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Submission to the Financial Sector Inquiry - Voluntary Administration and Recycling Capital

Turnaround Management Association Australia, Inc

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Key Points

- **The TMAA represents turnaround and restructuring principals, capital and professionals**
- **The TMAA survey of members provides empirical basis for these submissions:**
    - **The Australian Voluntary Administration system does not need replacing**
    - **The American Chapter 11 Bankruptcy Code system is under review in the USA**
    - **Aspects of the Australian system may be improved to help restructuring**
    - **Safe Harbour defences for directors executing against a restructuring plan should be re-examined as part of a cultural push to encourage business revival planning pre appointment of administrators**
    - **Abolition of key supplier and IT 'ipso facto' triggers to keep businesses whole during formal restructuring should also be examined to eliminate artificial barriers**
- **The TMAA asks the Inquiry to recommend Treasury undertake another review of ways to promote the rehabilitation of large and medium enterprises as part of the continuing process of making the Voluntary Administration system responsive to modern business**

Introduction

The Turnaround Management Association Australia, Inc (**TMAA**) is the Australian chapter of a 9,300 worldwide member association formed in 1988, focusing on corporate renewal and turnaround management.

The TMAAs membership includes trading and investment bankers, investment funds and financial advisors, lawyers, accountants, company directors and managers, predominantly the individuals within those organisations with expertise in undertaking structural and organisational turnarounds of reference entities undergoing some form of financial distress. Our education program recognizes professional excellence and provides an objective measure of expertise related to workouts, restructurings and corporate renewal.

The TMAA promotes the idea that an early engagement with financial, trade, labour and other stakeholders and development of a restructuring plan provides the best means of turning around the fortunes of ailing but viable businesses, maximising prospects of survival. Well known attendant benefits of business renewal include job preservation, protected tax revenue and maintaining the social compact between businesses and the local community.

TMAAs Response to the Inquiry

Our submission responds to this invitation at paragraph 2-71 of the David Murray chaired Financial Sector Inquiry interim report of July 2014:

> ***The Inquiry seeks further information on the following area:***
> Is there evidence that Australia’s external administration regime causes otherwise viable businesses to fail and, if so, what could be done to address this?

The following comments are intended to provide the Inquiry with the views and experience of those professionals whose day-to-day practice and business over many years deal with successful turnarounds and resolve business failures.

We have done so by surveying a number of members (207 survey responses), from whom we gained high level empirical insights, drawing the conclusions expressed below. We emphasise that the survey

respondents are those working in business rehabilitations across a broad church of financial, professional, advisory and governance undertakings.

Our submissions focus on the Australian and American statutory models for dealing with ailing enterprises. There are many other systems of interest to examine, ranging from the UK Enterprise Act, the Chinese hybrid of American and other systems, the French sauvegarde and its Canadian, Japanese, Indonesian and various other rehabilitation counterparts. We use the Australian model for its perception of being 'creditor friendly' as a counterpoint to the American model, perceived to be 'debtor friendly'. These are in fact myths, either system being equally adaptable to protection of a range of rights depending on the manner in which the setting within the system are set, monitored and executed.

The TMAAs starting point is to restate the purpose of voluntary administration (and its American counterpart in Chapter 11 of the US Bankruptcy Code) and then to assess whether this purpose is capable of being achieved within the existing or some alternate model.

Voluntary administration imposes a statutory moratorium on most unsecured creditors to provide a skilled person (the voluntary administrator) the opportunity to explore options that might preserve the business of the company in administration or, if this is not achievable, to maximise returns to creditors. The Inquiry's interim report well summarises key benefits associated with preserving businesses.

The Australian model is consistent in purpose with that of the American model, explained by Geoff Berman of the American Bankruptcy Institute (**ABI**) this way:

> a distressed company can find protection in the safe harbor of Chapter 11, dispose of unprofitable parts of the business, stabilize what remains, operate for a short time to see that the core business can be profitable, propose a plan based upon the smaller, profitable core business, restructure its balance sheet pursuant to a Chapter 11 plan, and emerge as a healthy, albeit smaller, business enterprise[1].

