**Preliminary Submission from Arnold Bloch Leibler**

**to the Productivity Commission**

**Inquiry into Business Set-up, Transfer and Closure**

**February 2015**

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1. Introduction

This submission has been prepared by Arnold Bloch Leibler in relation to the Productivity Commission’s public inquiry into ‘Business Set-up, Transfer and Closure’ and is based on oral submissions made by Leon Zwier to the Commission at its round table discussion in Sydney on Monday 9 February 2015.

We welcome the opportunity to make this written submission in response to the Issues Paper of December 2014.[[1]](#footnote-1)

Our submission is directed to business closure (or avoiding closure through restructuring in, or outside of, an insolvency administration, by the Company and its advisers. This submission is generally borne out of our experience in larger corporate solvent and insolvent reconstructions over the last 20 years including Brash 1994+ , Ansett 2001+, Newmont Yandal 2003+, Nine Entertainment 2012-2013, Alinta 2010 -2011, Centro 2007-2011, Timbercorp 2010-current, One.Tel 2014, Gunns 2012 - current and others not in the public domain.

1. Summary

This submission contains specific recommendations directed at improving the existing statutory frameworks to facilitate successful corporate reorganisation and insolvency arrangements. Improved insolvency arrangements provide the necessary counterfactual to enable a negotiated outcome that may circumvent corporate failure.

It is recommended that reforms are implemented to:

1. Foster a culture of **rehabilitation** through the re-orienting of voluntary administration as a reconstruction process rather than an as insolvency process. This requires a “re-branding” of voluntary administration because it currently connotes corporate failure. It also requires amendment to the objects of the Part and an Explanatory Memorandum that sets out that the underlying purpose of the newly branded part is the rehabilitation of distressed companies.
2. We advocate the following specific reforms to voluntary administration to enhance the prospect of success of a reconstruction:
	1. provide a moratorium on the enforceability of “ipso facto” clauses during administration;
	2. extend the liquidator’s power to disclaim onerous property to voluntary administrators and scheme administrators on precisely the same terms;
	3. amend the statutory objects of voluntary administration to expressly state that it is a rehabilitative regime;
	4. confine directors’ statutory power to appoint an administrator to circumstances where the company may become insolvent at some future time and expressly prohibit directors from appointing administrators when the company is hopelessly insolvent, or for any other purposes;
	5. require the voluntary administrators to be satisfied that there is an underlying viable business worthwhile preserving as a pre-condition to recommending a plan of re-organisation (currently Deed of Company Arrangement).
	6. if directors appoint an administrator to a company that is hopelessly insolvent, require the voluntary administrator to immediately place such companies in liquidation.
	7. prohibit the “Decision Period” from being extended by agreement between the secured financier and the voluntary administrator.
3. Establish a specialised, **expert panel** (made up of lawyers, insolvency practitioners, and industry experts) to assist in speeding up the resolution of commercial issues in reconstruction and insolvency scenarios and reducing the costs of the administration of justice in insolvency matters. The expert panel could also consider referred legal disputes from the Courts.
4. Introduce a statutory moratorium on creditor enforcement action in relation to schemes of arrangement; and
5. Implement **safe-harbour** provisions for directors in the ‘twilight zone’ of solvency.
6. Proposed Reforms

Our submission addresses four principal areas of reform to the legislative structure regulating corporate business closure. These areas of reform are intended to improve the incentive structures that encourage entrepreneurial activity and the efficient functioning of Australia’s insolvency and reconstruction regimes.

**A. Re-orienting Voluntary Administration towards rehabilitation**

Australia’s insolvency regime is viewed in the community as punitive. It is seen as punishing and stigmatising corporate failure. This can be contrasted with the position in the United States in which corporate restructuring is seen as and is rehabilitative.[[2]](#footnote-2)

*Rebranding voluntary administration*

Insolvency laws should be reframed to foster rehabilitation and thereby encourage entrepreneurial activity particularly in our changing economy. As the Commission identified in the Issues Paper,[[3]](#footnote-3) an entrepreneurial culture is required to enhance the prospects of financial success, yet also allow those who fail to attempt again.

