

Financial System Inquiry Interim Report of 15 July 2014, External Administration

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Is there evidence that Australia's external administration regime causes otherwise viable businesses to fail and, if so, what could be done to address this?

My submission comprises:

- **this paper, and**
- **a discussion paper enclosed as an addendum, titled 'Encouraging and facilitating corporate turnaround', prepared to inform government in its response to the Senate Economic References Committee's recommendation 61 in its report on the Performance of the Australian Securities & Investments Commission, 26 June 2014 (hereinafter, referred to as the "Addendum").**

Summary response

It is not the external administration regime that causes viable businesses to fail, but the lack of a positive corporate turnaround regime and culture in Australia, that results in companies responding to under-performance too late and at a time when voluntary administration is, too often, the only realistic option.

Once in voluntary administration, the process is value destructive, securing the company's fate. That is, in all probability, the company will face a liquidation outcome.¹

Realising the potential in existing business lies in our ability to support the continuous revival and transformation of corporate Australia. We also need to be able to attract and retain quality directors through periods of change and financial vulnerability.

Law reform along the lines described in this paper and the Addendum, directed at cooperative efforts to increase the value of Australian business, is welcomed.

¹ Once in voluntary administration, ordinarily a company is placed into liquidation or enters into a deed of company arrangement. According to the study undertaken by Mark Wellard, in 72% of cases, a deed of company arrangement delivers a quasi-liquidation outcome (see his article published in the ARITA journal April-June 2014, Feature 2 at page 12, 'A review of deeds of company arrangement').

‘Policy options for consultation’: annotated response

Before responding to the substantive question, I address specific comments set out in the Interim Report, in the chapter regarding external administration under the heading, ‘Policy options for consultation’, below.

To prevent viable businesses from entering voluntary administration, some submissions suggest that Australia adopt the US Chapter 11 regime, or certain aspects of it.

I agree, in the case of ‘viable businesses’, features of overseas’ regimes which have successfully delivered a corporate turnaround culture, should be considered.

The Inquiry considers adopting such a regime would be costly...

I agree, it is undesirable to adopt the Chapter 11 regime in its entirety, including because it is widely reported to be costly.

...and could leave control in the hands of those who are often the cause of a company’s financial distress.

In the case of ‘unviable businesses’, I agree, no reform to the legislation along the lines of Chapter 11 is warranted. Such businesses are appropriately dealt with via a robust insolvency framework which places control with a registered insolvency practitioner acting in the best interests of creditors, as is the case currently in Australia.

In the case of ‘viable businesses’, I consider that change is warranted. The fact that the directors may have contributed to the company’s financial distress, is not in and of itself reason to suggest they should no longer control the company. While a company’s directors control the company, in reality many persons connected with a company over its life make decisions (which at the time, absent fraud or misconduct, are ordinarily reasonably made), and it is the totality of those decisions which impact a company’s course. There are also external events, which are not within anyone’s control.

Take the example of an over-levered company with a good underlying business (*see Rural business, Small and medium sized enterprises, “debt levels in the agricultural sector have more than doubled over the past decade and have outpaced farm incomes...”, page 6 of 10 of that chapter*). At some point in the past, parties agreed to over-lever that business based on what is known with the benefit of hindsight, to be unrealistic, overly optimistic assessments of the company’s ability to service the debt in the future.

In fact, the company cannot service the debt and it has an unsustainable capital structure.

In other jurisdictions, for example in the UK, at the first signs of default or potential default, an assessment is made of the quality or potential quality of the underlying business. If the quality or potential quality is considered to be good, then parties consider what restructuring options are available irrespective of creditors’ rights to enforce.

If there are people at the company who are responsible for the company’s financial difficulties, or their continuing employment will adversely impact the successful turnaround of the company, it may be agreed as a term of the restructuring, that they be replaced. Alternatively, it may be that they simply require support for a period so that, for example, a chief restructuring officer is appointed.

In the Addendum, I propose reform which involves the directors (in the case of an informal restructuring) or an administrator acting in the best interests of the company with the support of the directors (pursuant to a new legislative regime), controlling a company in such circumstances.

Capital would be maintained in a business that is likely to fail, which would restrict or defer the capital from being channelled to more viable and productive enterprises.

Firstly, the statement assumes that a business which is likely to fail, will fail. If the assumption is wrong and the business which was likely to fail, was turned around, then the comment regarding the use of capital does not arise as the business is a viable, productive enterprise.

If capital is withdrawn pre-emptively, that action itself will cause further financial stress and so can be self-fulfilling.