Although the American model differs in stewardship, overview and impact on some creditors from the Australian voluntary administration model, the safe harbour of both models were designed for the same purpose, namely to provide time for the ailing business to develop a plan for its successful rehabilitation, or, if this cannot be achieved, a plan to maximise value in its assets for all stakeholders. Australia grants the stewardship of plan development to a voluntary administrator acting for all creditors, while the American model provides an overview of the Court to approve a plan developed by special interest creditor committees working with the existing board or a newly appointed credit restructuring officer. The objective, however, is to focus on business survival first or, if this is not achievable, asset maximisation. The TMAA believes that those are the two precepts upon which any review of the present or some alternate system need to assessed in order to determine success, failure or grounds for adjustment.

Of course, both the Australian system and the older American system (developed in 1978) were formed on a series of assumptions that no longer relate to all businesses. Principally, the assumption that most businesses would be underpinned by hard assets with a degree of liquidity available to attract the financing needed to rehabilitate the enterprise and that capital markets were sufficiently developed to provide liquidity in distressed or special situations. Secondly, the presumption that assets were not capable of forfeiture by the triggering of supplier or IT ipso facto clauses except in situations of financial default. Thirdly, that all stakeholders would have a self-interest in making decisions that continue the business to protect own positions.

These presumptions are no longer always accurate

The modern position in America was recently summarised this way by Mr Berman on behalf of the ABI:

> Instead of that classic Chapter 11 model [rehabilitation], today we see quick sales to new owners driven by creditor interests or an outright liquidation.
>
> The fundamental change is that employers were manufacturers, the biggest employers today are service companies such as retailers and technology-driven enterprises. Many of the

[1] Australian Bankruptcy Institute Journal, June 2011

> remaining American manufacturers are less dependent on hard assets and more dependent on contracts.
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> Since the Code's enactment, there has been an explosion in the use of secured credit, placing secured debt at all levels of the capital structure and trumping any long-term reorganization for the benefit of existing shareholders. The unparalleled expansion of distressed-debt markets and claims trading has made chapter 11 a financial and takeover play, minimizing the debtor's ability to control its own destiny. Debtors are more often multinational companies with international law implications[2].

In commenting on the change in direction of the American system, Mr Berman, after analysing market changes from 1978 on balance sheets, corporate structures, movement of capital by debt traders and various other "modern" events says:

> Early decisions (and the legislative history of the 1978 Code) emphasized that the primary purposes of the Code were the rehabilitation of businesses, and the preservation of jobs and tax bases at the state, local and federal level. As time passed, these purposes were eclipsed by "maximization of value" as the paramount goal and maximizing value often results in the liquidation of the business for a quick return. More recent discussions of the purpose of Chapter 11 tend to emphasize value maximization to the exclusion of other goals and purposes. This development also calls for a fresh assessment of the purposes and goals of a U.S. restructuring regime

As a result, the ABI has, since 2012, been undertaking a series of "field" surveys across the USA with a view to recommending, in a report due in late 2014, wholesale rethinking in terms of replacing the 1978 Chapter 11 process with another model, the details of which remain to be seen.

It would not seem appropriate, at this point in time, for Australia to look to migrate a system in its entirety which its own operatives believe needs to be rethought. Of course, there are elements of that system that work well in terms of promoting corporate renewal, those being the elements summarised later in this paper.

Returning to the Australian system, as noted in its interim report, this Inquiry is the latest group to explore possible change. Over the past decade, multiple submissions have been made to CAMAC, Treasury and a substantial body of scholarship now exists in law reviews, journals and papers on the subject of reform of the Australian system. Some of this scholarship is identified in the Inquiry's report.

Plainly, as with the ABI's review of the American system, our own needs to be constantly evaluated.

In assisting the Inquiry to make recommendations about the form of this evaluation, the TMAAs response here limits itself to two key questions (1) whether there is empirical evidence that the present Australian system causes business failures, with a subsidiary question of whether the American model or some variant would better preserve business from failure and (2) whether within the existing system there are settings that might be changed to fulfil the mission to, in circumstances of actual or apprehended future insolvency, either preserve business or achieve a better value in its assets than liquidation.