The lack of a restructuring culture in Australia inhibits economic growth by discouraging start-ups and investment and inhibits the productive restructuring of companies in distress. Furthermore, those most capable of taking on business risk are dissuaded from doing so for fear of the legal consequences of failure and professional ruin. Ultimately, the correlation between corporate risk and reward is misunderstood in the broader Australian community. This misunderstanding has far reaching consequences for the Australian economy.

In regard to voluntary administration, the stigma associated with an appointment and aspects of the current statutory regime will often immediately harm the goodwill and value of the enterprise. This undermines the very purpose for which the voluntary administration regime was established, namely, to maximise the chances of the company, or as much as possible of its business, continuing in existence, or if this is not possible, to produce a better return for creditors and members than would result from an immediate winding up of the company.[[4]](#footnote-4)

It has been suggested that this stigma results, in part, from the fact that for the board of directors to place the company into voluntary administration, it needs to resolve that “the company is insolvent, or is likely to become insolvent at some future time”.[[5]](#footnote-5) In other words, the stigma arises because the voluntary administration regime is only capable of being used as a restructuring tool in circumstances in which the board has formed the view that the company is, or is about to become, insolvent. The resulting delay in commencing the voluntary administration process undermines the prospects of a successful reconstruction of the company.

Consequently, voluntary administration is too often used as a de-facto liquidation procedure, or as a prelude to liquidation. The relative ease with which voluntary administration can be commenced by way of a directors’ resolution (compared with a court order or special resolution by members required to commence a winding up), coupled with the risks of personal liability for directors for insolvent trading and the director penalty regime in the tax legislation,[[6]](#footnote-6) have further encouraged the use of voluntary administration as a winding-up mechanism.

When examining some of the problems with the current structure of Part 5.3A, the ease with which voluntary administration can be commenced by directors and concluded by creditors has also seen it being improperly used by unscrupulous directors who trade in and out of the same business (which is often not viable as a going concern) by moving between different company structures with the assistance of insolvency professionals. A prohibition on utilising voluntary administration when a company is hopelessly insolvent may help curtail these “Phoenix” company activities particularly if the onus is placed on insolvency practitioners to place insolvent companies into liquidation as soon as practicable.

Looking at this issue from the perspective of rehabilitation, where voluntary administrators are appointed to hopelessly insolvent companies, there is usually no available cash resources to enable a restructure plan to be developed and implemented. Voluntary administration should not be used in such circumstances. It should only be used when the Voluntary Administrator is satisfied that there is an underlying viable business worthwhile preserving.

The voluntary administration process should be re-characterised and rebranded as a **reconstruction process** to enable a company to achieve a compromise with its creditors, in the same manner as a scheme of arrangement. This ‘rebranding’ would involve amending the objects of the voluntary administration regime and introducing reforms with an Explanatory Memorandum that clearly sets out the rehabilitative purpose of voluntary administration and the reforms in particular.

The objects of voluntary administration are currently defined in s 435A of the *Corporations Act* as follows:

*The object of this Part is to provide for the business, property and affairs of an insolvent company to be administered in a way that:*

*(a) maximises the chances of the company, or as much as possible of its business, continuing in existence; or*

*(b) if it is not possible for the company or its business to continue in existence--results in a better return for the company's creditors and members than would result from an immediate winding up of the company.*

That formulation provides for the administration of an “insolvent” company. We would advocate that the objects of the Part be adjusted to expressly articulate the rehabilitative purposes of the regime.

The amendments would include:

* + 1. stating that the Part provides for the administration and reorganisation of companies that may become insolvent at some future time (rather than being applicable to an “insolvent” company);
		2. the inclusion of a purpose of maximising the chances of the company’s employees retaining their employment;[[7]](#footnote-7) and
		3. expressly stating that the Part is not to be used as a mechanism to trigger the winding up of a company’s affairs other than by a voluntary administrator improperly appointed.

