KordaMentha

Rehabilitating Large and Complex Enterprises in Financial Difficulty

December 2003

The KordaMentha Research Unit
Paper 305

KordaMentha
Level 24, 333 Collins Street
GPO Box 2985
MELBOURNE VIC 3001
Telephone: 03 8623 3333

Table of Contents

Introduction

Thank you for the opportunity to make a submission to the Corporations and Markets Advisory Committee's ("CAMAC") review of the application of Part 5.3A of the Corporations Act 2001 to large and complex enterprises. CAMAC's September 2003 Discussion Paper represents a comprehensive review of the issues which arise in our day-to-day application of Part 5.3A to large and complex enterprises.

KordaMentha partners undertook the first voluntary administration in Australia, the largest voluntary administration in Australia (Ansett with 42 companies, 15,000 employees and >$1 billion assets), the largest group of voluntary administrations in Australia (Stockford with 84 companies) and more voluntary administrations than any other insolvency firm in Australia to date in 2003. We believe this experience makes us well placed to comment on both the practical issues associated with the conduct of an administration as well as CAMAC's policy options for reform.

The KordaMentha Research Unit has written a number of papers that are relevant to both the ongoing inquiry by the Parliamentary Joint Committee on Corporations and Financial Services and to CAMAC's review. We have appended relevant papers to this submission for your information. The first appendix is our analysis of the impact that Chapter 11 style insolvency laws would have had on the Ansett voluntary administration. A version of this paper was published as an open editorial article in the Australian Financial Review on 3 June 2003.

This submission represents a practitioner's perspective on a number of issues identified by both CAMAC and KordaMentha.

We have limited our submission to responding to issues where we believe legislative changes will have a significant, positive impact on the application of Part 5.3A to large and complex enterprises and will enhance the prospects of an enterprise continuing in existence or alternatively provide a better return to creditors and members than liquidation.

We believe that these changes will enhance the prospects of rehabilitating large and complex Australian enterprises and that separate rehabilitation procedures are not required for large and complex enterprises within Part 5.3A.

KordaMentha would welcome the opportunity to discuss the issues raised in this submission, as well any other issues, with the committee and provide further commentary if requested.

Use of the Court

There has been significant discussion and debate in relation to the role of the Court in the rehabilitation of large and complex enterprises and whether, amongst other suggestions, an increased Court role would facilitate more successful large and complex rehabilitations.

In US Chapter 11 rehabilitation procedures, where the debtor company is "in possession" or control of the rehabilitation process, the Court plays a significant role. By contrast, the Australian rehabilitation environment where creditors are effectively "in possession" through an independent insolvency expert, Court participation is available to stakeholders however its participation is not prescribed.

In our experience, Court involvement in voluntary administration falls into two broad categories:

i) Applications or directions that could be avoided by amending the regulatory framework to address a number of key issues such as the timing of meetings and the use of ipso facto clauses; and

ii) Applications or directions where there are more complex issues within administrations where Court rulings add certainty to the rehabilitation process and are a necessary and extremely valuable contributor to large and complex rehabilitations.

In the Ansett administration KordaMentha has made numerous applications to the Federal Court to date. There is no doubt that the sheer size and complexity of the Ansett administration validated the Court's role in the Australian voluntary administration regime. The attached KordaMentha Research Unit discussion paper 302 outlines some of the complex commercial issues we faced on the Ansett administration and how the Courts dealt with our applications on these issues.

The broad powers granted to the Courts under the Corporations Act and particularly under s447A, are essential to the effective and efficient rehabilitation of large and complex enterprises.

KordaMentha Recommendation 1

The role of the Court is a significant differentiating factor between the US Chapter 11 rehabilitation regime and the Australian voluntary administration process.

KordaMentha recommend the current approach to the role of the Court in the rehabilitation of large and complex enterprises.

Addressing issues identified in CAMAC's Discussion Paper (discussed below) will reduce the number of applications to the Courts and improve the overall efficiency of the voluntary administration procedure.

Ipso Facto Clauses

Ipso facto clauses represent a significant impediment to maintaining the trading operations and realising value for the assets of companies. In the Ansett administration, the presence of ipso facto clauses in the Sydney Airport terminal lease significantly complicated negotiations with stakeholders and potentially created a significant reduction in value. Significant issues were also experienced with other contracts such as leases and licences to operate (eg software licences) where creditors attempted to use these clauses to "greenmail" the administrators.

