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Three developments in insolvency law

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Introduction

Let me start with what I am not talking about, here drawing on a subject that I also did not speak about at a Corporate Law Workshop of the Law Council in 2016. I will not be speaking about the complexity of the corporations law or insolvency law generally or of the transitional provisions in the Insolvency Law Reform Act in particular. I may be in a minority in not speaking of that subject.

In an article published in 1992, Sir Anthony Mason observed, of the unlikely combination of fox-hunting and the then *Corporations Law*, that

> "Oscar Wilde described fox-hunting as "the unspeakable in full pursuit of the uneatable". Oscar Wilde, the supreme stylist, would have regarded our modern *Corporations Law* not only as uneatable but also as indigestible and incomprehensible."[1]

We should not pause to seek an answer as to why Oscar Wilde would have been the best judge of that question or further detain ourselves with the vision of Oscar Wilde as a judge of the dishes on a kind of legislative Master Chef.

In a later article with the marvellous title, "Unlovely and Unloved: Corporate Law Reform's Progeny", Associate Professor Cally Jordan begins with the remarkable sentence:

> "There is no dispute. The Corporations Act 2001 (Cth) … is unlovely and unloved".[2]

If Associate Professor Jordan's message was not clear enough from her title and her first sentence, she goes on to adopt Sir Anthony Mason's description of the *Corporations Act* as "indigestible and incomprehensible", and then turns to the question why consistency and coherence in business law is not valued in Australia. That question reflects that favourite tool of advocates, an unproven premise. Associate Professor Jordan goes on to argue that there should be a separate business corporations statute, that parallel streams of directors' duties under statute and general law should be eliminated (as has to some extent occurred in the United Kingdom) and to urge the development of a personal property security regime (which has now been introduced).

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[1] Sir Anthony Mason, "Corporate Law: The Challenge of Complexity" (1992) 2 *Australian Journal of Corporate Law* 1.
[2] C Jordan, "Unlovely and Unloved: Corporate Law Reform's Progeny" (2009) 33 *Melbourne University Law Review* 626.

Sir Anthony Mason and Associate Professor Jordan are by no means alone in their views as to the complexity, and possibly the unattractiveness of the *Corporations Act*. This has been a favourite theme in judgments of Rares J, including *Wingecarribee Shire Council v Lehman Bros Australia Ltd (in liq)* (2012) 301 ALR 1; [2012] FCA 1028, and a Full Court of the Federal Court (of which Rares J was part) returned to that theme with enthusiasm in dealing with disqualification of directors of insolvent companies under s 206F of the Corporations Act in *Oreb v Australian Securities & Investments Commission* [2017] FCAFC 49 at [54] as follows:

> "The refrain in explanatory memoranda that legislation in the form of the over 2,500 page long Corporations Act, replete with massive and over complex verbiage, is "user friendly" is patent nonsense. Professionals and judges must navigate tortuous, mind-numbingly detailed, cascading provisions to ascertain the meaning that the Parliament, supposedly, had in mind when enacting these telephone books, at huge cost to the community. Principles-based drafting would enable the elucidation of legislative intention much more effectively and also be likely to be user friendly and to reduce cost. "

I will not develop these themes further, other than to make four short comments. The first is that there is often (although not always) benefit in simplification. The second is that whether reforms simplify, deregulate or reduce costs can be a matter of perspective. The third is that the complexity of some of these provisions may reflect the complex policy objectives which the legislation is seeking to achieve. The fourth is that there is at least some benefit in continuity, including the ability to develop a body of case law over time, and that law reform does not always facilitate that objective.

Having now spent a significant part of the time allotted to me dealing with what I will not cover, let me now make some observations about my subject, three developments in insolvency law, with an apology. That apology is that I touched on some aspects of these matters in a paper given at the ARITA National Conference in August 2017, so my apologies if you have heard some of these matters before. I will, however, also be addressing significant matters in this paper that I had not addressed there.

