Turning to Chapter 11 to foster corporate rescue in Australia

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For more than two decades, Pt 5.3A of the Corporations Act 2001 (Cth) has remained the predominant mechanism for corporate rescue in Australia. However, in recent years its enshrined voluntary administration procedure has drawn strong criticism in the face of legislative inaction. Such criticism has often been accompanied by claims that distressed corporations have found it increasingly difficult to reorganise their financial affairs, provoking voluntary administration's label as a lengthier route to liquidation. Over the years, Chapter 11 of the US Bankruptcy Code has frequently been brandished as an alternative approach to company reorganisation, only to be rebuffed for its perceived procedural difficulties and incompatibility with the creditor-oriented mindset that permeates Australia's insolvency regime. After delving into some of the reported drawbacks of voluntary administration, this article challenges the denunciation of Chapter 11 in Australia. It sheds light on the redeeming features of Chapter 11 that merit detailed consideration in Australia's present-day corporate landscape and parries the legion of criticism that has been directed at the procedure. It is asserted that turning to Chapter 11 as a model for reorganisation and value maximisation is warranted at a time when calls to foster a corporate rescue culture in Australia are abounding.

INTRODUCTION

The last significant review of Australia's insolvency and reorganisation laws occurred in 1988, following the Australian Law Reform Commission's General Insolvency Inquiry (Harmer Report). In the meantime, rapidly evolving financial markets, altered lending practices and the age of the computer have drastically changed the face of Australia's economy. The voluntary administration (VA) procedure in Pt 5.3A of the *Corporations Act 2001* (Cth) (Act) has continued to be the primary reorganisation tool for insolvent and distressed companies during this time.[1] To be sure, its tenure has not been without considerable scrutiny by different corners of the business community who have questioned its accessibility and efficacy as a corporate rescue mechanism.[2]

This article first examines the place of VA both historically and in the context of Australia's present-day corporate landscape. It identifies several features of the procedure that are perceived as hindrances to corporate rescue, including: its short timeframes; the high incidence of delay; the lack of commercial decision-making by courts in the procedure; aspects of the legislative framework that seemingly deter directors from initiating VA at an early stage of a company's financial distress; the domineering influence of secured creditors; and the lack of protection afforded to companies in VA against parties terminating their contracts upon an insolvency event on the company's part.

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[1] Strictly speaking, the VA procedure is a precursor to corporate rescue. Corporate rescue in this context is only possible if a deed of company arrangement is executed, which brings VA to an end: *Corporations Act 2001* (Cth) s 435C(3). This article refers to VA in its totality as a reorganisation tool, encompassing the actions that are taken once the procedure has ended.

[2] Concerns about VA have been voiced in numerous reports prepared by government bodies and insolvency groups, the most recent of which include the Productivity Commission's *Business Set-up, Transfer and Closure Inquiry Report* (2015), the Senate Economic References Committee's *Performance of the Australian Securities and Investments Commission Report* (2014) and the Australian Restructuring Insolvency and Turnaround Association's "Dealing with Corporate Financial Distress in Australia" (Discussion Paper, 2014).

This is followed by an expository overview of Chapter 11 of the *Bankruptcy Code 1978* (US) (Code). The adoption of Chapter 11 as a reorganisation mechanism,[3] or the handpicking of desirable aspects of Chapter 11 to augment VA in Australia, is not a novel proposal: Chapter 11 has often surfaced in discussions concerning Australian insolvency reform.[4] Its "debtor-oriented" nature makes it an attractive alternative to VA, primarily because Chapter 11 allows a debtor's management team to retain possession of its company once the procedure has commenced.[5] However, the advantages of Chapter 11 transcend its "debtor-in-possession" model. This article concentrates on select advantages from a practical, rather than theoretical, perspective and strives to quell concerns with the regime that may undermine its application in Australia. This article does not advocate for a wholesale adoption of Chapter 11. It contends that, contrary to widely held belief, there is merit in considering some significant features of Chapter 11 that may be modified and implemented in Australia in order to respond to the perceived drawbacks of VA while creating an insolvency system that is conducive to reorganising distressed companies.[6]

HISTORICAL CONTEXT OF VOLUNTARY ADMINISTRATION

VA was introduced by the *Corporate Law Reform Act 1992* (Cth) in response to the recommendations made in the Harmer Report. Two major catalysts drove the inquiry that led to the Harmer Report and its review of Australia's insolvency system. First, there was dissatisfaction surrounding the voluntary insolvency procedures that were available at the time, being liquidation, schemes of arrangement and official management.[7] The latter two procedures were mechanisms for companies to reorganise their financial affairs, while liquidation was the final adieu. The inadequacies of the reorganisation mechanisms acted as a clarion call for legislative reform. Creditors' schemes of arrangement were labelled "cumbersome, slow and costly and … particularly unsuited to the average private company" in financial difficulties.[8] Official management – which required insolvent companies to pay their debts to unsecured creditors in full within a specified timeframe – was an unworkable proposition that was grossly underused.[9] It came as no surprise that liquidation was customary for distressed companies at the time.[10] By extension, the prevalence of liquidation in a system that offered little by way of corporate rescue was the second catalyst for meaningful reform.[11]

[3] In the US, Chapter 11 deals with both individual bankruptcy and company insolvency. For the purposes of this article, Chapter 11 will be discussed in the context of the latter. On issues relating to individual bankruptcies under Chapter 11, see A Lawton, "The Individual Chapter 11 Debtor Pre- and Post-BAPCPA" (2015) 89 *American Bankruptcy Law Journal* 455. See also M Murray, "The Alignment of the Laws of Personal and Corporate Insolvency" (2009) 9 *Insolvency Law Bulletin* 78.

[4] See, eg, Australian Government, Productivity Commission, *Business Set-up, Transfer and Closure Inquiry Report* (30 September 2015) 368-372 (*Business Set-up Transfer and Closure Inquiry Report*); Australian Government, Treasury, *Financial System Inquiry* (2014) 266 (*Financial System Inquiry*); Senate Economic References Committee, Parliament of Australia, *Performance of the Australian Securities and Investments Commission* (2014) 401 (*Performance of ASIC Report*); Australian Government, Corporations and Markets Advisory Committee, *Rehabilitating Large and Complex Enterprises in Financial Difficulties, Final Report* (2004) 13 (*CAMAC Final Report*); L Griggs, "Voluntary Administration and Chapter 11 of the Bankruptcy Code (US)" (1994) 2 Insolv LJ 93; CB Penman and TW Ferrell, "Bankruptcy and Directors' Duties: The United States Perspective" (1991) 9 C&SLJ 347; Australian Law Reform Commission (ALRC), *General Insolvency Inquiry*, Report No 45 (1988) Vol 1, [98] (Harmer Report).

[5] Australian Government, Productivity Commission, *Business Failure and Change: An Australian Perspective*, Staff Research Paper (2000) 86-87 (*Business Failure and Change Paper*).

[6] Cf J Harris, "Restructuring Nirvana? Chapter 11 Bankruptcy and Australian Insolvency Reform" (2015) 16 *Insolvency Law Bulletin* 42. Harris opposes "tilting at wind-mills in far flung jurisdictions" and posits that the questions surrounding Australia's insolvency regime are ones "that only a Law Reform Commission review can tackle": at 46.

[7] ALRC, Harmer Report, n 4, [45].

[8] ALRC, Harmer Report, n 4, [46].

[9] ALRC, Harmer Report, n 4, [47]-[50].

[10] ALRC, Harmer Report, n 4, [50].

[11] Liquidation does not always equate to "failure" in the plain sense of the word. For instance, Pt 5.5 of the Act allows for a solvent company to be wound up voluntarily where it may be in the company's best interests to do so. See generally M Murray and J Harris, *Keay's Insolvency: Personal and Corporate Law and Practice* (Lawbook Co, 8th ed, 2014) 290, [10.10].

These events prompted the Harmer Report to propose a "constructive or creative" alternative to insolvency: the voluntary administration of insolvent companies or companies with a reasonable prospect of insolvency.[12] This alternative required "the preservation, if practical and possible, of the property and business of the company in the brief period before creditors [were] in a position to make an informed decision",[13] and was a way to "encourage directors to take early and orderly steps to deal with an existing or impending state of insolvency".[14] It recognised that "[a]n ordered form of administration of the affairs of an insolvent [entity] is at the centre of insolvency law",[15] and that VA

> will be worthwhile and a considerable advantage over present procedures if it saves or provides better opportunities to salvage even a small percentage of the companies which, under the present procedures, have no alternative but to be wound up.[16]

The VA framework was designed with an emphasis on being "capable of swift implementation, as uncomplicated and inexpensive as possible and flexible, providing alternative forms of dealing with the financial affairs of [a] company" in the form of executing a deed of company arrangement (DOCA) or a winding-up.[17] Currently, the stated aim of VA – unchanged from the days of the Harmer Report[18] – is twofold: to maximise the chances of a company or its business continuing in existence; or, if reorganisation is not possible, to achieve a better return for the company's creditors and members than would result from immediate liquidation.[19]

CONTEMPORARY ISSUES WITH VOLUNTARY ADMINISTRATION

The prevalence of corporate failure: Is history repeating itself?

Two oft-cited statistics in respect of Pt 5.3A of the Act are the overall downward trend in VA's usage in the last 15 years and the corresponding increase in liquidations over the same period of time. Whether these developments alone are symptomatic of a foundering corporate rescue culture in Australia is doubtful, but they nonetheless call for close inspection.

In the period 1999-2000, VAs represented approximately 36% of all external administrations.[20] However, in the period 2014-2015, VAs represented less than 14% of all external administrations[21] and creditors' liquidations have more than doubled in the interim.[22] The rate of corporate failure is high after companies commence VA: 37% of companies are deregistered within two years and 78% are deregistered within five years.[23] A recent empirical study on DOCAs by Wellard concludes:

> In short, instances of the preservation or rescue of companies or their businesses in a trading sense under a DOCA were in a clear minority (though not negligible). Of the 68 DOCAs substantively

[12] ALRC, Harmer Report, n 4, [56]. The "reasonable prospect of insolvency" terminology was not adopted in the ensuing legislation. See *Corporations Act 2001* (Cth) s 436A.

[13] ALRC, Harmer Report, n 4, [53]; C Anderson and D Morrison, "Part 5.3A: The Impact of Changes to the Australian Corporate Rescue Regime" (2007) 15 Insolv LJ 243, 244, fn 7. Anderson and Morrison highlight that the Harmer Report focussed upon saving the *business*, not the company as such. The authors note that this "places paramount the interests of the creditors at the expense of the members", compared to Chapter 11, which "leaves more of a role for the board and indeed the members".

[14] ALRC, Harmer Report, n 4, [53].

[15] ALRC, Harmer Report, n 4, [53].

[16] ALRC, Harmer Report, n 4, [53].

[17] ALRC, Harmer Report, n 4, [54].

[18] See ALRC, Harmer Report, n 4, [59].

[19] *Corporations Act 2001* (Cth) s 435A.

[20] Australian Securities and Investments Commission, Insolvency Statistics Series 1, *Companies Entering External Administration*, (May 2016) Table 1.3. A limitation of these statistics is that each company is only accounted for once, meaning that a company which is liquidated after an unsuccessful VA is not included in the liquidation statistics.

[21] Australian Securities and Investments Commission, n 20.

[22] Australian Securities and Investments Commission, n 20.

[23] Australian Government, *Business Set-up Transfer and Closure Inquiry Report*, n 4, 363. The Productivity Commission notes that these figures include both companies under administration and companies operating under a DOCA.

> reviewed, only 28 percent appeared to involve substantial trading of the business through or under the DOCA. Indeed, in only eight of those instances did the terms of the DOCA appear to contemplate a contribution from the trading profits of the business.
>
> Of the 72 percent of DOCAs which did not entail any substantial trading-on of the business through the deed administration, the form of DOCA was invariably a "quasi-liquidation" composition.[24]

The precise causes of VA's decline in usage in a relatively short period of time are by no means clear. In 2007, amendments to Pt 5.3A of the Act were introduced with a view, among other things, to facilitate the ease with which companies can be placed into voluntary liquidation.[25] The time during which these amendments have been in place indeed coincide with a marked decrease in the number of companies entering VA over that period of time.[26] Another explanation, which is explored in detail below, is director behaviour: it is possible that the legislative regime deters directors from commencing VA either due to a systemic restraint in the VA procedure or against the backdrop of market conditions that have changed significantly since the global financial crisis.[27] It may also be that directors in the modern day economic climate have become wary of the stigmatising effect and reputational damage that stands to be inflicted as a result of the external administration approach of VA, calling into play the economics of identity as a factor that discourages directors from commencing the procedure.[28]

The drawbacks of voluntary administration

The scarcity of empirical research on the effectiveness of VA makes it difficult to explain concretely why VA is declining in popularity.[29] However, a number of commentators have advanced theories that attempt to expound the shortcomings of VA, the effects of which may contribute to the decline in VA's usage and the increased rate of corporate failure after a DOCA is executed.[30]

First, in cases where creditors vote in favour of the company executing a DOCA, it is suggested that VA does not allow sufficient time for the administrator and the company's creditors to develop the DOCA thoroughly.[31] The procedure imposes short timeframes[32] and, as discernible from the Harmer Report, is intended to be swift and practical.[33] Accordingly, companies in large and complex corporate groups within which there are intercompany loans and deeds of cross-guarantees, for example, stand

[24] M Wellard, "A Review of Deeds of Company Arrangement" (2014) 26 *Australian Insolvency Journal* 12, 15. Wellard further highlights:

> In 73 percent of the "quasi-liquidation" DOCAs there appeared to be negligible company assets which would (or could) generate any substantial return for unsecured creditors, let alone sustain trading. Indeed, across the entire sample of s 439A reports which were obtained, in 73 percent of instances the s 439A report projected a "nil return" to unsecured creditors (or a significant possibility thereof) in the event of a winding up.

[25] See *Corporations Amendment (Insolvency) Act 2007* (Cth); Explanatory Memorandum, *Corporations Amendment (Insolvency) Bill 2007*.