The survey responses from TMAA members provide some empirical basis to draw these preliminary conclusions:

- the present voluntary administration process does not generally *cause* business failure (in our experience, business failures are mostly caused by bad or untrained management)
- there is no great appetite to completely replace the Australian system with the American model (though there are aspects of the latter model which merit consideration within our own such as limits being placed on triggering the end of executory contracts by trade and IT suppliers, faster sales of business lines and some preferred financing packaging)

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[2] As reported in the Deal Pipeline, January 2013

- there is interest in improving some of the settings attending and preceding the engagement of a voluntary administration process, principally in relation to better defining the safe harbour protections to directors developing and executing against a restructuring plan to save the business, either before or as a critical part of triggering the statutory moratorium allowed by voluntary administration. The focus here is to express in a proper form that the role of directors in near-insolvent companies shifts from a sole focus on equity to making decisions that also best protect creditors. It is clear from case law that we need statutory change to emphasise this value shift. Sometimes this will be the appointment of administrators, other times it will not, other times again, administration will simply form part of the restructuring plan.

The TMAA submit the quantitative analysis associated with its survey as an annexure to this report, from which we provide the following commentary.

Importance of restructurings and informal workouts

Generally speaking, informal work-out situations involve stakeholders entering into private agreements outside of a formal insolvency process. More common among large enterprises and public companies, though increasingly so amongst small/medium enterprises (**SME**) with cashflows above $5m pa, a restructuring will involve negotiations between the company and its bankers, bondholders, major trade counterparties and/or major investors, and can involve the injection of fresh capital from an external source or moratoriums on terms. In the case of SMEs, new equity invests into a business and value transfers take place in the form of equity and warrants to mirror debt waterfalls and to provide for further equity transfers on the business meeting performance hurdles.

In both large and SME size restructures, successful negotiations can produce a restructured balance sheet that returns the company to a state of solvency, or otherwise eliminates the question mark over the company's solvency and may thereby preserve enterprise value, employment and the business as a going concern.

The significance of this for addressing doubtful solvency is twofold:

(a) by developing and executing against a restructuring plan and engaging with counterparties to risk share in the success of that plan, the risks of the business ending and assets being destroyed are largely avoided or diminished (whether equity is affected will depend on where the value breaks in the capital structure and whether or not there has been a successful early intervention in the business survival process).

(b) it is usually the case that the only losses that are experienced are at the banker/bondholder/investor level - ordinary trade creditors will generally get paid in full.[3]

In a circumstance of financial distress, "enterprise value" may be defined as the value of the company's assets and businesses. Preservation of enterprise value is important for at least two reasons:

(c) it maximises the prospect that a reorganisation, whether in or outside of a formal insolvency process, will be achievable - consistent with the 'continuing business' primary objective;

(d) in the event that the company cannot be saved and its assets need to be sold, the higher the enterprise value, the higher the return to unsecured creditors - consistent with the 'maximised value' secondary objective.

[3] An informal work-out of a major corporation likely see the claims of its financiers as so significant a percentage of its total liabilities, that it is in their commercial interests to permit the company to continue to trade under agreed funding arrangements while a restructuring is pursued. In such cases, the business continues to operate and trade creditors are paid in the ordinary course of business during the period of restructuring.

When speaking about enterprise value, we mean, the "real" value that is relevant, rather than a historic or unrealistic value. Particularly pertinent when dealing with a non- hard asset manufacturer, the value of the 'enterprise' lies in the contractual and services value of the relationships in the business. A formal process that cuts across contractual based structures may destroy all enterprise value given its construction. Equally, the advent of "efficient" financing structures such as OpCo/PropCo disaggregation are a clear example of why the insolvency laws need to evolve to deal with more complex structures. An enterprise stacked with value on one side of the business (in a separate proprietary structure) is better worked out in conjunction with a proprietary 'services' side business containing the liabilities, including payroll and labour, sitting within another proprietary vehicle. Directors should be encouraged to work up a restructuring plan solution dealing with both sides of the business on an aggregated basis.

There are, of course, a great number of other benefits to preserving enterprise value of viable businesses - preservation of jobs, tax revenue, non-disruption of trade suppliers (especially small businesses), non-disruption to local communities that rely on survival of the ailing business, avoidance of the on-costs of formal processes (direct and delay based), market dislocations and loss of market competitors are some of the more obvious of these benefits.

