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DOING BUSINESS IN AUSTRALIA

RESTRUCTURING AND INSOLVENCY

HERBERT SMITH FREEHILLS

Chapter 9

Restructuring and Insolvency

Australia has a comprehensive legal regime relating to restructuring and insolvency. It is predominantly contained in the *Corporations Act 2001* (Cth) (**Corporations Act**). The main restructuring and insolvency procedures in Australia are:

- administrations, including deeds of company arrangement (**DOCAs**);
- schemes of arrangement;
- liquidations (also known as 'winding ups'); and
- receiverships.

Each of these are discussed below.

Australia's restructuring and insolvency procedures are generally considered 'creditor-friendly', focused on achieving the best return for creditors.

Administration

Overview

Administration is governed by Part 5.3A of the Corporations Act and is the most common form of corporate reorganisation. It involves the appointment of an external administrator and is designed to resolve a company's future direction. The administrator takes control of the company and its business with the objective of maximising the chances of the company or its business continuing in existence or, if that is not possible, to obtain a better return for the company's creditors and members. This may include reorganisation in the form of a DOCA.

Appointment

Administration commences on the day an administrator is appointed. The company can appoint

an administrator if its board resolves that the company is, or is likely to become, insolvent (i.e. if it is not able to pay its debts as and when they fall due). This is referred to as 'voluntary administration'.

An administrator can also be appointed by a liquidator or provisional liquidator if he or she thinks that the company is, or is likely to become, insolvent, or a secured creditor who has an enforceable security interest in the whole, or substantially the whole, of a company's property. However, secured creditors usually prefer to appoint a receiver.

Supervision and control

The administrator has control of the company’s business, property and affairs, and has broad powers to carry on, terminate or dispose of the business or property of the company (subject to certain exceptions).

Although the appointment of an administrator cannot be revoked, an administrator can be removed by the creditors or the court in certain circumstances.

Stages and timing

The two main stages of an administration are the first and second meetings of creditors. Two issues are determined at the first meeting: (i) whether the administrator should be replaced by another person; and (ii) whether a creditors' committee should be appointed.

The company’s future direction is decided at the second meeting of creditors. The creditors will consider the administrator’s report and determine whether: (i) the company should execute a DOCA; (ii) the administration should end and control of the company be returned to the directors; or (iii) the company should be wound up.

Moratorium

A stay, referred to as a 'moratorium', applies throughout the duration of the administration which prevents, among other things, the winding-up of the company, secured parties enforcing security interests, lessors or third parties taking possession of leased or owned property, and court or enforcement proceedings against the company or its property.

There are exceptions to the moratorium including where creditors obtain the administrator’s consent, or leave of the court to enforce, or have taken steps to enforce the security before the administration’s commencement. A secured creditor with security over the whole, or substantially the whole, of the company’s property may also take enforcement action within the 'decision period' (13 business days from notice of the administrator’s appointment).

The stay does not commonly prevent counterparties from exercising contractual rights to terminate a contract, accelerate debt or make demands for payment, but this position is expected to change in 2018 when new legislation restricting the enforceability of ‘ipso facto’ clauses is anticipated to come into effect.

Ipso facto stay

Where a company enters administration there is a stay on contractual counterparties exercising contractual rights (including rights to terminate the contract) by reason of:

- the company having entered administration;
- the company’s financial position;
- a prescribed reason (none have yet been prescribed); or
- something that is in substance contrary to the above.

The *ipso facto* stay is not intended to restrict a counterparty from enforcing a right for any other reason, such as a breach involving non-payment or non-performance. The *ipso facto* stay does not apply to contracts entered into prior to 1 July 2018, and there are number of other exceptions, including for certain types of contracts and rights.

Operation of the business

The administrator has the power to operate the company's business. The company may continue to incur debts and obligations, and sell products and services in the ordinary course of business, with the administrator’s authorisation. The administrator is personally liable for debts and liabilities incurred in performing his or her functions and powers for: (i) services rendered; (ii) goods bought; (iii) property hired, used or occupied; and (iv) repayment of money borrowed (and related costs and interest). However, the administrator is entitled to be indemnified out of the company's property for debts and liabilities incurred in the performance of the administrator's functions. This will generally take priority over unsecured creditors but not secured creditors.

