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legal update

CORPORATE & BUSINESS RESCUE IN A COVID-19 WORLD

Executive power, court intervention and the opportunity for meaningful law reform to the voluntary administration regime.

COVID-19 marks a unique time in our history. Across the globe, COVID-19 has deeply impacted each of us in our personal and professional lives; the scale of business disruptions and the economic and financial crisis dovetailing with the ongoing health ramifications have been extraordinary.

As we look to transition to a phase of economic recovery – and an eventual return to growth – the objective of corporate and business rescue has assumed primary importance. This rescue has included providing incentives for financially distressed, but viable, entities to survive the worst of the economic impact of COVID-19 and to continue trade as the supply and demand shocks begin to subside in the remainder of 2020.

Initially, at the height of the uncertainty that followed the original outbreak of COVID-19, the *Coronavirus Economic Response Package Omnibus Act 2020* (Cth) (*Omnibus Act*) was passed by the Commonwealth Parliament on 24 March 2020.

Among other things, the *Omnibus Act*, until 25 September 2020, extends the timeframe for companies to respond to a statutory demand to six months (up from the previous 21 days), increases the minimum threshold debt for issuing a statutory demand to $20,000 (up from the previous $2,000)[1] and, moreover, introduces a moratorium on insolvent trading liability for directors.[2]

However, despite the six-month insolvent-trading moratorium, the incentive for directors of a financially distressed entity impacted by COVID-19 to appoint a voluntary administrator remains high. Notably, directors remain subject to their other statutory and general law duties, including their obligation to act in good faith and the best interests of the company.[3]

With the interests of 'the company' deemed to correlate to the interests of creditors where a company is facing imminent insolvency, it is difficult for directors, faced with the chronic uncertainty of the business and regulatory environment during the COVID-19 pandemic, to have the confidence that continued trade properly balances the interests of competing creditors.

The appointment of a voluntary administrator therefore continues to be a compelling option for directors to protect themselves from personal liability. Yet we have seen over the last two decades that the appointment of an administrator invariably precipitates the destruction of a company's enterprise value, with the re-emergence of the company, or at least its business, at the end of a period of administration the exception rather than the norm.

A NEW TRAJECTORY

With that background, the focus has turned to what can be done to maximise the prospect of saving distressed companies – or at least their businesses via a going-concern sale – that are financially impacted by COVID-19 but still have a realistic prospect of trading out of their difficulties as the economy scales back up over the next six months and beyond.

1 The increased response time and minimum threshold are implemented via new regulation 5.4.01AA of the Corporations Regulations 2001 (Cth) and corresponding amendments to the prescribed form for statutory demands (Form 509H). **2** The moratorium is contained in new s 588GAAA of the *Corporations Act 2001* (Cth) (the Act). **3** For the statutory duty, see s 181(1)(a) of the Act.

Part 5.3A of the *Corporations Act 2001* (Cth) (Act) is widely regarded as cumbersome and subject to various limitations that make the primary corporate and business rescue objective expressed in s 435A(a) little more than a motherhood statement.

Among those limitations are:

- the restricted scope of the enforcement moratorium applying after the appointment of a voluntary administrator, with an exception on enforcement for substantial secured creditors.[4] That is in contrast to the Chapter 11 process under the United States *Bankruptcy Code*, according to which there is a cram-down on the enforcement rights of all secured and unsecured creditors
- administrators' personal liability for debts arising under new contracts entered into during the administration, pursuant to s 443A of the Act
- administrators' personal liability for rental payments where the company remains in possession of property beyond five business days after the administration begins, under s 443B of the Act
- the absence of an express power for the court to approve debtor-in-possession (DIP) financing for lenders, providing them with super-priority status in relation to new funds advanced to a company to facilitate a restructuring attempt. This is also in contrast to the United States position where DIP financing is routinely ordered, usually at the time of the original Chapter 11 filing.

Pending any longer-term amendments to Part 5.3A once the immediate pandemic period subsides, in the interim the means for pursuing greater flexibility in the voluntary administration process to maximise corporate and business rescue in response to COVID-19 has concentrated on two avenues: executive power and court intervention.

Executive power

The Omnibus Act inserted the new s 1362A into the Act to enable the Commonwealth Treasurer to issue a declaration modifying any provision of the Act if, due to the impact of COVID-19, it would not be reasonable to expect that compliance or modification is otherwise necessary to promote business continuity. To date, the Treasurer has used this power to permit companies to give notice of, convene and conduct meetings (including AGMs) electronically and to permit company officers to sign a document electronically, in each case until 6 November 2020.[5]

Potentially, s 1362A could also form the basis of a declaration from the Treasurer addressing the Part 5.3A limitations noted above. However, the Treasurer has indicated that the s 1362A power will be used sparingly and its use in the context of Part 5.3A appears unlikely at this stage.

