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ARTICLE

How Australian Courts are Advancing Corporate and Business Rescue During COVID-19 and the Agenda for Enduring Law Reform

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Synopsis

The initial outbreak of COVID-19 saw the announcement of unprecedented government fiscal and stimulus packages across the globe. In Australia, an economic support package of $320 billion, including a $130 billion package[1] to guarantee wages and encourage employers to keep staff on their books with a view to scaling up their operations in the second half of 2020, was implemented by the Commonwealth Government in March and April, with states and territories also announcing separate measures such as tax concessions and cash flow support since that time.

These measures have been necessary in an economic and health environment of inherent uncertainty, where the rules have changed daily and projections for an unknown future have become redundant almost the second they have been issued. However, with the focus now turning to economic recovery and an eventual return to growth, it has become readily apparent that the business world will be a very different one to what it was pre COVID-19. Many of the business models that were so successful previously simply cannot continue in the future.

This can most clearly be seen in the hospitality, tourism, retail and personal services sectors, with businesses needing to adapt to changed patterns of consumer demand and behaviour, in terms of the how – with a push to online delivery – and also the desire and means – with declining levels of affluence and discretionary expenditure and a focus on simpler, safer living. More broadly, the unwinding of global supply chains and geopolitical tensions will impact businesses across all sectors, as the push for bigger and better now becomes a desire for smaller, more local and more sustainable. There will be an inevitable contagion effect on landlords, banks and insurers, which in turn will cycle back to hit businesses again in the form of higher cost bases and less availability of credit.

In this environment, there is a real prospect that many of the businesses simply hanging on for the last three months with the benefit of public support measures, along with loan and rental concessions from banks and landlords in the private sector, will not be able to do so once that support reaches its fast-approaching end.

The focus must therefore turn to Australia's insolvency framework and how existing laws, and future law reform, can support the restructure of viable companies and businesses while ensuring that capital in entities with endemic operational issues is recycled and reinvested in the innovative industries and business models that will fuel recovery and growth on a macro level.

The existing rescue process in Australia

The aim of any insolvency process should be to balance fairness with efficiency – recognising that, while it is important to promote the rehabilitation of entities that are experiencing financial distress but are viable and have a realistic prospect of trading out of their difficulties, liquidation may be the best option for entities facing endemic operational and financial failures. In the latter case, business failure should not carry a stigma. Rather, it is necessary to ensure that scarce capital can be reinvested to support equity finance for new ventures and projects, in turn driving the innovation and productivity enhancements so critical to economic recovery and long term growth in the period ahead.

Voluntary administration under Part 5.3A of the *Corporations Act 2001* (Cth) ('*Act*') is Australia's purported formal rescue process for insolvent companies. Its stated aim is to maximise the prospect of an insolvent company, or as much as possible of its business, continuing in existence.[2] Yet in practice, the experience has been that once a company enters voluntary

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1 The costing of this measure, the JobKeeper Scheme, has since been revised to be $70 billion rather than the originally expected $130 billion.
2 *Act*, section 435A(a).

administration, it rarely emerges, nor does its business under a going concern sale.

In comparison to the Chapter 11 process in the United States *Bankruptcy Code*, the enforcement moratorium that applies when an administrator is appointed does not extend to a company's major financier with security over substantially the whole of the company's assets.[3] Administrators are also personally liable for rental payments and new contracts entered into in support of a restructuring attempt[4] and there is no provision for court-ordered debtor in possession ('DIP') style financing to give new lenders injecting required debt finance in support of a restructure super-priority status. Following the execution of a deed of company arrangement ('DOCA'), there is also no broad-based cram-down of the kind seen in Chapter 11 for dissenting secured creditors.

As a result, a successful rescue attempt depends on administrators securing the collective support of all of the company's current and prospective creditors working together in a shared vision for the future of the company, or at least its business in a restructured form. In a creditor-dominant, individualist enforcement culture, in contrast to the more collectivist informal rescue process seen in the United Kingdom and the debtor-friendly process applying in the United States, this careful balance is typically a pipeline dream.