KordaMentha support a combination of the policy options identified by CAMAC in paragraphs 2.205 and 2.206 of the Discussion Paper. Our recommendation incorporates some but not all elements of our experience in relation to the Chapter 11 treatment of contractual obligations for Ansett's US subsidiary. Under Chapter 11, contracts are effectively frozen however a company may be required by the Court to provide evidence that they can honour post-petition contractual obligations which may include a requirement to place funds on deposit to support contractual obligations.

KordaMentha Recommendation 2

Overall, ipso facto clauses should not be enforceable as is the case under Chapter 11. We believe that freezing ipso facto clauses has the potential to significantly enhance a large and complex enterprise's prospects of rehabilitation.

Our recommendation does not apply to ipso facto clauses which enable the registered holder of a charge over the whole or substantially the whole of the property of a company under administration. This circumstance is adequately addressed by s441 of the Corporations Act.

We believe this is one of the most significant changes that need to be made to the existing operation of Part 5.3A.

Employee Entitlements

KordaMentha acknowledge that CAMAC does not seek to replicate the Parliamentary Joint Committee on Corporations and Financial Services' review of employee superannuation and other entitlements.

Employee entitlements and their treatment are critical to the prospects of rehabilitation for large and complex enterprises and, where these enterprises are not able to be rehabilitated, are critical to the timing and quantum of the return to creditors including employees. We believe that it is imperative that the issue of priority be clearly addressed to prevent a repeat of the uncertainty associated with superannuation and employee entitlements in the Ansett administration.

KordaMentha Recommendation 3

As we note in our analysis of the applicability of Chapter 11 to the Ansett administration (see appended KordaMentha Research Unit discussion paper 301) the limited priority given to employees in the USA enhances the chances that creditors will support a plan of rehabilitation. KordaMentha does not however, support the USA's treatment of employee entitlements.

We have attached the KordaMentha Research Unit's discussion paper 304 detailing our proposed changes to the employee entitlement regime. This paper will be submitted to the Parliamentary Joint Committee on Corporations and Financial Services.

In summary, KordaMentha propose that part of S556(1) relating to employee entitlements be amended such that:

- First Priority: employee entitlements equivalent to the GEERS entitlement. GEERS should be expanded to include unpaid SGC superannuation contributions calculated at the GEERS income cap.
- Second Priority: the balance of all remaining employee entitlements as a single claim, but calculated using the GEERS income cap.
- Unsecured: Balance of all other amounts owed (i.e. all employee entitlements which exceed the GEERS income cap will rank as unsecured).

NB – We believe this proposal should be phased in over a time period which enables both employers and employees to manage the transition and its impact on their entitlement balances and capital structure.

Could Chapter 11 have saved Ansett?

The KordaMentha Research Unit did extensive research on Chapter 11 procedures for airlines and whether it would have saved Ansett. A reprint of an article appearing in the Australian Financial Review 3 June 2003 is attached.

Our examination of Chapter 11 process in the US convinces us that such a system would not have saved Ansett. Ansett needed cash. The US government provided billions of dollars to the US airlines in Chapter 11. The New Zealand government saved Air New Zealand by an injection of cash in excess of $800m. The Australian government, as well as many other governments throughout the world, decided not to inject cash into faltering airlines.

Companies in Chapter 11, just like under voluntary administration, need cash and capital to trade during, and emerge from, Chapter 11. US Airways reorganised under Chapter 11 protection. US Airways' exit from Chapter 11 was facilitated by a US$900 million US government loan, the cancellation of all equity, 2¢ in the dollar to unsecured creditors, US$240 million of fresh equity, an injection of US$100 million of at-risk debt as well as annual wage and benefits concessions from employees of approximately US$1.9 billion a year. Additionally, priority for employee claims under Chapter 11 is limited to US$4,650.

With access to these concessions and additional capital, especially US$900 million of government funds, US Airways (or Ansett) could have reorganised under Australia's voluntary administration regulations.

Ansett traded for five months under administration. Ansett's trade-on was made possible by, amongst other things, significant EBA concessions, a $150 million settlement with Air New Zealand, federal government underwriting of passenger tickets, the continuing involvement of relevant management, significant cost cutting and fleet rationalisation.

Singapore Airlines and Patrick Corporation both considered recapitalising Ansett. The "Tesna" consortium committed to recapitalising Ansett. However, Tesna eventually chose not to proceed.

It is also worth noting, many Ansett businesses were sold and continue to operate. Kendell & Hazelton (now Rex), SkyWest, Aeropelican, Show Group and Ansett Cargo were all recapitalised and sold during the Ansett voluntary administration. The engine shop, simulator centre and engineering continue to operate and will also be sold.

