AUSTRALIAN BANKERS' ASSOCIATION

Submission by the Australian Bankers' Association to the Joint Parliamentary Committee on Corporations and Financial Services

Inquiry into Australia's Insolvency Laws

June 2003

Table of Contents

Introduction

Australian Bankers' Association (ABA) represents 23 banks authorised to carry on banking business in Australia. ABA's membership includes Australia and New Zealand Banking Group Limited, Commonwealth Bank of Australia, National Australia Bank and Westpac Banking Corporation together with a number of regional and foreign banks.

ABA's members are major providers of finance, secured and unsecured, to both large and small businesses operating in Australia.

The price, availability and terms of business finance provided by member banks is determined largely by their assessment of the credit risk in lending to a particular business. Part of this assessment includes the impact of regulatory risk. This relates, in part, to the laws that determine the ability of the bank to recover the money it has lent with certainty and expedition.

Credit policies and practices of banks have contributed to Australia's high standards of safety, security and stability in the financial system. This stability provides for a degree of certainty of lending. Australia's insolvency laws have played their part in this by recognising the importance and priority of loan security.

This submission will suggest some possible ways to improve the operation of voluntary administrations, explain why importing a US Chapter 11 style administration would be unsuitable for Australia and provide comments on selected topics that the Committee has under its consideration.

The Committee already has a submission from ABA dealing with the treatment of employee entitlements.

Operation of voluntary administration laws and the appointment of, removal and function of administrators and liquidators.

Secured Creditors' Rights

Banks support the current voluntary administration regime under the Corporations Act. They report positive experiences when dealing with voluntary administrations under the Act. They believe there are areas where the voluntary administration provisions could be improved.

Often, banks are secured creditors in a voluntary administration. On the appointment of a voluntary administrator a secured creditor is prevented from dealing with property subject to its security or enforcing guarantees during the administration period unless there is specific provision in the Act for this.

The Act does provide for a ten day business decision period from the appointment of the administrator for a secured creditor or chargee to make up its mind whether or not to enforce its security. This is often too little time for this important decision to be made. It is important for both the company under administration and the chargee. Ten days is insufficient for a chargee to make a proper assessment of the risks to assets that are subject to the security and whether the chargee creditor should appoint a controller (i.e. appoint a receiver and manager or enter into possession of the security property itself).

ABA submits that the decision period should be extended to 15 business days. This would be particularly relevant in the case of a large or complex company administration. The extra time would provide a better opportunity and basis for more accurate assessments to be made by both the chargee and the administrator on the future prospects for the company and the effect the continuing administration will have on the assets covered by the security.

Also, the Act could be made clearer that under section 440B, the written consent of an administrator to the chargee enforcing its charge is able to be given by the administrator during the decision period so that the chargee is free to act upon that consent at a later time after the decision period has expired. This would help to resolve the issue of uncertainty referred to above.

ABA submits that if the administrator forms the intention within a secured creditor's decision period to seek an extension of time for convening the second meeting of creditors, the administrator should be required to communicate this to the secured creditor. The fact that the administration may be extended would be a relevant consideration for a secured creditor in deciding whether to enforce its security over the company's property. It is relevant because of the potential risk to the value of the assets of the company in the extended period of the administration.

Meetings of Creditors

ABA has considered whether it is necessary for the voluntary administration regime to draw a distinction between large and complex companies and those of lesser dimensions. On balance ABA submits that this is not necessary. Defining and monitoring the application of criteria that would be necessary to administer the difference would be practically difficult. Presumably such criteria would include for example, turnover, size of workforce, whether the company is a holding company or a related entity in a group of companies or a combination of each.

ABA submits that the current system of voluntary administration works well.

For creditors and the company a key point is the time within which meetings of creditors must be called and the needs of creditors and the administrator for adequate time to make proper assessments of their respective positions.

Speed is an important ingredient of a voluntary administration because rights of certain parties are suspended during this period. Speed at the expense of adequate time to assess the future prospects of the company and to inform the creditors of the company is undesirable. The dragging on of an administration, whilst trading at a loss, dissipates assets that may be subject to a floating charge where a chargee may not have stepped in to protect those assets. Those assets would be available for priority creditors such as employees were the chargee to step in and enforce the charge

Often the company has been poorly run and has failed to keep proper records. Furthermore, existing management is likely to have contributed to the companies' difficulties for any number of reasons, such as inexperience, incompetence or inappropriate strategies. It can take time to discover relevant information before considered decisions can be taken about the company's future.