We also recommend below some specific reforms to Part 5.3A of the *Corporations Act* *2001* (Cth) to promote a shift towards rehabilitation.

*Appointing Administrators*

We would advocate that section 436A of the *Corporations Act (Cth) 2001* be amended so that it is available to a company whose board forms the view that the company may become insolvent at some future time or expressed differently is in the “twilight of solvency” but not insolvent (rather than necessarily being insolvent at that time, or imminently about to become insolvent).

The amendment would also expressly prohibit directors from appointing administrators when the company is hopelessly insolvent, or for other collateral purposes.

It is in this regard we note that almost all of the recent large reconstructions in Australia were undertaken by means of a scheme of arrangement (debt and/or equity). We would suggest that this was the case in order to avoid the stigma and loss of value associated with voluntary administration. In our experience, in all of these instances, a process utilising a voluntary administration or another insolvency process was developed as a backup in order to enable a similar commercial outcome to be achieved if the scheme had failed. These cases indicate that whilst voluntary administration is clearly designed to enable corporate reconstruction, the process is not being utilised.

To reinforce voluntary administration as rehabilitative rather than a precursor to liquidation, we also advocate that administrators be under a duty to place a company into liquidation immediately where it transpires that the company is hopelessly insolvent, or that the Part is being used for an improper purpose. This would deter directors from misusing voluntary administration for collateral purposes such as ‘phoenix’ schemes or to facilitate oppressive acquisitions of shareholdings in shareholder disputes.

And, by requiring an administrator to immediately liquidate hopelessly insolvent companies, efficiencies would be introduced into the corporate insolvency regime by avoiding the often substantial costs of:

* + 1. the preparation of the administrators’ report to creditors; and
		2. the convening and holding of the second meeting of creditors;

required by s 439A of the *Corporations Act*.

*Ipso Facto Clauses*

Many commercial contracts contain provisions that allow a party to terminate the contract if an insolvency event occurs with respect to the other party. These provisions are commonly referred to as “ipso facto” clauses because the simple act of an insolvency appointment triggers the right for the other party to terminate the contract. Chapter 11 of the US Bankruptcy Code, applying both to natural persons and corporations, generally bars the enforcement of ipso facto clauses in executory contracts (“ipso facto protection”).

Ipso facto protection is not afforded in Australia under the *Corporations Act* (the position is different in bankruptcy, which is illogical). The ability of counterparties to terminate contracts with a company in external administration significantly undermines restructuring efforts. This is because on the commencement of an insolvency process, such as voluntary administration, the company risks losing (or have to renegotiate) a number of its key commercial contracts. The loss or renegotiation of contracts may significantly affect its viability and ability to continue as a going concern as well as its ability to pay its creditors.

It is submitted that ipso facto protection should be afforded in order to remove the impediment that ipso facto clauses present to restructuring efforts. This would involve creating a moratorium on the triggering of ipso facto clauses in contracts generally. A moratorium of this kind is already reflected in Australian bankruptcy law,[[8]](#footnote-8) which recognises the benefit of allowing a trustee or bankrupt person the opportunity to operate free from impediments of this kind to the advantage of creditors.

*Disclaimer power*

Liquidators have a power to disclaim onerous property under Part 5.6, Division 7A of the *Corporations Act*. The purpose of the disclaimer power is “…*to rid the company of burdensome financial obligations which might otherwise continue to the detriment of those interested in the administration*…”[[9]](#footnote-9)

Disclaimer is not presently available to voluntary administrators or scheme administrators. Given the scope of the disclaimer power to be used to restructure a distressed company’s contractual or other liabilities, there is no good reason in principle to confine the power to a liquidator. Scheme Administrators derive their powers from the Court’s order approving the scheme. The Court will therefore supervise the grant of the power. Voluntary Administrators powers derive from the Corporations Act and they and Deed Administrators should have the same powers as liquidators expressly granted to them (the Deed Administrators powers derive from the Deed).

