INSOLVENCY REFORM: LET’S NOT FORGET ABOUT THE SCHEME OF ARRANGEMENT REGIME (AGAIN!)

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Legal Briefings – By Andrew Rich and Malika Chandrasegaran

IN BRIEF

- The Australian Federal Government (Government) has announced a number of welcome proposed insolvency reforms in its Improving Bankruptcy and Insolvency Laws Proposals Paper released on 29 April 2016¹ (Proposal).

- To complement these proposals, reforms to the creditors’ scheme of arrangement regime should also be added to the agenda. While creditors’ schemes of arrangement are an effective tool for restructuring large corporate groups, reforms to the regime are necessary to meet modern day restructuring needs.

- We discuss seven key reforms: (1) giving the court broader moratorium powers; (2) extending the court’s jurisdiction to deal with foreign subsidiaries under an Australian scheme of arrangement; (3) cramming down on out of the money shareholders and creditors; (4) removal of Listing Rule restrictions on issuing new shares; (5) abolishing the anachronistic head count approval requirement; (6) giving the court the discretion to make a binding determination on class composition at the first court hearing; and (7) ensuring that explanatory statements are publicly available.

BACKGROUND

As part of the Government’s innovation agenda, a shake-up of insolvency laws is on the cards, with the focus set to shift from penalising failures to encouraging entrepreneurship.

About a week before the Federal election was called, and following a December 2015 Productivity Commission report entitled ‘Business set-up, Transfer and Closure’² (Report), the Government released for comment the Proposal containing three major insolvency reform proposals. However, an important aspect of the insolvency law reform process - reforms to the creditors’ scheme of arrangement regime – was not included in the current agenda.

This is particularly significant given that the regime was introduced in the late 1800s and has not been materially amended since, leaving it failing to meet modern day restructuring needs in a
number of respects. Modification to the regime is crucial to advance Australia's reputation as a regional hub for large corporate restructures.

An effective tool for restructuring large corporate groups, creditors’ schemes of arrangement have recently been successfully used in a number of high profile restructures, including Alinta, Centro, Nine Entertainment and Atlas Iron. Creditors’ schemes have significant advantages over the alternative of deeds of company arrangement (or DOCAs). Most notably, when creditors’ schemes are used, the distressed company is not exposed to the stigma of entering an administration process, thus avoiding significant potential value destruction.

**REFORMS TO THE CREDITORS’ SCHEME OF ARRANGEMENT REGIME**

To enhance the creditors’ schemes of arrangement framework, seven key reforms are necessary. These complement the reform proposals contained in the Proposal and we hope to see them added to the agenda. These are discussed below.

**REFORM 1 - BROADER MORATORIUM POWERS**

It is essential that the courts are given broader powers to create moratoriums on creditor enforcement action during the formation of a scheme of arrangement.

In its Report, the Productivity Commission recommended that the Corporations Act be amended to achieve that result. As a safeguard, the Productivity Commission proposed that the courts also be given the power to lift all or part of a moratorium if its application would lead to unjust outcomes. Unfortunately, this important reform proposal was not included on the Government’s current agenda.

Currently, s411(16) of the Corporations Act enables a company to apply to the court to restrain further proceedings against it where a restructuring has been proposed. While this is intended to provide the company with breathing space to implement a restructure, a number of deficiencies limit its effectiveness in practice.

The Corporations Act should be amended to give the court the discretion to make a restraining order from the early stages of formulation of a creditors’ scheme. The current language requiring the scheme of arrangement to have been 'proposed' presently limits this ability - the limited case law to date has indicated that a scheme will have been proposed if the draft scheme documentation has been submitted to ASIC as part of its statutory review process. It should be possible for moratoriums to be put in place much earlier than this.

The Corporations Act should also give the court discretion to not only restrain 'further proceedings' but impose a moratorium on any enforcement action generally by creditors subject to the proposed scheme.

In addition, the court should have the discretion to impose the moratorium on the relevant creditors of not only the company that is the subject of the proposed creditors’ scheme of arrangement, but also other members of its corporate group (at least to the extent that the proposed creditors’ scheme would be capable of effecting a release of claims against such other group entities). This would recognise the reality of multiple obligors and complex cross-guarantee arrangements in large corporate groups.
REFORM 2 - ABILITY TO DEAL WITH FOREIGN SUBSIDIARIES UNDER AN AUSTRALIAN SCHEME OF ARRANGEMENT

A large Australian corporate group will often have foreign subsidiaries which cannot currently be the subject of an Australian creditors’ scheme of arrangement. This can lead to difficulties and inefficiencies in seeking to implement a restructure. The Corporations Act needs to be reformed to expressly extend the court’s jurisdiction to foreign subsidiaries in appropriate cases.