Debt Financing

The availability of ongoing financing for a company in financial distress is often critical to its rehabilitation and, as was the case with the Ansett administration, may be critical to an administrator's ability to make timely payments to priority creditors.

In the Ansett *SEESA* case, the Court ruled that the Administrators had no personal liability for funds to be provided by the Federal Government. In the absence of personal liability (and therefore no indemnity out of the assets of the company) statutory priority is not available to financiers for funds loaned to voluntary administrators.

Debt financing is very difficult to obtain, even where sufficient assets exist, unless funds can be secured against unencumbered fixed assets or the court orders that funds will have priority. In some instances company assets must be sold quickly to raise funds to conduct an administration.

KordaMentha Recommendation 4

KordaMentha support the recommendation in paragraph 2.100 that debt financing be facilitated by ascribing the same priority to funds loaned to administrators as is presently ascribed to goods or services purchased by the company during the period of the administration.

Set-off

In KordaMentha's experience, as a direct result of creditor's set-off rights, creditors with both debit and credit balances are able to achieve a 100% return on that portion of their creditor position that is off-set by an amount owed to the entity in administration. Typically other creditors who do not have both debit and credit balances with the entity in administration will receive a lower return on their claim as a result.

Leaving aside the creditor priority issue, the set-off right is particularly detrimental to the chances of rehabilitation where a creditor exercises this right against the cash balances of an entity. Cash is critical to the chances of rehabilitation. The absence of access to cash in addition to the existing difficulties associated with raising debt financing combine to significantly diminish an entity's rehabilitation prospects. A consequential issue is that businesses may be unnecessarily discontinued or assets may be sold too quickly as a result of a lack of cash.

KordaMentha Recommendation 5

KordaMentha support the policy option in paragraph 2.171 which proposes a moratorium on set-off rights. This moratorium should extend until the conclusion of the second creditors' meeting.

Creditors should not have the ability to set-off debit and credit balances when a voluntary administrator is appointed.

Timing Issues

Australian courts have recognised that the time period contained in Part 5.3A is insufficient to allow the administration of large and complex enterprises in a manner which achieves the objectives of the Part. Recently, in the large and complex administration of the Newmont Yandal group of companies, KordaMentha applied for a s439A extension. Merkel J granted an extension to the convening period and noted that:

"The authorities have consistently cautioned about extensions of time but have always made an exception in respect of cases where it's established on the evidence that the administration is large and complex …"

The court also granted a s439A extension in both the Ansett and Pasminco administrations.

Whilst the timeframe prescribed by Part 5.3A is evidently too short for the rehabilitation of large and complex enterprises a continued focus on rapid resolution is a sound principle when rehabilitating companies. KordaMentha support and recommend the continued existence of and use of s439A.

KordaMentha Recommendation 6

KordaMentha support CAMAC recommendations 2 and 6 in CAMAC's 1998 report on Corporate voluntary administrations and further support the suggestion in policy option 2.74 that creditors should have the opportunity to extend the convening period at their first meeting.

We believe that the creditor's right to extend the convening period should be limited to a period of up to 3 months post appointment, which may then be extended again at the discretion of the Court.

Post Appointment Liability

KordaMentha does not want to appear to be self-serving in relation to an administrator's personal liability for goods and services purchased during an administration.

KordaMentha believe however, that it is important to note that the existence of broad personal liability in large and complex administrations, where continued trading involves millions of dollars, creates a natural aversion to continuing the operations of the business.

The first voluntary administrators of Ansett grounded the fleet. In making this decision we believe the administrators would have considered the sheer size of their personal liability (which may easily have exceeded $100 million) the short time available to make a risk assessment and, the risk associated with the complexity of the industry in a post September 11 environment. There would have been understandably a natural aversion to personal liability in this context.

KordaMentha Recommendation 7

Personal liability of administrators is a complex and emotive issue.

In other industries such as the professional services and medical industries it has been recognised that a level of risk limitation or capping is required to attract and retain high calibre professionals.

The issue of an administrator's personal liability should be reviewed to determine whether a new process can be implemented which:

- continues to hold administrators accountable for their actions; and
- which decreases or removes an administrators natural aversion to liability in the context of the rehabilitation of large and complex enterprises.

Grouping of Complex Entities

In our experience, large and complex enterprises such as Ansett, Newmont Yandal and Stockford typically have complicated group structures that may or may not incorporate cross-guarantees which may be ASIC approved. CAMAC's *Corporate Groups Report* recommended that administrators have the ability to pool the administration of group companies in the absence of creditor or court opposition.