Safe harbour from insolvent trading

The Treasury Laws Amendment (2017 Enterprise Incentives No 2) Bill 2017, introduced into Federal Parliament on 1 June 2017, will implement a "safe harbour" for insolvent trading for directors, with some qualifications. There are arguments that are capable of being put each way in respect of these amendments. On the one hand, the Australian insolvent trading regime is significantly more onerous than comparable regimes in other developed economies[3] and there is a strong case that the insolvent trading regime operates as a significant practical disincentive to informal workout arrangements. The contrary view is that individual creditors, or creditors generally, may be left with the risk that a restructuring proposal fails and they are left without recourse for debts incurred in the course of it. The proposed

[3] J Harris, "Director Liability for Insolvent Trading: Is the Cure Worse than the Disease?" (2009) 23 *AJCL* 266 at 269.

safe harbour regime does not provide priority for debts incurred in the safe harbour period, and has the capacity to disadvantage creditors who extend new credit, or increase the amount of credit extended, in that period. The proposed amendments do not draw a distinction between large public companies and proprietary companies, or between entrepreneurial companies and traditional trading businesses, although the case that has been put in support of them largely relates to the difficulties for large public companies in proceeding with a restructuring and to entrepreneurial entities, whereas the cases before the courts largely relate to proprietary companies conducting trading businesses.

Proposed s 588GA(1) would exclude liability for insolvent trading under s 588G of the Corporations Act if:

- at a particular time after a person starts to suspect a company may become or be insolvent, he or she starts developing one or more courses of action that are reasonably likely to lead to a better outcome for the company; and

- the debt is incurred directly or indirectly in connection with that course of action and during a specified time period.

Several complexities are likely to arise in the operation of this section:

- The question whether the course of action is "reasonably likely to have a better outcome" for the company seems to be an objective question one, on its face.[4] The Court is to have regard to matters relating to what the director has done under proposed s 588GA(2), which provides an inclusive list of matters relevant to determining whether the course of action was reasonably likely to lead to a better outcome for the company, focussing on steps taken by directors. The fact that such steps are taken may make it more likely an informal restructuring would be reasonably likely to have a better outcome for the Company. It is, however, logically possible that, even after those steps are taken, the informal restructuring which is undertaken was misconceived, and would not be reasonably likely to lead to that better outcome for the company, and the "defence" would not then be available.

- The term "better outcome" is defined, in s 588GA(7), as a better outcome for the company than the immediate appointment of an administrator or liquidator. The case law will need to determine what is the threshold at which steps taken are "reasonably likely" to lead to a better outcome for the company, and whether that comparison has regard only to the corporate entity or also to the interests of its creditors, and further complexity will arise if differing classes of creditors would have different interests. This comparison may also require a party relying on that defence to prove the likely outcome of a

[4] S Maiden, "Safe Harbour: How will it Work? Will it Work?", presentation at Corporate Law Workshop, 29 July 2017, cited by permission of Mr Maiden.

hypothetical administration or liquidation that had taken place at the time the directors instead undertook an informal restructuring.

- There will be a question as to the extent of connection that is required to fall within the language "directly or indirectly in connection with the course[s] of action", although the Explanatory Memorandum (at [1.48]) contemplates that trade debts will fall within the section.

Proposed s 588GA(3) would provide that a director relying on that defence has the "evidential burden" (as defined in proposed s 588GA(7)), and, if the director raised evidence that was sufficient to suggest that the facts relied on for the defence exists, then the liquidator or creditor bringing the insolvent trading claim must then displace that defence.

There are several exclusions from the defence under proposed s 588GA(4)-(5), applying where, when the debt was incurred, the company was:

- failing to pay employee entitlements when due or give returns etc as required by taxation law, and that failure amounts to less than substantial compliance with that obligation and was one of two or more failures to do those matters during the 12 month period ending when the debt was incurred; and

- after the debt was incurred, there was a substantial failure to furnish information or reports to an external administrator.

This exclusion is triggered by late payment of the employee entitlements, and not only by non-payment. A question may arise, if a company makes some late payments or fails to lodge some taxation returns, whether that amounts to less than "substantial" compliance for the purpose of the exclusions. These exclusions do not apply if the court is satisfied on an application under s 588GA(6) that the relevant failure was due to exceptional circumstances or that it is otherwise in the interests of justice to make that order. There will no doubt also be future issues as to when a court should make such an order.