[26] See Australian Securities and Investments Commission, n 20. See also M Hirst, "Death of Administrations: Unrealistic Fetters on Litigation Funding" (2008) 9 *Insolvency Law Bulletin* 2.

[27] See, eg, R Schaffer, "The Rise and Fall of Voluntary Administration" (2010) 10 *Insolvency Law Bulletin* 160.

[28] L Chapple and J Routledge, "External Administration in Corporate Insolvency and Reorganisation: The Insider Alternative" (2015) 23 Insolv LJ 69. On a comparative analysis of the external administration system and debtor-in-possession model, see D Hahn, "Concentrated Ownership and Control of Corporate Reorganisations" (2004) 4 *Journal of Corporate Law Studies* 117.

[29] Indeed, a debate in this area without empirical evidence would be largely an exercise in conjecture. As a prominent American commentator in the area of bankruptcy observed in 1998:

> Debates about the law of corporate reorganizations often seem to be debates about facts. From this it might seem that good empirical research can resolve the large differences that exist between competing camps of bankruptcy scholarship.

DG Baird, "Bankruptcy's Uncontested Axioms" (1998) 108 *Yale Law Journal* 573, 573-574.

[30] Statistics are not readily available on the number of companies that execute a DOCA after entering VA. As such, it is difficult to pinpoint whether company deregistration can be attributed to an asset sale DOCA or a failed reorganisation. See generally A Herzberg, M Bender and L Gordon-Brown, "Does the Voluntary Administration Scheme Satisfy its Legislative Objectives? An Exploratory Analysis" (2010) 18 Insolv LJ 181, 190.

[31] Herzberg, Bender and Gordon-Brown, n 30, 190; Anderson and Morrison, n 13, 254-255.

to suffer from VA's brief duration. A court may offset this detriment by extending its supervisory jurisdiction in large and complex matters – the court in the Ansett VA was commended for its accommodating stance towards a corporate group with 41 different companies and more than 15,000 employees[34] – but this seems to be the exception rather than the rule. It is arguable that, during a speedy VA, creditors are the only stakeholders whose interests are properly considered.[35] On application, a court has the power to extend the time period during which the all-important meeting of the company's creditors is to take place,[36] but history shows that the court may be reluctant to do so.[37] This leaves large companies and those within a complex corporate group with the difficult question of whether entering or remaining in VA can be vindicated on grounds other than expediency and low costs.[38]

Secondly, despite the brevity inherent in the procedure, it is remarked that VA is often slower and more expensive than was contemplated by the Harmer Report,[39] so much so that it has been described as "the scenic route to winding up".[40] Whilst this criticism is partly due to administrators seeking court directions on various aspects of the administration,[41] arguably it is aggravated by the unwillingness of courts to engage in commercial decision-making.[42] The merits of establishing a new court that is equipped to deal with issues arising from corporate reorganisations are discussed below.

Thirdly, there is a perception that directors of distressed companies commence VA when it is too late, leaving many companies under-resourced and illiquid at the outset of the procedure.[43] It is asserted that a bulk of the problem can be ascribed to the high threshold to commence VA imposed by

[32] *Corporations Act 2001* (Cth) s 439A(5). An administration that begins either between 31 November and 31 December or less than 25 business days before Good Friday provides for a 25-day convening period during which a meeting of the company's creditors is to take place. Otherwise, the convening period is 20 business days.

[33] *Deputy Commissioner of Taxation v Pddam Pty Ltd* (1996) 19 ACSR 498, 510 (Heerey J); *Cresvale Far East v Cresvale Securities* (2001) 37 ACSR 394; [2001] NSWSC 89.

[34] See L Zwier and D Merkel, "The Scope of the Court's Supervisory Jurisdiction under Part 5.3A: The Ansett Experience" (2003) 11 Insolv LJ 27. On the magnitude of the Ansett group's operations, see KordaMentha, *The Battle to Save Ansett*, <http://www.kordamentha.com/our-stories/ansett-australia>. For a recent example of the court extending its supervisory jurisdiction to accommodate for the administration of 94 companies in a large and complex corporate group, see *Re Arrium Ltd (admins apptd)* [2016] FCA 487.

[35] Anderson and Morrison, n 13, 244.

[36] *Corporations Act 2001* (Cth) s 439A(6). At the creditors' meeting, the creditors may resolve that the company execute a DOCA, that the administration should end or that the company be wound up: s 439C. In relation to court powers, the court has a general power to make orders as it thinks appropriate about how Pt 5.3A of the Act is to operate: s 447A. For an application of s 447A in the context of an extension of time to convene a creditors' meeting, see *Re Western National Earthmoving Corp Pty Ltd* (1997) 141 FLR 121.

[37] *Mann v Abruzzi Sports Club Ltd* (1994) 12 ACSR 611; *Brian Rochford Ltd v Textile Clothing & Footwear Union (NSW)* (1998) 47 NSWLR 47. Cf *Re Diamond Press Australia Pty Ltd* [2001] NSWSC 313, [10] (Barrett J); *Re Riviera Group Pty Ltd* (2009) 72 ACSR 352, 356-357; [2009] NSWSC 585 (Austin J).

[38] H Anderson, "Voluntary Administration and the Protection of Employee Entitlements" (2012) 30 C&SLJ 170, 185-186.

[39] Anderson, n 38, 178 (citation omitted).

[40] Schaffer, n 27, 160. See also K Jones, "What is in the Best Interests of Creditors? The Commercial and Public Interest Dichotomy in Voluntary Administration" (2010) 18 Insolv LJ 7.

[41] C Anderson and D Morrison, "Applications for Advice from Courts by Insolvency Practitioners" (2007) 25 C&SLJ 406; S Guthrie and I Caudwell, "External Administrators: Can You Help Me with Directions?" (2011) 23 *Australian Insolvency Journal* 14.

[42] See *Re Pasminco Ltd (No 2)* (2004) 49 ACSR 470, 474; [2004] FCA 656 (Finkelstein J); *Re Ansett Australia Ltd (No 3)* (2002) 115 FCR 409, 428; [2002] FCA 90 (Goldberg J).

[43] J Routledge and D Morrison, "Voluntary Administration: Patterns of Corporate Decline" (2009) 27 C&SLJ 95, 105-106; Herzberg, Bender and Gordon-Brown, n 30, 190; A Keay, "Voluntary Administrations: The Convening and Conducting of Meetings" (1996) 4 Insolv LJ 9; V Mitchell, "The Water Wheel Case: What Do We Learn From It?" (2003) 16 *Australian Journal of Corporate Law* 65.

s 436A of the Act[44] – which requires insolvency or a likelihood of future insolvency – and the reluctance of directors to cede control of their company to an external administrator.[45] In their empirical study on director behaviour prior to entry into VA, Routledge and Morrison conclude:

> Significant decline [in company performance] is evident much earlier than the time of entering VA; more timely action may well preserve resources and minimise financial exposure suffered by stakeholders. Given its flexibility, efficiency and transparency, one might imagine that timely entry into VA would be seen as critical by all stakeholders. It seems, however, that there is insufficient motivation for the VA path to be taken in the early stages of distress.[46]

As foreshadowed above, the issue of director motivation is evaluated by Chapple and Routledge, who assert that a director's belief that a company is unable to pay its debts may also act as a basis for entering VA pursuant to an abuse of process.[47] For instance, VA ostensibly offers a perverse incentive to some directors whose foremost concern is to avoid personal liability for insolvent trading.[48] The current insolvent trading provisions in the Act have been described as "arguably the strictest in the world",[49] encouraging "directors to put businesses to the sword even where there may be prospects for future prosperity".[50] In determining whether a particular defence to insolvent trading applies, a court must have regard to any action that the directors took with a view to appointing an administrator.[51] Thus, there is a risk that miscreant directors may deliberately propose "an unviable DOCA which if accepted enables them to avoid a current or anticipated winding-up application that may ultimately result in adverse personal consequences".[52] Although creditors may refuse to comply with such an arrangement, it is conceived that the Act nonetheless encourages risk-taking by some directors who may be tempted to engineer a DOCA with the semblance that it will facilitate corporate rescue.[53] Saul Fridman observes more generally that "some companies are taking advantage of the relative informality of [VA] to achieve corporate governance reform" rather than genuine reorganisation.[54] An

[44] Routledge and Morrison, n 43, 106.

[45] Chapple and Routledge, n 28. See also Parliamentary Joint Committee on Corporations and Financial Services, Parliament of Australia, *Corporate Insolvency Laws: A Stocktake* (2004) 82-84 (*Corporate Insolvency Laws: A Stocktake*). This point was deliberated by the Parliamentary Joint Committee on Corporations and Financial Services prior to the release of its 2004 report, which recommended that the threshold test allowing directors to appoint an administrator be lowered "in order to alleviate perceptions that the VA procedure is only available to insolvent companies". This recommendation was not adopted in the 2007 amendments to Pt 5.3A of the Act.

[46] Routledge and Morrison, n 43, 106.

[47] Chapple and Routledge, n 28, 72, citing S Fridman, "Voluntary Administration: Use and Abuse" (2003) 15 BLR 333.

[48] C Anderson and D Morrison, "Should Directors be Pursued for Insolvent Trading Where a Company has Entered into a Deed of Company Arrangement?" (2005) 13 Insolv LJ 163, 165; Parliamentary Joint Committee on Corporations and Financial Services, *Corporate Insolvency Laws: A Stocktake*, n 45, 82. On the applicability of directors' duties in this context, see N D'Angelo, "What Directors Need to Consider Before Calling in an Administrator – and It's Not Just Solvency" (2006) 24 C&SLJ 7.

[49] Chief Justice Wayne Martin, Supreme Court of Western Australia, "Official Opening Address" (Speech delivered at the Insolvency Practitioners' Association of Australia 16th National Conference, Perth, 28 May 2009). See *Corporations Act 2001* (Cth) Pt 5.7B Div 3.

[50] J Harris, "Director Liability for Insolvent Trading: Is the Cure Worse than the Disease?" (2009) 23 *Australian Journal of Corporate Law* 266, 286, quoted in Australian Institute of Company Directors, "The Honest and Reasonable Director Defence: A Proposal for Reform" (Policy Paper, 2014).

[51] *Corporations Act 2001* (Cth) ss 588H(5)-588H(6).

[52] Herzberg, Bender and Gordon-Brown, n 30, 192 (citations omitted). See also J Duns, "Recent Developments" (2002) 10 Insolv LJ 59.

[53] See, eg, *Blacktown City Council v Macarthur Telecommunications Pty Ltd* (2003) 47 ACSR 391; [2003] NSWSC 883; Jones, n 40, 12. On the abuse of VA and Chapter 11 by the exploitation of the entry threshold tests under each regime, see I Eow, "The Door to Reorganisation: Strategic Behaviour or Abuse of Voluntary Administration" (2006) MULR 300.

[54] Fridman, n 47, 333. See also *Kazar v Duus* (1998) 88 FCR 218; *Aloridge Pty Ltd v Christianos* (1994) 13 ACSR 99; *Cadwallader v Bajco Pty Ltd* [2002] NSWCA 328.

interested party may apply for a court order on the basis of an abuse of the VA provisions,[55] but the reality is that the facts to support this application may not always be manifest.

Fourthly, entering VA to reorganise can be futile where a secured creditor is involved. A secured creditor with a charge over the whole, or substantially the whole, of the company's property has the power to enforce its charge within a "decision period".[56] In these circumstances the secured creditor is unaffected by the moratorium in VA, and may – subject to the terms of the security agreement – appoint a receiver to sell those assets of the company that are subject to the charge.[57] This action neither precludes a company from entering VA nor terminates a VA that has already commenced. However, given the extent of the charge, a reorganisation that benefits all stakeholders is unworkable unless the administrator agrees with the secured creditor at the outset of the administration that the charge will not be enforced.[58] In a case where consensus is achieved, the administrator's powers are still subject to the power of the secured creditor or any appointed receiver or controller.[59] Consequently, the unequal footing between the parties is such that any agreement virtually acts as a proverbial gun to the administrator's head, undermining the interests of those stakeholders who wish to see the company reorganise.[60]

Finally, where an ipso facto clause is present in a contract between a company and another stakeholder, the latter is permitted to modify or terminate its contract with the company upon an insolvency event on the company's part.[61] In an insolvency context, these clauses encourage parties – such as suppliers, lessors or lenders – to terminate their contracts with a company by virtue of that company having entered VA. This automatic default trigger "can result in a loss of valuable business for the company in circumstances where the administrator is attempting to revive its fortunes".[62] Mirzai observes that in practice this manifests itself as a domino effect by which creditors will successively terminate their contracts after learning that one creditor has already done so.[63]

[55] *Corporations Act 2001* (Cth) s 447A(2)(b); *Blacktown City Council v Macarthur Telecommunications Pty Ltd* (2003) 47 ACSR 391, 397-398 (Barrett J).

[56] *Corporations Act 2001* (Cth) s 441A. The "decision period" is a period of 13 days commencing on the later of the day the administration begins or the day on which notice is given to the secured creditor under s 450A(3) (if such notice is required).

[57] See *Corporations Act 2001* (Cth) Pt 5.2. Secured creditors without a charge over the whole, or substantially the whole, of the company's property may only enforce their charge with the written consent of the administrator or leave of the court: *Corporations Act 2001* (Cth) s 440B.

[58] M Rose and LJ Law, "Voluntary Administrations: Will they Work?" (1995) 3 Insolv LJ 11, 13.

[59] *Corporations Act 2001* (Cth) s 442D.

[60] See generally S Maiden, "What Can a Voluntary Administrator do about a Concurrently Appointed Receiver?" (2006) 24 C&SLJ 410. Maiden highlights that one way to achieve consensus is for the parties to enter into a "deed of forbearance", whereby the secured creditor foregoes its power to appoint a receiver during the decision period while the administrator – upon notice provided by the secured creditor – consents to the appointment of a receiver after that period: at 414. See also *Federal Commissioner of Taxation v Prescribing Biochemists Pty Ltd* (1994) 30 ATR 9; 14 ACSR 703, 715. Whilst the frequency of execution of deeds of forbearance is largely undocumented, Sackville J held that their fetter on an administrator's powers is not inconsistent with the objects of Pt 5.3A of the Act.