Without the benefit of hindsight, a judgement must be made to determine which businesses to support in their turnaround efforts. I note with interest the statement in relation to small to medium enterprises (*page 3 of 10 of that chapter*) “Requirements for collateral to be held against SME loans can result in allocative inefficiencies, where loans are made to businesses with the best collateral, rather than those that are the best business prospects.” I agree with that statement and it is a behaviour that we see reflected in decisions made when those businesses are under stress.

Secondly, the comment seems to suggest a finite basket of capital that must be recycled.

There is no reason to believe that demand for capital to fund distressed companies pursuing turnaround attempts, would preclude other businesses from accessing capital. The arguments to that end, are addressed in the context of the question raised mainly from the banking sector, in the banking system chapter at page 2 of 6 under the title ‘Funding credit growth’, how [would] the banking system fund higher economic growth in Australia.

Superannuation funds are cited as a part of the solution and indeed, in the superannuation chapter at page 3 of 4, there is a concern raised that Australia will in the future be unable to absorb the growing pool of funds; that is, there will be an excess of capital.

In a market where restructurings are prevalent, there are persons who are willing to inject capital into distressed businesses including existing lenders and funds, via a variety of structures offering varying degrees of liquidity. In Australia, there is an ever increasing market of such parties and variety of structures, permitting those who wish to exit their capital to do so, with new capital being injected. I consider that a developing corporate bond market, as exists in the USA and Europe, would be beneficial to corporate turnarounds, to continue to grow the pool of capital available and the flexibility by which that capital can be injected and traded.

Thirdly, I appreciate that certain enterprises are subject to criteria which impact their decisions around the risk they elect to carry and the associated cost. Those institutions may prefer not to (or consider themselves unable to) support company turnaround activity. From their perspective, based on their business model, it may be more efficient for them to withdraw the capital and recognise the loss. However, at a macro level, taking all available sources of capital, this is not a basis to suggest that efforts to support the turnaround of companies in distress involves an inefficient use of capital, which deprives others of capital. Moreover, in my experience, this is not an argument that is raised by banks in the UK as precluding restructuring activity.

Adopting such a regime would also create more uncertainty for creditors by limiting their rights.

Uncertainty can be dealt with by having a clear framework. The balance of a debtor’s rights and creditors’ rights is a policy decision. If the balance is shifted in favour of debtors who, albeit in financial difficulties have a viable business, creditors need to be adequately protected. The concept of adequate protection is a well-entrenched principle overseas and is discussed in the Addendum.

The Inquiry seeks further information on the following area:

Is there evidence that Australia's external administration regime causes otherwise viable businesses to fail and, if so, what could be done to address this?

- In my time in Australia in the period from around 1995 to 2010, I worked on and was aware of my direct colleagues working on, a number of voluntary administrations. In my experience, voluntary administrations tended not to result in a company being rescued as a going concern. Rather, the usual pattern involved a company proceeding into liquidation or a company being subjected to a deed of company arrangement which involved a sale of business or cherry-picked assets with liabilities left behind, a cash contribution often by directors or a related party, and a distribution of funds to creditors. At the end of the deed of company arrangement (which sometimes involved a creditors trust), the company was returned to the directors as a corporate shell.
- My experience is consistent with the findings of Mark Wellard.²
- This should be unsurprising. When one looks at the voluntary administration regime it is not designed to deliver the rescue of a company as a going concern. This is addressed under the heading "*Key issues with the Australian culture and existing framework*" below.
- **The question to my mind, is not whether Australia's external administration regime causes otherwise viable businesses to fail, rather does it provide a framework which encourages and facilitates the survival of such businesses? Based on my experience in Australia and overseas, there are significant improvements that could be made.**
- Informal work-outs are identified as a part of Australia's external administration regime. This is notwithstanding the fact that there is no clearly defined framework in Australia which regulates the manner in which such work-outs are delivered. Our informal work-out regime is ad hoc, lacks certainty and tends to be creditor-led, not company-led. Whether an informal work-out is considered and how effective it is as a turnaround tool depends on the parties involved and requires a significant degree of luck, in obtaining the right advisors, company personnel and creditors in a particular transaction. The position is complicated where there is insolvent trading risk. Below, I comment on the lack of a business rescue culture in Australia which routinely delivers corporate turnarounds pursuant to a clearly defined framework.
- During my time working overseas for three years from March 2011, I was exposed to a strong business rescue culture of company-led turnarounds supported by creditors outside of formal insolvency vehicles. It struck me, from that experience, that in Australia, we do not have such a culture. The Addendum (at Chapter 2) addresses the question, what does a business rescue culture look like and how does that compare to Australia? Australia's lack of a business rescue culture adversely impacts the way that Australia responds to corporate underperformance and financial distress.
- In the UK, in the 1990's, the 'London approach' evolved as a market practice which parties adhered to, to deliver restructurings. The 'London approach' had the support of the British Banking Association and the Bank of England. Subsequently, the INSOL principles were developed and are now well-entrenched market best practice throughout Europe and beyond.³ The INSOL principles are supported

² See footnote 1.

