INSOLVENCY LAW REFORM PROPOSALS IN AUSTRALIA

The Australian Government is currently undertaking three significant reform procedures each of which is considering reform of major aspects of corporate insolvency law in Australia.

The three areas of discussion on corporate insolvency law are as follows:

1. An enquiry into the question of whether a system along the lines of Chapter 11 of the United States Bankruptcy Code should be introduced in Australia for the restructuring of large corporate enterprises.

2. A proposal to adopt the UNCITRAL Model Law on Cross Border Insolvency.

3. A review of eight important aspects of Australia's existing corporate insolvency laws.

The Voluntary Administration Procedure

In 1992, a system of voluntary administration was introduced into Australia's corporate insolvency laws. This system has become the dominant form of insolvency administration in Australia. It is now much less common for banks or other secured creditors to appoint receivers, and, although many companies are eventually wound up in liquidation, often this only occurs when the company's business has either been sold during an administration or been proven by an administration to be worthless.

The voluntary administration system has proven to be very successful. The Government is merely looking at ways in which it can be improved.

The system was designed to be quick and cheap. There is no requirement for any involvement by the courts or the Australian Securities and Investment Commission ("ASIC").

Directors of a company can commence the administration procedure immediately by simply passing a simple resolution that the company is about to become insolvent, and nominating an administrator. The administrator will be a partner from a chartered accounting firm who is a professional insolvency practitioner.

The administrator immediately takes full control of all the assets and decision-making powers of the company. It is common for the administrator to decide to continue to trade on the business of the company. However, he must be careful in making that decision, because the administrator is personally liable for any losses suffered by the company, although he or she has the benefit of an indemnity from the assets of the company. This can be a very difficult problem for an administrator. If the major asset of the company is the value of the business as a going concern, but for commercial reasons the administrator is unable to immediately stop the losses being suffered by the business, and it turns out that there are no genuine purchasers of the business at a sufficient price to cover those trading losses, the administrator will have to reimburse the company for those losses.

The administrator must send a report to creditors within three weeks of his appointment setting out his observations of the financial position of the company, including any potential claims for damages that the company might have including claims against directors for insolvent trading, and claims for recovery of voidable preferences. Such claims are not available to an administrator, and can only be pursued by a liquidator if the company is wound up.

The administrator must either recommend a deed of company arrangement be entered into by the company, or recommend that the company be wound up. Obviously this is a very short period of time, although it can be extended by resolution of the creditors for up to sixty days or by order of the Court for an indefinite time.

Although there are occasions on which a company in administration is reconstructed and then continues to trade on its business, it is also common for the administrator to sell the business as a going concern, distribute the proceeds among the creditors, and then place the remaining shell of the company into liquidation.

Should Australia introduce a Chapter 11 procedure?

In September 2002, the Australian Government asked the Corporations and Markets Advisory Committee to review the restructuring laws for large and complex enterprises. The Advisory Committee had published a report in June 1998 on the voluntary administration system and although it had recommended a number of minor changes, it reported that the system was generally successful and popular.

It has only been in the last two years or so that the voluntary administration system has been used to any significant extent in the insolvency of large corporations, for the simple reason that during the middle and late 1990s Australia experienced a long period of sustained economic growth. However, tech wrecks, problems in the airline industry, and collapses in some commodity prices resulted in the insolvency of several major public companies.

In particular, the collapse of Ansett, one of Australia's two airlines, and the failure of the voluntary administration system to be able to achieve the rehabilitation of Ansett, has lead to an inevitable comparison with the U.S. Chapter 11. The comparison is particularly stark with the current restructuring work being done on United Airlines in Chapter 11 and American Airlines under threat of Chapter 11. Both airlines continue to operate, their employees still have jobs, their suppliers keep their contracts, and their customers even keep their frequent flyer points. In the case of Ansett, the administrators had no choice other to close down the airline services because of the burden of potential personal liability for trading losses. Partners in international accounting firms are not very enthusiastic about the prospect of being jointly liable for the trading losses of a major international airline.

The worth of Ansett was in the business as a going concern. Although many of its assets were leased, the company had a major revenue flow from its regular customers. After being closed down for 10 days, Ansett recommenced flying but only on a very limited basis for a period of 4 months with the benefit of a government guarantee. By the time the administrators recommenced Ansett's operations, the customer base had gone elsewhere and the business had already been ruined.

The Advisory Committee has had several meetings in which the issue of Chapter 11 has been discussed, and it is likely that a discussion paper will be published in a few months.

Fairly predictably, Australian banks have reacted negatively to the suggestion. Banks in Australia are accustomed to having almost absolute power in the event of the insolvency of a customer. Banks were also antagonistic towards the concept of voluntary administration when it was being discussed. However, they have come to learn to live with it and, in many cases, to use it to the bank's advantage.

The proposal is not radical. It is not being suggested that the current voluntary administration system should be abolished. It is safe to assume that any system along the lines of Chapter 11 will require a court order before the procedure can commence and the company obtains protection. No doubt it will require ASIC to be served with the relevant papers and to be given the opportunity to make submissions to the court if it considers that the management of the company should not continue to be entrusted with the operations of the company.