Voluntary Administration is a successful model but could be better

As a matter of policy, the TMAA suggests that the legislative framework should, wherever possible, encourage businesses to consider whether a restructuring plan can be developed as one response to distressed trading conditions. Balancing policy objectives ensure there is no dilution of the requirement that companies cease trading when it becomes obvious the company is insolvent and the subsidiary policy objective encouraging directors to access the statutory moratorium of voluntary administration when there is some doubt about whether the company is or will become insolvent.

It is apparent that these policy objectives are substantially met - a significant majority of survey respondents (83.57%) do not believe that the existing voluntary administration system *causes* business failures, though some respondents suggest that fears of insolvent trading laws meant directors placed *Allco, Timbercorp, Henry Walker Eltin* in administration without properly investigating whether a restructuring plan was capable of execution outside of administration (we discuss below the remedy to this concern in the context of introducing express safe harbour protection for directors engaging in a restructuring plan). While some respondents (29.41%) question whether the American model would have saved a business placed into administration, the more significant outcome from the survey is the overwhelming support (76.34%) for improving the safe harbour protection for directors following a properly formed restructuring plan. That is, protecting directors from insolvent trading risk if a plan properly formed, disclosed and followed fails and the company still proceeds to administration.

The reflective of these survey results shows some turnaround specialists (16.43%) still believe companies are being placed into administration too early, with even more (29.41%) claiming that an American model would have saved companies, notwithstanding that most survey respondents (71.36%) accept the American model adds cost in the form of court and ad hoc committee requirements than the Australian model. Examples given include those mentioned above as well as *Ansett, Babcock & Brown* and other large and complex conglomerates. Given both models have the same objectives, namely business survival or asset maximisation, the latter results show a number of turnaround specialists believe key settings within the American model could better deliver the revival outcomes intended by the voluntary administration model.

If cost is not the relevant differentiator, there must be other settings that drive respondents to examine the American model.

When we look into the specifics of what changes turnaround specialists believe should be made, we see overwhelming majorities (76.34%%) favouring providing directors with safe harbour protections when developing restructuring plans for the benefit of creditors. This involves two policy changes in Australian law:

- to recognise that the 'interests of a company' approaching the 'zone of insolvency' shifts from a primary focus on equity to a primary or at least key focus on what is best for company creditors (including, preferentially, employees)

- to recognise that a well advised director forming a restructuring plan to save a viable business is making a decision that potentially benefits creditors, and other stakeholders including counterparties and that if the plan is well formed and properly executed against, the directors should have the statutory protection of 'safe harbour' defences against later insolvent trading claims should the business still fail or the company still be placed into administration or wound up.

The above points do not represent the present state of Australian law. The source of director duties in the USA is found within company legislation, principally State based. In the majority of States in which companies are formed, for example, Delaware, the courts have found directors owe actionable duties to look out for the interests of creditors once a company finds itself in the twilight zone of insolvency. This focus on creditor interests means that as the enterprise value slips below the value of creditor liabilities (negative shareholder value if the business is not realised as a going concern), boards must make decisions that best protect creditors when a company approaches insolvency situations.

Australian law does differ in this respect as our insolvent trading law, in practical effect, requires the directors to place a trading company that is, or might in the future be, insolvent into administration (or liquidation), even though this may immeasurably harm the company and its business, and even if the directors are in receipt of professional advice that a restructuring was feasible. In such a situation, the directors ought to be permitted to take proper steps to pursue a restructuring, as is the case in all other major Western economies. A safe harbour is needed to provide the necessary degree of flexibility for directors to make that choice to save viable businesses.

The TMAA survey also shows respondents believe the existing voluntary administration model can be improved by active encouragement of a restructuring mentality amongst directors. The TMAA considers that part of this change is legislative, in terms of expressing a view that directors should focus on creditor positions when a company is close to insolvency.

However, and more importantly, the TMAA submits that whatever model we use, change is educative, accepting that not all directors have the skillsets to respond to the value transfer of interest between shareholders and creditors as an enterprise progresses through the twilights of solvency. In cases of inexperience, it is appropriate for the board to retain a skilled person to help develop that plan, preferably someone with experience in business revivals. It is here that the AICD, ABA, ARITA, TMAA and other member organisations dealing with companies and directors or financiers have an educative offering to improve a restructuring mentality amongst company managers and boards that should be encouraged.

