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Helping Companies Restructure by Improving Schemes of Arrangement

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Closing date for submissions: 10 September 2021

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The principles outlined in this paper have not received Government approval and are not yet law. As a consequence, this paper is merely a guide as to how the principles might operate.

Helping companies restructure by improving schemes of arrangement

Introduction

The Government is committed to facilitating the successful restructure of companies, including those impacted by COVID-19, so that they can survive and go on trading.

In September 2020, the Government announced changes to Australia's insolvency framework to better serve Australian small businesses, their creditors and their employees.

These reforms, which came into effect on 1 January 2021, introduced new insolvency processes suitable for small businesses, reducing complexity, time and costs. Complementary measures were also enacted to ensure the insolvency sector can respond effectively to any increased demand and to the needs of small businesses.

Following the commencement of the small business reforms, the Government is exploring further insolvency reform to help larger companies in distress to reorganise and survive, while further reducing regulatory burden for business. The intent is to complement the Government's existing small business reforms, ensuring more companies can benefit from improvements to insolvency law.

Schemes of arrangement have been identified as one area for improvement. A creditors' scheme of arrangement is a corporate restructuring process regulated under Part 5.1 of the *Corporations Act 2001* (the Corporations Act). It has been used to help financially distressed but solvent companies restructure their balance sheets, and to avoid voluntary administration and liquidation.

Reforms around schemes of arrangement could further support the use of this process as a means of restructuring more severely distressed companies. As a scheme proposes a restructured solvent outcome, and does not involve the removal of the board from management and control or the appointment of administrators or liquidators, the impact of the process is less disruptive than voluntary administration and potentially less damaging to the reputation of the company and its directors.

Reform could further support business, particularly larger businesses, to reorganise and survive. In turn, this could benefit employees, creditors and suppliers, and make Australia a more attractive place to do business.

In particular, this consultation will explore whether the lack of a moratorium during the consideration and formation of a scheme is impacting the utility and usefulness of schemes as a means of restructuring insolvent companies. Currently, there is no automatic moratorium on creditor enforcement actions that is applied during the formation of a scheme of arrangement. This is a key difference from other restructuring processes for insolvent companies like voluntary administration, where a moratorium is automatically applied to give the company breathing space during the process.

The paper will also seek input on whether other improvements to schemes of arrangement could be made.

The Government remains committed to further simplifying and streamlining insolvency law so that viable businesses that do encounter economic challenges have the opportunity to restructure and go on trading. To achieve this, the Government will also:

- Consult on clarifying the treatment of trusts with corporate trustees under Australia's insolvency law.

- Increase the minimum threshold at which creditors can issue a statutory demand on a company from $2,000 to $4,000, commencing 1 July 2021.
- Commence an independent review of the insolvent trading safe harbour.

These will build on the progress of the small business reforms, promoting a flexible and streamlined insolvency system. These other measures will be progressed separately to this consultation process.

Request for submissions

Written submissions are sought from stakeholders on the issues raised in this discussion paper. Submissions may be provided until 10 September 2021. Discussion questions are included to guide feedback. However, stakeholders are welcome to provide further information and suggestions relevant to the issue.

Creditors' scheme of arrangement

What is a creditors' scheme of arrangement?

A creditors' scheme of arrangement is a process available to financially distressed companies seeking to restructure and avoid liquidation. A scheme allows for the creation of a binding agreement between the company and its creditors (or a class of creditors). This modifies the pre-existing legal rights of both parties to allow the company to continue trading.

The process involves a Court-approved compromise or arrangement to vary the terms of debts or claims between the company and a class (or classes) of creditors. This may involve restructuring the debt owed to affected creditors, allowing for interest free periods, payment by instalment over an extended period of time, or debt for equity swaps.

There are two broad types of schemes of arrangement: creditors' schemes (which are used to restructure the debts of a financially distressed company) and members' schemes (which are typically used to effect the takeover of a company). It should be noted that a creditors' scheme may impact a company's members as well as its creditors, depending on the scope of the proposal.

The matters explored in this paper are relevant to creditors' schemes affecting financially distressed companies only.

The process to make a creditors' scheme

Unlike Deeds of Company Arrangement, which must follow on from voluntary administration, schemes can be entered into without separately entering other insolvency processes.