Business and asset sales

The administrator has the power to dispose of the business and property of the company. The administrator must act reasonably in exercising that power. However, the administrator must not dispose of secured property, or property of which someone else is the owner or lessor,

unless: (i) the disposal is in the ordinary course of the company's business; (ii) the written consent of the secured party, owner or lessor has been obtained; or (iii) leave of the court has been granted. Proceeds of sale of secured property must be applied to any debts secured by the security interest over the assets sold. The purchaser will acquire the assets free of existing claims and security.

DOCA

Before the second meeting of creditors, any person may propose a reorganisation by way of a DOCA. The DOCA may recommend a variety of things to achieve a better return to creditors than would otherwise be available in a liquidation. The rights of secured creditors, owners and lessors will generally not be affected by a DOCA (subject to certain important exceptions).

The administrator will give its opinion as to whether a DOCA is in the creditors' interests. The creditors will subsequently vote on whether the company should enter into the DOCA. If a majority of the creditors (by value and number) vote in favour of the resolution, the DOCA will be approved. It will subsequently be executed by the administrator. A DOCA will bind the company, its officers and members, the deed's administrators, and all creditors (subject to certain exceptions).

Schemes of arrangement

Schemes of arrangement in Australia may be creditors' schemes (i.e. schemes affecting the rights of creditors of a company) or members' schemes (i.e. schemes affecting the rights of members (shareholders) of a company). A creditors' scheme is a court approved compromise or arrangement between a company and its creditors (or class thereof).

A scheme of arrangement is usually proposed by a company to its creditors. The process involves the following 3 main steps:

- an application is made to the court for an order to convene a meeting of creditors (or class thereof) to vote on the proposed compromise or arrangement. Notice must be given to ASIC, who must have a reasonable opportunity to consider the terms of the proposed compromise or arrangement and to make submissions to the court;

- the meeting of creditors is held at which creditors vote on the proposed compromise or arrangement; and

- if the creditors vote in favour of the proposed compromise or arrangement, the court then decides whether to approve the scheme.

To be approved, a majority in number and at least 75% by value of creditors present and voting must vote in favour of the scheme. The court may grant its approval of the scheme subject to any conditions it thinks fit. Once approved, the scheme takes effect in accordance with its terms.

Creditors’ schemes of arrangement are generally only used in respect of large financial restructurings as they are considered relatively lengthy and expensive processes.

There is an *ipso facto* stay that applies where a scheme of arrangement is proposed to avoid an insolvent liquidation of the company.

Compulsory liquidation and voluntary liquidation

Compulsory liquidations (where the court orders the winding up of the company) and voluntary liquidations (where the shareholders vote for the company to be liquidated) are governed by the Corporations Act and are commonly used in Australia. They involve the appointment of an external liquidator to the company. The objective of the liquidation is to collect the company's assets, realise them and distribute the proceeds of sale to creditors. The liquidator also has broad powers to investigate the company's affairs and challenge certain transactions entered into by the company.

Initiation

Compulsory liquidation

Compulsory liquidations are initiated by application to the court for an order that the company be wound up. The application may be made by a variety of persons including the company, its members and creditors. The court can make the order on a number of grounds. It is most commonly made on the basis the company is insolvent. The company is presumed to be insolvent if it fails to comply with a statutory demand.

Voluntary liquidation

Members of a company can resolve to wind up the company by way of a voluntary liquidation, at which point a liquidator is appointed. If a declaration of solvency is made by the directors, it will be a 'members' voluntary liquidation, which is intended to be a solvent process. If no such declaration is made, or if a liquidator subsequently finds the company is in fact insolvent, it will be a creditors’ voluntary liquidation. Creditors of a company in administration may also appoint a liquidator at the second meeting of creditors, having resolved that the company be wound up. The administrator generally becomes the liquidator in that instance.