³ See the well regarded text that discusses the history of the London approach, the INSOL principles and restructurings in the UK, *Restructuring Law & Practice*, 2nd Ed (Revised), by Chris Howard and Bob Hedger. The INSOL principles are described at <https://www.insol.org/page/57/statement-of-principles>. I also provide a summary in Chapter 3 of the Addendum.

by the World Bank, the Bank of England and the British Bankers' Association. I acted for the coordinating committee on a large restructuring in the Middle East involving 36 lenders, where the INSOL principles were acknowledged and applied by parties from the Middle East, Europe, Asia and the USA.

- To my mind, Australia would benefit from a framework that adopts restructuring principles along the lines of those globally accepted principles, which is supported by all stakeholders and adopted as market practice. While Chapter 11 is not a complete answer, that framework does incorporate a number of features which we can be guided by.
- A new corporate rescue framework could be adopted by legislative means or a code of conduct. Both would assist to bring about cultural change in the way restructurings are conducted. In the Addendum, I describe in detail, a proposed new framework. I comment on some of the differences between a legislative framework and a code of conduct at page 29 of the Addendum.

Key issues with the Australian culture and existing framework

A number of key issues with the Australian culture and existing framework are:

- When faced with credit issues, creditors tend to react individually, seeking to protect their own position in the short term, with little consideration given to the return that might be available in the medium to long term, if effort is coordinated. This is to be compared with the position in the UK:
“The London Approach would never have developed in the way that it did unless it yielded tangible benefits for the domestic and international banks that have observed some of its fundamental tenets and in this regard, it is worth noting that the initiative grew from the recognition that financial creditors would likely achieve better returns through collective efforts to support an orderly rescue of a firm in distress, instead of forcing it into a formal insolvency.”⁴
- Informal work-outs tend to be creditor-led, are ad hoc without a clear framework, carry insolvent trading risk and are unsupported by a business rescue culture.
- Our company 'reorganisation' regime, voluntary administration, takes all control away from the board. Control is given to an administrator who acts in the best interests of the creditors. No-one with any control or power, acts with the primary interests of the company in mind.
- The voluntary administration regime has a number of features that worsen a company's position upon appointment. Creditors are permitted to take their share of sale proceeds attributed, for example, to retention of title stock, certain secured creditors are entitled to enforce, and all creditors are entitled to terminate contracts under insolvency termination provisions. All of this, severely and adversely impacts the company's ability to trade as a going concern, immediately upon appointment. It is value destructive.
- Directors of companies in financial difficulty are not permitted to negotiate sensible turnaround solutions with their creditors, while continuing to trade, due to the actual or perceived risk of personal liability for insolvent trading and other suits if the efforts fail. Potential action by regulators is also a concern.
- Directors respond to underperformance and financial stress too late.

The key legal reform required to address these issues includes:

- The framework needs to incentivise directors to respond to underperformance and financial stress early; to take the initiative and deliver a company-led turnaround.

⁴ See Restructuring Law & Practice, 2nd Ed (Revised), by Chris Howard and Bob Hedger, at 1.22.

- The framework needs to be robust, to prevent directors of unviable businesses with no viable plan to turn the company around, from using the regime to avoid creditors.
- Creditors need to agree to stand still, that is, not take enforcement action and not terminate contracts, whilst a business rescue plan is agreed. This applies to all creditors, including secured creditors.
- Creditors should not be disadvantaged whilst they stand still. For example, they should be entitled to be paid interest on their debt, and protected via concepts such as adequate protection and new money priority.
- Creditors need to coordinate their response to a company in distress, and act cooperatively with the objective of (i) giving the company time to stabilise in the short term, and (ii) increasing the value of the company in the medium to long term.
- Either the board, or under a formal regime an administrator who acts in the best interests of the company, needs to control the company during the period of business rescue.
- Directors who act reasonably to avoid liquidation, who make business judgements in good faith for a proper purpose, on an informed basis and believing that the judgement is in the best interests of the company, should not be personally liable for trading whilst insolvent.

Macaire Bromley, Partner DibbsBarker, has prepared this submission based on her experience in the restructuring & insolvency industry since 1995, including the past three years working on large complex restructurings in Europe and the Middle East with Allen & Overy LLP, London.

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