Court intervention

As a result, the power for the courts to modify the operation of Part 5.3A has now become the dominant focus for administrators and legal practitioners.

Under s 447A of the Act, a court has the power to make any order it thinks appropriate about how Part 5.3A operates in relation to a particular company. There is a similar power under s 90-15 of the Insolvency Practice Schedule (IPS), included as Schedule 2 of the Act. However, s 90-15 is expressed in broader terms, allowing a court to make any order it sees fit simply 'in relation to' the external administration of a company.

Potentially, reliance on s 90-15 of the IPS could allow a court to make broad-based orders designed to enhance the prospect of a company pursuing a successful restructure, for example orders imposing a mandatory cram-down on the rights of all creditors, even when the orders do not involve the modification of any existing provisions of Part 5.3A of the Act (the latter being a mandatory precondition for the s 447A power to arise).

POST-COVID-19 COURT APPLICATIONS

Since the outbreak of COVID-19, there has been a raft of applications under s 447A of the Act and s 90-15 of the IPS.

Re CBCH Group (No.2)

In the first post-COVID-19 application, *Re CBCH Group Pty Ltd (Administrators Appointed) (No.2)*,[6] Markovic J made orders on 1 April 2020 in the Federal Court modifying s 443B of the Act to exempt the administrators from personal liability for rental obligations in relation to property that the Colette Group entities (which operated as a mid-market bag, jewellery and accessories retailer) in administration remained in possession of.

The orders were designed to give the administrators time to investigate a 'mothballing strategy' of hibernating the company's 138 physical stores in Australia and New Zealand while maintaining a scaled-back online presence and negotiating a sale to a third party with a view to a recovery in sales in the second half of 2020.

Markovic J noted that the orders would give effect to the express overriding purpose of corporate and business rescue in s 435A(a) of the Act. Even though the orders deprived the commercial landlords of the immediate benefit of the rental payments, the landlords were unlikely to obtain any other replacement tenant in a severe COVID-19 retail downturn.

4 Section 441A of the Act. **5** These modifications are set out in the *Corporations (Coronavirus Economic Response) Determination (No.1) 2020* (Cth). **6** [2020] FCA 472.

Voluntary administration

Further, the temporary relief from rental liability enabled the Colette Group entities to maintain additional cash reserves of up to $650,000, critical for their survival, and it was in the interests of the landlords for the entities to eventually be able to resume trade and exist as viable, long-term tenants post COVID-19.

Markovic J said that during the COVID-19 pandemic both administrators and courts 'need to be agile and able to react to the interests of a number of stakeholders'.

Re CBCH Group (No.3)

The exemption of the administrators from personal liability was extended by Markovic J on 15 April 2020 for a further three-week period in *Re CBCH Group (Pty Ltd) (Administrators Appointed) (No 3)*.[7] Despite the objection of the landlords to the extension, Markovic J noted the devastating impact mandatory social-distancing measures during the COVID-19 pandemic had across the entire retail sector; it meant that the financial impact on the lessors of not being able to recover additional rental payments could not be mitigated by securing another tenant.

Markovic J also referred to the 'National Cabinet Mandatory Code of Conduct – SME Commercial Leasing Principles During COVID-19' and the obligation, under that code, for lessors to refrain from eviction and negotiate rental reductions, waivers and deferrals with tenants. The administrators indicated their willingness to negotiate with the landlords about when deferred rent could be repaid and Markovic J accepted the mothballing strategy as the best means of ensuring a restructure and an ongoing tenant for the landlords' long-term benefit.

Re Techfront Australia (No.1)

On 17 April 2020, Farrell J also ordered an exemption from personal liability for rent, this time for the administrators of a chain of technology companies in *Re Techfront Australia Pty Ltd (Administrators Appointed) (No.1)*.[8]

The exemption applied for a two-week period to enable the administrators to preserve up to $710,000 in rental payments while they reached a commercial decision about whether the leases were necessary to the ongoing trade of the companies (a decision made more difficult by the ongoing changes to mandatory government social-distancing measures and doubt over commercial tenancy obligations) and whether continued trade with a view to selling the businesses of the companies to a third party was a viable option.