[61] Australian Government, Corporations and Markets Advisory Committee, "Rehabilitating Large and Complex Enterprises in Financial Difficulties" (Discussion Paper, 2003) 53-54 (CAMAC Discussion Paper). The CAMAC Discussion Paper frames this as any "material adverse change" in the company's financial circumstances or entry into VA.

[62] Murray and Harris, n 11, 618, [19.95].

[63] R Goode, *Principles of Corporate Insolvency Law* (Thomson Reuters, 3rd ed, 2005) 176, cited in N Mirzai, "Ipso Facto Clauses: Should They Be Enforceable under Pt 5.3A?" (2011) 19 Insolv LJ 5, 8.

RECONCILING TWO CONFLICTING INSOLVENCY CULTURES

The place of voluntary administration in Australia's corporate landscape

It is accepted as a general principle in both Australia and the US that a corporation is more valuable as a going concern than in liquidation.[64] Given the criticisms of VA that have emerged over time, it is debatable whether VA engenders this precept. The Harmer Report stated that VA would be vindicated if it saved or provided better opportunities "to salvage even a small percentage" of the companies which, at the time, had no alternative but to be wound up.[65] VA was intended to achieve this end through procedural expediency and informality.[66] As well as being more flexible and generally cheaper and swifter to implement when compared to a creditors' scheme of arrangement, VA promotes rapid decision-making by all parties involved, which in some cases may accelerate the onset of corporate rescue.[67]

Worthy of attention, however, is this article's observation that some of the inherent benefits of VA envisaged by the Harmer Report prior to its enactment – for instance, its short timeframe and the low level of court supervision – have seemingly morphed into criticisms instead. It is submitted that, whilst VA may be apposite in realising its aims as expressed in the Harmer Report, its benefits have become increasingly irrelevant in an economy that is influenced by a disposition towards entrepreneurship, greater leveraging through increased competition in consumer lending and the establishment of complex corporate structures – an economy that is vastly different to the one in existence at the time of VA's inauguration.[68] From a reformist perspective, one may conclude that there is robust impetus for considering a system that may quell many of the perceived disadvantages of VA while presenting a model for corporate rescue that properly takes into account the interests of distressed companies with ambitions to reorganise.

That is not to say that the pendulum should swing completely in the direction of distressed companies. Of paramount importance to any discussion on groundbreaking insolvency reform is gauging the impact of proposed legislative changes on the deep-seated attitudes towards insolvency in Australia. It is acknowledged that departing from VA in order to adopt a regime that is more debtor-oriented is likely to disrupt the intrinsic preference towards creditors' rights that underpins Australia's insolvency system,[69] but how far would this disruption extend? Would the implementation of a regime that divests creditors of some of the powers that they enjoy under the current system be not only foreign, but also inimical to Australia's corporate landscape? These questions invariably invite theoretical speculation in a space that is devoid of empirical research.

Australia's creditor-oriented insolvency system sprung from the United Kingdom where creditors could "effectively control the direction and pace of [insolvency] procedures" without having their

[64] See, eg, Parliamentary Joint Committee on Corporations and Financial Services, n 45, 267; Australian Restructuring Insolvency and Turnaround Association, "Dealing with Corporate Financial Distress in Australia" (Discussion Paper, 2014) 18 (ARITA Discussion Paper); CN Katsoris, PA Soden and SM Bernstein, "The Ninth Annual Albert A DeStefano Lecture on Corporate, Securities and Financial Law: Is Chapter 11 Dead?" (2009) 15 *Fordham Journal of Corporate & Financial Law* 1.

[65] Harmer Report, n 4 [53].

[66] Anderson and Morrison, n 13, 245.

[67] Australian Government, *CAMAC Final Report*, n 4, 111-112; R Langley, "The Future Role of Creditors' Schemes of Arrangement in Australia after the Rise of Voluntary Administrations" (2009) 27 C&SLJ 70, 76; I Bickerdyke, R Lattimore and A Madge, "Liquidation or Reorganisation? An Economic Comparison of Australian and US Insolvency Codes" (2001) 13 *Australian Journal of Corporate Law* 98.

[68] See R Mason, "Consumer Bankruptcies: An Australian Perspective" (1999) 37 *Osgoode Hall Law Journal* 449, 458. See also R Efrat, "Global Trends in Personal Bankruptcy" (2002) 76 *American Bankruptcy Law Journal* 81, 91-99. Efrat observes these characteristics of the Australian corporate landscape in the context of personal bankruptcies.

[69] See generally Jones, n 40; K Lightman, "Voluntary Administration: The New Wave or the New Waif in Insolvency Law?" (1994) 2 Insolv LJ 59. See, eg, *Kinsela v Russell Kinsela Pty Ltd (in liq)* (1986) 4 NSWLR 722; *Lam Soon Australia Pty Ltd v Molit (No 55) Pty Ltd* (1996) 70 FCR 34.

interests compromised by debtors or third parties.[70] This custom is now supplemented by a stigma that attaches to corporate and personal insolvency – a stigma that stems from the 19th century English practice of imprisoning those who were unable to pay their debts.[71]

In view of the mentioned drawbacks of VA, it is considered that the reverberations of this stigma are still palpable in the present-day VA procedure, which is viewed by some as a form of "value destruction" for a company that commences the procedure.[72] Whilst Australian courts have occasionally stated that the purpose of giving distressed or insolvent companies a "fresh start" is implicit in Pt 5.3A of the Act,[73] it is suspected that the legislative framework endows creditors with significant power at the outset of VA and a fortiori "the ultimate control of the reconstruction" once a DOCA is executed following VA.[74]

The US attitude towards insolvency

The creditor-oriented overtone of Australia's insolvency system is in sharp contrast to the American attitude that corporate failure is often a natural consequence of risk-taking in an entrepreneurial environment, with an emphasis on rehabilitation over retribution.[75] Nathalie Martin explains the policy underpinning the US bankruptcy system – encompassing both personal and corporate insolvency – in the following terms:

> The current US bankruptcy system grew directly out of the United States' unique capitalist system, which rewards entrepreneurialism as well as extensive consumer spending. It makes sense that a society in which dollars rule would have a forgiving personal bankruptcy system in order to keep consumer spending high, and an equally forgiving business reorganization system to encourage risk taking and economic growth. Both systems are part of a larger scheme to keep economic players alive and active in the game of capitalism. US bankruptcy systems are among the country's few social programs and they address many of society's ills. Thus, they are broad and form an integral part of the social system from which they sprung.[76]

In this context, economic efficiency in the US is realised not by imminently shutting down distressed businesses, but by reaping the rewards of businesses that have been rescued from the brink of failure.[77] This ideology is perpetuated by Chapter 11 of the Code, which is regarded as the flagship reorganisation mechanism in the US. The crux of reorganisation under Chapter 11 is the preservation of going concern value, the rationale being that "[i]t is more economically efficient to reorganize than to liquidate, because it preserves jobs and assets".[78]

[70] Australian Government, *Business Failure and Change Paper*, n 5, 86-87. See also Efrat, n 68, 91. Efrat cites "the continuing influence of the bankruptcy laws of the former colonial power" as a reason for global disparity in the "fresh start" policy in insolvency and bankruptcy law.

[71] M Quilter, "Bankruptcy and Order" (2013) 39 *Monash University Law Review* 188, 196-197.

[72] Australian Restructuring Insolvency and Turnaround Association, ARITA Discussion Paper, n 64, 15.

[73] See, eg, *Blacktown City Council v Macarthur Telecommunications Pty Ltd* (2003) 47 ACSR 391, 396 (Barrett J); *Brash Holdings Ltd v Katile Pty Ltd* [1996] 1 VR 24, 28 (Brooking, Phillips and Hansen JJ); *Australian Gypsum Industries Pty Ltd v Dalesun Holdings Pty Ltd* (2015) 106 ACSR 79, 124-125 (Newnes and Murphy JJA); *Re Bluenergy Group Ltd (admin apptd)* (2015) 300 FLR 155; 107 ACSR 373.

[74] A Keay, "Corporate Governance During Administration and Reconstruction under Part 5.3A of the Corporations Law" (1997) 15 C&SLJ 145, 154; *Australian Gypsum Industries Pty Ltd v Dalesun Holdings Pty Ltd* (2015) 106 ACSR 79, 96 (Buss JA). One may conclude that a high degree of creditor control is also exercised in the context of company resolutions that decide whether a company should execute a DOCA. See, eg, *Promnitz v Indochine Mining Ltd; Re Indochine Mining Ltd* (2015) 108 ACSR 134; [2015] FCA 857 [83]-[88] (Foster J). Cf Jones, n 40, 9-10. See generally Wellard, n 24.

[75] Parliamentary Joint Committee on Corporations and Financial Services, *Corporate Insolvency Laws: A Stocktake*, n 45, 88.

[76] N Martin, "The Role of History and Culture in Developing Bankruptcy and Insolvency Systems: The Perils of Legal Transplantation" (2005) 28 *Boston College International and Comparative Law Review* 1, 3 (citations omitted).

[77] Cf BE Adler, "Bankruptcy and Risk Allocation" (1992) 77 *Cornell Law Review* 439, 463-464.

[78] HR Rep No 95-595, 220 (1977) reprinted in 1977 USCCAN 5963, 6179.

It warrants mention that Chapter 11 was not created in a vacuum. The widespread failure of the railroad industry following the American Civil War[79] was injurious to a new national economy that needed an efficient way to transport goods and people around the country.[80] As Miller and Waisman explain:

> By their nature, the assets of a railroad crossed multiple state lines. Consequently, in the event of default, the railroad faced the threat of individual creditors obtaining state court judgments and causing the dismemberment of the railroad's assets to satisfy such judgments.[81]

To ensure that the US railroad system did not disintegrate, courts drew upon their equitable jurisdiction to appoint receivers to administer the affairs of distressed railroad companies.[82] What followed was a single unified forum that enabled the debtor railroad, its major creditors and the court to collaborate to ensure that the railroad industry survived in the public interest.[83] Driving these reorganisations was the "railroad paradigm": due to its importance to the national economy, "the railroad was more valuable as a going concern than in liquidation".[84] It was therefore seen as pivotal to reorganisation efforts that a railroad company's management actively participated in its business operations and in the formation of a reorganisation plan.[85]

In the early years of the Great Depression in the US, legislation was enacted to codify the corporate reorganisation principles developed in the early railroad reorganisation cases.[86] This legislation included three reorganisation chapters, two of which are relevant for present purposes: Chs X and XI.[87] Under Ch X, which was designed for large publicly owned corporations, an independent trustee was appointed to replace the debtor's management, with a regulator providing formal oversight in the reorganisation process.[88] Chapter XI, on the other hand, was designed for small, privately owned businesses and allowed the debtor to remain in control of its assets while enjoying an unlimited right to propose a reorganisation plan.[89] These chapters had been in force for some 40 years prior to the enactment of the Code in 1978. Eventually, factors that contributed to a widespread perception that this tripartite system was unworkable, setting in motion the genesis of the current Chapter 11 of the Code, include: the belief of creditors that the system dissipated assets and delayed payouts unnecessarily;[90] the aversion of debtors towards external administration in times of

[79] See DA Skeel, *Debt's Dominion* (Princeton University Press, 2001) 51-52, quoted in HR Miller and SY Waisman, "Is Chapter 11 Bankrupt?" (2005) 47 *Boston College Law Review* 129, 134. Skeel notes that "[b]etween 1873 and the end of the nineteenth century, roughly one-third of all the railroads – some seven hundred in all – failed, and in some years nearly 20% of the nation's track was in receivership".

[80] Miller and Waisman, n 79, 134.

[81] Miller and Waisman, n 79, 134.

[82] Miller and Waisman, n 79, 135.

[83] Skeel, n 79, 57.

[84] Katsoris, Soden and Bernstein, n 64, 11, 14.

[85] Miller and Waisman, n 79, 136. See also A Martin, "Railroads and the Equity Receivership: An Essay on Institutional Change" (1974) 34 *The Journal of Economic History* 685, 697-701.

[86] C Tabb, "The History of Bankruptcy Law in the United States" (1995) 3 *American Bankruptcy Institute Law Review* 5, 22, cited in Katsoris, Soden and Bernstein, n 64, 12. This legislation was known as the *Chandler Act 1938*.

[87] Tabb, n 86, 7. The third chapter, Ch XII, concerned certain types of real estate bankruptcies. See HR Miller and SY Waisman, "Does Chapter 11 Reorganization Remain a Viable Option For Distressed Businesses For The Twenty-First Century?" (2004) 78 *American Bankruptcy Law Journal* 153, 167-169, quoted in Katsoris, Soden and Bernstein, n 64, 12.

[88] American Bankruptcy Institute, *Commission to Study the Reform of Chapter 11: Final Report and Recommendations* (December 2014) 22 (*ABI Report*); D Bussel, "Coalition-Building Through Bankruptcy Creditors' Committees" (1996) 43 *UCLA Law Review* 1547, 1557-1558.

[89] Katsoris, Soden and Bernstein, n 64, 12.