Reform options considered by ABA include extending the times within which the first and second meetings of creditors may be convened.

Commonly in the larger and more complex administrations an administrator will make application to the Court to extend time for convening second meeting of creditors. It is sometimes necessary for an application to the court for time to be extended in less complex administrations. The cost of applications to the court for extra time for convening meetings could be reduced by extending the convening time but preserving the timing advantages of the voluntary administration for the creditors and the company. However, the availability of the court to enlarge time as an aid to flexibility of the administration is an important aspect of the success of the voluntary administration regime. ABA does not see the need to amend the Act to extend or significantly extend the time within which these meetings are required to be convened.

However, it is unclear if the Court has power to extend the convening period for the first meeting of creditors. This meeting must be convened within five business days of the administration beginning. Experience has shown that for large organisations such as banks, this notice often takes longer than 5 business days to reach the relevant area in the organisation leaving little time for a proper assessment to be made.

ABA submits that the Act should be amended to confer an express power on the Court to extend the time within which the administrator should convene the first meeting.

ABA also submits that the statutory time for convening the first meeting should be extended to seven business days. More time would mean that all creditors were more likely to be identified and notified.

The second meeting of creditors is a critical meeting. This is recognised in the Act in two ways. First, the time for convening the meeting is between 28 and 35 days (depending on public holidays) after the administration begins. In the time available, the administrator must prepare a report on the company and its affairs, provide a statement of the administrator's opinion about the future direction of the company and if necessary, provide details of any proposed deed of company arrangement.

Secondly, there is an express provision for the court to extend the convening period for the second meeting of creditors. ABA agrees this power is necessary and repeats its view that the ability of the court to enlarge time in this way has been a major contribution to the success of the voluntary administration regime...

In summary, ABA submits that:

1. the decision period for a secured creditor to decide whether to enforce its security should be extended under the Act to 15 business days;

2. if, during the decision period the administrator forms the intention to seek an extension of time for convening the second meeting of creditors, the administrator must notify secured creditors;

3. the voluntary administration provisions with some modifications are sufficiently robust to avoid the need to make distinctions in the law between large and complex companies and other companies;

4. the convening period for the first meeting of creditors should be extended for up to 7 business days; and

5. it should be made clear in the Act that the court has the power to order an extension of the convening period for the first meeting of creditors.

Is a US Chapter 11 Style Administration needed in Australia?

Introduction of a US Chapter 11 style regime as currently operates in the US to deal with perceived shortcomings in Australia's voluntary administration regime has been suggested in at least one submission to this inquiry. The suggestion seems to be based on the presumption that the voluntary administration regime is restricting large or more complex companies from attempting to restructure and return to the market competitively and with economies of scale.

It is noted that the Australian Companies and Markets Advisory Committee (CAMAC) is currently conducting an investigation into aspects of Australia's voluntary administration regime. CAMAC has been asked to recommend ways the voluntary administration regime might be improved if it is found there are difficulties in the way the regime applies to large and complex enterprises. One of CAMAC's tasks is to consider whether a US style Chapter 11 system would assist in this respect.

ABA will be making a submission to CAMAC on this matter. An issues paper is expected to be released by CAMAC soon for public comment.

ABA submits that the voluntary administration regime in Australian has worked comparatively well and that any perceived difficulties with the regime can be addressed through ensuring that the right balance is struck between the information needs of creditors, the position of secured creditors and time constraints imposed by the legislation. CAMAC (then CASAC) made a finding in its 1998 report that the corporate voluntary administration regime in Australia was generally successful and popular. Recent statistics indicate that about 40% of companies have utilised the voluntary administration system.

Some recent public comment on Chapter 11 provide some helpful insights into the pitfalls of this form of bankruptcy protection (see Australian Financial Review 3 June 2003 "Chapter 11 doesn't fit Australian story" by Messrs Korda and Mentha).

The instance that some cite of the Pasminco administration as supporting the case for introduction of a Chapter 11 regime into Australia on closer analysis does not support the case that the voluntary administration regime fails large and complex companies. In the Pasminco administration the court was able to extend time where necessary to deliver flexibility. This allowed the administrator to address the complex legal and business issues encountered. The flexibility provided within the framework of Part 5.3A of the Corporations Act combined with the judicial overview of the administration process provided for a successful and efficient restructure to be attained.

