Australian Government: The Treasury

Consultation Paper

Helping Companies Survive by Improving Schemes of Arrangement

Submission by Ashurst Australia

Introduction

The Australian Government through the Treasury has issued a Consultation Paper; "Helping Companies Restructure by Improving Schemes of Arrangement" dated 2 August 2021.

The Paper seek submissions concerning the improvement of Schemes of Arrangement since:

> "*Reforms around [schemes] could further support the use of this process as a means of restructuring more severely distressed companies"*

The Paper identifies a number of possible areas of reform including:

(a) Automatic Moratorium;

(b) Continuing role advisers who are Insolvency Practitioners

(c) Cross-class cram down;

(d) Protection of Directors

(e) "Debtor-in-possession" financing; and

(f) Cross-border enforcement of schemes.

In addition to these possible areas of reform we will also submit that consideration should be given to the position of "out-of-the-money shareholders".

The *Harmer Report* made critical comment on the role of the Court in relation to Schemes of Arrangement; ALRC 45, [46]. We do not consider it to be necessary for there to be reform to this aspect of the process of approving Schemes of Arrangement. However, we do make a submission in relation to the possibility that the Court might not have a continuing role in that process. [what is this a reference to? – the role of the Court or out of money stakeholders]

An automatic moratorium

A threshold issue?

The Consultation Paper does not elucidate the issues which are sought to be resolved by the introduction of an automatic moratorium.

It would be useful in the context of a discussion of any proposed reforms if these issues could be ventilated.

Against those possible issues, one concern which we have with the introduction of such a moratorium is that it may adversely affect the capacity of a company to continue to operate. In this regard, it is our experience that most, if not all, schemes involve negotiations with sophisticated creditors, such as the company's financiers. In such circumstances, the company's trade creditors are dealt with and paid in the ordinary course on the basis that their interests will not be the subject of any proposed compromise or arrangement. If, however, their claims become subject to an automatic moratorium, it is to be expected that the terms on which they will deal with the company are likely to be adjusted, including by requiring to be paid on a c.o.d. basis. As we have noted, such developments may impact the company's continued operations pending the implementation of a scheme.

With these comments in mind our submissions below proceed upon the premise that the Government is satisfied that there is a need to provide for an automatic moratorium when a company is proposing a scheme of arrangement.

What event should trigger the moratorium?

There are two possibilities as to the events which, in our **submission**, should trigger a moratorium:

(a) in the case of a listed public company which has continuous disclosure obligations, when it announces that it will be applying for orders to convene a scheme meeting; or

(b) in the case of all other companies, when the summons for orders convening the scheme meeting is filed.

Each of the options has the merit of being independently ascertainable. Beyond that, it can reasonably be expected that at those times the scheme documentation and, in particular, the commercial elements of the scheme will have been finalised or, at least, substantially so. In the absence of there being some reasonable degree of certainty concerning that circumstance, there is the risk that the opportunity of triggering moratorium on creditors' claims could be used for no better purpose than frustrating the prosecution of those claims.

Even if there is to be an automatic moratorium, there may still be cases where an ability to apply earlier in time for injunctive relief under s411(16), *Corporations Act* will have utility; see, eg, *Boart Longyear Limited* [2017] NSWSC 537. That case and the earlier decisions to which it refers illustrate examples of creditors seeking to take pre-emptive action when they learn of the possibility that a creditors' scheme is to be proposed by a company.

In our **submission** that sub-section should be amended, in any event, with a view to clarifying:

(a) whether it applies to current proceedings or only prospective or foreshadowed proceedings;

(b) whether it applies to the enforcement of their contractual rights by either a secured creditor or the owner of property in the possession of the company; and

(c) whether it applies to an order restraining an individual creditor or whether an order can be made under the subsection which applies to proceedings by all creditors.

To whom should the moratorium apply?

Pre-Moratorium Creditors

The Government's stated policy objective in pursuing the reform is:

> "*Simplifying and streamlining insolvency law so that viable businesses that do encounter economic challenges have the opportunity to restructure and go on trading.*"

In that context and given the need for the company to continue to operate while the terms of the Scheme of Arrangement are negotiated and refined, should the moratorium apply to:

(a) secured creditors; and

(b) owners and lessors of property in the possession of the company?

If so, should that be the case irrespective of whether the proposed scheme will bind them? Indeed, should the moratorium bind all creditors irrespective of whether the proposed scheme will bind them?