[90] E Warren, "Bankruptcy Policymaking in an Imperfect World" (1993) 92 *Michigan Law Review* 336, 371-372.

financial difficulty, which encouraged some debtors to downsize their operations in order to be eligible for reorganisation under Ch XI;[91] and procedural elements of Ch XI that made it easier for debtors to bind creditors to their reorganisation plans.[92]

After a period of popularity soon after the enactment of Chapter 11,[93] the rate of filings under this system began to decline markedly from the mid-1990s.[94] According to Chief Judge Bernstein of the US Bankruptcy Court of the Southern District of New York, two events that triggered this decline were: first, the increased availability of credit which enabled companies to borrow their way out of immediate financial distress; and, secondly, that "creditors began to exert more influence and many more cases culminated in the sale of the debtor's assets followed by the liquidation of the debtor".[95] This burgeoning influence of creditors is thought to have stemmed from creditor groups and trade associations successfully lobbying Congress over time to "clawback" the powers and rights of debtors, coupled with the economic environment that had for the most part left debtors in a precarious financial position.[96]

The expansion of creditor power continues to have ramifications for Chapter 11 filings in the US today. This issue is deliberated below with respect to the recent proliferation in asset sales under § 363 of the Code,[97] under which a debtor may sell its assets outside the ordinary course of business. Miller and Waisman argue that a "creditor-in-possession" phenomenon has engulfed Chapter 11 in recent times,[98] symbolised by the low rate of Chapter 11 cases filed in the past decade coupled with the high rate of company recidivism after first-time Chapter 11 filings.[99] Among other things, this phenomenon is said to have compelled debtors to use § 363 at a time when they are entering Chapter 11 "over-leveraged, cash strapped, and [with their] assets fully encumbered".[100]

Numerous commentators in the US have even questioned the viability of Chapter 11's existence. Those labelled as "rehabilitationists"[101] contend that the frequency with which § 363 has been invoked recently is subversive to Chapter 11's purported rehabilitative function[102] and that a solution to the

[91] DE Deutsch, "Ensuring Proper Bankruptcy Solicitation: Evaluating Bankruptcy Law, the First Amendment, the Code of Ethics, and Securities Law in Bankruptcy Solicitation Cases" (2003) 11 *American Bankruptcy Institute Law Review* 213, 217-219, cited in *ABI Report*, n 88, 22.

[92] Skeel, n 79, 165. One such element is the "absolute priority rule", which is discussed below.

[93] See JS Bhandari and LA Weiss, "The Increasing Bankruptcy Filing Rate: A Historical Analysis" (1993) 67 *American Bankruptcy Law Journal* 1, 14. Bhandari and Weiss state that Chapter 11 filings increased to five times the annual filings under the three previous reorganisation chapters during their twilight years.

[94] Katsoris, Soden and Bernstein, n 64, 14.

[95] Katsoris, Soden and Bernstein, n 64, 14-15.

[96] Katsoris, Soden and Bernstein, n 64, 15.

[97] See JM Landers, "The Changing Face of Chapter 11 for Large Operating Businesses" (2012) 8 *Pratt's Journal of Bankruptcy Law* 99, 103-104. Landers observes that "[i]n recent years, the s 363 sale has evolved from a device permitted only under limited circumstances to an alternative restructuring mechanism". The author notes:

> Part of the reason for this evolution has been the change in composition of the senior creditor group from banks to hedge funds and other distress investment vehicles, the emergence of loan to own strategies, and the willingness of the "new" senior creditors to accept equity and exhibit flexibility in dealing with priorities vis-à-vis other creditor groups.

[98] Miller and Waisman, n 87, 182, 198. See also JL Westbrook, "Secured Creditor Control And Bankruptcy Sales: An Empirical View" (2015) *University of Illinois Law Review* 831, 835-836.

[99] See LM LoPucki and JW Doherty, "Delaware Bankruptcy: Failure in the Ascendancy" (2006) 73 *The University of Chicago Law Review* 1387; EI Altman, "Evaluating the Chapter 11 Bankruptcy Reorganization Process" (1993) *Columbia Business Law Review* 1.

[100] Miller and Waisman, n 87, 182, 198. See also Westbrook, n 98, 835-836.

[101] JHM Sprayregen, J Friedland and RJ Higgins, "Chapter 11: Not Perfect, But Better Than The Alternatives" (2005) 14 *Journal of Bankruptcy Law and Practice* 6. But see HR Miller and SY Waisman, "Is an Imperfect Chapter 11 the Best of All Alternatives?" (2006) 15 *Journal of Bankruptcy Law & Practice* 2.

[102] HR Miller, "Chapter 11 in Transition – from Boom to Bust and into the Future" (2007) 81 *American Bankruptcy Law Journal* 375; Miller and Waisman, n 101; Miller and Waisman, n 79; Miller and Waisman, n 87; GW Kuney, "Hijacking

upsurge in creditor power may be to mandate the appointment of an independent trustee in all Chapter 11 cases.[103] Commentators in the so-called "efficientists" camp submit that, in order to reduce transactional costs on the economy caused by Chapter 11's perceived distortion of contractual relationships outside the restructuring context, Chapter 11 should be supplanted by a private, contract-based restructuring procedure.[104] Commentators who apparently occupy the middle ground assert that the decline in traditional corporate rescues in favour of asset sales is merely indicative of Chapter 11's systemic development in a changing economy, as well as being exemplary of Chapter 11's multiple functions.[105] Whichever way one looks at the evolution of Chapter 11 in the US insolvency framework, there is no denying that the increase in creditor power has been among the most topical discussion points surrounding Chapter 11 in recent times.

Bridging the cultural gap

Having considered the past and present attitudes of both the Australian and US jurisdictions towards insolvency, it is convenient to set out the premise of the proposals that will be offered in this article. As a starting point, the nature of any intricate insolvency system is such that there is an invariable trade-off between upholding creditors' interests and enabling distressed debtors to reorganise. The debtor-oriented characteristics of Chapter 11 mean that embracing its key features in Australia would to some unknown extent tip the scales in favour of debtors.[106] However, difficulties also lie in formulating a system that safeguards the interests of all stakeholders in a restructure without sacrificing the interests of any one stakeholder. The conflicting attitudes between both jurisdictions towards insolvency means the question whether an insolvency system strikes a "balance" between competing stakeholder interests is a subjective one that may ultimately be dictated by the specific governance characteristics of debtors.[107]

It may be deduced from the foregoing that the unique foundations of Chapter 11 in the US would make it unsound to argue in favour of a wholesale adoption of this procedure in Australia. Instead, the purpose of this article is to elucidate select features of Chapter 11 which are conceived to be worthy of consideration at a time when calls to foster a corporate rescue culture in Australia are abounding. Indeed, the increasingly globalised and changing face of Australia's economy, which is apparently fuelling the present-day zeitgeist of corporate rescue and rehabilitation in Australia,[108] bears some resemblance to the interconnected railroads that acted as a catalyst to the railroad paradigm in the US.

Chapter 11" (2004) 21 *Emory Bankruptcy Developments Journal* 19; E Warren and JL Westbrook, "The Success of Chapter 11: A Challenge to the Critics" (2009) 107 *Michigan Law Review* 603; E Warren and JL Westbrook, "Secured Party in Possession" (2003) 22 *American Bankruptcy Institute Journal* 12; E Warren, "The Untenable Case for Repeal of Chapter 11" (1992) 102 *Yale Law Journal* 437.

[103] See, eg, HR Miller, "Chapter 11 Reorganization Cases and the Delaware Myth" (2002) 55 *Vanderbilt Law Review* 1987.

[104] DG Baird, "The New Face of Chapter 11" (2004) 12 *American Bankruptcy Institute Law Review* 69; DG Baird and RK Rasmussen, "The End of Bankruptcy" (2002) 55 *Stanford Law Review* 751; DG Baird and RK Rasmussen, "Chapter 11 at Twilight" (2003) 56 *Stanford Law Review* 673; Baird, n 29, 573-574; A Schwartz, "A Contract Theory Approach to Business Bankruptcy" (1998) 107 *Yale Law Journal* 1807; BE Adler, "Financial and Political Theories of American Corporate Bankruptcy" (1993) 45 *Stanford Law Review* 311. See also M Bradley and M Rosenzweig, "The Untenable Case for Chapter 11" (1992) 101 *Yale Law Journal* 1043.

[105] AM Dickerson, "The Many Faces of Chapter 11: A Reply to Professor Baird" (2004) 12 *American Bankruptcy Institute Law Review* 109; LM LoPucki and JW Doherty, "Bankruptcy Fire Sales" (2007) 106 *Michigan Law Review* 1; LM LoPucki, "The Nature of the Bankrupt Firm: A Response to Baird and Rasmussen's The End of Bankruptcy" (2003) 56 *Stanford Law Review* 645. See also Sprayregen, Friedland and Higgins, n 101; Warren and Westbrook, n 102.

[106] Australian Government, *Business Failure and Change Paper*, n 5, 86-87.

[107] See S Franken, "Creditor- and Debtor-oriented Corporate Bankruptcy Regimes Revisited" (2004) 5 *European Business Organization Law Review* 645. On the question of which of the debtor-oriented or creditor-oriented systems is more "optimal", Franken submits that "bankruptcy regimes function efficiently to the extent that they complement the specific governance characteristics of firms", and that "a bankruptcy regime may have a comparative advantage if it is more responsive than other regimes to the governance mechanisms at work in firms": at 647. On that basis, Frankel hypothetically puts that "a high level of protection of creditors' rights in general, in combination with a debtor-oriented bankruptcy procedure that is responsive to the governance structure of SMEs, may have a positive impact on the comparative efficiency of a debtor-oriented regime": at 675.

[108] See Senate Economic References Committee, *Performance of ASIC Report*, n 4, 449; Australian Government, *Business Set-up Transfer and Closure Inquiry Report*, n 4, 362.

The Australian economy is not impervious to some of the factors that have spurred the perceived creditor-in-possession regime in the US, such as globalisation and the presence of distressed debt traders "who are unwilling to sacrifice recovery for the sake of the debtor's rehabilitation".[109] However, this does not change the fact that those charged with exploring the avenues for insolvency reform in Australia have at their disposal an established model for corporate rescue that can be tailored to suit the idiosyncrasies of Australian insolvency law.

That the function of Chapter 11 in the US has changed over time to such an extent that some American commentators have queried whether the system is "dead",[110] reinforced by the corresponding high rate of company recidivism into "Chapters 22 and 33",[111] should not be a reason to discount the value that some of Chapter 11's fundamental features may offer to Australia's corporate landscape. Nor should the debtor-oriented philosophy underpinning the US insolvency system preclude Australian policymakers and practitioners from placing certain aspects of Chapter 11 under the microscope in an attempt to devise a framework that strikes a suitable balance – as closely as possible in accordance with Australian attitudes towards insolvency – between competing stakeholder interests, or at the very least augment the current insolvency procedures in Australia. It is with this contention in mind that this article will proceed to provide an outline of Chapter 11 before highlighting some redeeming features of this procedure which, it is submitted, make it particularly conducive to corporate rescue.

Chapter 11 in Australia: Turning the whispers into words

An outline of Chapter 11

A fundamental advantage of Chapter 11 is its flexibility: the regime facilitates pre-packaged or pre-negotiated plans, on the one hand, and "freefall" cases with no planned exit strategy, on the other hand.[112] Both types of cases allow reorganisation plans to be proposed by both the debtor and creditors. The regime also facilitates going concern sales, which are discussed below, and also provides a path to liquidation which allows for the extraction of greater value than if a company were to file initially for the dedicated liquidation procedure under Ch 7 of the Code.[113]

A momentous feature of Chapter 11 is that a company's incumbent management team retains possession of the company's assets and continues to operate its business after filing for Chapter 11. The permission of the court, being a specialised bankruptcy court that oversees the procedure, is not required to effectuate this "debtor-in-possession" model.[114] Filing for Chapter 11 triggers a moratorium or "automatic stay of proceedings", which generally thwarts all parties – including secured creditors – from enforcing their rights or exercising remedies against the debtor's property.[115] This provides the debtor's management with the respite necessary to reorganise the company since

[109] Miller and Waisman, n 79, 153. See generally D Perkis, "Corporate Restructuring: The Impact of Credit Derivatives and Distressed Debt Investing" (2010) 21 JBFLP 185.

[110] See nn 103-104.

[111] Katsoris, Soden and Bernstein, n 64, 18.

[112] Whilst pre-packaged and pre-negotiated plans often afford flexible outcomes for stakeholders involved in Chapter 11, this article will focus on "freefall" cases, on which the Code places a greater legislative emphasis. On pre-packaged and pre-negotiated plans generally, see DJ Connolly, "Current Issues Involving Prepackaged and Prenegotiated Plans" (2004) *Annual Survey of Bankruptcy Law* 2. See also Australian Government, *Business Set-up Transfer and Closure Inquiry Report*, n 4, 387-394. The Productivity Commission has discussed the potential implementation of pre-packaged sales in Australia, with reference to the current system in the United Kingdom.

[113] Asset sales under Chapter 11 are discussed below. On a discussion of Chapter 11's liquidation function, which is outside the ambit of this article, see Baird and Rasmussen, n 104.

[114] 11 USC § 1108.

[115] 11 USC § 362(a). Notably, the American Bankruptcy Institute states that

> allowing a secured creditor to foreclose immediately on the debtor's property or to demand payment in full from the debtor [which can be done in the VA procedure if the secured creditor holds a charge over the whole, or substantially the whole, of the company's property] would crater the debtor's reorganization efforts at the outset … [and] *essentially turn chapter 11 into a liquidation statute*.

secured creditors cannot enforce their rights unless they can convince the court that they do not have "adequate protection" for their security.[116] Management has an exclusive right to propose a company reorganisation plan within 120 days after filing the petition, after which creditors may choose to file their own plans individually or as part of a creditors' committee.[117] The court may extend this time period on application[118] and "[i]t is not unusual that there be several extensions of time".[119] A debtor will often appoint a chief restructuring officer, outside the ambit of the Code, to guide it through the reorganisation process and advise on its compliance with the Code.[120] With the court's approval, the debtor may also obtain post-petition financing from lenders outside the ordinary course of business.[121]

The reorganisation plan is the cornerstone of a corporate rescue under Chapter 11.[122] The plan must include certain information that principally deals with the treatment of creditors and how the business will operate under Chapter 11.[123] The debtor must also prepare a disclosure statement that contains adequate information about the company and the plan for a "hypothetical investor … to make an informed judgment about the plan".[124] Once the court approves the disclosure statement, the debtor transmits these documents to each holder of a claim or interest. The debtor then solicits support for the plan, after which creditors and shareholders vote on the plan.[125] A confirmed plan binds all creditors and discharges the debtor from prepetition claims, with the property of the estate vesting in the debtor.[126] The voting rights of creditors under Chapter 11 are discussed below in the context of creditors' rights generally. For now, it is proposed to set out the features of Chapter 11 that warrant appraisal in Australia's present-day corporate landscape.