The following is an outline as ABA understands of the timeframes within the Pasminco administration worked:

- 19 September 2001 – Appointment of Administrator
- 26 September 2001 – First meeting of creditors held
- 5 October 2001 – Court order approving extension of the convening period by 90 days to 7 January 2002
- 13 December 2001 – further order made by the court approving the extension of the convening period by 90 days to 8 April 2002
- 27 March 2001 – further order made by the court approving the extension of the convening period by 90 days to 8 July 2002
- 15 July 2002 – Second meeting of creditors held, adjourned for 14 days
- 30 August 2002 – Deed of Company Arrangement executed

Another administration which has been the subject of media comment is the Ansett administration. The administrators of Ansett have stated their belief (op cit Messrs Korda and Mentha) that Chapter 11 would not have saved Ansett. ABA supports that view. Whatever strategies an administrator might have taken with the benefit of hindsight, the losses were always going to be there. There was no failure of the voluntary administration regime and in stating this we do not suggest any failure on the part of the administrators.

The Ansett example also points to the flexibility of the voluntary administration process and to the focus on preserving assets for the benefit of all creditors.

ABA does not support importing an overseas style regime to Australia's local conditions to replace a voluntary administration regime that is working well. Indications on US experience under Chapter 11 indicate that many of the companies that emerge from bankruptcy protection later require further restructuring.

The important distinguishing features between a Chapter 11 administration and a voluntary administration are:

1. Whilst both regimes impose a moratorium on creditors' claims, the voluntary administration regime places tighter timeframes to minimise the inconvenience and prejudice to creditors through the abridgement of their propriety rights and rights accrued under freedom of contract. The court is able to provide flexibility while taking account of creditors' interests.

2. Unlike Chapter 11, under the voluntary administration the secured creditor or chargee retains control over the decision about its security even though there is a time limit affecting the decision whether to enforce the security. This makes it less likely for a chargee to act due to uncertainty and therefore more likely to work with a restructure.

3. Under Chapter 11, the company generally retains its own executives to administer the affairs of the company. This is known as "debtors in possession". As noted earlier, existing management is likely to have contributed to the company's difficulties for any number of reasons including, inexperience, incompetence and inappropriate strategies and possibly even fraud. Under voluntary administration the company's management is assumed by an independent, qualified administrator.

4. Under Chapter 11 bankruptcy protection ABA understands that a company could enjoy substantial taxation relief which in effect transfers the company's failure beyond its creditors and shareholders onto the entire community.

5. ABA understands that quite lengthy timeframes apply to proposed plans for reorganisation that would see a company under Chapter 11 administration having no certainty of future direction for over 6 months and in practice much longer. The "debtors in possession" develop the plan in the first 120 days after the commencement of the Chapter 11 administration and then a further 60 days is available for them to secure confirmation of the plan. The court also routinely extends these periods in large cases. Once these times have expired its open for other interested parties to propose their own plans of re-organisation and if none of the plans is accepted the company will be liquidated. Under voluntary administration there are time frames that mean similar decisions are undertaken more quickly and under the supervision of a qualified independent administrator. In the Ansett and Pasminco cases, quite lengthy periods of time were approved by the court for all available avenues to be explored to avoid liquidation.

6. The voluntary administration regime provides a transparent framework for all creditors, through the appointment of an independent administrator whose primary responsibility lies with all creditors. Whereas the Chapter 11 process supports existing management and benefits shareholders, to the detriment of creditors. The investor seems to be preferred over the creditor.

7. With the longer timeframe for a standard Chapter 11 bankruptcy protection administration there is the increased ability of management to trade at a loss, thereby dissipating assets available to creditors. Under the voluntary administration process Part 5.3A of the Corporations Act imposes personal

liability on the administrator for amounts incurred in the course of the administration. This causes the administrator to minimise unprofitable trading. In turn this will mean less likelihood of assets available to creditors being dissipated.

8. The advantage of the current Australian insolvency model is that there is the access to a number of different regimes, dependent upon the given situation. Should administration not be appropriate, there is the possibility of a company/creditor utilising a provisional liquidator, a creditors' voluntary winding up and even a receivership. Accordingly, the current regime is adaptable to the given situation. The extensive provisions already open to companies and advisers means that adoption of a Chapter 11 type regime would be superfluous.

Chapter 11 has the potential to significantly distort a competitive market and disadvantage competitive businesses that have run their businesses efficiently and properly. The standard prolonged timeframes under Chapter 11 increases this potential flow-on detriment. Chapter 11's aim seems to be to save the company almost at all costs. The objective of the voluntary administration is to maximise the return to creditors. With saving the company as the priority this could lead to creditors having to accept a substantial reduction in their claims or nothing at all while the company with its competitive advantage carrying on with that advantage over its competitors.