We also note, usually groups are run by management with little regard to them as separate legal entities. This results in many issues, most unintended arising on insolvency such as:

- centralised treasury function results in no cash in operating entities,
- employees in companies but operations in different companies making the administration much more complex, difficult and expensive,
- holding companies (eg Air New Zealand) that remove wholly owned subsidiaries, and
- difficulty in apportioning assets sold that have been viewed as group assets ie intellectual property.

KordaMentha Recommendation 8

KordaMentha believes that all related wholly owned companies should be automatically grouped unless they apply to ASIC to be ungrouped. i.e. currently companies opt in to grouping via cross deeds of guarantee, they should be grouped unless they opt out.

We note that recent changes to company "consolidations laws" for taxation purposes, that the tax liability is joint and several for all group companies, unless a company opts out. We recommend the same.

KordaMentha also support CAMAC's recommendations referred to in paragraph 2.181 and the recommendations contained in paragraph 2.188 of the September 2003 Discussion Paper.

Dealing with Equity

KordaMentha supports the proposal in paragraph 2.138 of the Discussion Paper namely that equity for debt offers to creditors made under a Part5.3A deed of company arrangement should be exempt from the disclosure requirements of Part 6D.2. The US Chapter 11 process frequently incorporates an equity for debt swap to facilitate the restructuring of a company in order to exit Chapter 11 especially as a means to address employee entitlement liabilities.

A further issue in relation to equity that is not specifically addressed in the Discussion Paper is an administrator's ability to deal with existing shareholder equity. Typically this limitation results in the sale of business assets rather than equity when restructuring large and complex enterprises. The sale of business assets rather than equity may result in a reduction in total consideration realised as a result of stamp duty costs and, in the case of the restructuring of an ASX-listed entity, an inability to realise full value from the entity's listed status.

KordaMentha Recommendation 9

Where a deed of company arrangement or business sale results in a return to creditors of less than 100 cents in the dollar the administrator should have broad power to deal with the entity's equity in order to maximise the return to creditors.

This broad ability may incorporate a "cancellation" or "deemed transfer" which would have the added benefit of immediately crystallising a capital loss that may represent a tax benefit for existing shareholders.

Branding and Perception

In our experience, the use of voluntary administrations has been well received in what is a very difficult area. In fact, liquidation and provisional liquidation are now seen as very negative. In certain instances voluntary administration is also seen more positively than a receivership.

Many American brands, practices and culture are well known to the world. Chapter 11 is one example. It is also embedded in Amercian business and every day language.

We believe for insolvency laws to be generally accepted by the public, they must be managed and nurtured like any product or brand. For example, "Part 5.3A – Administration of a company's affairs with a view to executing a deed of company arrangement" is hardly conducive to branding.

KordaMentha Recommendation 10	Stakeholders consider the appropriate positioning and branding of insolvency laws to support the objective of Part 5.3A which is to maximise the chances of the company, or as much as possible of its business, continuing in existence.

Other Issues

CAMAC's September 2003 Discussion Paper identified numerous important issues which we have not specifically addressed in this submission e.g. fee approvals, committee of creditor roles and disclosures. KordaMentha do not wish to duplicate commentary provided in other submissions such as the IPAA submission.

About The KordaMentha Research Unit

Background

KordaMentha partners undertook the first voluntary administration in Australia, the largest voluntary administration in Australia (Ansett with 42 companies, 15,000 employees and >$1 billion assets), the largest group of voluntary administrations in Australia (Stockford with 84 companies) and more voluntary administrations than any other insolvency firm in Australia to date in 2003.

The strength of the KordaMentha experiences and our expertise makes us well placed to monitor and evaluate issues and developments in the insolvency industry and to recommend changes.

Statement of Direction

The KordaMentha Research Unit aims to:

- Develop intellectual property
- Share our knowledge of specialist topics with insolvency stakeholders
- Develop balanced solutions for issues in the industry. We will do this by preparing position papers on topics of interest, and encouraging discussion with a view that changes to the industry will result.

Personnel

The KordaMentha Research Unit is headed by Leanne Chesser. All KordaMentha Partners and Directors contribute to the KordaMentha Research Unit.

Current Research

The KordaMentha Research Unit has conducted research in a number of areas, including:

- 301: Ansett - Part 5.3A and Chapter 11
- 302: Large and Complex Administrations – The Courts and Ansett
- 303: Regulatory Review of Australia's Insolvency Laws
- 304: Employee Entitlements
- 305: Rehabilitating Large and Complex Enterprises in Financial Difficulty