There is also a limit, under s 588GB, on a director's ability to rely on information that is not delivered to an administrator or liquidator to establish the safe harbour, unless the court relieves the director from that limit. The inability of a director to rely on books or records which it had not delivered up to an administrator or liquidator should encourage cooperation with the liquidator.

There may be a question whether the safe harbour will be available to, or will appeal to, directors of smaller proprietary companies, where delays in payment of employee entitlements or failures to comply with obligations to report withholding tax or superannuation guarantee liabilities may well have occurred when such a company came under financial pressure. The exclusions to the safe harbour may be triggered in that situation and there will also be a question as to the position of a director who seeks to rely on the "safe harbour" regime and receives a director penalty notices if the company has reported but not paid PAYG and superannuation guarantee liabilities.

Stay on ipso facto clauses

The Treasury Laws Amendment (2017 Enterprise Incentives No 2) Bill would also impose a stay on the use of ipso facto clauses to amend or terminate contracts with a company that passes into administration. The Explanatory Memorandum to the Treasury Laws Amendment (2017 Enterprises Incentive No 2) Bill 2017 describes the effect of the amendment, (para 2.9) as follows:

> "Subject to exceptions, under this amendment contractual rights will be unable to be enforced against a company which is undertaking a formal restructure when the rights are triggered by the company's financial position or its entry into a formal restructure. That stay will continue indefinitely in circumstances where the event on which the right depended occurred before or during the formal restructure."

The Explanatory Memorandum recognises (para 2.11) that a counterparty would retain the right to terminate or amend an agreement for another reason, such as a breach involving non-payment or non-performance.

Proposed s 415D would provide a stay on enforcing rights in respect of, broadly, a scheme of arrangement where that scheme is for the purpose of avoiding insolvent liquidation, for a three month period which may be extended by order of the Court. Proposed s 434J will provide a stay on enforcing rights merely because of the appointment of a managing controller over all or substantially all of the property of the company. Proposed s 451E would provide for a stay where a company is under administration, which continues until the affairs of the company are fully wound up, where a company enters into voluntary administration and then into liquidation, but not where it enters directly into liquidation (s 451E(2)(c)). The stay also extends to provisions for termination or amendment solely based on the company's financial position, except where the company is not in a creditor's scheme, voluntary administration or managing controllership. This appears to function as an anti-avoidance mechanism, where financial criteria might otherwise provide a substitute basis for amendment or termination in the context of a scheme, voluntary administration or managing controllership.

In each case, the Court would have power to lift the stay. Proposed s 415E (schemes) would allow the court to order the lifting of the stay if it is satisfied that (1) the scheme is not for the purpose of the body avoiding being wound up in insolvency or (2) where that is appropriate in the interests of justice. Proposed ss 434K (managing controller) and 451F (administration) would allow the court to order the lifting of the stay if the Court is satisfied that that is appropriate in the interests of justice. The power to lift a stay where it is "appropriate in the interests of justice" is at large and will require the court to answer the question when it is in the "interests of justice" that the stay not exist. A question will arise as to whether there is any sort of presumption in favour of a stay, where the provisions provide for it. The exercise of this power is otherwise likely to involve the interests of the company and its creditors on the one hand and the party seeking to enforce rights on the other, and possibly a wider public interest in the success of restructurings. The Court may well draw on the case law dealing with the stay on exercise of

rights by secured creditors or lessors during an administration, at least by way of analogy.

Proposed ss 415F (schemes), 434L (managing controller) and 451G (administration) would allow the Court to order that rights under a contract are enforceable only with the leave of the Court and on such terms as the Court imposes in specified circumstances.

Clause 17 of the Treasury Laws Amendment (2017 Enterprise Incentives No 2) Bill provides that the provisions apply only to new contracts entered into after the commencement date of the Bill, which would have the result that many existing contracts will remain outside that regime, including if those contracts are extended or amended. This may result in inequities of treatment between creditors, where those with pre-existing contracts can terminate on an ipso facto basis but those with new contracts cannot. Several contracts including contracts managing financial risk such as swaps and hedging contracts are to be excluded by regulation.

