and their judgement, if exercised in good faith and not for an irrelevant purpose, is not open to review in the courts."[22]

This attitude to the use and conduct of the corporate form, described as a business judgement rule, can be seen as founded in earlier judicial comment such as that of Greer LJ in *John Shaw & Sons (Salford) Ltd v Shaw*[23] in which after reiterating the *Salomon*[24] principle that "a company is an entity distinct alike from its shareholders and directors" goes on to say that the "powers of management are vested in the directors, they and they alone can exercise those powers". This position is now embodied as s 198A(1) [Management of business] of the Corporation Act which sets a firm basis of demarcation in the conduct and external review of the management of the affairs of a company.

[22] *Harlowe's Nominees Pty Ltd v Woodside (Lakes Entrance) Oil Co NL* (1968) 121 CLR 483 at 493.
[23] (1935) 2 KB 113 at 134.
[24] [1897] AC 22.

2.4 Possible criteria for court evaluation and approval of the bona fide basis of director initiated and controlled corporate restructures

Both the elements of business judgment and good faith are embodied in statute, respectively as s 180(2) (Business judgement rule) and the civil obligation s 181(1) (Good faith – directors and other officers). The latter contains separate but interrelated standards of good faith in the best interests of the corporation and proper purpose.

These two standards may in turn be considered in the context of their ability to affording to directors scope to initiate a restructure within Chapter 11 type judicial approval and protection.

2.4.1 *"Good Faith"*

In its common law form, the notion of 'good faith in the best interests of the corporation' in one in which the courts have expressed reluctance to closely supervise the decisions of boards[25] in relation to matters of business judgement.
The duty of good faith nonetheless requires directors to act honestly, exercise the powers in the interests of the company and to avoid conflict of interest.[26] As such this duty is often described in terms of a fiduciary who "is subject to higher standards of behaviour than the standards imposed upon parties in an arm's length relationship."[27] The general principle is that the duty is owned only to the company[28], except in situations in proprietary company type relationships where the shareholder might be vulnerable to detriment at the hands of the director because of some special fact or opportunity.[29] Consistent with fiduciary principles, judicial assessment of good faith exercise of powers and discharge of duties, applies an external objective standard which disregard directors' subjective good intent and an absence of self-interest. Assumed instead, the director "must act in a way which he conceives to be for the benefit of the company as a whole, as that concept is understood by the law."[30]

Within the above constraints and absent the circumstance of insolvency, s 181(1)(a) would clearly afford to directors significant latitude to initiate complex corporate restructures unencumbered by threat of shareholder, let alone, creditor challenge. Nonetheless, the notion of a fiduciary relationship which underpin such assessments, being "of different types, carrying different obligations"[31] is however of little practical guidance to the specifics of evaluating the bona fides of a rehabilitation proposal and would thus seem to demand significant judicial oversight of director motives and actions in areas to which courts have traditionally been reluctant to venture.

2.4.2 *"Proper Purpose"*

The further 'proper purpose' limb now covered in s 181(1)(b) has attracted greater levels of judicial review of the bona fides of director actions, though substantially in the narrow context of considering the powers of directors to issue shares.[32] A reluctance however to establish strict rules is again evident:

> "To define in advance exact limits beyond which directors must not pass is, in their Lordships' view, impossible. This clearly cannot be done by enumeration, since the variety of situations facing directors of different types of company in different situations cannot be anticipated."[33]

Developments in Australia[34] beyond *Howard Smith* take no further substantive steps towards the development of a propensity amongst the courts to deal with the bona fides of business judgement more widely beyond the review of the specific purpose for which a power is vested. Developments as there are deal almost exclusively with such narrow matters as the issue of shares for shifting or diluting power, actions

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[25] HAJ Ford, RP Austin & IM Ramsay, *Ford's Principles of Corporations Law* (11th ed 2003 Butterworths) 8.060 pp 318-319.
[26] *Chew v R* (1991) 5 ACSR 473.
[27] HAJ Ford, RP Austin & IM Ramsay, *Ford's Principles of Corporations Law* (11th ed 2003 Butterworths) 8.065 pp 321.
[28] *Percival v Wright* [1902] 2 Ch 421.
[29] *Brunninghausen v Glavanics* (1999) 17 ACLC 1,247
[30] *Australian Growth Resources Corp Pty Ltd v van Reesema & Ors* (1988) 6 ACLC 529 at 538 per King CJ.
[31] *Hospital Products Ltd v United States Surgical Corp* (1984) 156 CLR 41 at 69 per Gibbs CJ.
[32] The CCH Australian Corporations & Securities Law Reporter at 42-240.
[33] *Howard Smith Ltd v Ampol Petroleum Ltd* [1974] AC 821 at 835.
[34] *Whitehouse v Carlton Hotels Pty Ltd* (1987) 162 CLR 291.