THE MERITS OF CHAPTER 11 AS A CORPORATE RESCUE MODEL

Debtor-in-possession model

The debtor-in-possession model under Chapter 11 gives management the latitude to make decisions in respect of trading, approaching its everyday operations, and the way in which it will attempt to reorganise its company's affairs. It is submitted that the dangers of trusting an incumbent management

ABI Report, n 88, 69 (emphasis added).

[116] 11 USC § 361. A secured creditor may receive adequate protection of its secured interest through cash payments, a replacement lien or other protection as will result in the realisation of the indubitable equivalent of their interest in the property.

[117] 11 USC § 1121(b), § 1121(c)(2)-§ 1121(3).

[118] 11 USC § 1121(d).

[119] Griggs, n 4, 94.

[120] But see Miller n 102, 385.

[121] 11 USC § 364. The potential impact of the debtor-in-possession model upon the insolvent trading provisions under the Act is mentioned below.

[122] Chapter 11 also allows for a liquidation plan to be proposed by debtors in appropriate cases: see 11 USC § 1123(b)(4). This article will focus on the reorganisational qualities of Chapter 11 with an emphasis on companies that are distressed yet salvageable. Asset sales under § 363 of the Code are discussed below.

[123] 11 USC § 1123(a) states:

> (a) Notwithstanding any otherwise applicable non-bankruptcy law, a plan shall–
> (1) designate … classes of claims … and classes of interests;
> (2) specify any class of claims or interests that is not impaired under the plan;
> (3) specify the treatment of any class of claims or interests that is impaired under the plan;
> (4) provide the same treatment for each claim or interest of a particular class, unless the holder of a particular claim or interest agrees to a less favorable treatment of such particular claim or interest;
> (5) provide adequate means for the plan's implementation …

[124] 11 USC § 1125(a)-§ 1125(b).

[125] 11 USC §§ 1125(b), 1126.

[126] 11 USC § 1141.

team in Chapter 11 are often overstated in jurisdictions outside the US,[127] including in Australia where this approach is said to invite "moral hazard problems associated with giving debtors immediately realisable second chances".[128] The American Bankruptcy Institute (ABI) asserts that the debtor-in-possession model

> allows the debtor to avoid the additional time, cost, and resulting inefficiencies of bringing in an outsider who is not familiar with the debtor's business specifically or the debtor's industry generally. The prepetition management team may also have industry relationships or "know-how" that would benefit the debtor's restructuring efforts.[129]

In Australia, the appointment of an external insolvency practitioner is the bedrock of VA.[130] After informing the administrator about the company's finances and operations, the company's management relinquishes its control of the company to the administrator.[131] In this respect a debtor-in-possession model is diametrically divergent to VA, where the debtor's management is displaced irrespective of the cause of the company's failure. Under Chapter 11 it is possible, but exceptionally rare, that an independent trustee-in-bankruptcy is appointed after filing.[132] The trustee-in-bankruptcy ousts the company's management and effectively acts "like an insolvency practitioner in Australia".[133] A common precursor to this appointment is the suspicion of "fraud, dishonesty, incompetence, or gross mismanagement" of the debtor's affairs by its current management.[134] In these cases the trustee-in-bankruptcy safeguards the interests of creditors who have misgivings about management. Under an Australian Chapter 11 equivalent, this threat of dismissal would act as a deterrent against dishonesty or gross mismanagement while ensuring that a debtor-in-possession model can operate with full effect.

It is seldom the case that a company's financial struggles can be solely attributed to either its management's ineptness or dishonesty, on the one hand, or exogenous factors, on the other hand.[135] Many instances of failure will invariably involve some from column A and some from column B.

[127] See, eg, Warren and Westbrook, n 102, 625; Martin, n 76. See also ED Flashen and L Plank, "The Foreign Representative: A New Approach to Coordinating the Bankruptcy of a Multinational Enterprise" (2002) 10 *American Bankruptcy Institute Law Review* 111.

[128] Australian Government, *CAMAC Final Report*, n 4, 14-16. See also Australian Government, *Business Set-up Transfer and Closure Inquiry Report*, n 4, 343; Australian Government, *Business Failure and Change Paper*, n 5, 90; Parliamentary Joint Committee on Corporations and Financial Services, *Corporate Insolvency Laws: A Stocktake*, n 45, 88-91; Parliament of Australia, *Evidence to Parliamentary Joint Committee on Corporations and Financial Services* (Canberra, 14 August 2003) 216 (Keay); Parliament of Australia, *Evidence to Parliamentary Joint Committee on Corporations and Financial Services* (Canberra, 17 September 2003) 273 (Harmer); Parliament of Australia, *Evidence to Parliamentary Joint Committee on Corporations and Financial Services* (Canberra, 11 November 2003) 287 (Ipp).

[129] American Bankruptcy Institute, *ABI Report*, n 88, 22 (citations omitted).

[130] C Anderson, "Miracle Workers or Ambulance Chasers? The Role of Administrators in the Part 5.3A Process" (2004) 12 Insolv LJ 238. Anderson remarks that "no detailed analysis of Pt 5.3A could be undertaken without consideration of the role of the administrator": at 238.

[131] *Corporations Act 2001* (Cth) s 437B, s 437C. See, eg, *Smarter Way (Aust) Pty Ltd v D'Aloia* (2000) 35 ACSR 595, 601; [2000] VSC 408 (Byrne J).

[132] 11 USC § 1104(a). See generally KA Alces, "Enforcing Corporate Fiduciary Duties in Bankruptcy" (2007) 56 *University of Kansas Law Review* 83, 84.

[133] Parliament of Australia, Evidence to Parliamentary Joint Committee on Corporations and Financial Services, n 128, 216 (Keay).

[134] 11 USC § 1104(a)(1).

[135] To illustrate this proposition, over 8% of companies that entered into external administration between 1 July 2014 and 30 June 2015 nominated "poor economic conditions" as causes of their financial failure. Other cited causes that may conceivably be attributed to exogenous factors include "inadequate cash flow or high cash use", "under-capitalisation" and "industry restructuring", which together comprised 27% of companies in external administration during this period. Causes that may fit into the category of management ineptness include "poor financial control, including lack of records", "poor management of accounts receivable", "poor strategic management of business", "dispute among directors" and "fraud", which together comprised almost 37% of companies. The lack of anecdotal evidence and information on the precise causes of each company failing, in addition to the potential overlap between the nominated causes, render the distinction made in this article between management ineptness and exogenous factors somewhat arbitrary; however, the core of the assertion made is that in many cases there may be a multitude of factors which contribute to a company's failure. Another limitation to these statistics is that the data

Often there is an interrelationship between management action and the external environment; for example, unfavourable economic conditions may prompt improvident decision-making by management. The difference between the American and Australian mindset towards insolvency may be illustrated in the example of an honest and competent management team that makes a rational business decision, or takes a calculated risk, that bears little reward for its company. In most instances the sheer volume of variables at play makes it impossible to identify precisely the extent to which any one factor is responsible for the company's financial difficulties. Nonetheless, in the upkeep of "the general tradition in the Anglo-Australian systems of appointing an independent person",[136] the Australian approach dictates that management should be overthrown in times of financial distress. But does leaving an honest and competent management in charge of the debtor's affairs really act as a detriment to that company's reorganisation prospects? Where corporate distress is partially or even predominantly attributable to the external economic environment, is the company's management a scapegoat in VA? To what extent must the creditor-oriented mindset that permeates Australia's insolvency system be shifted to entrust honest and competent management teams, which are most familiar with the debtor's business operations, to foster corporate rescues? The debtor-in-possession model and the external administration model respectively represent an "all-or-nothing" approach in relation to dealing with a distressed company's management.[137] It is asserted that a "nothing" approach – namely, the removal of incumbent management at the outset of an administration – is unsustainable at a time when corporate rescue is on the agenda for insolvency reform in Australia.

It is worth noting that debtors-in-possession need not be given free rein to do as they please during a company's reorganisation. Under the current Act, there are measures available to shareholders who are dissatisfied with one or more directors in their company.[138] Directors and other officers must also adhere to rigorous statutory duties under the Act.[139] It is envisaged that these provisions should endure in the face of a potential shift to a debtor-in-possession regime so as to not divest power from shareholders while ensuring that directors adhere to their statutory duties.

Another deterrent to management acting with dishonesty, gross incompetence or in breach of their duties is found in equity's powerful exclusive and auxiliary jurisdictions. In the US, the debtor-in-possession is a fiduciary for the estate.[140] In respect of creditors, the debtor-in-possession also acts as a trustee and has all the rights, powers, functions and duties of a trustee.[141] Such duties include: being accountable for all property received;[142] examining creditors' claims and objecting to any claim that is improper;[143] furnishing information about the bankruptcy estate to a party in

is drawn only from instances where the insolvency practitioner has prepared a report to ASIC in accordance with ss 533, 422 or 438D of the Act. See Australian Securities and Investments Commission, Insolvency Statistics, *External Administrators' Reports (July 2014 to June 2015)*, November 2015, Table 11, 20.

[136] Parliamentary Joint Committee on Corporations and Financial Services, *Corporate Insolvency Laws: A Stocktake*, n 45, 88.

[137] See Y Rotem, "Contemplating a Corporate Governance Model for Bankruptcy Reorganizations: Lessons from Canada" (2008) 3 *Virginia Law & Business Review* 125; Chapple and Routledge, n 28, 71.

[138] *Corporations Act 2001* (Cth) s 203D(1) (power to remove directors in public companies); *Corporations Act 2001* (Cth) s 203C(a) (power to remove directors in proprietary companies). But see *Corporations Act 2001* (Cth) s 9 (definition of "senior manager"). The above provisions do not capture senior managers, since they are not classified as "directors" under the Act.

[139] *Corporations Act 2001* (Cth) ss 180(1) (care and diligence), 181(1) (good faith), 182(1) (no improper use of position), 183 (no improper use of information), 184 (criminal offence for lack of good faith, improper use of position or improper use of information).

[140] 11 USC §§ 1106(a)(1), 1107(a); *Re Frankel* 77 BR 401 (1987).

[141] 11 USC §§ 1106(a)(1), 1107(a).

[142] 11 USC § 704(a)(2).

[143] 11 USC § 704(a)(5).

interest;[144] filing periodic reports and summaries of the business' operation;[145] and making a final report and filing a final accounting of the administration of the estate.[146]

Australian law recognises the trustee-beneficiary relationship as the paradigm fiduciary relationship.[147] It also recognises that directors are fiduciaries to their companies[148] and, in more limited cases, individual shareholders.[149] On insolvency, a company's directors owe fiduciary duties to their company to consider the interests of creditors ahead of its shareholders' interests.[150] Depending on the circumstances and an individual's responsibilities within a company, company officers other than directors may also owe fiduciary duties.[151] Breaches by a fiduciary that are within the scope of the fiduciary relationship give rise to a panoply of equitable remedies for the entity to whom duties are owed.[152] This adds to the armoury of protection provided to stakeholders where an errant management team is in control of the debtor's business.

The espoused benefits of a debtor-in-possession model cannot, however, be isolated from the realities of this system applying in Australia. For example, a pertinent issue to consider is the implications for, and one may suppose the potential abolition of, private receivership under Pt 5.2 of the Act. For one thing, a moratorium as broad as the one currently in Chapter 11 would restrain a secured creditor with a charge over the whole, or substantially the whole, of a company's property from enforcing its charge, thereby precluding the appointment of a receiver or controller. A correlated issue, the discussion of which is outside the ambit of this article, is the role of secured credit in the Australian economy generally: will secured creditors be more reluctant to lend money where the ability to enforce their proprietary rights against a debtor is impeded?[153] To overcome this dilemma in Chapter 11 from the secured creditor's viewpoint, the creditor will ordinarily reach an out-of-court agreement with the distressed debtor to obtain post-petition financing or use cash collateral.[154] The

[144] 11 USC § 704(a)(7). In this context, the Code does not explicitly define the term "party in interest". See *Caserta v Tobin* 175 BR 773, 774 (1994). In the context of who may file a reorganisation plan, § 1121 states that a party in interest includes "the debtor, the trustee, a creditors' committee, an equity security holders' committee, a creditor, an equity security holder, or any indenture trustee".

[145] 11 USC § 704(a)(8).

[146] 11 USC § 704(a)(9).

[147] *Keech v Sandford* (1726) Sel Cas t King 61; *Chan v Zacharia* (1984) 154 CLR 178.

[148] *Regal (Hastings) Ltd v Gulliver* [1967] 2 AC 134; *Consul Developments Pty Ltd v DPC Estates Pty Ltd* (1975) 132 CLR 373.

[149] See, eg, *Brunninghausen v Glavanics* (1999) 46 NSWLR 538; [1999] NSWCA 199; *Nocton v Lord Ashburton* [1914] AC 932.

[150] *Kinsela v Russell Kinsela Pty Ltd (in liq)* (1986) 4 NSWLR 722; *Westpac Banking Corp v Bell Group Ltd (in liq) (No 3)* (2012) 44 WAR 1; [2012] WASCA 157.

[151] *Avtex Airservices Pty Ltd v Bartsch* (1992) 107 ALR 539; *C & KA Flanagan Sailmakers Pty Ltd v Walker* [2002] NSWSC 1125, [44] (Macready AJ). See, eg, *Morley v Australian Securities and Investments Commission* (2010) 247 FLR 140; 274 ALR 205; [2010] NSWCA 331.

[152] *Boardman v Phipps* [1967] 2 AC 46; *Chan v Zacharia* (1984) 154 CLR 178.