In our opinion the disclaimer power could be used by administrators or scheme administrators to facilitate the successful reorganisation of distressed companies and should be available to them and not just to liquidators.

*Extensions to the “Decision Period”*

The moratorium in voluntary administration is subject to a substantial secured creditor[[10]](#footnote-10) enforcing their security (including by the appointment of a receiver) during a limited period of 13 business days from the appointment (known as the “Decision Period”).

Where a substantial secured creditor enforces the security, the opportunity for the company to be successfully rehabilitated through the voluntary administration process is invariably lost because the receiver’s primary focus is on realising the pledged assets for the benefit of the secured creditor rather than restructuring the company for the benefit of all stakeholders.

Further, the very appointment of an administrator may trigger receivership and thereby undermine the rehabilitative purposes of voluntary administration.

Under the current statutory regime, secured creditors and administrators often extend the “Decision Period” by agreement so that the secured creditor retains the ability to appoint a receiver ‘over the top’ of the administrator at any time during the administration. By doing so the secured creditors exercise a defacto negative control over the administration. That is if it does not approve of the conduct of the Administrators it will appoint a Receiver over the company. This can inhibit the ability of the administrator to pursue the rehabilitation purposes of Part 5.3A and convert the administration into a *de facto* receivership.

We would therefore advocate an amendment being made to the voluntary administration provisions that prohibits extensions of the “Decision Period” by private agreement with the administrator. Extensions would only be permitted where approved by either the Court or a specialist panel. The secured Creditors are conscious of adverse mainstream and other media and are often initially disinclined to appoint Receivers. By making the Court supervise extensions it will create a more even playing field for the negotiations between the secured Creditors and the Administrators.

**B. Specialist Panel: The administration of justice in the insolvency context**

The administration of justice in insolvency matters would, in our opinion, be assisted by the increased involvement of specialised judges in the Superior Courts who hold an expertise in insolvency. But this is unlikely to occur.

It is submitted that a reconstruction panel, similar to the Takeovers Panel, would assist in delivering outcomes to affected parties (and in particular would allow creditors a greater role in the process) without incurring the level of costs that are associated with a full court process.

A reconstruction panel would address the concerns raised by the Commission in the Issues Paper regarding the costs associated with formal court processes,[[11]](#footnote-11) as well as the evolving role for tribunals identified in the Commission’s Access to Justice Arrangements Inquiry Report.[[12]](#footnote-12) Along with a reduction in cost, an expert panel would assist parties to reach commercially sound and pragmatic outcomes, as the members of the panel would be persons of relevant experience, such as insolvency practitioners, investment bankers, corporate advisors and lawyers practising in the field of insolvency. As such, the panel members would have the capacity to understand and to adequately balance the interests of all stakeholders.

In establishing such a panel, regard would need to be had to the issues under the Constitution which prevent an expert tribunal from exercising federal judicial power. These issues were addressed in the context of the Takeovers Panel in cases such as the High Court decision in *Attorney-General (Cth) v Alinta Ltd (2008).[[13]](#footnote-13)* The ambit of the reconstruction panel would therefore be restricted, like the Takeovers Panel so that it is:

* + 1. seen to be making decisions based on matters of general policy and expediency;
		2. providing no absolute limitation on court proceedings;
		3. utilising its powers to create new rights, even when considering whether a breach of the *Corporations Act* has occurred; and
		4. not able to enforce its own orders.

In addressing these issues, a reconstruction panel could be vested with the power to make declarations with regard to transactions being undertaken or being proposed to be undertaken as part of an insolvency process in the same manner as the Takeovers Panel is able to make declarations of unacceptable circumstances in takeovers matters.