On balance, our view is that there should be some flexibility for the company to exempt certain classes of creditors from the moratorium in order to preserve goodwill and credit support as required.

Clearly, the Government's policy objective may not be achieved if the moratorium did not apply to creditors of that kind. Equally, if a company was to exploit the opportunity of obtaining relief by way of a moratorium when those creditors had commenced enforcement proceedings, would that involve conduct which was at least oppressive? Of course, any such limitation on the rights of creditors, particularly those with a charge over the whole of a company’s property, would be a significant departure from the traditional approach to allowing the exercise of those rights.

In our **submission**, though, the regime which applies in the context of the Voluntary Administration process is now a well-accepted model in the landscape of Australia’s insolvency laws and could well be adapted to apply in the circumstance where a Scheme of Arrangement is being proposed. That regime does apply (with certain exceptions) to secured creditors and owners and lessors of property. Those exceptions include the possibility of a secured creditor with an enforceable charge over the whole or substantially the whole of a company’s property enforcing its charge within 13 business days of being notified of the commencement of a voluntary administration. That exception should apply during any automatic moratorium. Additionally, as we have mentioned, the company should have the flexibility to exempt certain classes of creditors from the moratorium. That is analogous to a similar authority which can be exercised by a voluntary administrator.

It might be noted that that regime also applies to the suppliers of essential services beyond precluding them from pursuing their claims by requiring them, additionally, to continue to supply their services to the company without requiring it to pay pre-appointment debts.

Importantly, that regime provides the company with the “breathing space” which it needs to negotiate the detail of a restructuring plan whilst at the same acknowledging that there may be circumstances where creditors either have commenced enforcement proceedings or should be permitted, with the leave of the Court, to exercise their rights.

Post-Moratorium Creditors

As with Voluntary Administration, it is **submitted** that the moratorium should not apply to creditors to whom debts or liabilities are incurred once the moratorium has commenced. Their position should be further protected by excluding them from the classes of creditors whose claims can be bound by a Scheme of Arrangement.

Beyond that, though, it is **submitted** that creditors to whom debts are incurred after the commencement of the moratorium are in a position where they should take such steps as they consider appropriate to protect their position without the Act conferring any particular benefit or protection upon them.

It follows, in our **submission**, that in order to promote certainty and awareness of the effect of the moratorium, companies (particularly unlisted companies) should be required to publish a notice concerning the commencement of the moratorium and its effect.

Should the period of the moratorium be limited?

Given the impact of any moratorium on the exercise by creditors of their rights, in our **submission**, there should be a time limit during which the moratorium would operate, at least in the first instance. By reference to international practice, there could be an automatic moratorium of 30 days once the scheme application is filed, as is the case in Singapore, or 20 business days, which is the period of the moratorium applicable under the UK legislation. However, the Court should have a power, in appropriate cases, to extend the period of the moratorium.

In the absence of such a limitation, there is always the risk that a company could abuse the option of availing itself of the moratorium merely to delay the pursuit by its creditors of their claims against it.

Protection of Directors

Do the provisions giving directors defences from claims on account of insolvent trading need to be clarified or strengthened?

Much is made of Chapter 11 of the United States Bankruptcy Code by at least some protagonists for insolvency law reform.

One aspect of the regime established by that Chapter is that the company's management remain in control of its affairs.

It is the case in Australia, as the Consultation Paper acknowledges, that one of the attractions of Schemes of Arrangement is that the directors of the company remain in office as such and its management continue to be responsible for the operation of its business whilst the terms of the Scheme are being developed and during the process of its approval.

That circumstance has been supported by the introduction of the "safe-harbour defence" to any prospective insolvent trading claim.

The Consultation Paper asks whether there should be further or other protections available to directors to protect against liability for insolvent trading.

It is our **submission** that, for the time being at least, nothing further is required by way of substantive amendments to the *Corporations Act* to further protect directors from claims on account of insolvent trading. In this regard, we note that independently of the review of Schemes of Arrangement, there is a concurrent review of the safe harbour defence.

If the moratorium does not apply to debts incurred post the commencement of the moratorium (as we submit should be the case), the company will need to ensure that these debts are paid and the creditors are able to decide whether to continue dealing with the company or not.