Before a scheme is entered into, the company must prepare an explanatory statement that sets out the purpose of the scheme and the compromises which the scheme would effect. It also sets out the powers of the scheme administrator (the party that oversees the scheme), where relevant. The explanatory statement must also set out the expected dividend that would be available to scheme creditors if the company were to be wound up within 6 months after the date of the first Court hearing.

The company must inform ASIC about the terms of the proposed scheme and provide it with the draft explanatory statement. This must occur at least 14 days in advance of the first Court hearing (unless the Court or ASIC permits a shorter period). This allows ASIC to examine the terms of the scheme and make submissions to the Court.

The first Court hearing involves the Court determining whether to make an order convening creditors' meetings. Once a Court grants an order convening these meetings, the creditors will vote on the proposed scheme.

To approve a scheme, a majority of creditors who are present and voting (either in person or by proxy) must vote in favour of the scheme. The debts and claims owed by those voting to approve the scheme must also constitute at least 75 per cent of the total debts or claims. Where multiple classes of creditors are affected by the scheme, the requisite majorities must be obtained for each class.

If creditors resolve to approve the scheme, a second Court hearing is convened to consider whether or not the scheme should be approved by the Court. In doing so, the Court considers whether the scheme is fair and reasonable, among other considerations.

A scheme typically takes between three to six months to implement. However, this can vary depending on its size and complexity.

The utility and uptake of creditors' schemes

Schemes provide significant flexibility in how the rights and liabilities of creditors (and sometimes members) of a company are reorganised. This provides for greater flexibility in terms of the restructure a company may undertake, which could enhance the prospects for a company's survival. Unlike voluntary administration, a scheme also allows the company's directors to retain control of the company during the process, and to put a proposal directly to its creditors. This may help prevent disruption and uncertainty, as well as limit the loss of value associated with entering other insolvency processes.

However, schemes are not often used relative to other insolvency processes. ASIC data shows that the number of scheme administrators appointed in recent years remain low: two in 2019-20, one in 2018-19, and three in 2017-18.[1] For comparison a total of 10,063 insolvency processes were entered into in 2019-20.[2]

The Productivity Commission, in its 2015 report, 'Business Set-Up, Transfer and Closure', noted that the formality of the process means that schemes were typically used in relation to more complex restructurings involving larger businesses. Submitters to the report noted that the high level of Court involvement could mean schemes were costly and time-intensive. However, it was also noted that this was appropriate to ensure that creditor interests were protected given the flexibility embedded in the process.

The Productivity Commission also noted issues associated with the lack of an automatic moratorium on creditor actions during the formation of a scheme. While the Court can grant a moratorium once a scheme is 'proposed', there is no guarantee that the Court will do so which may create uncertainty and ultimately affect the utility of the process. This sets schemes apart from other insolvency processes like voluntary administration and small business debt restructuring, both of which automatically apply wide protections against creditor actions upon the commencement of the process.[3]

The Commission recommended that the Corporations Act be amended to create a moratorium on creditor enforcement during the formation of schemes of arrangement and that this moratorium be aligned with the approach used in voluntary administration. It also recommended that Courts be given the explicit powers to lift all or part of the moratorium in circumstances where its application would lead to unjust outcomes.

Improving the effectiveness and uptake of schemes

Automatic moratorium

As noted, the Productivity Commission found that an automatic moratorium may enhance the utility of schemes by allowing a company and its creditors the breathing space to create a binding agreement to ensure that restructure of economically viable companies is not disrupted by a minority of creditors. The Commission considered that this moratorium should be aligned with the moratorium that currently applies in relation to voluntary administration.

[1] https://asic.gov.au/regulatory-resources/find-a-document/statistics/insolvency-statistics/
[2] https://asic.gov.au/regulatory-resources/find-a-document/statistics/insolvency-statistics/
[3] These moratoriums prevent unsecured creditors from commencing or continuing enforcement action against the company without the permission of the Court or external administrator. They also limit the ability to enforce some property rights during the processes. Note that a stay on 'ipso facto' clauses applies to schemes of arrangements, limiting the ability of parties to exercise termination, suspension and other contractual rights for reasons related to the scheme.