[153] See 11 USC § 361; Franken, n 107, 672-673. As foreshadowed above, in Chapter 11 it is intended that secured creditors be protected to the extent of their prepetition claims. To that end, a secured creditor may receive adequate protection of its secured interest through cash payments, a replacement lien or other protection as will result in the realisation of the indubitable equivalent of their interest in the property. However, as Frankel asserts, "much may depend on the possibility that creditors have in an early stage of a bankruptcy procedure to approach and be quickly heard by the bankruptcy judge", calling into play the importance of an efficient judicial process. On the valuation of a secured creditor's collateral in these situations, see DG Baird, "The Rights of Secured Creditors after Rescap" (2015) 2 *University of Illinois Law Review* 849; American Bankruptcy Institute, *ABI Report*, n 88, 71-72.

[154] Baird, n 153, 71.

extent to which the dynamics of such an agreement will be acceptable to creditors in Australia's present-day corporate landscape remains to be seen.[155]

Another significant stakeholder to consider in the debtor-in-possession debate is the Australian Taxation Office (ATO), which is the largest unsecured creditor in a majority of VAs.[156] Under the *Taxation Administration Act 1953* (Cth), a director whose company has certain unfulfilled corporate tax obligations will be issued a director penalty notice, the non-compliance of which may result in legal proceedings brought by the Commissioner of Taxation to recover the penalty.[157] The overarching objective of the director penalty regime is to ensure that directors cause their companies to comply with certain taxation and superannuation obligations,[158] as well as to combat "fraudulent phoenix activity".[159] As it stands, directors are obliged to either remit such taxes or alternatively appoint a voluntary administrator or liquidator.[160] If one were to accept that a director who commences a formal insolvency procedure in a timely fashion will be exonerated from liability under the penalty regime, it stands to reason that the director ought not to be personally liable for a penalty notice if his or her company has filed, or will soon file, as a debtor-in-possession. Upon filing, the company would then have the liberty to negotiate with the ATO as part of its formulation of a reorganisation plan.[161] Whatever the case may be, it is necessary for legislators to strive to develop insolvency, corporate and taxation law in tandem, bearing in mind both the broader context in which the law operates[162] and the tax consequences of corporate reorganisation.[163]

Reorganisation on demand

Unlike in VA, a company seeking to reorganise under Chapter 11 need not be insolvent or even in financial difficulty; a Chapter 11 reorganisation plan must only be proposed lawfully and in good faith.[164] Chapter 11 therefore offers a pre-emptive approach to reorganisation that enables companies to address potential solvency problems before they escalate.[165] Such a system would be accessible to

[155] For a recent article on the related topic of intercreditor agreements, which are perceived as controversial for their prejudicial effect on investors who are not privy to such arrangements, see ER Morrison, "Rules of Thumb for Intercreditor Agreements" (2015) 2 *University of Illinois Law Review* 721.

[156] Recently published statistics from ASIC indicate that approximately 85% of companies that entered into external administration between 1 July 2014 and 30 June 2015 had unpaid taxes and charges. A limitation of these statistics is that the data is drawn only from instances where the insolvency practitioner has prepared a report to ASIC in accordance with ss 533, 422 or 438D of the Act. See Australian Securities and Investments Commission, Insolvency Statistics, *External Administrators' Reports (July 2014 to June 2015)* November 2015, Table 38, 49.

[157] *Taxation Administration Act 1953* (Cth) Sch 1, s 269-15. See generally M Broderick, "Legislative Change to Director Penalty Notices and Security for Tax Payments" (2011) 40 ATR 60.

[158] Australian Taxation Office, *Director Penalty Regime – Guide for Directors* <https://www.ato.gov.au/Business/Starting-your-own-business/In-detail/Getting-started/Director-penalty-regime>.

[159] Explanatory Memorandum, Tax Laws Amendment (Transfer of Provisions) Bill 2010, 17.

[160] *Taxation Administration Act 1953* (Cth) Sch 1 s 269-15.

[161] The process involved in formulating a reorganisation plan is discussed below.

[162] C Brown, C Anderson and D Morrison, "The Certainty of Tax in Insolvency: Where does the ATO Fit?" (2011) 19 Insolv LJ 108; D Morrison, "Why is there a Gap in the Tax Treatment of Solvent Versus Insolvent Companies and Why Does It Matter?" (2014) 22 Insolv LJ 192.

[163] See generally DL Dick, "Bankruptcy's Corporate Tax Loophole" (2014) 82 *Fordham Law Review* 2274. Dick explains that taxation laws in the United States are designed to work in conjunction with the Code so as to protect debtors from the harsh taxation consequences of insolvency. Examples include provisions of the Code that recognise certain transactions entered into by bankrupt companies as tax-free and permanently exclude some of a debtor's income from taxation: at 2285-2286 (citations omitted). See also D Baird, A Bris and N Zhu, "The Dynamics of Large and Small Chapter 11 Cases: An Empirical Study" (Yale ICF Working Paper No 05-29, January 2007).

[164] 11 USC § 1129(a)(3).

[165] Anderson and Morrison, n 13, 245.

distressed albeit technically solvent companies which fail to meet the high threshold required to initiate VA yet, for one reason or another, seek to restructure their operations under the aegis of a legislative regime.[166]

The key reason for VA not being propitious to enabling timely reorganisation is said to be that it cannot be commenced at an early stage of corporate distress.[167] To that end, a prominent criticism of VA is the wording of s 436A of the Act. As noted above, one of the prerequisites to a company's directors appointing an administrator under this provision is if, "in the opinion of the directors … the company is *insolvent* or is *likely to become insolvent* at some future time".[168] This threshold test diverges from the Harmer Report's proposal that insolvency or a "*reasonable prospect* of insolvency" will suffice.[169]

Opinions differ as to whether the current wording places an undue constraint on the companies that seek to use VA to reorganise. One view is that the test is inflexible and "implies a high degree of probability that the company will become insolvent".[170] This invites the observation that some directors invoke VA when it is too late to salvage a company[171] and lends credence to the argument that VA is a lengthier route to liquidation.[172] As such, it has been suggested that the threshold should be lowered to allow companies that are "insolvent or *may* become insolvent" to enter into VA.[173] The counterargument is that "any alternative formulation … could be too open-ended" to the detriment of shareholders and secured creditors, and that the current prerequisite in s 436A should be retained.[174] This view relies on the decision of Palmer J in *Crimmins v Glenview Home Units Pty Ltd* [2001] NSWSC 699 (*Crimmins*), who held that "[t]he scope for forming an opinion of likely insolvency is very broad under s 436A",[175] and such opinion must consider "the realities as well as the legalities of a company's particular position".[176]

The pressing question, then, is whether lowering the threshold in s 436A would encourage more distressed albeit solvent companies to use VA with a view to reorganising their affairs. The starting point is to recognise that shareholders largely drive the future direction of a solvent company and that

[166] See MN Coleman and MS Kirschner, "The Case in Favour of the US Chapter 11 Reorganisation System: Debunking the Myths and Mischaracterisations" (1993) 4 *International Company and Commercial Law Review* 363, 364. The authors note:

> This important feature of US bankruptcy law has enabled such clearly distressed (but perhaps not yet technically insolvent) companies such as Texaco, Johns-Manville and AH Robins, which had potential massive litigation liabilities that threatened to wipe out their entire businesses, to salvage their businesses before it was too late. By maintaining strong going concern values, these companies were able to resolve literally billions of dollars of litigation problems, and, in the case of Manville and Robins, massive social problems allegedly caused by defective products, through a very flexible use of the US Bankruptcy Code.

[167] Routledge and Morrison, n 43, 106; Chapple and Routledge, n 28, 71-72.

[168] *Corporations Act 2001* (Cth) s 436A(1)(a) (emphasis added). VA may also be initiated by a liquidator, provisional liquidator or a secured creditor with a charge over the whole, or substantially the whole, of the company's assets. See *Corporations Act 2001* (Cth) ss 436B, 436C.

[169] Harmer Report, n 4, [56] (emphasis added).

[170] Australian Government, CAMAC Discussion Paper, n 61, 22. See also Rose and Law, n 58.

[171] Harris, n 50, 286.

[172] Parliamentary Joint Committee on Corporations and Financial Services, *Corporate Insolvency Laws: A Stocktake*, n 45, 81-82.

[173] Parliamentary Joint Committee on Corporations and Financial Services, *Corporate Insolvency Laws: A Stocktake*, n 45, 84 (emphasis added).

[174] Australian Government, *CAMAC Final Report*, n 4, 24.

[175] *Crimmins v Glenview Home Units Pty Ltd* [2001] NSWSC 699, [51].

[176] *Crimmins v Glenview Home Units Pty Ltd* [2001] NSWSC 699, [52]. Palmer J provided the following example:

> [A] director may legitimately form the view that insolvency is likely ten years hence because the company's business is founded upon a particular technology which will be completely obsolete by that time and the company's business is already dwindling at such a rate that continuing liabilities will inevitably outstrip the company's ability to pay.

Crimmins v Glenview Home Units Pty Ltd [2001] NSWSC 699, [51]. See also *Mt Nathan Land Owners Pty Ltd (in liq) v Morris* [2008] QSC 239 [116]-[118] (Atkinson J).

creditors strongly influence the fate of an insolvent or soon-to-be insolvent company. Placing a solvent company in VA in order to reorganise its affairs would shift the balance of power from that company's shareholders to its creditors.[177] VA in this situation would enable the creditors to dictate the company's future by voting at a creditors' meeting, which may yield an outcome contrary to the interests of shareholders. If the creditors vote for the company to execute a DOCA, the shareholders would be bound by this DOCA and could not withdraw from the company by a share transfer.[178] This conflict between the interests of creditors – whose interests potentially lie in recouping debt owed to them – and the interests of shareholders – whose desire it may be for the company to reorganise without having their own rights undermined – produces an objectionable situation for a company that is still solvent yet wishes to reorganise its way out of financial difficulty. As it stands, the current wording of s 436A means that VA is not a mechanism for reorganisation unless it is invoked during insolvency or likely future insolvency, at which time it may be too late to rescue the company. One would think that lowering the threshold in s 436A would increase the number of companies entering VA to reorganise, but the inherent tension between shareholders and creditors would surely deter directors of distressed albeit solvent companies from doing so. There is much to be said for considering the Chapter 11 good faith requirement as an alternative gatekeeper to promote reorganisation without hindering shareholder interests.

In addition to clearing the path for distressed albeit solvent companies to reorganise, a good faith requirement would serve a protective function. A logical corollary of implementing the debtor-in-possession model is that Australia's insolvent trading laws would need to be radically altered, lest they become otiose. The perverse incentive for some directors to enter VA in order to avoid personal liability for insolvent trading would therefore be lessened. However, entry into Chapter 11 comes with its own challenges. Lynden Griggs observes that Chapter 11 can be a form of business strategy since it "has been used to lessen the impact of massive tort liability, awards of punitive damages and onerous labour contracts".[179] Accordingly, Chapter 11 may embolden debtors to abuse the insolvency regime by allowing them to evade their corporate responsibilities.[180] It is submitted that the risk of companies using a reorganisation procedure to avoid or postpone paying creditors, or to obtain a commercial advantage over their competitors, would be minimised by the good faith requirement in Chapter 11.[181] The US articulation of the requirement suggests that the test is flexible.[182] It examines the debtor's need to file, whether the filing is for a valid reorganisation purpose and whether an improper motive is apparent.[183] Functionally, the good faith requirement enables a court to dismiss or strike out a petition made in bad faith,[184] such as when it is used as a "mere strategic device to pressure creditors".[185] Whilst imperfect, it is asserted that the good faith requirement's duality of function as both a gatekeeper and defence mechanism renders it superior as an entry threshold when compared to the current wording of s 436A of the Act.

[177] Australian Government, CAMAC Discussion Paper, n 61, 22.

[178] Australian Government, CAMAC Discussion Paper, n 61, 22. See also Keay, n 74, 154.

[179] Griggs, n 4, 94. In the United States, tort and union claimants have traditionally been divided into separate creditor classes for the purposes of voting on the reorganisation plan. See *Re Dow Corning Corp* 280 F 3d 648 (2002); *Re Premiere Network Services Inc* 333 BR 130 (2005).

[180] G Dal Pont and L Griggs, "Realignment of Competing Interests and Periods of Grace: The Business Recovery Law Conundrum" (1991) 1 *Australian Journal of Corporate Law* 117, 130; Parliamentary Joint Committee on Corporations and Financial Services, *Corporate Insolvency Laws: A Stocktake*, n 45, 88.

[181] See *Re James Wilson Assoc* 965 F 2d 160, 170 (1992), quoted in DG Baird, *Elements of Bankruptcy* (Foundation Press, 3rd ed, 2001) 204. Concerns to that effect were raised in Australia in the Australian Government, CAMAC Discussion Paper, n 61, 3.

[182] See Eow, n 53, 323-324.

[183] Eow, n 53, 324.

[184] 11 USC § 1112(b); *Re James Wilson Assoc* 965 F 2d 160, 170 (1992). For other circumstances in which a court will dismiss a Chapter 11 petition or convert it to a Ch 7 case, see 11 USC § 1112(b)(4).

[185] Harris, n 6, 44.