We offer some further commentary on the idea of developing safe harbour protections for directors executing against restructuring plans in the following observations in this submission.

Solvency is often a complex issue

Particularly in large and disaggregated enterprises, assessing the "solvency" or more accurately the liquidity of the business is rarely a simple exercise.

Mere temporary illiquidity in the business may not establish a company is unable to pay its debts as these fall due but it should trigger a properly functioning board to consider its forward cashflows and take appropriate action to protect stakeholder positions.

The board needs to be involved to assess whether the cause of its liquidity crisis is bad management decisions, bad accounting or reporting situations, internal operational problems, or unexpected macro events. In short, whether the crisis is transient or likely to be persistent in nature.

Having identified a cause to address, the board needs to then assess the timetable of the solution. This timetable may be impacted by all manner of questions outside the immediate control of an Australian board:

(i) when a "mere temporary lack of liquidity" is weighed against the ability to sell assets in the short term, what assumptions may reasonably be made by the directors as to how quickly the assets can be sold (ie what is meant by "temporary"), whether there

should be a "mark to market" based on fire sale value or, in a number of cases, whether there are real concerns whether the assets can be sold at all;

(ii) where the company has a tetter of comfort or term sheet or standby "support" from its parent or JV partner or shareholder or overseas banker that is not legally binding but which has always been supported in the past, is it reasonable for directors to assume that they are solvent if they can only meet their debts by reason of their ability to call on that party? With multinational entities, how much weight can an Australian director place on the collectability of a debt from a related entity based offshore?

(iii) where the parties to a JV are offshore parties requiring home country approvals to release funds into Australia, how do directors measure the timing delays and opacities associated with funding financial commitments from those offshore parties?

If the solvency of a financially distressed company is uncertain or incapable of precise determination, it follows that it may be difficult for the director to form the necessary positive expectation that the company actually is able to pay all its debts and its future incurred debts as and when they fall due.

Thus, not only will honest, diligent directors of companies that are actually insolvent place them into administration, but also there will be directors who feel compelled to do the same thing where the solvency is simply brought into question, because of the absence of their ability to form their positive expectation of solvency.

As submitted above, the focus here is wrong. As with every other major insolvency system, once the company enters the 'twilight zone of insolvency', there should be a focus on creditors, and the decisions of the directors should be measured against whether their decisions are in the best interests of creditors and the company as a whole.

Sometimes, this decision will lead to the appointment of administrators, other times, to further work being done on executing against a restructuring plan and engaging with counterparties in bilateral negotiations to reset contracts.

There are other settings that might also be changed to preserve the business of ailing businesses.

Administration - Improving the Settings

Supplier Ipso Facto Clauses

A key difference between the Australian and American models is the extent of the moratorium. On both models, the moratorium stays executed contract claims, except, in Australia, secured claims.

The American model also stays executory claims (financial and non-financial based). An executory contract is one in which obligations remain to be performed, for example, future finance drawdowns, continuing supply arrangements, continuing use/licence agreements - typically, information technologies licenced to use of the ailing enterprise.

Australian executory contracts often contain *ipso facto* triggers, permitting the counterparty to determine future performance on appointment of administrators to the ailing enterprise. The company proceeding into administration accordingly has no control over the termination of executory contracts, or the subsequent detriment to business. In the case of companies reliant on supply - from miners unable to use control room technologies to operate through financial service providers and disaggregated businesses unable to utilise trading platforms. Hardest hit are businesses reliant on telecommunications and technologies, 'just in time' logistics and supply and services. These increasingly form the breadbasket of business in modern Australia. Further, as 'cloud storage' increases in use, even hard asset businesses are dependent on technology based payroll, inventory record, maintenance plans and other executory arrangements.

These should not be denied to an administrator seeking to revive and explore opportunities to continue viable businesses.

In contrast, the American model stops counterparties terminating contracts simply because of a Chapter 11 filing. The onus is on the counterparty to establish 'hardship' to end performance; rarely established if the counterparty continues to be paid in accordance with the contract. Certain protections are built into the Bankruptcy Code to ensure counterparties are not prejudiced by these stays on contractual rights.