Additionally, consideration might also be given as to whether transactions with third parties undertaken in advance of a scheme which are also part of a restructuring plan and which might otherwise be creditor defeating dispositions should be protected by a safe harbour defence. So, take the examples of the expeditious sale of the one of the company's businesses which is only operating at marginal profitability or a "fire sale" of its stock where, in each case, a purpose of the transaction was to provide finance while the company develops a restructuring plan. In those and other like circumstances it is our **submission** that there should be a safe harbour defence available to a claim on account of a creditor defeating disposition along with the other usual defences.

Insolvency Practitioners

The Consultation Paper asks whether Insolvency Practitioners who assist a company with the formulation and propounding of a Scheme of Arrangement could have a continuing role in the event that the Scheme fails and the company is liquidated or enters Voluntary Administration.

It is our **submission** that the present provisions of the *Corporations Act;* s.532 and s.483C, provide a sufficient balance between, on the one hand, allowing for the ongoing services of a practitioner who is familiar with the company and, on the other, ensuring that a practitioner either who does not have or who may not be perceived as having a sufficient degree of independence does not have a continuing role; see, eg, *Re Ten Network Holdings Ltd* [2017] FCA 914.

Subject to the nature of the insolvency practitioner's involvement and retainer, in our view it would be generally appropriate, subject to obtaining the leave of the Court, for that practitioner to be able to be appointed as the voluntary administrator if the Scheme failed (noting that creditors have the right to replace the administrator at the first meeting of creditors if they wish).

Class rules

Should the class rules be reviewed?

The Consultation Paper acknowledges that a problematic issue which can present itself when a scheme is being propounded is the need to segregate creditors into classes. Such a circumstance presents itself when the interests of creditors to be bound in either scheme:

> "… *are so dissimilar as to make it impossible for them to consult together with a view to their common interest*."; *Sovereign Life Assurance Co v Dodd* [1892] 2 QB 573 at 583.

A countervailing consideration has been recognised to the extent that:

> "*To break creditors up into classes, however, will give each class an opportunity to veto the scheme, a process which undermines the basic approach of decision by large majority, and one which should only be permitted if there are dissimilar interests related to the company and its scheme to be protected.*"; re *International Harvester (Aust) Ltd* (1983) 7 ACLR 796 at 799

That circumstance is explained by the requirement that, where creditors are divided into classes, each class must approve the scheme by a majority in number representing 75% in value are those creditors attending and voting at the scheme meetings.

Recent reforms in each of the United Kingdom and Singapore, both described as "class cram down rules", have sought to ameliorate the effect of the class rules and provide models for possible reform in Australia.

Under the UK reforms, the court is given a discretion to approve a scheme, notwithstanding that there is a dissenting class or classes, if:

(a) the members of the dissenting class would be no worse off than they would be if, say, the company was liquidated; and

(b) those members of at least one class which had an economic interest in the scheme had approved it by the statutory majority.

Somewhat more detailed provisions are to be found in the Singaporean legislation, although their commercial effect is substantially the same.

In our **submission**, the UK model should be adopted in Australia as it represents a fair balance between protecting the interests of differing classes of creditors whilst, at the same time, eliminating the risk identified in the *International Harvester* decision that the members of any one class could veto a proposed restructuring.

Presumably, in most cases anyway, the "no worse off test" would involve a comparison between the return to creditors under the scheme and the return which they would receive in a liquidation, although this might desirably be made plain by any legislative amendment. Alternatively, in our **submission** it would be preferable to use the test of "unfair prejudice" which is found in s.445D(1)(f)(i), *Corporations Act*, which has a settled meaning; see, eg, *Lam Soon Australia Pty Ltd v Molit (No 55) Pty Ltd* (1996) 70 FCR 34.

Without reforms of this nature, creditors schemes will remain a limited tool to manage a minority objection of a particular class of creditors rather than a vehicle to give effect to whole of company restructures.

"Debtor-in-possession" Financing

As the Consultation Paper recognises, there are "*some other jurisdictions [which] also make provisions for 'debtor-in-possession or rescue financing for distressed companies*". The question is raised as to whether such provisions should be introduced into Australian law.

It is almost certainly the case that a distressed company which is seeking to restructure its financial affairs by way of a Scheme of Arrangement where its directors and management remain in control will require access to finance beyond that already available to it. This will particularly be the case once an automatic moratorium is initiated.

That will be so albeit that that need might be mitigated to some extent:

(a) if, as we have submitted, the claims of post-moratorium creditors are not bound by the Scheme of Arrangement; and

(b) by the moratorium operating to preclude the claims of existing creditors being prosecuted.