Outside of Part 5.3A of the *Act*, there is also limited incentive for directors of a distressed company to do anything other than appoint a voluntary administrator to begin with. Faced with one of the strictest insolvent trading regimes in the world, and with the appointment of an administrator taken into account as an express defence to insolvent trading liability,[5] voluntary administration is a compelling option.

While a safe harbour from insolvent trading, introduced in September 2017, applies where directors develop a course of action 'reasonably likely to lead to a better outcome for the company' than the immediate appointment of an administrator or liquidator[6] – that course of action requiring directors to, among other things, obtain advice from a restructuring expert and implement a restructuring plan devised by that expert[7] – the safe harbour is largely untested in the courts. Directors have not yet put their faith in the new laws and the cultivation of a deeper informal rescue culture in Australia is still a long way off.

How the courts have stepped in

Pending legislative change – a point returned to below – administrators have in the interim, following the outbreak of COVID-19, resorted to provisions in the *Act* which permit an application for court orders modifying the usual operation of Part 5.3A. The most prudent course for administrators in this case is to rely, in the alternative, on section 447A of the *Act* and section 90-15 of the Insolvency Practice Schedule included in Schedule 2 of the *Act*. Section 447A allows a court to, in its sole discretion, make any order about 'how Part 5.3A operates in relation to a particular company.' Section 90-15, even more broadly, allows a court to make any order 'in relation to the external administration of a company'.

In seven post COVID-19 applications to the Federal Court of Australia,[8] the Court has made a combination of one or more of the following sets of orders under those provisions:

– convening and conducting creditors' meetings electronically;
– extending the usual period for convening the second meeting of creditors of a company (normally 20 business days after a period of administration begins) by anywhere between six weeks and three months. The second meeting is a time when creditors vote on whether the company should be liquidated or alternatively returned to its directors or proceed to the execution of a DOCA;
– exempting administrators from personal liability for rental payments owing after the commencement of the administration for up to a month; and/or
– exempting administrators from personal liability for debts incurred under new contracts entered into during the administration.

While the orders for electronic meetings have been made for practical purposes in response to mandatory social distancing measures adopted at Commonwealth,

Notes

3 *Act*, section 441A.
4 *Act*, sections 443A and 443B.
5 *Act*, sections 588H(5) and 588H(6).
6 *Act*, section 588GA(1)(a).
7 These are express factors a court must consider, pursuant to sections 588GA(2)(d) and 588GA(2)(e) of the *Act*, in assessing whether a course of action is reasonably likely to lead to a better outcome for the company.
8 *Re CBCH Group Pty Ltd (Administrators Appointed) (No 2)* [2020] FCA 472; *Re CBCH Group Pty Ltd (Administrators Appointed) (No 3)* [2020] FCA 555; *Re Techfront Australia Pty Ltd (Administrators Appointed) (No 1)* [2020] FCA 542; *Re Virgin Australia Holdings Ltd (Administrators Appointed) (No 1)* [2020] FCA 571; *Re Techfront Australia Pty Ltd (Administrators Appointed) (No 2)* [2020] FCA 618; *Re CBCH Group Pty Ltd (Administrators Appointed) (No 4)* [2020] FCA 671; and *Re Virgin Australia Holdings Ltd (Administrators Appointed) (No 2)* (reasons for decision not yet published).

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state and territory level, the final three sets of orders have been made specifically with a view to increasing the likelihood of a successful restructure. Giving administrators further time to call the second meeting of creditors provides them with the critical negotiating period required to canvass restructuring options with the major creditors, landlords and suppliers whose support is necessary for there to be any prospect of resumed trade.

Careful and sensitive negotiations across multiple interest groups simply is not possible in a tight timeframe of 20 business days after an administrator is appointed, particularly in the context of heightened regulatory uncertainty during COVID-19 which impacts stakeholders in different ways. In the absence of extension orders, the inevitable outcome in many voluntary administrations during COVID-19 would be a recommendation to creditors for immediate liquidation.

