NORTON ROSE FULBRIGHT

A new era for schemes of arrangement?

Australian Court grapples with important policy issues

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On 21 December 2020, the NSW Supreme Court gave its judgment in ***In the matter of Ovato Print Pty Ltd*** (Black J), a decision which raises significant public policy implications in relation to the interplay between schemes of arrangement proposed pursuant to sections 411 and 413 of the Corporations Act 2001 (Cth) (***Act***) and the implementation of the Fair Entitlements Guarantee regime (***FEG Scheme***).

Brief facts

The Ovato Group, one of the largest integrated print and distribution businesses in Australia and New Zealand and employing 1,187 employees across 10 of its sites, sought to implement a financial restructuring as a result of declining financial performance, including a significant adverse impact on the Group's business caused by the COVID-19 pandemic. A fall in sales, combined with the Group's continuing obligations to its secured financiers, employee and lease liabilities led to a necessary restructuring in order to recapitalise the Group's balance sheet and enable it to continue to trade as a going concern.

By the plaintiffs' application (***Application***), two inter-conditional schemes of arrangement (***Ovato Schemes***) were proposed pursuant to sections 411 and 413 of the Act, respectively:

1. A creditors' scheme of arrangement proposed by the plaintiffs, Ovato Print Pty Ltd (***Ovato Print***), Ovato Limited (***Ovato***), Hannanprint NSW Pty Limited (***Hannanprint NSW***), Hannanprint Victoria Pty Limited (***Hannanprint VIC***) and Inprint Pty Limited (***Inprint***), all members of the Group. Importantly, the creditors' scheme related only to a small number of specifically identified creditors, compromising their claims at 50 cents in the dollar. Retrenched employees were not comprised within the creditors' scheme. (It is the absence of any process addressing these employees that is the subject of the final observation in this article);
2. Member's schemes of arrangement between each of Ovato Print and its sole member, Ovato; Hannanprint NSW and its sole member, the Independent Print Media Group Pty Limited (***IPMG***); Hannanprint VIC and its sole member, IPMG; and Inprint and its sole member, Woodox Pty Ltd.

The purpose of the restructuring was designed to consolidate the Group's printing operations and reduce its cost base to enable the Group to retain the vast majority of its staff and continue to trade. It was a condition precedent of the Ovato Schemes that Ovato raise $30 million by issuing new shares.

The effect of the creditors' scheme was that the identified scheme creditors would receive 50% of the unsecured portion of their claims in return for a release from both claims against the plaintiffs and their directors in respect of the sums due and Ovato's obligation to meet amounts in respect of any subordinate claims.

The effect of the member's schemes was to transfer identified assets and liabilities of Ovato Print, Hannanprint NSW, Hannanprint VIC and Inprint (***Transferor Companies***), to Ovato Creative Services, Ovato Print Cairns or Ovato. Transferred liabilities included all employment

liabilities of employees who were retained in the business. Redundant employees were to be left behind in their employer (a Transferor Company), together with assets the value of which was calculated as the realisable value in a hypothetical liquidation of that company's pre-scheme assets. The Application included a request for an order that, following the implementation of the member's' schemes, the Transferor Companies would be liquidated. The shortfall in meeting the liabilities to non-transferring employees would, upon the mandated liquidation, fall within (and therefore be met under) the Fair Entitlements Guarantee Act 2012 (Cth) (***FEG Act***). An order was also sought under section 413(1)(g) that the Deed of Cross Guarantee between Ovato Limited and its subsidiaries, rendering each company liable for the debts of each other in a liquidation, be revoked.

The evidence suggested that in the absence of the schemes, the companies would likely be liquidated, substantially increasing the required redundancies and – in consequence - the magnitude of the employee claims which would be met by the FEG Scheme.

Interplay with FEG Scheme

By its implementation of the FEG Scheme, the Australian Government (***Commonwealth***) provides financial assistance to eligible employees who lose their job due to the liquidation of their employer. The underlying public policy objective of the FEG Scheme is for it to constitute a safety net scheme of last resort for eligible, redundant workers. The FEG Scheme is not available outside of liquidation (or personal bankruptcy, where the employer is a natural person). It is not, for example, available where the employer is restructured through a DOCA, or through a scheme of arrangement where there is no liquidation.

The Convening Hearing: [2020] NSWSC 1683

On 18 November 2020, the Court made the orders sought by the plaintiffs, convening relevant scheme meetings in relation to the Ovato Schemes. In doing so, the Court noted that complex and possibly controversial issues would remain to be determined at the sanction hearing, and that the proposed restructure of the Group appeared to come at a substantial public cost, since liabilities of redundant employees in remaining companies would be left to be met by the FEG Scheme.

In terms of class composition, the Court accepted the appropriate test for the constitution of classes summarised by the Court of Appeal in *First Pacific Advisors LLC v Boart Longyear Ltd*[1] as to whether creditors have different rights, or rights differently affected by the creditors' scheme and whether those differences make it impossible for the creditors in question to consider the scheme as one class. The Court accepted that the rights of creditors affected by the scheme in this instance were identical and no class issue had arisen.