to defeat a hostile takeover bid[35] and changes to a company constitution to expropriate a minority of its shares.[36]

Australian corporate law in its current state of statutory and common law development possibly contains a general basis for measuring and applying criteria against which both the good faith and proper purpose basis of a financial difficulty motivated proposal for restructure might be evaluated. Nonetheless, in CPA Australia's view, there would be required further significant statutory and associated guidance enhancement to meet the type of complexity likely to be found under these circumstances.

2.5 Alternative adaptation of existing judicial approaches to court discretion in insolvency administration

Cautious reference to particular judicial statements concerning the operation of Part 5.3A in relation to a particular company[37], might alternatively be indicative of the extent of courts' willingness to apply its discretion to the wider context of reviewing the "good faith" and "proper purpose" basis of a corporate restructure sanctioned under a Chapter 11 style scheme.

The Discussion Paper itself at 2.163 (p 48) makes reference to the statement of Golderg J, in one of the Ansett Administration cases, to the effect that the court would confine itself to matters of legal judgement. In the absence of courts assuming for itself a role in giving direction or approval in relation to a business or commercial aspect of an administration, the narrower legal matters to which it would make reference may in turn be deduced from the leading case concerning the operation and scope of s 447A.

In *Australasian Memory Pty Ltd v Brien*[38] their Honours make the following statement to the effect that the discretion though wide, functions within considerations of achieving cohesion within the Part itself determined with reference to the legislative intent in enacting the Part:

> " - - - a 447A is not properly described as a general power standing apart from the scheme found in Pt 5.3A."

and further

> "Yet the evident legislative intention of 447A is to permit alterations to the way in which Pt 5.3A is to operate."

Notwithstanding the breadth of the available discretion, these are underpinned by the court having "regard to the extent that the order facilitates the expedition of the purpose of Part 5.3A without prejudicing a creditor."[39] Over and above these considerations directed at facilitating the cohesive development of the Part[40], courts have demonstrated a willingness in applying their discretion under s 447A to overlay these practical considerations with a cognizance to broader commercial morality and public policy. A noteworthy case illustrating these latter elements in the application of s 447A is *Deputy Commissioner of Taxation v Woodings*[41] in which Wallwork J presented as significant earlier comments of Gillard J in *Re Mascot Home Furnishers Pty Ltd; Re Spaceline Industries (Aust) Pty Ltd*[42]*:*

> " - - - the court which was concerned not only with considering whether what was proposed was for the benefit of creditors, but also whether it would be a safe course to sanction, and conducive to commercial morality and in the interests of the public at large."

Professor Keay[43] in his commentary on the *Woodings* case indicates that in applying public interest considerations the courts are nonetheless cautious in substituting their views for those of creditors. Moreover

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[35] *Darvall v North Sydney Brick & Tile Co Ltd* (1989) 16 NSWLR 260.
[36] *Gambotto v WCP Ltd* (1995) 182 CLR 432.
[37] Section 447A General Power to Make Orders
[38] [2000] HCA 30 at para 24.
[39] C Anderson & D Morrison, *Crutchfield's Corporate Voluntary Administration* (3rd Ed Thomson Lawbook Co. Sydney 2003) p 246. Note also for example the statement in *Australasian Memory*: " - - - the other provisions of Div 13 of Pt 5.3A give a court wide powers to protect creditors during the administration."
[40] *Brash Holdings Ltd v Katile Pty Ltd* (1994) 12 ACLC 472 at 474: "an unusual section, which evidently proceeds on the view that Part 5.3A is inadequate in the provision which it otherwise makes for the new form of administration and that it is therefore necessary to enable gaps in the Part to be filled by the exercise by the court of wide powers - - - "
[41] (1995) 13 ACLC 469.
[42] [1970] VR 593 at 596
[43] A Keay & M Murray, Insolvency: Personal and Corporate Law and Practice (4th edition, Lawbook Co, 2002) p 509.

in the earlier edition of this text[44], Professor Keay made the further observation concerning judicial attitude in considering the broadly analogous Bankruptcy Act Part X[45] arrangements stating that:

> " - - - the courts have overwhelmingly taken the view that Part X leaves the decision to the creditors and the courts should not foist their opinions on the creditors."