Again, the overriding corporate and business rescue objective of Part 5.3A was critical, with Farrell J also conscious of the need for the courts to assist administrators in navigating the severe financial impact of COVID-19, along with the corresponding period of regulatory uncertainty.

Re Virgin Australia Holdings (No.1)

Following the appointment of voluntary administrators to the Virgin Australia entities in the wake of the virtual worldwide shutdown of the airline industry, the administrators obtained orders under s 447A of the Act and s 90-15 of the IPS in *Re Virgin Australia Holdings Ltd (Administrators Appointed) (No.1)* on 24 April 2020 that, among other things, deferred their personal liability for rental payments under various airport and aircraft-leasing arrangements for four weeks.[9]

Once again, the critical factor for Middleton J in making the orders was that the administrators required additional time to investigate whether it was viable for the Virgin entities to remain in possession under the leases. The answer in turn depended on further examination of the complex business structure of the entities, the likelihood of the entities being able to resume trade and negotiations with third parties to ascertain their interest in a future sale.

Although the interests of the lessors were prejudiced in the short term because they would not receive immediate rental payments, in maximising the prospect of a going-concern sale the orders 'increased the prospect that there will remain a counter-party in place' to eventually resume paying rent in the long term.

The orders reflect a trend for the courts to play a proactive role to assist administrators to investigate genuine restructuring options for viable entities impacted by COVID-19. This comes with express understanding of the commercial environment in which they are now operating, replete with continued demand and supply chain disruptions, and difficult and continually changing regulatory and policy settings.

Re Techfront Australia (No.2)

On 6 May 2020, the Techfront matter returned before Farrell J in Re *Techfront Australia Pty Ltd (Administrators Appointed) (No.2)*.[10]

7 [2020] FCA 555. **8** [2020] FCA 542. **9** [2020] FCA 571. **10** [2020] FCA 618.

Despite the six-month insolvent-trading moratorium, the incentive for directors of a financially distressed entity impacted by COVD-19 to appoint a voluntary administrator remains high.

Voluntary administration

This time, the administrators obtained orders extending the convening period for the second meeting of creditors (normally 20 business days after a period of administration begins)[11] by six weeks until 18 June 2020. The extension was granted to enable the administrators to continue negotiations with prospective purchasers.

A going-concern sale would ultimately be in the best interests of all stakeholders because it would preserve existing relationships with creditors, employees and customers and avoid an inevitable fire sale that would result if the companies entered liquidation. In the absence of further time to investigate a going-concern sale, the administrators would have been compelled to prematurely recommend liquidation to creditors with the ordinary second meeting-convening period imminent.

Re Virgin Australia Holdings (No.2)

And finally, in hearings on 13 May and 15 May 2020, the administrators obtained additional orders in the Virgin Australia matter to, among other things:

- extend the convening period for the second meeting of creditors until 18 August 2020
- exempt the administrators from personal liability (beyond the free assets of the Virgin Australia entities) for debts arising under future contracts entered into during the administration – including those relating to airport leases and services, operations, ground staff, cargo, fuel, in-flight services, charters, maintenance, insurance, the issue of conditional credits to be used by customers and alliance partnerships with global airlines. The exemption also extended to any personal liability that would otherwise apply in relation to intra-group loans entered into between the Virgin entities in administration, as well as liabilities arising from the administrators' employment of staff and payment of wages under the Commonwealth Government's JobKeeper scheme.

The additional Virgin Australia orders represent a significant departure from the ordinary position under s 443A of the Act. The purpose of the orders was to enable the administrators to continue their efforts to pursue a successful restructuring attempt, with a view to a sale of the airline operations of the Virgin entities to one or more interested third parties and a resumption of flights, domestically and possibly internationally, in the second half of 2020.

Contracts of the kind specified in the orders are clearly indispensable to the administrators being able to position the Virgin entities as a viable prospect for third-party purchasers. Without the orders, the personal liability risk would realistically have spelled the end of restructuring negotiations, resulting in a transition to liquidation.

The orders reflect considerable flexibility on the part of the Court – and a distinct shift towards using the discretionary powers in s 447A of the Act and s 90-15 of the IPS to effect the underlying primary purpose of Part 5.3A. At the same time, the orders show a clear recognition by the Court of the need to fairly balance the interests of all creditors.

Notably, the orders require all counterparties to any prospective contract to be notified of the limited liability of the administrators before the time of execution. Creditors can therefore make an informed decision about whether they are prepared, as a matter for their own commercial judgement, to support the Virgin entities in the belief they are 'backing a winner' in a post-COVID-19 world.