A large number of survey respondents (61.83%) consider that the settings associated with administrations can be further improved by abolishing contractual rights of supplier and Information Technology counterparties to terminate executory contracts solely on the basis of the appointment of administrators to a company.

The world has moved on from 2004, when CAMAC last considered imposing moratoriums on the trigger of *ipso facto* clauses in its *Rehabilitating large and complex enterprises in financial difficulties* report. Its then prime objection to imposing moratoriums lay in pricing impacts upon loan finance.

It is not the TMAAs intention to suggest that the moratorium affect loan finance, but instead be explored as relating to supplier and critical IT contracts that are both executory and otherwise are either not in financial default or are capable of remedial action by the administrators.

The TMAA considers it timely to question whether such executory contracts should fatally wound a company appointing administrators when other non-secured creditors are placed under a moratorium to allow the administrator to investigate business survival options.

Allowing supplier and IT *ipso factos* to remain incapable of moratorium means those companies without hard asset backing, particularly those reliant on services, potentially have fewer restructuring options available in an administration, meaning asset maximisation (or liquidation) becomes the only possible outcome of administration. This was never the primary objective of voluntary administration.

Pre-packaged Administrations

The UK system (akin to voluntary administrations) has seen a rise in the "pre-packaging" of restructures, principally for use in retail, services and 'immediate value wasting' businesses. In a common example, the assets of a business are sold to a purchaser on a limited warranty basis, a key condition of completion being the 'cleansing' of liabilities via the administration system. To preserve the goodwill and trading value of the assets, these transactions happen quickly, often within days of the administration commencing. To facilitate such a timetable, the administration timetables are truncated and, importantly, the administrator executes a transaction having regard to sales programmes and valuations undertaken before their appointment. In most cases, the administrators see (but do not negotiate) the terms of the sale agreement before execution.

Australia's conflict laws and the principles under which most administrators in Australia operate (the ARITA guidelines), as well as the less flexible administration timetable, make the "pre-packaging" of administrations more difficult.

TMAA survey respondents favour (63.44%) investigating whether the Australian settings can be amended to better cater for restructures being developed prior to, but implemented within, administration.

The TMAA accepts that it remains possible to undertake this form of restructure within the existing model. The TMAA is also keen to ensure there is no shift in promoting asset maximisation over business revival outcomes (as the US commentary quoted above suggests is happening under the American model) and to ensure related party and phoenix transactions conform to existing requirements, achievable through appropriate drafting, education and court overview. The TMAA considers a proper investigation of this idea will lead to debate that can only promote restructuring as the focus of voluntary administration.

To the extent this debate leads to a statutory recognition that directors should be focusing on the development and, to the extent possible, execution of restructuring plans and transactions to facilitate business revival and to protect creditors, appropriate changes to the conflict laws can be developed. To the extent that flaws are identified in both the American and UK models, these can be addressed.

Priority Funding

Worth exploring further, a slight majority of respondents (52.15%) thought offering super-priorities to funding creditors in administrations might assist the restructuring process.

The issue was last considered by CAMAC in its in 2004 report, which recommended against introducing the super-funded priorities of the American model on grounds that "the displacement of pre-administration security may facilitate risky or unsuccessful turnaround attempts".

As with all policy changes, it is worthwhile keeping this matter under review. The TMAA is not presently offering any recommendation favouring change in the law to accommodate adding restructuring funding as a priority payment in any distribution waterfall.

Concluding Remarks

The TMAA considers it time to examine how settings within the Australian model might be improved to actively encourage the better rehabilitation and revival of enterprises. Our empirical survey results strongly support the idea that safe harbour protections for directors executing on a restructuring plan, properly formed, properly disclosed to the market and executed, should be investigated. These investigations will run parallel with ABIs own investigations as to ways in which the American model can be improved.

The focus, as always, is to ensure that settings, education and regulation promote the idea of successful revival of viable enterprises rather than defaulting to encouraging asset maximisation as the preferred outcome of administration or restructuring assignments.

We encourage this Inquiry to make a recommendation to Treasury to investigate these matters further by way of separate inquiry in similar brief to the CAMAC inquiry that led to the report into the rehabilitation of large and medium enterprises in 2004.