The proposal is only looking at whether a further option should be made available to large and complex corporations. Any system that was introduced would adapt Chapter 11 to Australian conditions. In particular, it would be appropriate for any such company to have a professional insolvency practitioner appointed in a reporting and advisory capacity, as an independent check and balance on the continuing operations of management.

However, it is important that these issues are seriously and properly considered. Chapter 11 is not a perfect system. It can be very cumbersome and very expensive. It does not always result in the best outcome for creditors. However, the appalling debacle of the Ansett insolvency shows that there are major problems with the voluntary administration system in dealing with large and complex enterprises, and it is appropriate that the Advisory Committee considers these issues.

UNCITRAL

The Uncitral Model Law on Cross Border Insolvency was endorsed by UNCITRAL in 1997, having originally been proposed in 1992. It has achieved an enigmatic status amongst insolvency lawyers and practitioners. It has been the subject of endless hours of debate at international insolvency conferences, but for many years the only country which adopted it was Eritrea.

However, in recent years, it has been largely adopted in Japan, Mexico and South Africa, and has been under serious consideration in the United States, United Kingdom, Canada, New Zealand and Malaysia.

The Australian Government has announced a proposal that the UNCITRAL Model Law on Cross Border Insolvency be enacted in Australia subject to certain qualifications, such as the exclusions of banks and insurance companies which are covered by separate insolvency regulations.

Article 19 of the Model Law, if adopted in Australia, would permit an Australian court to grant relief of a provisional nature to protect assets or the interests of creditors. This would include a stay of execution against the assets of the debtor, and entrusting the administration of assets of the debtor to the foreign representative or an Australian insolvency practitioner appointed by the court. The Australian Government proposes that there be an exception in Australia to protect the rights of a secured creditor to enforce a security over property of the debtor. It also proposes that the foreign representative would have standing to initiate claims of voidable preferences and other voidable transactions available under the Corporations Act.

It also proposes that the provisions of the Model Law dealing with co-operation between courts should be adopted in addition to the existing provisions in the Corporations Act for such co-operation.

It is appropriate that Australia adopts the UNCITRAL Model Law. Australia has an effective and internationally respected legal system, including its established insolvency laws. It is also a major trading nation and many of its major companies operate internationally. Australia has the opportunity to set a positive example for many of its trading partners and regional countries.

Review of Australia Voluntary Administration Laws

The Australian Parliamentary Joint Committee on Corporations and Financial Services has advertised for submissions on certain aspects of Australia's insolvency and voluntary administration laws, including the laws relating to the appointment of administrators and liquidators, the duties of directors, the rights of creditors, the cost of insolvency administrations and the treatment of employee entitlements.

Some of these are very broad topics and have already been the subject of extensive consideration by the Australian Government. In particular, directors duties and employee entitlements have been regular topics of parliamentary discussion and legislative amendment in recent years.

However, the enquiry provides the opportunity to address one of the major weaknesses in the voluntary administration system. The administrator is usually appointed by the directors of the company. One of the tasks of the administrator is to recommend to creditors as to whether the company should enter into a deed of company arrangement, or whether it should go into liquidation. Claims against directors for breach of directors duties and insolvent trading, and claims for voidable transactions, can usually only be pursued if the company goes into liquidation.

Accordingly, there is a very strong incentive for insolvency practitioners to market themselves as being lenient on investigations into directors and to develop a reputation for being able to succeed in having deeds of company arrangement approved in such a manner that the previous conduct of the directors does not come under close scrutiny.

Clearly, many directors of small and medium companies who are concerned about exposure to such potential liability would be more inclined to appoint an administrator who they think will not investigate their previous behaviour too closely.

There is a conflict. The directors appoint someone who has the task of investigating the conduct of the directors themselves.

The position is exacerbated if the company moves from voluntary administration into liquidation because the administrator, who has previously been appointed by the directors, automatically becomes the liquidator of the company. It is a rather startling outcome that directors of an insolvent company can appoint the liquidator to that company.

The creditors do have an opportunity to remove the administrator and appoint a new administrator at a meeting of creditors that is convened within 5 days of the initial appointment of the administrator. However, in practice the creditors are not going to know about any negotiations or discussions that might have occurred between the administrator and the directors prior to the appointment of the administrator.

The conflict has lead to ASIC making allegations of misbehaviour against several leading insolvency practitioners based on conflicts of interest in their position as voluntary administrators.

Australia should seriously consider introducing a system whereby such appointments are either made by ASIC or by the court, or at least require approval by ASIC or the court.

Conclusion

The various insolvency law reform enquiries and proposal in Australia provide the opportunity for Australian Insolvency Law to progress to the next stage of its development through improving the existing system which has generally been shown to work extremely well. However, in the case of some large and complex corporations, and in the case of cross border insolvency issues, and in the case of appointments of administrators, experience has shown that there are opportunities for the system to be significantly improved.