The Court also noted correspondence which had been received from two third parties. One, a creditor of the Group, argued that bondholders should be given an opportunity to be heard on the member's schemes, in circumstances where the members of the companies no longer had an economic interest. The Court accepted that, so far as this criticism involved a question of law, it was a matter which should properly be addressed at the sanction hearing, where the creditor would have the opportunity to seek to appear and be heard, if it wished to do so.

The Court noted that so far as the member's schemes raised other issues of legal principle and process, and contemplated member schemes in relation to single member companies, the submissions made on behalf of the plaintiffs that these matters did not prevent the meetings being convened were accepted, on the basis that any objections would be dealt with at the sanction application.

Recognising the financial urgency of the position affecting the Group, the Court made orders convening meetings in respect of the Ovato Schemes and the proceeding was stood over until 18 December 2020.

1 [2017] NSWCA 116; (2017) 121 ACSR 136 at [80]

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The Sanction Hearing: [2020] NSWSC 1882

The creditor and member meetings were held and the participants voted in favour of the schemes by the requisite majorities.

At the sanction hearing which took place on 18 and 21 December 2020, the Court accepted the relevant factors it was required to take account of when determining whether to exercise its discretion to approve the Ovato Schemes, including:

1. whether the orders of the Court convening the scheme meetings had been complied with;
2. whether the resolution to approve the Ovato Schemes was passed by the requisite majority and whether other statutory requirements have been satisfied;
3. whether all conditions to which the Ovato Schemes are subject (other than Court approval and lodgement of the Court's orders with ASIC) had been met or waived;
4. whether the Ovato Schemes were fair and reasonable so that an intelligent and honest member of the relevant class, properly informed and acting alone, might approve them;
5. whether the plaintiffs had brought to the attention of the Court all matters that could be considered relevant to the exercise of the Court's discretion;
6. whether there had been full and fair disclosure to creditors of all information material to the decision whether to vote for or against the Ovato Schemes;
7. whether the Ovato Schemes had a compulsive or oppressive effect upon minority shareholders or creditors; and
8. whether the interests of other groups who were not parties to, but would be affected by the Ovato Schemes had been dealt with appropriately.

The Court noted the expert evidence which specifically addressed the solvency of the relevant companies following the implementation of the Ovato Schemes and expressed the view (with several qualifications) that the transferee companies would remain solvent for the 12 months following the implementation of the Ovato Schemes.

Assessing whether the Ovato Schemes were fair and reasonable, the Court considered third-party criticisms drawn to its attention. In response to the suggestion that the member's schemes did not involve any compromise or arrangement, the Court accepted the plaintiffs' submissions that the member's schemes involved arrangements, as they touched upon the rights and liabilities of the relevant companies where, on their implementation, those companies would cease to hold any assets or liabilities save for certain plant and equipment, non-transferring employees and retained funds.

Responding to the Court's concerns regarding interplay with the FEG Scheme, the plaintiffs argued that the proposed transactions did not offend any identified public policy where, under section 3 of the FEG Act, its main objects are to provide for the Commonwealth to meet unpaid employee entitlements in cases where employers are insolvent, the end of employment was connected with the insolvency and the employees cannot get payment of their entitlements from other sources.

The Court recognised the novel nature of the interplay between the Ovato Schemes and the FEG Scheme. Having considered the implications for the FEG Scheme, the Court did not consider it should refuse to approve the Ovato Schemes on this basis:

> *"In reaching that result, I bear in mind that the evidence suggests that the relevant companies would at least have been placed in administration, and potentially in liquidation, absent the restructuring and the schemes, potentially leading to the loss of more employees' jobs and a larger claim under the Fair Entitlements Guarantee Act, so this is not a case where the transactions create a claim which would not otherwise have arisen or increase the amount of that claim... The question whether approval of other schemes of this kind should be declined on public policy grounds will remain open to be determined in a future case, if the Commonwealth of Australia seeks to oppose such a scheme on that basis."*

Conclusion

In the present economic climate, it is likely that in other corporate groups, the sheer weight of employee entitlements will prevent a successful informal restructure, and instead result in the company being placed in liquidation in order that the employee entitlements of the workers to be retrenched are able to be met under the FEG Scheme. It is not difficult to conceive of circumstances where the FEG liability in a liquidation will be more, potentially significantly more, than would have been payable on account of retrenched workers as part of a downsizing restructure of the type deployed by Ovato.

A thorough examination of the public policy underpinning the FEG program points to the liquidation pre-requisite to accessing the FEG Scheme being a manifestation of the underlying policy intent, that the FEG Scheme not supplement any form of business restructuring. Any future scheme of arrangement of this type, if contested, may well involve a fuller consideration of the public policy considerations evident from a review of historical extrinsic material. This material will, at the very least, require close attention when the court considers whether to sanction such a scheme.

There also remains scope to question whether the restructure of a **financially distressed** company, the substantive effect of which is to transfer assets out of the company and leave unmet liabilities behind, is a permissible use of the **members'** scheme of arrangement provisions of the Act, at least in the absence of a Court sanctioned concurrent **creditors'** scheme in relation to the affected creditors.

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