From a systemic standpoint, the reorganisation options available to distressed companies that fall below the high threshold of s 436A are scant. Outside the legislative framework, an informal restructure poses a risk to all stakeholders involved if the restructure is unsuccessful.[186] Within the legislative framework, the only alternative to VA is for directors to propose a creditors' scheme of arrangement under Pt 5.1 of the Act, which lingers from the days of the Harmer Report.[187]

A creditors' scheme of arrangement allows a company to restructure its debt repayment arrangements with creditors. A scheme that is successfully initiated binds all creditors, including those who oppose the scheme.[188] A scheme may also bind third parties, which a DOCA cannot do.[189] Compared to VAs, creditors' schemes are considerably more expensive and complex to initiate: they require the court's approval at different stages – once to hold a creditors' meeting and once to initiate the scheme itself;[190] creditors must be divided into different classes based on the similarity of their rights;[191] and, in order to pass, a scheme requires a 75% majority in number and value of each creditor class.[192] The court will also take into account the commercial morality of the scheme,[193] public policy considerations and the public interest.[194] The court's discretion creates uncertainty, and the rigorous statutory procedure means that a scheme "cannot be put into place as a matter of urgency, which is desirable in an insolvency context".[195] There is also no moratorium in a scheme to reprieve a company from its creditors realising their interests. Despite their occasional use in particularly large and complex restructures,[196] creditors' schemes provide an uninviting option for the vast majority of distressed companies.[197]

This article does not intend on indulging in the irony of proposing the Australian adoption of certain elements of Chapter 11 – perceived as a rigorous process under which the court's involvement is extensive – after having lambasted schemes of arrangement for their complexity and high degree of court involvement. The rationale for accepting these features under a Chapter 11 equivalent, yet not doing so for a creditors' scheme of arrangement, chiefly lies in the protective function that a

[186] See, eg, L Zwier, J Vaatstra and O Bigos, "Can Managed Investment Schemes Be Restructured in the Context of Insolvency?" in SJ Maiden (ed), *Insolvent Investments* (LexisNexis Butterworths, 2015) 128-130, [5.71]-[5.76]. Cf Australian Restructuring Insolvency and Turnaround Association, ARITA Discussion Paper, n 64, 15.

[187] Schemes of arrangement can be traced back to the 19th century. The current statutory regime for schemes originated in the *Companies Arrangement Act 1870* (UK) s 2. See Langley, n 67, 72.

[188] Murray and Harris, n 11, 683, [20.40].

[189] *Lehman Bros Holdings Inc v Swan City* (2010) 240 CLR 509; 77 ACSR 489, 527 (French CJ, Gummow, Hayne and Kiefel JJ); *Boral Bricks Pty Ltd v Davey* [2011] 2 Qd R 301, [9]; [2010] QSC 131 (Douglas J). On the implications of the *Lehman Brothers* decision for creditors, see J Harris, "Adjusting Creditor Rights Against Third Parties during Debt Restructuring" (2011) 19 Insolv LJ 22.

[190] *Corporations Act 2001* (Cth) s 411(1). See, eg, *Re NRMA Insurance Ltd (No 1)* (2000) 156 FLR 349; [2000] NSWSC 82.

[191] *Sovereign Life Assurance Co (in liq) v Dodd* [1892] 2 QB 573; *Re Bond Corp Holdings Ltd* (1991) 5 WAR 143. For an application of this test, see *Re Opes Prime Stockbroking Ltd* (2009) 179 FCR 20; 258 ALR 362, 380 (Finkelstein J).

[192] *Corporations Act 2001* (Cth) s 411(4)(a). For a proposal to change the VA procedure "so as create an additional outcome allowed under that regime, being a scheme of arrangement", see N Hannan, "Voluntary Administrations and Schemes of Arrangement" (2014) 15 *Insolvency Law Bulletin* 131, 133.

[193] *Re Alabama, New Orleans, Texas & Pacific Junction Railway Co* [1891] 1 Ch 213; *Re CSR Ltd* (2010) 183 FCR 358; [2010] FCAFC 34.

[194] *Re Brian Cassidy Electrical Industries Pty Ltd* (1984) 9 ACLR 140; *Re Centro Properties Ltd* (2011) 6 BFRA 543; 86 ACSR 584; [2011] NSWSC 1465.

[195] Langley, n 67, 74.

[196] See, eg, *Re Centro Properties Ltd* (2011) 6 BFRA 543; 86 ACSR 584; [2011] NSWSC 1465; *Re Seven Network Ltd (No 3)* (2010) 267 ALR 583; [2010] FCA 400; Zwier, Vaatstra and Bigos, n 186, 125-128, [5.61]-[5.70]; P Bowden, N Poole and P James, "Channel Nine Lives to Fight Another Day" (2012) 13 *Insolvency Law Bulletin* 93.

[197] See Australian Securities and Investments Commission, n 20. Between 1999 and 2015, 12 companies entered into a formal creditors' scheme of arrangement. In that same period, more than 30,000 companies entered into VA.

debtor-in-possession model would confer on a company's directors and shareholders.[198] This is reinforced by Chapter 11's automatic stay of proceedings and its relaxed voting requirements to approve a reorganisation plan.[199] Given the limited circumstances under which creditors' schemes are initiated and their unpopularity when placed beside VA on the Act's shelf of reorganisation options, it stands to reason that the versatility of Chapter 11 renders it more effective in reorganising both small and large enterprises.

Breaking down the barriers for small and medium sized enterprises

Chapter 11 has a penchant for reorganising large corporations with substantial creditors and sophisticated finance structures. So much is apparent in the examples of the enterprises in the US that have successfully emerged from Chapter 11 filings.[200] However, a prominent criticism of the regime is that it fails to provide a convenient and inexpensive means of reorganising small and medium sized enterprises (SMEs).[201] The administrative costs, professional fees and relatively long duration of a Chapter 11 case compared to VA are frequently cited in Australia as disadvantages of Chapter 11: the process is said to be "subject to uncertain time limits and may be open to abuse", as well as being "too time-consuming, costly, and … friendly towards debtors"[202] The same concerns have appeared in the US, where some small companies are "squeezed out of the system, forcing the managers to liquidate the business quickly … or die quietly completely outside the bankruptcy system".[203]

The idea of implementing a Chapter 11-type system in Australia may seem farfetched given that a majority of insolvencies in Australia are those of small companies[204] and 97% of Australian businesses are small businesses.[205] This raises the question of whether there is value in additionally legislating for a cost-effective debtor-in-possession procedure that is specific to SMEs.[206]

In December 2014, the ABI released its comprehensive *Commission to Study the Reform of Chapter 11: Final Report and Recommendations* (ABI Report). The ABI recognises the importance of SMEs to the American economy and accordingly recommends the adoption of a streamlined Chapter 11 procedure intended to be more favourable to distressed SMEs in the US.[207] In an attempt to alleviate the concerns about Chapter 11's seeming unsuitability to SME reorganisation, this section examines the central aspects of the ABI's proposal as a potential framework for a specialised SME procedure in Australia.

[198] See Langley, n 67, 74. Langley notes that "[u]sually the directors must allow the company to continue trading and incur new debts over an extended period of time, exposing them to potential liabilities if liquidation results".

[199] See also Australian Government, CAMAC Discussion Paper, n 61, 65-66. The process of approving a reorganisation plan is outlined below.

[200] Such companies include United Airlines, General Motors, Lehman Brothers, Chrysler and Kmart. See also M Huebner and R James, "Duties and Obligations of Officers and Directors in §363 Sales" (2010) 28 *American Bankruptcy Institute Journal* 36, 36-37; Dickerson, n 105, 116.

[201] See, eg, American Bankruptcy Institute, *ABI Report*, n 88, 299.

[202] Parliamentary Joint Committee on Corporations and Financial Services, *Corporate Insolvency Laws: A Stocktake*, n 45, 90. See generally American Bankruptcy Institute, *ABI Report*, n 88, 22.

[203] Warren and Westbrook, n 102, 625; GW Kuney, "ABI Commission Testimony" (2014) 15 *Transactions: Tennessee Journal of Business Law* 333, 334.

[204] See Australian Securities and Investments Commission, Insolvency Statistics, *External Administrators' Reports (July 2014 to June 2015)* November 2015, Table 2, 6. Between 2014 and 2015, 79% of initial external administrators' reports concerned companies with fewer than 20 employees. In the same period, 85% of failed companies had estimated assets of $100,000 or less.

[205] Australian Bureau of Statistics, "The Number of Australian Businesses have Increased" (Media Release, 2 March 2015) <http://www.abs.gov.au/ausstats/abs@.nsf/mediareleasesbytitle/950EC94DB899312ECA2573B00017B8F4?OpenDocument>.

[206] See Wellard, n 24. In his recent empirical study reviewing DOCAs, Wellard questions whether "the modest returns generated by DOCAs justify a rethink of whether a 'debtor in possession' or more streamlined model might better serve Australian small company insolvencies": at 16.

[207] American Bankruptcy Institute, *ABI Report*, n 88, 275-296.

In order to promote SME reorganisation "in and outside of Chapter 11",[208] the ABI recommends that "estate neutrals" be appointed by the court on a case-by-case basis to guide SME debtors throughout the procedure.[209] The estate neutral, which is a novel concept in the ABI Report,[210] is a disinterested, non-adversarial third party that may be appointed from the outset of an SME Chapter 11 case. This concept bears resemblance to the "safe harbour" recommendations for the VA regime, pursuant to which a restructuring advisor should be appointed to assist directors with the VA process.[211] The purposes for which an estate neutral may be appointed include

> a financial review of the debtor, consulting with the debtor concerning its finances and restructuring options, or investigating the debtor's affairs when necessary or appropriate. The estate neutral, with court authority, also could assist the SME debtor in developing its [reorganisation] plan, which would provide oversight of the debtor-in-possession and a counterbalance to any particular individual creditor influence in the case.[212]

Although the costs of appointing the estate neutral would be borne by the debtor's estate, the ABI Report considers that "the courts could and should closely monitor the fees and expenses of the estate neutral and could even use caps or budgets to protect the estate".[213] Further, legislation may provide for a fee structure available to an estate neutral – based on the size of the case or amount of creditor distributions – to control the costs of the process, thereby instilling certainty in the parties involved in the reorganisation.[214] It is submitted that these measures would assist in subduing concerns expressed by small companies about the procedure's high costs and at times protracted nature.[215] The appointment of an estate neutral in an Australian Chapter 11 equivalent would also be another means of mollifying the apprehension about a company's management team misusing their position to act against the best interests of the debtor's estate.

The content of the reorganisation plan is perhaps the most unique aspect of the SME procedure proposed by the ABI Report. The ABI Report elaborates several recommendations that should, in the ABI's view, be implemented in SME cases. These recommendations predominantly deal with how a reorganisation plan should treat specific claims and interests, and include a situation where holders of prepetition equity interests – comprising owners and shareholders – obtain voting rights or an

[208] American Bankruptcy Institute, *ABI Report*, n 88, 278. The ABI notes that "74% of companies that filed bankruptcies in 2013 had revenue below $1 million. In addition, based on this same dataset, 90% of the companies that filed bankruptcy in 2013 had 50 or fewer employees": at 286.

[209] American Bankruptcy Institute, *ABI Report*, n 88, 291. See also MM Harner, "Creating Right Tools for Distressed Companies and their Creditors" (2015) 34 *American Bankruptcy Institute Journal* 8.

[210] The ABI believes that the estate neutral should replace the "examiner" under the current Code. The role and functions of examiners are as follows:

> An examiner with a specific directive may be appointed to investigate the affairs of the debtor. An examiner does not displace the debtor in possession or its management, and it is available only if no trustee has been appointed and only upon request of a party in interest or the U.S. Trustee and after notice and a hearing. In those circumstances, section 1104(c) requires the court to appoint an examiner if such appointment is in the interests of creditors, equity security holders, or the estate, or if "the debtor's fixed, liquidated, unsecured debts, other than debts for goods, services, or taxes, or owing to an insider, exceed $5,000,000".

American Bankruptcy Institute, *ABI Report*, n 88, 33 (citations omitted).

[211] See Australian Government, Treasury, "Improving Bankruptcy and Insolvency Laws" (Proposals Paper, 2016); Australian Government, *Business Set-up Transfer and Closure Inquiry Report*, n 4, 378-387; Australian Government, Treasury, "Insolvent Trading: A Safe Harbour for Reorganisation Attempts Outside of External Administration" (Discussion Paper, 2010).

[212] American Bankruptcy Institute, *ABI Report*, n 88, 294.

[213] American Bankruptcy Institute, *ABI Report*, n 88, 294.

[214] American Bankruptcy Institute, *ABI Report*, n 88, 291.

[215] Parliamentary Joint Committee on Corporations and Financial Services, *Corporate Insolvency Laws: A Stocktake*, n 45, 87-90; Australian Government, *Business Failure and Change Paper*, n 5, 90-93; Senate Economic References Committee, *Performance of ASIC Report*, n 4, 448. See generally Australian Government, *CAMAC Final Report*, n 4; Bickerdyke, Lattimore and Madge, n 67.

ownership stake in the reorganised debtor (SME Equity Retention Plan).[216] The recommendations also prescribe the circumstances in which the court should confirm an SME Equity Retention Plan that is rejected by any class of unsecured claims.[217] One recommendation, in essence, provides that

> prepetition equity security holders [should have] four years after confirmation [of the reorganisation plan] to repay the business's prepetition unsecured creditors. If the prepetition equity security holders are not able to achieve this result in that time period, then the unsecured creditors may convert their preferred interests into common ownership interests, significantly diluting the common ownership held by the prepetition equity security holders.[218]

The foregoing recommendations keep with the theme of protecting unsecured creditors' interests during reorganisation. The underlying basis for these proposals is the tension between, on the one hand, prepetition equity holders being essential to the debtor's reorganisation and, on the other hand, the desire of other stakeholders – such as unsecured creditors – to stifle the shareholding or power of prepetition equity holders because such equity holders "may be considered part of the problem or ineffective".[219] Indeed, in the context of an SME reorganisation, it is asserted that these recommendations strike an appropriate balance without indiscriminately favouring the interests of one stakeholder over the other. An equivalent framework in Australia that sits alongside a Chapter 11 equivalent would also obviate the need for a rigid one-size-fits-all approach and ensure that companies have at their disposal a reorganisation mechanism suitable for all structures and sizes.

Involvement and oversight of specialised courts

The relatively subdued function of the court in VA is part and parcel with the procedure's intended swiftness and expediency.[220] Despite the court's general power under s 447A of the Act to make orders as it thinks appropriate, its role is nonetheless described as "supervisory".[221] The power under s 447A must be exercised in the "spirit and objects" of Pt 5.3A[222] and not in a way that is contrary to the interests of any parties involved in the procedure.[223] Early confusion as to how such an ostensibly broad provision as s 447A would operate[224] has receded over time to the point that "[t]he sections that allow for the court to intervene in the outcome of a VA have been described as 'safety valves'".[225] In large administrations, the court has demonstrated a willingness to break the shackles imposed on it by the Harmer Report.[226] Zwier and Merkel observe that the court's willingness to exercise its

[216] American Bankruptcy Institute, *ABI Report*, n 88, 296.