A fully contested creditors' scheme

Section 411 of the Corporations Act authorises the court to grant approval to a compromise or arrangement between a Pt 5.1 body and its creditors or a class of them or between a Pt 5.1 body and its members or a class of them. The Supreme Court of New South Wales has recently addressed several significant issues in respect of the use of schemes of arrangement to reorganise an insolvent or near insolvent company in a fully contested creditors' scheme concerning Boart Longyear Limited ("BLY"). By way of background, BLY had defaulted on its secured loans and was, or was likely to become, insolvent absent some form of debt restructuring, and had entered into a Restructuring Support Agreement with several of its lenders.

Restraint on proceedings

In its first decision in *Re Boart Longyear Ltd* [2017] NSWSC 537, the Court made an order under s 411(16) of the Corporations Act, prior to a first court hearing in respect of the relevant schemes of arrangement. That section provides that:

> "Where no order has been made or resolution passed for the winding up of a Part 5.1 body and a compromise or arrangement has been proposed between the body and its creditors or any class of them, the Court may, in addition to exercising any of its other powers, on the application in a summary way of the body or of any member or creditor of the body, restrain further proceedings in any action or other civil proceeding against the body except by leave of the Court and subject to such terms as the Court imposes."

The Court there restrained the commencement or continuance of proceedings against BLY until further order. The Court held that the announcement of the intended schemes to Australian Securities Exchange Limited was sufficient to constitute a "proposal" of the schemes for the purposes of s 411(16) of the Corporations Act. The Court also followed the relatively broad view of that subsection taken by McLure J in *Re Glencore Nickel Pty Ltd* (2003) 4 ACSR

210; [2003] WASC 18, in holding that the term “further proceedings” under s 411(16) could extend to proceedings that had not yet been commenced. The Court found that matters that supported the relief sought included the risk that individual steps taken by creditors could give rise to a preference or frustrate the procedure for a compromise of creditors’ claims under the schemes; that several substantial creditors of the company had committed to supporting the schemes; and that the schemes offered the possibility of a better return than a winding up. The Court also appointed the General Counsel and company secretary of BLY as a “foreign representative” of the proceedings under the Cross-Border Insolvency Act 2008 (Cth) and BLY subsequently made a successful application for recognition of the Court’s orders in the United States under Chapter 15 of the US Bankruptcy Code.

Composition of classes

A further issue as to the composition of classes for the proposed schemes was addressed in the Court of Appeal’s decision in *First Pacific Advisors LLC v Boart Longyear Ltd* [2017] NSWCA 116. The Court of Appeal dismissed an appeal brought by First Pacific Advisors LLC (“First Pacific”) against an order made under s 411 convening meetings of creditors of BLY and several associated companies, to consider and, if thought fit, agree to the proposed schemes. One of the proposed schemes was a secured creditors’ scheme relating to senior secured notes and monies owed to affiliates of Centerbridge Partners LP (“Centerbridge”) under two term loans. First Pacific held approximately 29% of the secured notes and contended that separate class meetings should be held of secured note holders in one class and Centerbridge as the term loan holder in the other class. First Pacific relied on several aspects of the secured creditors’ scheme which it contended amounted to differences in the treatment of the secured notes debt and the term loan debt, and also pointed to several associated transactions that were conditions precedent to the schemes, and contended that they made it impossible for the parties to consult as one class.

At first instance, the Court held that those differences were not so great as to give rise to an inability of the secured note holders and Centerbridge to consult together with a view to their common interest. On appeal, Bathurst CJ (with whom Beazley P and Leeming JA agreed) recognised the well-established principle that separate classes should only be ordered where the rights of creditors are so different that consultation as to their common interests would be impossible, with the authorities indicating that that question is determined by reference to legal rights rather than commercial interests.[5] The Chief Justice observed that the context of the proposed scheme was important in considering whether any difference in rights or different treatment of rights would make it impossible for creditors to consult together as a class,

[5] *Sovereign Life Assurance Company v Dodd* [1892] 2 QB 573; *Re Jax Marine Pty Ltd* [1967] 1 NSWR 145 at 148–149; *UDL Argos Engineering & Heavy Industries Co Ltd v Li Oi Lin* [2001] HKCU 1184; 3 HKLRD 634 at [27]; *Re Hills Motorway Ltd* (2002) 43 ACSR 101; [2002] NSWSC 897 at [12]; *Re HIH Casualty and General Insurance Ltd* (2006) 57 ACSR 791; 200 FLR 243; [2006] NSWSC 485 at [70]; *Re Opes Prime Stockbroking Ltd (No 2)* (2009) 179 FCR 20; [2009] FCA 813 at [64]; *Re Aston Resources Ltd* [2012] FCA 229 at [33].

and the creditors' rights under the terms of the scheme should be compared with those that would arise in an insolvent liquidation. The Court of Appeal held that, in that context, and taking into account the company's financial position, the creditors' existing rights and the rights provided for by the scheme were not so dissimilar as to require separate class meetings.