Against that, it will be reasonable to expect that suppliers will impose tighter credit controls and may require payment on a c.o.d. basis. Additionally, of course, employees will still have to be paid. Likewise, tax liabilities will have to be discharged.

It is our **submission** that a reasonable balance can be struck by the following means:

(i) unlike voluntary administrators, directors should not be personally liable for debts incurred during the moratorium for so long as either the company is solvent or they can establish a defence to an insolvent trading claim including a safe-harbour defence;

(ii) subject to the same exception as applies in a Voluntary Administration, the security arrangements made by existing creditors should not be able to be displaced;

(iii) in the same way and on the same terms that voluntary administrators can look to circulating assets as a source of indemnity for debts which they incur, a company which is propounding a Scheme of Arrangement should be able to charge its circulating assets to secure finance raised to pay debts incurred during the course of a moratorium;

(iv) where there is existing security over a company's assets, the company should be able to give later-ranking security over those assets to secure finance raised to pay debts incurred during the course of a moratorium and, if necessary, have standing to apply to the court for leave to do so in the event that an existing security holder either refuses its consent to the grant of such security or declines to provide additional funding on similar terms to those offered by an alternate funder; and

(v) where a company has given a negative pledge to creditors and, in particular financiers, by which it has agreed not to grant security over its assets, then, as with the case where there is existing security, the company should be able to give security over its assets to secure finance raised to pay debts incurred during the course of a moratorium and, if necessary, have standing to apply to the court for leave to do so in the event that the creditors who have the benefit of the negative pledge refuse their consent to the grant of such security.

Cross-border Recognition of Schemes of Arrangement

The Consultation Paper raises the possibility that, when considering improvements to Schemes of Arrangement, attention might need to be given to their cross-border enforcement. A threshold issue, of course, in the context of any such consideration is the circumstance that the recognition of an "Australian Scheme" in other jurisdictions cannot be brought about by Australian legislation.

It is our **submission** that the provisions of s.581, *Corporations Act* and the *Cross-Border Insolvency Act* 2008 are adequate for that purpose, including in the circumstance that there is an automatic moratorium; see, eg, *re Boart Longyear Limited* [2017] NSWSC 537.

Australian schemes have often been recognised in the United States under Chapter 15 of its Bankruptcy Act.

"Out of the Money" Shareholders

Should a creditors' scheme be able to bind "Out of the Money" Shareholders?

As with the claims of subordinated creditors; s411, *Corporations Act* and shareholders in the case of a Deed of Company Arrangement; s444GA, *Corporations Act*, it is **submitted** that "Out of the Money" Shareholders should be able to be bound by a Scheme of Arrangement without it being necessary for there to be a members' scheme.

A provision to that effect could provide for either the cancellation or transfer of their shares. Of course, in the case of a listed public company, it would be necessary for it to continue to comply with the ASX's Listing Rules if its shares were to continue to be able to be traded on the Exchange.

Role of the Court

Should the Court have a continuing role in approving schemes?

As already noted above, one of the bases for the criticism of Schemes of Arrangement which was made in the *Harmer Report* concerned the necessary involvement of the Court in the approval process for Schemes and the attendant cost.

Against that criticism, an advantage of a Scheme of Arrangement when compared with a Deed of Company Arrangement is that, as a Scheme operates as an order of the Court, once it has been approved it is not open to challenge once the relevant appeal period has expired. For example, this was a relevant consideration in the recently approved Ovato Limited scheme on which this firm acted.

Additionally, the involvement of the Court in the process of approving a Scheme was a matter to which the High Court had regard when contrasting that process with the Voluntary Administration regime; *Lehman Brothers Holdings Inc v City of Swan* [2010] HCA 11 at [54] and [73]. The High Court did not have to resolve the question of whether a Scheme could release the claims of creditors against third parties. However, it considered the involvement of the Court in the Scheme approval process as one basis upon which it would be justified in taking a less restrictive view of the terms of a compromise which could be achieved by a Scheme when contrasted with that which was achievable by way of a Deed of Company Arrangement.

Moreover, if the contemplated reforms provide for class cram down rules, the Court will have a necessary role in the approval process for a Scheme and in hearing objections to the scheme by affected parties asserting unfairness.

A further consideration which militates in favour of the continuing involvement of the Court is that the dynamic of the process can provide an environment in which the detail of a compromise can be negotiated and agreed.

On balance, therefore, it is **submitted** that the Court should have a continuing role in the process of approving Schemes.