Matters could also be referred to the reconstruction Panel by the Courts. Such a power to refer certain questions to expert referees already exists within the court rules.[[14]](#footnote-14) For example, in Victoria the Supreme Court has the power to refer any question to a special referee to decide the question or to give the referee’s opinion with respect to it. If the reconstruction Panel is established to operate in this way, then the reports of the reconstruction Panel would be returned to the Supreme Court for adoption.[[15]](#footnote-15) This may assist in avoiding legal costs as the Panels processes would be less formal and far more open to speedy determinations based on written submissions.

**C. Moratorium for Schemes of Arrangement**

In recent years, schemes of arrangement under Part 5.1 of the *Corporations Act* have been successfully utilised to facilitate large, complex corporate reconstructions of distressed enterprises including the Centro Group Alinta and Nine Entertainment. As suggested above, this has been, at least in part, to avoid the stigma and loss of value associated with the voluntary administration regime.

There are, however, disincentives for distressed (but not insolvent) companies to undergo a scheme of arrangement because of the risk that creditors can enforce rights during the period in which the scheme is being propounded and implemented. There is no statutory moratorium on creditor enforcement actions in respect of schemes of arrangement until the compromise or arrangement becomes binding under s 411(4) of the *Corporations Act*. This allows creditors with readily enforceable rights to disrupt, or undermine, reconstruction attempts or extract disproportionate concessions.

In order enhance the utility of schemes as a means of reorganising distressed but not insolvent companies, we believe that a moratorium on creditor enforcement actions (subject to Court supervision) be introduced into s 411 of the *Corporations Act*.

The moratorium would take effect from the date that a compromise or arrangement is “proposed” by the filing of the court application for orders convening meetings of the company’s creditors and/or members in accordance with s 411(1) of the *Corporations Act*. Similar to the position in voluntary administration, the moratorium would be subject to abridgment by the Court or the consent of the company.

**D. Safe-harbour Provisions for Directors**

In the “twilight zone” of solvency (that is the uncertain period when a company is at risk of insolvent trading as it attempts to extricate itself from difficult financial circumstances), directors are exposed to a fundamental conflict between their duty to act in the best interests of the company including its creditors and the personal liability that is imposed on directors if they allow the company to continue to trade at a time when it is insolvent. Unsurprisingly, a board of directors or a director may opt to appoint administrators in order to avoid the risk of personal liability, notwithstanding that it may not be in the best interests of the company or its creditors to do so.

In our submission, directors who wish to “stay the course” and facilitate the reorganisation of their company should be permitted to do so without the risk of personal liability. After all, it is in the public interest to preserve good businesses for the benefit of all stakeholders including employees, shareholders, creditors, suppliers, counterparties and customers. Businesses should not be forced into a cumbersome, slow, expensive and value-diminishing process because the directors are fearful of their own position.

Protection of this kind (sometimes called a “safe-harbour”) is contemplated by the Commission in the Issues Paper.[[16]](#footnote-16) The law should create a safe harbour for directors who trade in the twilight zone in good faith, who have no material interest in the decisions they make and who have sought, obtained and relied on advice from reputable insolvency professionals. Such a safe harbour would, in appropriate circumstances, encourage restructuring efforts for businesses facing financial difficulty, without the need for an external administration process to be invoked.

The Insolvency Practitioners Association suggested in 2007 that Australia adopt a further and wider defence for insolvent trading, namely a “financial judgment rule”.[[17]](#footnote-17) If a “financial judgment rule” is to be adopted, we would propose that the rule suggested by the IPA should be modified. The modified rule would require:

* + 1. that the judgment was made in good faith for a proper purpose;
		2. that the director considered the interests of creditors in making the decision;
		3. that the director had informed themselves about the subject matter of the judgment to the extent they reasonably believed appropriate; and
		4. that the director rationally believed that the decision was in the best interests of the corporation.

It is submitted that the availability of a safe-harbour or a “financial judgment rule” be available to directors to resolve the conflict created for the directors when the best interests of the company (and its economic creditors) dictate the pursuit of the restructure.

