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Does Australia need a US style chapter 11? Encouraging and facilitating corporate turnaround in Australia

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In its report on ASIC's performance of 26 June 2014, the Senate Economic References Committee recommends that government review the law to consider reform which will encourage and facilitate corporate turnaround. It suggests that features of Chapter 11 (a reorganisation regime in the USA) be considered.

Subsequently, the Financial Systems Inquiry (FSI) Interim Report which was released on 15 July 2014 makes recommendations with respect to External Administration, including to suggest that Chapter 11 would not be beneficial to Australia, and that there is little empirical evidence that Australia's external administration process is causing otherwise viable businesses to fail. Submissions in response to the Interim Report are due by 26 August 2014.

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 directed at cooperative effort to increase the value of Australian business is welcomed.

It is difficult to argue against law reform aimed at increasing the value of corporate Australia.

The value of our superannuation depends, not insubstantially, on the value of corporate Australia. Our financial services industry is exposed to the value of corporate Australia, both directly in the commercial arena, and indirectly in the retail arena where company employees with residential mortgages comprise a significant part of bank debt. Key industries such as resources, infrastructure and agribusiness, are significant employers. The negative social impact of corporate failure and enforcement action is not to be underestimated, and reform which has the potential to lessen that burden is beneficial.

However, for law reform in this area to be effective, a cultural change is required. The mindset of our creditor landscape will need to be adjusted. We need to instil greater faith in boards of companies suffering from under-performance or an unsustainable capital structure. We need to understand that by reacting impulsively from an individual standpoint, a financial 'complexity' becomes a financial 'crisis'. Controlled, cooperative effort in those same circumstances might have seen the 'complexity' restructured, with the immediate grave outcome exchanged for a medium to longer term rewarding outcome.

In the USA and the UK, there is a strong business rescue culture supported by a legal framework which does not unduly penalise corporate entrepreneurs, and protects creditors for supporting a company through difficulties via concepts such as adequate protection and new money priority.

To my mind, Australia would benefit from a framework that adopts global restructuring principles which are widely accepted as market practice throughout the USA and Europe, and acknowledged and applied in the Middle East and Asia. Whilst Chapter 11 is not a complete answer, that framework does incorporate a number of appealing features which we can be guided by.

A number of key issues with the Australian culture and 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 if effort is coordinated.
- Our company rescue 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 worsens 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, is value destructive.
- Directors of companies in financial difficulty are not permitted to negotiate sensible turnaround solutions with their creditors, whilst 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 financial stress too late.

The key legal reform required to address these issues includes:

- 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.
- 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.
- Directors who act reasonably to avoid liquidation, who make business judgments in good faith for a proper purpose, on an informed basis and believing that the judgment is in the best interests of the company, should not be personally liable for trading whilst insolvent.
- The framework needs to incentivise directors to respond to financial stress early; to take the initiative and deliver a company-led turnaround.
- 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.

I do not in this paper address whether Australia should invest in propping up failed companies and industries. I do however suggest that Australia should be wary of judging something as failed too soon. I also suggest that Australia should invest in the continuous revival and transformation of our corporate landscape, to better equip corporate Australia to build a sustainable future.

DibbsBarker has obtained the input of key business leaders on a detailed paper which responds to the recommendation for law reform intended to encourage and facilitate corporate turnaround and a submission to the Interim Report. Macaire Bromley, Partner, has prepared these submissions 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. The submissions outline a possible legal framework to encourage and facilitate corporate turnaround. Copies are available here:

Encouraging corporate turnaround, a discussion paper, DibbsBarker

FSI Interim Report, External Administration, DibbsBarker submission

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Footnote:
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").

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