Supervision and control

The liquidator supervises and controls the liquidation. The court has little or no involvement, unless applications are made to, or the liquidator has been appointed by, the court. The court and the creditors may, in certain circumstances, remove and replace the liquidator.

Operation of the business

The business of the company is usually shut down before or upon commencement of the liquidation. However, the liquidator has the power to carry on the business of the company provided it is for the beneficial disposal or winding up of the business.

Business and asset sales

The liquidator will conduct a sale of the business and assets of the company with a view to benefiting the creditors. The liquidator is at liberty to choose the nature of the sale, and does not need creditor or court approval, but in doing so, the liquidator is required to exercise due care and diligence. Except in certain circumstances relating to the sale of secured property and payments statutorily preferred, sale proceeds form part of the assets of the company available for distribution to the company's creditors. If the liquidator sells secured property, the secured creditor will be entitled to be repaid from the proceeds of any sale in priority to other creditors. The liquidator does not have the power to sell assets free of security (unless in certain circumstances where the security has vested).

Receivership

Secured creditors may appoint external officeholders, known as 'receivers', to take possession of and sell the secured property to repay the debt secured by the security interest. A 'receiver and manager' has broad powers to manage the company’s business and will generally seek to sell it as a 'going concern'.

Receiverships are governed by Part 5.2 of the Corporations Act and the security agreement between the company and the secured party. The court also has the power to appoint receivers, but this rarely occurs in practice.

The court typically has little or no involvement in the receivership, although it has certain powers which it can exercise if necessary.

There is an *ipso facto* stay that applies where a receiver is appointed to the whole, or substantially the whole, of a company’s assets.

Appointment

The security agreement generally grants the secured party the right to appoint a receiver when the security becomes enforceable. This is generally following the occurrence of an 'event of default'. The appointment is made by way of deed, entered into between the secured party and the receiver, and the receiver usually requires an indemnity from the secured creditor.

Operation of the business

The receiver frequently operates the business of the company during the receivership if the receiver has been appointed over all the assets of the company.

Business and asset sales

The receiver has the power to sell the secured property over which they are appointed. The receiver must take reasonable care to sell the property at market value or, if the property does not have a market value, for the best price reasonably obtainable.

Proceeds of sale are applied according to the security agreement under which the receiver was appointed. The security agreement will normally provide for payment of the receiver's costs, expenses and remuneration first and then repayment of the debt secured by the security interest. Any surplus must be paid back to the company.

Comparison with the U.S. Bankruptcy Code

Whilst the insolvency laws in Australia and the U.S. have similar purposes, there are key differences between these regimes. Broadly speaking, Chapter 7 of the U.S. Bankruptcy Code (**Chapter 7**) is the equivalent to Australian liquidation. Certain features of administration and schemes of arrangement in Australia are analogous to Chapter 11 of the U.S. Bankruptcy Code (**Chapter 11**), however there are also significant distinctions.

Chapter 11 is intended to comprehensively deal with all creditors and other interest holders in a single process, which is intended to result in a plan of reorganisation. If approved, all secured debt will typically be treated under such plan and all unsecured debt and equity interests may be compromised. By contrast, a scheme of arrangement under Australian law would only deal with a specific class of debt.

Filing for relief under Chapter 7 or Chapter 11 provides a debtor with a broad moratorium, which stays an array of creditor actions. This moratorium has some similarities to the stay applicable during an administration in Australia. However, the stay under a liquidation in Australia is more limited than a Chapter 7 or Chapter 11 moratorium, and there is no stay

applicable to a scheme of arrangement under Australian law.

Under Chapter 11, a debtor and its management are permitted to continue operating the business and acting for the company (except in limited circumstances). Chapter 11 is a 'debtor in possession' regime. By contrast, the Australian regimes (except for a scheme of arrangement) all involve the appointment of an external administrator who takes control and management of the debtor company.

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