1. Conclusion

The Australian economy is going through massive change. Our population is aging. We must encourage entrepreneurial endeavours of a younger generation. Manufacturing, mining or farming is not their future. These industries and agriculture will not create jobs and wealth. We need to encourage the development of ideas and their commercialisation. An important part of doing so is to demonstrate there are no adverse consequences of honest endeavour and honest failure. The draconian consequences that may flow from corporate distress or failure are a major imposition to the encouragement of this entrepreneurial culture that is necessary to create jobs and wealth. Any insolvency system needs to recognise, balance and maximise the interests of companies, employees, shareholders, secured and unsecured creditors and other key stakeholders. It must also be capable of providing specific and general deterrence against dishonest conduct.

* 1. The recommendations outlined in this submission seek to alleviate some of the key constraints that Australia’s current insolvency processes pose to a successful corporate restructure.

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February 2015

1. Productivity Commission, *Issues Paper*, Inquiry into Business Set Up, Transfer and Closure, 19 December 2014. [↑](#footnote-ref-1)
2. See Colin Anderson & David Morrison, *Crutchfield’s Corporate Voluntary Administration*, 3rd ed, 2003, p.350. See also *Report of the Commission on the Bankruptcy Laws of the United States* published in The Business Lawyer, Vol. 29, No. 1 (November 1973), pp. 75-116 at 108ff. [↑](#footnote-ref-2)
3. Productivity Commission, *Issues Paper*, Inquiry into Business Set Up, Transfer and Closure, 19 December 2014, p 19. [↑](#footnote-ref-3)
4. Section 435A *Corporations Act 2001* (Cth). [↑](#footnote-ref-4)
5. Section 436A *Corporations Act 2001* (Cth). [↑](#footnote-ref-5)
6. Division 269 *Taxation Administration Act 1953* (Cth). [↑](#footnote-ref-6)
7. Preservation of employment was identified as a purpose for rehabilitative insolvency regimes in the Harmer Report (see Australian Law Reform Commission, *General Insolvency Inquiry* (Report No. 45, 1988), para 52. [↑](#footnote-ref-7)
8. See *Bankruptcy Act 1966* (Cth) s 301. [↑](#footnote-ref-8)
9. See *Re Middle Harbour Investments* [1977] 2 NSWLR 652 at 657. [↑](#footnote-ref-9)
10. Only a secured creditor with security over the whole, or substantially the whole, of the property of the company under administration can enforce its security during administration (s 441A of the *Corporations Act*). [↑](#footnote-ref-10)
11. Productivity Commission, *Issues Paper*, Inquiry into Business Set Up, Transfer and Closure, 19 December 2014, p 16-17. [↑](#footnote-ref-11)
12. Productivity Commission, *Inquiry Report,* Access to Justice Arrangements, 5 September 2014. Chapter 10: Tribunals. [↑](#footnote-ref-12)
13. 242 ALR 1; 82 ALJR 382; 26 ACLC 1; [2008] HCA 2. [↑](#footnote-ref-13)
14. *Supreme Court (General Civil Procedure) Rules 2005* (Vic) r 50.01; *Federal Court of Australia Act* (Cth) *s 54A; Court Procedures Rules 2006* (ACT) r 1531; *Uniform Civil Procedure Rules 2005* (NSW) r 20.14; *Supreme Court Act 1979* (NT) s 26; *Supreme Court Act 1995* (Qld) s 255; *Uniform Civil Procedure Rules 1999* (Qld) r 501; *Supreme Court Act 1935* (SA) s 67; *Supreme Court Rules 2000* (Tas)r 574; *Supreme Court Act 1935* (WA) s 50. [↑](#footnote-ref-14)
15. *Supreme Court (General Civil Procedure) Rules 2005* r 50.04, [↑](#footnote-ref-15)
16. Productivity Commission, *Issues Paper*, Inquiry into Business Set Up, Transfer and Closure, 19 December 2014, p 16-17. [↑](#footnote-ref-16)
17. See IPA, *Submissions, Review of Sanctions in Corporate Law,* 15 June 2007, *16 ff.* [↑](#footnote-ref-17)