As Markovic J held in *Re CBCH Group Pty Ltd (Administrators Appointed) (No 4)*, 'undue speed should not be allowed to prejudice sensible and constructive actions directed to maximising a return for creditors'[9] as the administrators in that case looked to position a group of entities that operated as a mid-market bag, jewellery and accessories retailer for a going concern sale after an initial period of mothballing operations ahead of the reopening of stores from 1 June 2020 to coincide with a relaxation of social distancing measures.

The exemption orders provide an incentive for administrators to in fact pursue restructuring negotiations without the prospect of personal liability for the obligations that must necessarily be incurred to prime the company for resumed trade or to otherwise position the business as an attractive going concern prospect for a sale to one or more third parties. Although exemptions from rental liability mean that landlords are deprived of the benefit of immediate rental payments, the courts in the cases to date have emphasised that the pursuit of a restructure with a reasonable prospect of success is in their long-term interests too, insofar as that outcome would deliver a viable tenant in an uncertain market.[10]

Indeed, in the latter regard, COVID-19 has had a consistently devastating impact for commercial tenants in most sectors due to the restrictive social distancing measures in place, with the consequence that landlords are better off taking a hit with interim rental waivers and reductions from existing tenants (if they are likely to trade out of their difficulties post COVID-19) than watching those tenants go into liquidation, only to be left with a vacant asset indefinitely.

The orders exempting administrators for debts incurred under new post-administration contracts have so far only been made in *Re Virgin Australia Holdings Ltd (Administrators Appointed) (No 2)*, involving the administration of Australia's second major airline. In that case, the orders required all counterparties to any contract that might be negotiated by the administrators in relation to airline operations, in-flight services, fuel, cargo, charters, maintenance, insurance and other matters to be provided with notice of the administrators' excluded liability as part of the contractual terms entered into.

This was a means for the Federal Court to balance the 'extraordinary nature' of the modification of the administrators' usual personal liability by ensuring the protection of counterparties – specifically, by allowing them to, before entering a contract, make an informed commercial judgment about whether they think Virgin has enough of a prospect of a return to profitable trade to justify the risk of their investment. Again, without the orders, there would have been no incentive for the administrators to continue their negotiations for a going concern sale and do the extensive groundwork needed to place the Virgin entities in a position to be able to return to trade ahead of any sale.

The need for law reform

While beneficial as emergency measures during the initial COVID-19 economic downturn and gradual recovery period, in the long-term, a well-functioning insolvency process which supports the rehabilitation of viable entities and businesses cannot be left to depend on the exercise of the court's discretion in individual cases. Not only does this expose the potential for uncertain outcomes, with no guarantee standard orders will be made in every application under section 447A and section 90-15, but a court application is also costly and diminishes scarce capital needed by administrators to pursue the very restructuring attempt for viable entities and businesses that section 447A/section 90-15 orders are designed to achieve.

Going forward, it is critical for the insolvency industry in Australia to press the need for permanent amendments to Part 5.3A of the *Act* to ensure the primary aim of corporate and business rescue does not continue to operate as a lofty goal unsupported by its underlying structure. Apart from modifications to administrators' personal liability and possible revisions to the voluntary administration timeframe, court-ordered DIP financing is worth serious consideration. Indeed, in the absence of super-priority, debt finance is not a realistic restructuring option, with little incentive for funders to prove the capital injection needed to position distressed entities and businesses for resumed trade.

Notes

9 [2020] FCA 671, [26].

10 See, for example, the remarks of Middleton J in *Re Virgin Australia Holdings Ltd (Administrators Appointed) (No 1)* [2020] FCA 571, [49].

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A broader enforcement moratorium during voluntary administration, along with provision for a Chapter 11-style alternative cram-down restructuring plan to a DOCA, which generally only binds secured creditors who vote in favour of it, and a creditors' scheme of arrangement under Part 5.1 of the *Act*, pursuant to which there is no provision for a cross-class cram down preventing a class of creditors (as distinct from minorities within a class) from enforcing their claims where they do not approve the scheme – should also be considered.

These are some of the features – stopping well short of a wholesale adoption of Chapter 11 in Australia which would be reactive and out of step with the unique and intricate legal, policy and cultural settings that have developed in this country over centuries – have already been found to have merit by the Productivity Commission and three previous Government Inquiries.[11] Yet, despite those findings, and continued advocacy in the insolvency industry, changes to Part 5.3A of the *Act* have not been forthcoming.