If creditors are prevented over a lengthy period of time from recovering monies due by the company they, in turn, will suffer reductions in cash flow that will impact on their ability to pay creditors of their own business. There is a flow on effect.

The Chapter 11 moratorium on the company's also places the company in a competitively advantageous position relative to other businesses that are not financially troubled. Because a voluntary administration process is conducted over a relatively short period during which a work-out might be considered feasible, the creditors of the company do not suffer long term financial and competitive disadvantage as they would if the Chapter 11 protection regime applied.

By freezing existing creditors' claims against the company under Chapter 11 protection the company can continue at a competitive advantage by being able to offer customers terms that its competitors could be unable to match. The competitors risk losing their client to the company under Chapter 11 protection and increasing their own risk.

If a Chapter 11 style administration is included in Australian law, secured creditors will need to reassess their lending policies and practices to take account of the increased risk should one of their clients seek protection of a Chapter 11 style administration. If a secured creditor is unable to exercise the option of replacing a client's existing management with an administrator, such as a controller, it is very likely that there will be an appreciable rise in credit (and regulatory) risk accompanied by stricter terms and conditions on lending which would extend to the price and availability of finance.

There is a significant difference between the US and Australia in relation to the nature of a security that a lender can take over a company's assets. In short the concept of a fixed and floating charge by way of security over the whole of a company's assets, a concept that is central to Australian corporate law and bank lending, is not a feature of the US system. Therefore, ABA understands that Chapter 11 protection does not recognise the right of a secured creditor to appoint its own controller to a company under bankruptcy protection. Australia's voluntary administration regime recognises and protects this right through the "decision period" provisions in the Corporations Act.

ABA submits for the Committee's consideration how creditors and the general community would have fared had the existing management of Quintex, Bond Corporation, One-Tel, Ansett and other companies too numerous to mention had the management of those companies not been replaced by an administrator.

ABA further submits that with CAMAC's inquiry to include a consideration of the merits and demerits of Chapter 11 bankruptcy protection, ABA submits that the Joint Committee might reserve its findings and recommendations on this matter until after CAMAC has reported.

The duties of Directors

ABA notes that unless it appears to the voluntary administrator that conduct of the directors or other relevant persons involved with the company constitutes a breach of the certain laws, particularly in respect of insolvent trading and antecedent transactions of the company, there is possibly little incentive for the administrator to actively investigate such matters where the creditors may be prepared to accept a deed of company arrangement. This may be despite section 439A(4).

In the absence of liquidation, it may be easier for directors to avoid subsequent investigations into their conduct by utilising the voluntary administration option. Therefore a deed of company arrangement that could provide a marginally better return than under liquidation could be supported by creditors but without their full knowledge of how the director's had discharged their duties to the company in the past.

ABA acknowledges that cost is a key factor in a voluntary administration but creditors should know when considering a deed of company arrangement whether there is evidence that the directors have continued to operate the company whilst it is insolvent or have committed other breaches of the law. At present the administrator need only form an opinion for creditors about voidable transactions (regulation 5.3A.02) and not whether there has been insolvent trading.

The administrator has little time to form a clear opinion on this aspect. Perhaps ASIC could provide to administrators their own checklist of insolvent trading indicators for the administrator to use and give to creditors and to ASIC for their consideration.

ABA notes that section 438D (3) provides an opportunity for an interested person to seek a court order that the administrator lodge a report with ASIC on such matters.

Commonly, directors tend to only seek the protection of a voluntary administration once the Australian Taxation Office has served a statutory notice on the company as a precursor to winding up the company. Also, a voluntary administration prevents a creditor enforcing a guarantee against a director whilst the administration is in force. This allows time for directors to rearrange their affairs (if they have not already done so prior to the appointment of the administration) to the possible disadvantage of creditors.

Rights of Creditors

Enforcing charges

Within the decision period after the commencement of a voluntary administration, a secured creditor has an option whether to enforce a charge over the property of a company under administration. Under section 441A of the Act the right of a secured creditor to opt within the decision period to enforce its security is limited to-

a. holders of charges over the whole or substantially the whole of the property of the company and
b. who wish to enforce the charge in relation to all the property of the company.