Ultimately, that belief can only exist (as is the case in any restructuring attempt) if the administrators can build a sufficient consensus among current and prospective creditors in a collaborative and consultative negotiation process. But exempting the administrators from personal liability at least provides an incentive for them to do so.

A successful restructuring will also depend on securing new finance. In Virgin Australia's case, this may extend beyond intra-group finance among the Virgin entities to third-party financing, as would invariably be required in other restructuring cases. In that context, we may see new court applications in coming months seeking orders for DIP-style super-priority status to be given to lenders advancing new funds to support a rescue attempt, given the strong incentive this would provide to financiers to offer that support.

Future court applications

Looking ahead, we are likely to see an influx of further applications in other matters with the peak insolvency period in response to COVID-19 still at least another three to four months away even as talk now shifts to economic recovery and an eventual

11 Section 439A of the Act

return to growth. We can expect an inevitable contagion effect with widespread – and possibly permanent – changes to business as we knew it before the COVID-19 pandemic.

Although many businesses now seek to transition back to some kind of office structure, the advantage of more agile, remote workforces will drive down the demand for the same floor spaces that were occupied previously. This will in turn impact on landlords, as well as local retailers, cafes, restaurants and personal services businesses. While retailers and hospitality businesses may be able to resort to online services in some cases, that may not be a realistic option for all operators and certainly not for personal services businesses such as cleaning, beauty and health-care operators.

In that event, it can be anticipated that administrators will continue to push the boundaries of Part 5.3A and that courts will continue to take a proactive, commercially minded approach in supporting restructuring attempts for viable entities. That may include not only further exemptions from personal liability and support for DIP financing, but also possible cram-down orders restricting the enforcement rights of major secured creditors unwilling to support a rescue attempt even where there is a realistic prospect of resumed trade.

THE IMPETUS FOR MEANINGFUL & LASTING LAW REFORM

While relief granted by the courts under s 447A of the Act and s 90-15 of the IPS is a useful interim measure to ensure the flexibility in Part 5.3A of the Act required to maximise corporate and business rescue, it is necessarily limited to particular companies and depends on the exercise of discretion following a costly court application.

That is no substitute for regulatory and business certainty, and the cultivation of a stronger entrepreneurial and rescue culture in the long term that would be delivered by legislative reform.

Beyond COVID-19, there is an opportunity for the existing court decisions we have referred to in this article – and those still to come – to be used as the impetus to build an industry 'critical mass' advocating for enduring amendments to Part 5.3A of the Act. This would bring the actual process of voluntary administration into greater alignment with its stated primary aim of corporate and business rescue. Those amendments could include, at least, modifications to administrators' personal liability, provision for DIP financing and longer meeting-convening periods, as well as a possible broad-based enforcement moratorium subject to adequate protection measures for creditors of the kind adopted in Chapter 11 of the United States *Bankruptcy Code.*

The pace at which the *Omnibus Act*, and other fiscal and support legislation, has been drafted, debated and passed in response to COVID-19 – all in a matter of weeks – and the previously unimagined prospect of executive intervention to relieve regulatory burdens in circumstances where they are plainly unsuited to actual business and economic circumstances – show that there is a different way to approach law reform in the future.

COVID-19 can be seen as a circuit-breaker for the law-reform process in future. Rather than spending years consumed in review after review of the same issues, with extensive consultation periods and reports failing to deliver any final outcome and address underlying industry concerns, there is a way to implement timely and meaningful change for the benefit of businesses and the broader economy. Indeed, there is a way to achieve the flexibility required to position Australia as a regional centre in the Asia-Pacific for insolvency and restructuring.

The implementation of cohesive, consistent and best-practice laws to shape corporate and business rescue in Australia under a streamlined Part 5.3A process is critical. Ultimately, this needs to be driven by the expert industry practitioners who have seen and know so deeply the fabric of the Australian and international insolvency regimes in practice.

The Financial Recovery Law Reform Commission proposed by ARITA, comprising eminent commissioners and primarily self-funded, could play an important role in this process as a primary government advisory panel with expertise not held by Parliamentary committees, individual government departments or the broader Australian Law Reform Commission.

Without enduring law reform – both in substantive changes to Part 5.3A of the Act and in the very process for achieving those changes – it will not be possible to transcend the creditor-dominated culture and the stigmatisation of business failure that has defined the Australian insolvency landscape for the last 50 years.

Breaking this impasse is precisely what is required to drive the innovation, productivity improvements and sustainable, long-term economic growth now sought as the focus turns towards economic recovery and growth in a post-COVID-19 world.