In this regard, the Corporations Act should specify that a court has jurisdiction in respect of not only ‘Part 5.1 bodies’ (as is currently the case), but also foreign subsidiaries that have an Australian centre of main interests (or “COMI”). In addition, if a foreign subsidiary has debt obligations that are governed by an Australian law, those obligations should be capable of being compromised under an Australian scheme of arrangement.

REFORM 3 - ABILITY TO CRAM DOWN ON OUT OF THE MONEY SHAREHOLDERS AND CREDITORS

Scheme proponents should be able to 'cram down' on shareholders and subordinated debt holders by giving the court a discretionary power to extinguish their rights if the court is satisfied that, in light of the level of indebtedness of the distressed company, such holders no longer have any real economic interest in that company. From a policy perspective, it is not appropriate that persons with worthless assets be able to use those assets for ransom value to impede a restructure which would otherwise save a distressed company from the alternative of liquidation.

The ability to 'cram down' on shareholders already exists in the context of DOCAs, with s444GA of the Corporations Act permitting an administrator, with the order of a court, to transfer shares in a company (without consent of the shareholder). There is no reason not to extend this power to creditors’ schemes. As shown in the Mirabela and Nexus Energy DOCAs, there would be sufficient protection for shareholders as a court will take into account their interests in considering whether to exercise its discretion.

Similarly, in the context of creditors’ schemes, the courts have already indicated that, if they are satisfied that subordinated debt holders have no real economic interest in the scheme company, they are not entitled to have a vote on the outcome of a creditors’ scheme.

REFORM 4 - REMOVAL OF LISTING RULE RESTRICTIONS ON ISSUING NEW SHARES

ASX Listing Rules 7.1 and 7.1A should be amended to incorporate an exemption for issues of securities over the 15% limit in the case of creditors’ schemes because shareholders are already adequately protected through the court approval process. Indeed, in deciding whether or not to approve the creditors’ scheme, the courts have already indicated that they will consider the economic interests of shareholders.

Furthermore, it is anomalous that the ASX is content to dispense with the requirement for shareholder approval in Listing Rule 11 which applies where a listed entity (through its administrator) is disposing of its main undertaking, yet there is no corresponding dispensation for new share issuances.
REFORM 5 - ABOLISHING THE HEAD COUNT TEST

The anachronistic requirement that, in addition to requiring a 75% vote by value of the debt, a creditors’ scheme must also be approved by a majority in number of the creditors should be abolished. It is inappropriate that creditors with a small economic exposure should be able to block a creditors’ scheme which is supported by creditors holding the overwhelming majority by value of the debt.

Alternatively, the Corporations Act should (at a minimum) be amended to give the court the power to dispense with the head count test requirement (as it can already do in a shareholders’ scheme of arrangement). This power could be used by the court if, for example, there was evidence of debt splitting which was intended to manipulate the outcome of the head count test.

REFORM 6 – FACILITATING BINDING CLASS DETERMINATIONS

The court should be given the discretion to make a binding determination on class composition for voting purposes at the first court hearing and to approve a scheme even if the classes have been marshalled incorrectly. This would avoid the potential waste of resources associated with a creditors’ scheme which falls over right at the end because of a technicality.

REFORM 7 – ENSURING THE EXPLANATORY STATEMENTS ARE PUBLICLY AVAILABLE

Finally, to provide a more transparent and efficient regime, there should be a requirement that explanatory statements for creditors’ schemes be lodged with ASIC so that they are publicly available (as is the case with explanatory statements for members’ schemes).

CONCLUDING REMARKS

It should come as no surprise to anyone that laws that were enacted in the late 1800s no longer adequately serve the needs of Australian businesses today.

It is important that these matters make their way on to the Government’s current agenda for reform – a more effective and efficient tool to effect large corporate restructures in Australia will have wide reaching benefits.

In 2009, a number of very sensible, and well received, reforms to the scheme of arrangement regime (in so far as it applies to public company takeovers) were proposed by the Government’s Corporations and Markets Advisory Committee. Unfortunately, those reform proposals were never acted upon. We hope that the creditors’ scheme of arrangement regime does not suffer a similar fate in the current insolvency law reform process.

ENDNOTES

1. Improving Bankruptcy and Insolvency Laws Proposal Paper.

The views expressed in this publication are the authors' personal views and do not necessarily represent the views of Herbert Smith Freehills or any of its clients.

This article is one of a series that Herbert Smith Freehills is publishing on the Government’s insolvency and bankruptcy law reform proposals.

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