During a voluntary administration, the moratorium is imposed upon the appointment of the voluntary administrator. During a scheme, there is no equivalent transfer of the administration of the company from its directors to an external administrator.

The earlier an automatic moratorium is provided, the more effective it will be in providing 'breathing space' to the financially distressed company. However, this needs to be balanced with any impact on creditor rights, the need for creditors to be appropriately informed, and the need for the moratorium to be targeted toward genuinely distressed companies seeking to make a scheme.

Likewise, consideration needs to be given to the appropriate duration of any automatic moratorium, particularly given the length of the process. Existing court hearings may provide the opportunity to assess whether to terminate or extend a moratorium.

A financially distressed company may not obtain the full benefits of any automatic moratorium if its directors are concerned that trading the business during the scheme process may expose them to personal liability for insolvent trading. The Corporations Act presently contains safe harbour provisions which provide directors with protection from insolvent trading liability where they are pursuing the restructure of the company, provided certain conditions are met. The new small business restructuring process contains an additional protection where directors are trading in the ordinary course of business.

Question 1: Should an automatic moratorium apply from the time that a Company proposes a scheme of arrangement? Should the automatic moratorium apply to debt incurred by the Company in the automatic moratorium period?

Question 2: Would the moratorium applied during voluntary administration be a suitable model on which to base an automatic moratorium applied during a scheme of arrangement? Are any adjustments to this regime required to account for the scheme context? Should the Court be granted the power to modify or vary the automatic stay?

Question 3: When should the automatic moratorium commence and terminate? Are complementary measures (for example, further requirements to notify creditors) necessary to support its commencement?

Question 4: How long should the automatic moratorium last? Should its continued application be reviewed by the Court at each hearing?

Question 5: Are additional protections against liability for insolvent trading required to support any automatic moratorium?

Question 6: What, if any, additional safeguards should be introduced to protect creditors who extend credit to the Company during the automatic moratorium period?

Question 7: Should the insolvency practitioners assisting the Company with the scheme of arrangement be permitted to act as the Voluntary Administrators of the Company on scheme failure?

Other issues

In its working paper, Flattening the Insolvency Curve: Promoting Corporate Restructuring in Asia and the Pacific in the Post-C19 Recovery, the IMF notes that Australia's schemes of arrangement process could be improved by, among other things, enabling cross-class cram down.

Currently, when a proposed scheme affects multiple classes of creditors, the requisite majority approval must be obtained from each classes for the scheme to be approved. This requires a majority in number and at least 75 per cent by value of creditors (or creditors of each class) present and voting (in person or by proxy). However, corresponding processes in other jurisdictions have different thresholds or include a 'cross-class cram down' mechanism, meaning not all classes of creditors are required to support a scheme for it to be approved.

Some other jurisdictions also make provisions for 'debtor-in-possession' or rescue financing for distressed companies. They do so, for example, by enabling priority of payment to creditors providing this finance if the company enters liquidation. While this may support successful restructure, enabling debtor-in-possession financing may impact other creditors and the terms upon which they provide credit.

Other issues may need to be considered when examining improvements to schemes. For example, issues around cross-border enforcement may affect the utility of a scheme where multiple jurisdictions are involved. It may also be necessary to consider the impact of any improvements on particular parties (e.g. creditors) or programs (e.g. the Fair Entitlements Guarantee program).[4] This may particularly be the case where schemes involve inter-group asset and liability transfers, as this could result in unmet liabilities being left behind in entities that are wound up, while other entities in the group continue to trade.

Question 8: Is the current threshold for creditor approval of a scheme appropriate? If not, what would be an appropriate threshold?

Question 9: Should rescue, or 'debtor-in-possession', finance be considered in the Australian creditors' scheme context?

Question 10: What other issues should be considered to improve creditors' schemes?

Question 11: Are there any other potential impacts that should be considered, for example on particular parties or programs? If so, are additional safeguards required in response to those impacts?

[4] The Fair Entitlements Guarantee program, established under the *Fair Entitlements Guarantee Act 2012*, operates as a scheme of last resort to fund certain outstanding employee entitlements for former employees whose employment has ended as a result of their employer's insolvency or bankruptcy.