This means that a secured creditor would not be able to make an appointment of a controller to just one part of the property of the company subject to the charge even if its charge extended over most of the company's property. The creditor would have to appoint a controller over all of the property subject to the charge.

There can be assets, which the secured creditor could conveniently deal with whilst leaving other assets in the hands of the administrator in a way, which may facilitate the company continuing to operate, rather than going into liquidation.

Also, the creditor may need only to enforce this charge over a part of the assets of the company to be repaid its debt in full. However the way the Act is worded, the chargee would have to enforce the charge over all of the property and return any surplus to the administrator. This would seriously affect the prospects of the company continuing to operate.

Other incorporated bodies

A voluntary administration is not available to incorporated entities that are not companies such as clubs, associations and the like. Were such entities are to become insolvent there is no alternative other than receivership or liquidation.

ABA submits that the Act should allow incorporated entities other than companies to avail themselves of the voluntary administration process.

Effect of section 440C

The Act does not make it clear whether a controller who is appointed to the property of a company during the course of the company's voluntary administration is an agent of the company or an agent of the secured creditor who appointed the Administrator.

It is generally clear that in the liquidation the controller's agency of the company ceases.

This is important because of the effect of section 440C of the Act. If the controller ceases to be the agent of the company in voluntary administration then the controller may be unable to take active steps to stop an owner or lesser of property that is in possession of the company from recovering possession of that property.

ABA submits that this should be clarified and that the controller should continue to be regarded as the agent of the company.

Effect of section 443A (1)

Under Section 443A (1) it is not clear whether an administrator who obtains financial accommodation in the course of the administration is liable to pay for the that financial accommodation as a debt incurred for "services" rendered in the course of the administration. ABA submits that Section 443A(1) should be amended to make it clear that an administrator is personally liable for financial accommodation (i.e. financial services) obtained by the administrator in the course of the administration in the same way as the administrator is liable for other "services".

Creditors' voting

Confidence in the voluntary administration process depends in part on creditors being able to verify that voting according to creditors' claims can be verified. This is particularly relevant where there is some other relationship of the creditor with the company or its directors.

ABA submits that in order to avoid possible manipulation of voting all proofs of debts should include a declaration stating the relationship, if any, between the creditor and the company and its directors and whether the transaction was entered into on a commercial or arms length basis. The administrator may exercise a discretion whether to allow or disallow the vote of such creditors.

Also, where voting on a proposal fails to achieve a majority by number and amount the administrator may exercise a casting vote. ABA submits that the casting vote should be exercised by the administrator in favour of the vote of the majority of creditors by amount rather than by number

The Cost of External Administrations

Notice requirements under the Act and the need for an administrator to apply to the court for leave to give required notices more efficiently and at much less cost indicate scope for streamlining the Act to reduce the cost of these administrations. Option such as were sought in the Ansett administration should be considered for inclusion in the Act as authorised means for these requirements to be met. They include use of websites, provision of material on request electronically and newspaper advertisements for some notices and information material.

Compliance with and Effectiveness of Deeds of Company Arrangement

Creditors need adequate time to assess the merits of a deed of company arrangement (DOCA). Generally speaking, with the existing time constraints for convening the second meeting of creditors it is unrealistic to expect creditors to receive a copy of the proposed deed much time before the meeting at which it is to be considered.

ABA submits that at a proposed DOCA should be provided to creditors at least 7 days before the relevant meeting. If the time for convening the meeting is extended as proposed this would be achievable.

Performance under DOCAs has been the subject of criticism. This has been attributed to a lack of proper supervision of the company's performance under the DOCA.

A DOCA should be developed with its own performance standards or indicators so that creditors can monitor the DOCA and be confident the company is "on track". The directors should be required to report to creditors at appropriate intervals on the company's performance against the DOCA's performance indicators.

There should be consequences for anyone who interferes in or obstructs the company's performance under the DOCA.

Whether Special Provisions should be made regarding the use of Phoenix Companies

ABA members report that the incidence of the use of Phoenix companies does not seem to be abating.

Those persons involved in multiple corporate failures where creditors receive less than 50c in the dollar (usually nothing) are known to ASIC and often receive bans for up to five years from acting as directors or taking part in the management of a company.

There would be a benefit to the business community if this information were organised in a way, for example as a register, that is readily available to businesses as part of their business and credit risk decision making processes.

ABA appreciates the opportunity to make this submission to the Joint Committee and thanks the Committee for its indulgence for the extra time it has taken us to prepare and lodge this submission.

Australian Bankers' Association
20 June 2003.