Approval of the schemes

The three creditor groups who would obtain equity in BLY voted in favour of the schemes at the scheme meetings, just satisfying the statutory majorities by number and value, and all other creditors voted against the schemes. The focus then shifted to the Court's decision whether to approve the schemes in their original form.

The scheme then had to be delayed after the fourth day of the second scheme hearing, since BLY had not yet been able to satisfy a condition precedent to the scheme as to further funding. I took the unusual step in a scheme of referring the matter to mediation, where (1) the parties to the schemes were highly sophisticated creditors, largely US and international hedge funds and institutional investors; (2) virtually all of them had voted in respect of the schemes, several of them appeared at the second hearing and those who did not appear had communicated their attitude to the schemes to the parties or the Court and (3) BLY was a large enterprise, with operations in 40 countries and 400 employees and was insolvent or close to insolvency, with risks to employees and the communities in which it conducted business if the schemes failed and BLY passed into external insolvency administration.

The creditors that had previously opposed the schemes, those that had supported them and BLY reached agreement at the mediation on terms that allowed a modest reduction in the equity to be issued to Centerbridge, Ares and Ascribe, the allocation of that equity to secured creditors, and an improvement to the return to secured creditors in exchange for the extension of the terms of their debt and the capitalisation of interest for a period. By the time the second court hearing resumed, after the mediation, the secured creditors' scheme was supported by all of the voting creditors and all but one of the voting unsecured creditors (and that one voting unsecured creditor's attitude was unknown). However, two associated shareholders opposed the schemes, which were disadvantageous to BLY's shareholders, at least by way of a comparison with the original scheme. The increased return to secured creditors reduced the value of equity value in BLY to a lesser positive value on a best case and to nil on a worst case, although the value of BLY's equity was also nil in a winding up.

The first instance judgment in respect of the second hearing dealt with both the original and altered schemes. The court held that less weight should be given to the majority vote in favour of the scheme where that majority had collateral interests, and that increased the focus on whether the scheme was fair. That judgment also dealt with issues as to the adequacy of expert reports, the extent of inquiry which was required by an expert in respect of a creditors' scheme, and particular criticisms of the approach adopted by the experts to the determination of BLY's value. The court held that, in the

possibly unique circumstances, it had power to approve the scheme in altered form under s 411(6) of the Corporations Act, which allows the Court to approve a scheme with such alterations as it thinks just, and should do so although the amendments were material in character. There appears to be no previous case where the Court had approved a scheme with material amendments of this kind.

A more difficult question at first instance was whether the Court should approve the schemes, where shareholders of BLY had previously voted to approve the issue of equity to Centerbridge under s 611 item 7 of the Corporations Act (dealing with takeovers) on the basis of more favourable original scheme. The Court held that the preferable course was for the Court to assess the alterations to the schemes on their merits, and leave any challenge to the validity of the approvals given by shareholders under s 611 to be determined in substantive proceedings, given the risk to the BLY Group and the shareholders of further delay and the fact that the altered schemes were still more favourable to shareholders than a winding up. The Court also addressed an argument as to the possible application of Ch 2E of the Corporations Act, dealing with related party transactions, to the scheme.

On appeal ([2017] NSWCA 215) the Court of Appeal upheld the decision that the Court had power to approve the scheme as altered, and there was no challenge to the exercise of the Court's discretion to do so.

Some aspects of the Boart Longyear decisions, including the extent of creditor involvement and the result of the mediation may be so out of the ordinary that they will have little general application. However, the decisions will be of wider significance in respect of the constitution of classes where a company is facing insolvency and in confirming that the alteration power in respect of schemes can have wide operation, at least if a significant number of shareholders or creditors affected by a scheme support alterations to it.