With the views and position of creditors being of paramount consideration in deciding insolvency outcomes in the Australian corporate environment, it remains uncertain as to what practical considerations might be substituted in a courts assessment of the good faith and proper purpose of a restructuring proposal in a scheme modelled on Chapter 11 granting substantially greater moratorium protection to debtors that are practical, equitable and predictable to all participants.

The Courts have throughout applied a reference to well defined and articulated criteria. The increment in judicial discretion that would need to be applied to the scrutiny of director's good faith and proper purpose motives in proposing a financial difficulty induced corporate restructure, is potentially too great a gap given the importance and wide acceptance of these well established underlying principles.

2.6 Interrelationship between corporate recovery and other elements of the Australian insolvency regime

The contrasting comparatively structured approach to the judicial assessment of insolvency which provides an important adjunct to the insolvent trading penalties, serves a useful illustration of the relative cohesiveness present across each element of the Australian corporate insolvency regime. CPA Australia suggests that the safeguarding of this important characteristic needs to be carefully considered in any proposal for separate arrangements specific to the financial difficulty based reconstruction needs of enterprises having particular scale characteristics.

As noted in the Discussion Paper, the threshold criteria bringing a company within the ambit of availing of Part 5.3A protection is that of insolvency[46]. Notwithstanding the potential difficulty associated with its very limited statutory definition[47], the corresponding judicial approach to defining solvency is substantially more precise than the notion of good faith, and moreover, serves as a commercially realist underpinning to the various facets of the present Australian corporate insolvency regime. This "well-accepted approach laid down in the authorities" is comprehensively dealt with by Mandie J in *ASIC v Plymin, Elliott & Harrison* under the heading Insolvency[48] where he cites a number of cases, within the final of which the following remark of Young CJ is perhaps the most succinct:

> "Solvency and insolvency are defined - - - as meaning a company which is unable to pay all debts as and when they become payable. This - - - requires a cashflow test rather than a balance sheet test. - - - it will be seen that (this) proposition expounded is not only quite in accordance with authority, but is also good commercial and legal common sense."[49]

Similarly, the question of "reasonable grounds to suspect" contained in both the insolvent trading definition[50] and defences[51] is consist with various other aspects of solvency law, and more importantly, draws upon wider development in the understand of the changing scope of directors duties:

> "The existence of reasonable grounds - - - is an objective test. The standard of reasonableness is that of a director of reasonable competence - - - capable of reach a reasonable informed opinion about the financial capacity of the company. The enquiry whether there are reasonable grounds to expect the company will not be able to pay its debts when due is a factual one to be decided in the light of all the circumstances of the case. It is to be decided as a matter of commercial reality and thus requires a consideration of the company's financial condition in its entirety, - - - including its activities - - - and ability to raise capital."[52]

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[44] A Keay, Insolvency: Personal and Corporate Law and Practice (3th edition, John Libbey & Co, 1998) p 320.
[45] Arrangements with Creditors without Sequestration
[46] Section 435A – "The objective of this Part is to provide for the business, property and affairs of an insolvent company to be administered - - - "
[47] Section 95A.
[48] [2003] VSC 123 para 368 – 379.
[49] *Manpac Industries Pty Ltd v Ceccattini* [2002] NSWSC 330.
[50] s 588G(1)(c)
[51] s 588H(2)
[52] Per Finkelstein J, *Quick v Stoland Pty Ltd* (1998) 29 ACSR 130 at 142.

Particular elements of the insolvent trading structure of legislation are designed largely for the protection of unsecured creditors and contain "safe haven" provisions linked to the voluntary administration scheme.[53] These have contributed for some time to fewer insolvent trading cases being litigated.[54] Therefore, considerable caution should be taken in the introduction of Chapter 11 type arrangement that may erode either the current scope afforded to administrators to report on breaches of the Act[55] or which empower a liquidator to pursue compensation for the benefit of creditors.