The United Kingdom is already moving to adopt new permanent corporate and business rescue laws to shape its economic recovery in response to COVID-19 (along with temporary relief, until 30 June 2020, relieving directors from wrongful trading and requiring a court to review statutory demands and winding up petitions where a company's failure to pay its debts is related to the pandemic). Under the *Corporate Insolvency and Governance Bill* (UK) presented to the House of Commons on 20 May:

- directors of all companies (with limited exceptions) can apply to the court for an initial 20 business day 'Part A1' enforcement moratorium, which can be extended for a further 20 business days without creditor consent or indefinitely with creditor consent, while a restructure is negotiated.[12] This requires the appointment of an expert monitor who considers it is likely a moratorium would result in the rescue of the company as a going concern. The moratorium is broad-based and extends to the enforcement of claims by landlords and secured creditors (other than steps taken to enforce a collateral security charge or security arising under a financial collateral arrangement). This is, in effect, a quasi-Chapter 11 DIP model, with directors continuing to be in charge of the day to day operation of the company during the Part A1 moratorium;
- an ipso facto moratorium, broadly similar to that applying in Australia, which prevents suppliers of goods or services to the company terminating contracts on the basis of the company having entered an insolvency procedure (including a Part A1 moratorium), subject to relief if this causes hardship to a supplier's business;[13]
- there is provision for a new type of restructuring plan to be entered into.[14] Unlike existing company voluntary arrangements (CVAs), a restructuring plan can bind both secured and unsecured creditors. Creditors must vote on the plan in classes (similar to the scheme of arrangement approval process), with minimum required support of 75% in value of each class. However, the court has the ability to approve a plan even if that threshold is not reached for one or more classes of creditors, and the court also retains a discretion to reject a plan even where it has been approved by all classes of creditors.

With the rapid pace of regulatory change across the globe in the current environment, and the need for flexible and dynamic laws to shape the economic recovery, Australia cannot afford to be left behind.

Rather than commissioning years of further reviews under the auspices of broad law reform or Parliamentary committees, greater cut-through could be achieved under a managed law reform project with experts from the insolvency industry appointed to advise the Government on best practice corporate and business rescue processes for Part 5.3A of the *Act*, and the interrelationship between formal rescue laws and the informal restructuring encouraged by the existing insolvent trading safe harbour.

With a specific timeframe for consideration and implementation, there would be a positive and proactive drive for the enduring and impactful law reform needed to support businesses and the broader Australian economy in what will be a difficult 12 to 24 months – incentivising innovation and entrepreneurialism and overcoming the entrenched fear of failure that has pervaded in Australia and placed it at a major competitive disadvantage to the United Kingdom and the United States.

Notes

11 Australian Government, Productivity Commission, *Business Set-Up, Transfer and Closure*, Productivity Commission Inquiry Report No. 75, 30 September 2015, 372; Senate Economics References Committee, Parliament of Australia, *Performance of the Australian Securities and Investments Commission* (2014) 449; Independent Committee, Australian Government, *Financial System Inquiry* (2014) 265-266; and Corporations and Markets Advisory Committee, Australian Government, *Rehabilitating Large and Complex Enterprises in Financial Difficulties* (2004) 13-17.

12 Proposed Part A1 of the *Insolvency Act 1986* (UK).

13 Proposed sections 233B-233C of the *Insolvency Act 1986* (UK).

14 Proposed Part 26A of the *Companies Act 2006* (UK).

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International Corporate Rescue addresses the most relevant issues in the topical area of insolvency and corporate rescue law and practice. The journal encompasses within its scope banking and financial services, company and insolvency law from an international perspective. It is broad enough to cover industry perspectives, yet specialised enough to provide in-depth analysis to practitioners facing these issues on a day-to-day basis. The coverage and analysis published in the journal is truly international and reaches the key jurisdictions where there is corporate rescue activity within core regions of North and South America, UK, Europe Austral Asia and Asia.

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