The importance of these interrelated provisions can be further considered within the context of why it might be that Australian corporate legislation has for many years contained an insolvent trading regime (unlike the US bankruptcy scheme) that penalises directors of failed companies (for the benefit the general body of unsecured creditors).

The economic efficacy and market efficiency consequences of an insolvent trading censure of directors behaviour, has been debated extensively at least at an academic level, however the various themes are beyond the scope of this submission[56]. Suffice to say that the insolvent trading regimes serves an important role in reconciling the relative positions of secured and unsecured creditors providing to the latter group well established and predictable avenues for collective relief in the event of corporate collapse:

> " - - - at least in some contexts, there may be significant dangers of inefficient transfers of insolvency wealth from non-adjusting unsecured creditors to secured creditors or to those availing of quasi-security devices."[57]

As such, differentials in negotiating power shifts 'insolvency value' away from non-involved third party creditors whose size of interest and commercial power would not "justify the expense involved in adjusting terms."[58] Applied to the emphasis stated in the Discussion Paper that in the development of any alternative arrangements for the rehabilitation of large and complex enterprises there should be an objective of preserving the rights of security holders[59], **CPA Australia submits that careful consideration is thus also warranted to retaining in such arrangements appropriate protections for unsecured creditors.**

A final noteworthy basis upon which the regulatory intervention of insolvent trading is justified is in terms of public policy approaches to protect against the misuse for the corporate form. Also cited in the *Woodings* case mentioned above is the following:

> " - - - concern on the part of the court that an insolvent company or an insolvent individual does not have a potentiality of bringing harm to future (as well as, of course, to past) creditors."[60]

Such attitude has persisted in allowing solvency considerations to shape key elements in the reform of the current regulatory framework. To this end, within the current statutory framework under which business judgement is allowed for in any examination of directors' general duty of care and diligence, insolvent trading sits as a separate and distinct duty:

> " - - - a stricter and more specific duty than the duty of care and diligence in order to send a strong deterrent message to directors that insolvent trading will not be tolerated."[61]

Establishment of Chapter 11 debtor in possession type schemes, as indicated in the Discussion Paper at para. 1.38 (p 8) may affect creditors' assumptions about a particular corporate debtor's solvency.

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[53] Part 5.7B Division 3 Director's duty to prevent insolvent trading, s 588H Defences, sub-section (6) Relevant matters (b) – any action the person took with a view to appointing an administrator of the company.
[54] See for example Herzberg, "Why Are There so Few Insolvent Trading Cases?" (1998) 6 ILJ 77 particularly with reference to the impact of Pt 5.3A VA arrangements: "While a company is subject to a deed of company arrangement, no compensation recovery action can be brought against its directors for contraventions of s 588G" at p 83. The contrasting position of ASIC standing to initiate such proceedings whilst a deed is on foot is extensively dealt with and confirmed in *ASIC v Plymin, Elliott & Harrison* in Parts III and IV of Justice Mandie's judgement.
[55] Section 438D Reports by Administrator.
[56] See for example Mannolini, "Creditors' Interests in the Corporate Contract: A Case for the Reform of our Insolvent Trading Provisions" (1996) 6 AJCL 16 and Whincop, "The Economic and Strategic Structure of Insolvent Trading" in *Company Directors' Liability for Insolvent Trading*, I Ramsay (editor) (2000) CCH Aust & The University of Melbourne.
[57] Finch, "Security, Insolvency and Risk: Who Pays the Price?" (1999) 62 Mod LR 633 at p 668.
[58] Finch, "Security, Insolvency and Risk: Who Pays the Price?" (1999) 62 Mod LR 633 at p 644.
[59] 0.11 page vii of Introduction.
[60] *Re Denistone Real Estate Pty Ltd* [1970] NSWR 327 at 331 per Street J.
[61] Langford, "The New Statutory Business Judgement Rule: Should it Apply to the Duty to Prevent Insolvent Trading?" (1998) 16 C&SLJ 533 at 557.

The absence of adequate protections or disclosure may unduly delay independent assessment of directors' errant behaviour which should be subject to censure.

Furthermore, CPA Australia views possible procedures whereby directors remain in control as perhaps inconsistent with current regulator initiatives though targeted at small/medium enterprises, which are directed at ensuing higher levels of director awareness and compliance with insolvent trading obligations.[62]

[62] Refer 2003-04 Budget Paper No 2 ASIC corporate insolvency initiative $12.3m over four years.