[217] American Bankruptcy Institute, *ABI Report*, n 88, 296.

[218] American Bankruptcy Institute, *ABI Report*, n 88, 302.

[219] American Bankruptcy Institute, *ABI Report*, n 88, 300.

[220] See ALRC, Harmer Report, n 4, [62]; KJ Bennetts, "Voluntary Administration: Shaping the Process Through the Exercise of Judicial Discretion" (1995) 3 Insolv LJ 135, 135-136.

[221] *Demcox Pty Ltd v Sydney Wide Fabrications Pty Ltd* [2011] FCA 1331; A Gormly, "How can a Lessor Stop a Lessee's Administrator Running its Property into the Ground?" (2006) 14 Insolv LJ 81, 86; Anderson, n 130, 246, quoting RP Austin and R Brown, "Voluntary Administrators as Fiduciaries" in I Ramsay (ed), *Key Developments in Corporate Law and Trusts Law: Essays in Honour of Professor Harold Ford* (LexisNexis Butterworths, 2002) 199-200; Bennetts, n 220, 140.

[222] *Cawthorn v Keira Constructions Pty Ltd* (1994) 33 NSWLR 607; 13 ACSR 337, 341 (Young J). See also *Australasian Memory Pty Ltd v Brien* (2000) 200 CLR 270, 281 (Gleeson, McHugh, Gummow, Hayne and Callinan JJ).

[223] *Re Ansett Australia Ltd (No 1)* (2001) 115 FCR 376; [2001] FCA 1806. On the constitutionality of s 447A of the Act, see R Collins, "When General Powers Become Unconstitutional: s 447A and the Infringement of the Separation of Powers Doctrine" (2004) 12 Insolv LJ 72; J Harris, "The Constitutional Basis of s 447A: Is it a Power without Limit?" (2006) 14 Insolv LJ 135.

[224] See, eg, *Brash Holdings Ltd v Katile Pty Ltd* [1996] 1 VR 24; Bennetts, n 220, 139.

[225] Anderson, n 130, quoting Austin and Brown, n 221, 183.

[226] Zwier and Merkel, n 34. Another example is the administration of the Pasminco Group, in which deed administrators continue to act in relation to various residual companies in the Group. See Ferrier Hodgson, *Pasminco Limited*, <http://www.ferrierhodgson.com/au/publications/specialisation-case-studies/mining/pasminco-limited>.

supervisory jurisdiction in the Ansett Administration signified "a shift closer to [Chapter 11]" and was "a necessary and vital development of the law".[227]

Under Chapter 11, the involvement of the specialised bankruptcy court goes beyond that of the current supervisory role ordinarily assumed by courts in VA. Certain proposals set out in this article demonstrate that an Australian court would often need to cross the divide between supervision and active involvement in giving effect to a Chapter 11-type procedure. Examples include the need for court hearings and approvals at different stages of the process and the appointment and oversight of an estate neutral. This increased supervision is said to degrade the merits of adopting Chapter 11, especially given the passive function of the courts under the current VA system.[228] It is, however, submitted that the increased involvement of the court in Chapter 11 should not be perceived as a shortcoming in the same way that broadening the court's role under VA would be perceived. It was never intended for the court in VA to have a prominent role in the conduct and outcome of the procedure. So much can be distilled from the aims of VA as stated in Harmer Report.[229] Chapter 11, with its debtor-in-possession model and pronounced emphasis on corporate rescue, operates under a different backdrop to VA. Accordingly, the mandatory involvement of the court under Chapter 11 should not be criticised solely through the spectacles of VA.

In its summary of submissions against adopting an Australian Chapter 11, the Corporations and Markets Advisory Committee's *Rehabilitating Large and Complex Enterprises in Financial Difficulties: Final Report* alluded to a number of potential problems in respect of court supervision. Setting aside concerns about the cost and delays of increased court involvement, two arguments came across as particularly compelling. First, it was opined that "an Australian equivalent of [Chapter 11] may also require establishing a separate court system to deal with the large number of applications that would be required".[230] Secondly, it was argued that

> the quite appropriate reluctance of Australian courts to make decisions on commercial matters, in substitution for the discretion of the directors, is not readily compatible with the extensive court involvement in approving and monitoring corporate reconstructions under Chapter 11.[231]

The establishment of a separate court system and the court's amplified role under an Australian Chapter 11 equivalent should not be the subject of disdain. Whilst it may be inappropriate and contrary to accepted practice for courts under the current system to delve into the purview of commercial decision-making,[232] the same is not necessarily true for a specialised court established to deal with Chapter 11-type cases.

Before highlighting the potentially valuable features of a specialised court in the corporate rescue space, mention must first be made of two important caveats to this proposal. First, there is the obstacle of Federal Parliament establishing a "legislative court" or tribunal that operates independently of the Federal Court of Australia and state courts, both of which currently exercise federal jurisdiction under Chapter III of the Australian *Constitution*.[233] Secondly, from an institutional viewpoint, consideration ought to be given to how judges of this specialised court would be selected. In the US, judges are appointed from a specialist bankruptcy bar comprised of lawyers who practice almost exclusively in this area.[234] The bankruptcy bar in the US emerged in response to a demand for advocates in an area

[227] Zwier and Merkel, n 34, 27.

[228] Australian Government, *Business Set-up Transfer and Closure Inquiry Report*, n 4, 344; Australian Government, *Business Failure and Change Paper*, n 5, 92; Parliamentary Joint Committee on Corporations and Financial Services, *Corporate Insolvency Laws: A Stocktake*, n 45, 84-86; Australian Government, *CAMAC Final Report*, n 4, 16.

[229] ALRC, Harmer Report, n 4, [62].

[230] Australian Government, *CAMAC Final Report*, n 4, 16.

[231] Australian Government, *CAMAC Final Report*, n 4, 16.

[232] See, eg, *Re Permanent Trustee Co Ltd* (2002) 43 ACSR 601; [2002] NSWSC 1177.

[233] See WMC Gummow, "Bankruptcy and Insolvency in Australia" (1995) 46 *South Carolina Law Review* 893, 894-895. But see *Lane v Morrison* (2009) 239 CLR 230, 242.

[234] Skeel, n 79, Ch 1.

of law where external administrators traditionally played a pervasive role, and "[s]ince 1898, bankruptcy professionals have been the single most important influence on the development of bankruptcy law" in the US.[235] In Australia, no institution equivalent to the US bankruptcy bar currently exists, although one would envisage that such a need might arise if the jurisdiction were to adopt a system that conferred debtors with extra protection during insolvency.[236]

The court in Chapter 11 serves a "critical screening function to eliminate hopeless cases relatively quickly", and "courts are actively engaging in culling cases that have little prospect of confirming a plan of reorganization".[237] A specialised court whose judges possess a wide discretionary power and thorough understanding of the workings of a Chapter 11-type system would be qualified to grapple with processes pursuant to, and disputes arising from, reorganisations under this system.[238] It also arguable that, where a party to a proceeding files a motion or makes an objection, empowering the court with the ability to exercise commercial judgment and grant swift orders is likely to minimise delays and the likelihood of recidivism after first-time filings.[239]

It is considered that a specialised court is also likely to alleviate the burden that some filings would place on the current court system, particularly in the context of large and complex restructures. As regards the court's own procedure, the efficiency and certainty with which courts navigate through Chapter 11 cases is facilitated by the use of "procedural history".[240] Procedural history, which denotes "the incidences and timing of filing of motions and other documents in a case and the bankruptcy court's disposition of those documents",[241] has assisted in minimising information asymmetry and reducing costs and delays under Chapter 11.[242] The courts thus have a wealth of information and – if they can afford to use it – ample time to assess a company's path to reorganisation. This differs from VA where, depending on the time of the year, an administrator has either 20 or 25 business days to convene the creditors' meeting at which a company's future will be decided,[243] with courts often being disinclined to extend this convening period.[244] Further, the unpredictability in respect of costs in

[235] Skeel, n 79, 47.

[236] A related issue is the high amount of professional fees that is expended by the debtor's estate. This has reportedly deterred debtors in the US from reorganising under Chapter 11 in favour of expedited asset sales, liquidations, informal workouts or assignments for the benefit of creditors. See Wurst JA, "Is Chapter 11 Still a Viable Option or Has High Cost Rendered the Process Unaffordable?" (2013) 11 *ABF Journal* 56, 56-57; American Bankruptcy Institute, *ABI Report*, n 88, 56-59, 62. Under a debtor-in-possession regime, the issue of professional fees may plausibly displace the current debate surrounding insolvency practitioner remuneration – as it applies to administrators – in Australia. See generally Anderson, "Editorial" (2014) 22 Insolv LJ 167.

[237] Warren and Westbrook, n 102, 620, 634. See also P Foohey, "Bankrupting the Faith" (2013) 78 *Missouri Law Review* 719, 747.

[238] LM LoPucki and WC Whitford, "Venue Choice and Forum Shopping in the Bankruptcy Reorganisation of Large, Publicly Held Companies" (1991) *Wisconsin Law Review* 11, 34-38, quoted in R Cranston (ed), *Making Commercial Law: Essays in Honour of Roy Goode* (Clarendon Press, 1997) 465. See also Senate Economic References Committee, *Performance of ASIC*, n 4, 447-448.

[239] Miller and Waisman, n 79, 177, fn 267. Miller and Waisman query whether courts should impart their own views in an adversarial process, especially when the parties in interest have reached agreement on the outcome of the Chapter 11 case. In an earlier article on the role and power of judges in the bankruptcy court, Miller describes the judge as "the producer, director, and, potentially, star of the drama presented by bankruptcy cases" through a melding of the judge's judicial and administrative functions. See HR Miller, "The Changing Face of Chapter 11: A Reemergence of the Bankruptcy Judge as Producer, Director, and Sometimes Star of the Reorganization Passion Play" (1995) 69 *American Bankruptcy Law Journal* 431, 440.

[240] See ER Morrison, "Bankruptcy Decision Making: An Empirical Study of Continuation Bias in Small-Business Bankruptcies" (2007) 50 *Journal of Law & Economics* 381, 393. On case management considerations in Chapter 11, see MB Jacoby, "What Should Judges Do in Chapter 11?" (2015) 2 *University of Illinois Law Review* 571.

[241] Foohey, n 237, 744; Rotem, n 137; Morrison, n 240, 393.

[242] Morrison, n 240; Warren and Westbrook, n 102; Foohey, n 237.

[243] *Corporations Act 2001* (Cth) s 439A(5). See nn 32, 36 and accompanying text.

[244] *Mann v Abruzzi Sports Club Ltd* (1994) 12 ACSR 611; *Brian Rochford Ltd v Textile Clothing & Footwear Union (NSW)* (1998) 47 NSWLR 47. Cf *Re Diamond Press Australia Pty Ltd* [2001] NSWSC 313 [10] (Barrett J); *Re Riviera Group Pty Ltd* (2009) 72 ACSR 352, 356-357 (Austin J); [2009] NSWSC 585.

a Chapter 11-type system may be assuaged by a legislative fees schedule that prescribes the expenses that stand to be incurred from initial filing and subsequent hearings or approvals.[245] By and large, these proposals acknowledge the scarcity of the courts as an essential resource to the community and the importance of not pushing this scarcity to its limits.[246] They also offer a cost-effective means of facilitating court hearings without attracting the stigma associated with Australian courts exercising commercial judgment.

Flexibility through asset sales

One of the stated aims of VA – if it is not possible for the company or its business to continue in existence – is for the process to "result in a better return for the company's creditors and members than would result from an immediate winding up".[247] In the same way, it is asserted that an efficient liquidation of a large company or sale of its assets under § 363 of the Code are both legitimate uses of Chapter 11.[248] Section 363 has been the subject of scrutiny in the US for its tendency to guide companies towards the sale of substantially all of their assets.[249] As explained below, this view is unappreciative of Chapter 11's multiple functions.[250] This section outlines the advantages of § 363 of the Code and comments on the viability of a similar provision under an Australian Chapter 11 equivalent.

Section 363 allows a debtor to use, sell or lease its assets outside the ordinary course of business. In recent years, however, it has become customary for debtors to conduct § 363 sales for the purpose of selling substantially all of their assets.[251] This decision effectively creates an escape hatch for debtors who no longer want to reorganise under a lengthier Chapter 11 process and is considered to be a principal cause underlying Chapter 11's unpopularity in the US.[252] The sale requires an auction and public sale process since "competitive bidding ensures that fair and valuable consideration is received, thus helping to avoid any suspicion of collusion or impropriety".[253] The debtor's assets can be sold as a going concern or liquidated piecemeal,[254] and secured creditors may use their allowed secured claims instead of cash to bid on the assets.[255] Assets are sold free of encumbrances so long as one of the five conditions in § 363(f) is satisfied,[256] including obtaining the consent of the secured creditor[257] – a provision which Erens and Hall believe "was designed to balance the rights of secured creditors

[245] See American Bankruptcy Institute, *ABI Report*, n 88, 56, fn 202.

[246] See, eg, *Labocus Precious Metals Pty Ltd v Thomas (No 3)* [2007] FCA 1346 [15] (Allsop J).

[247] *Corporations Act 2001* (Cth) s 435A(b).

[248] Dickerson, n 105, 115-117. Dickerson believes that "the goal [of Chapter 11] has always been to maximize value, which may be accomplished either through reorganization *or orderly liquidation*": at 115 (emphasis added). See also *Re Jartran Inc* 886 F 2d 859, 866-867 (1989); *Re Sandy Ridge Dev Corp* 881 F 2d 1346, 1352 (1989).

[249] See, eg, AJ Casey, "The Creditor's Bargain and Option-Preservation Priority in Chapter 11" (2011) 78 *University of Chicago Law Review* 759, 760.

[250] See Dickerson, n 105.

[251] DE Deutsch and MG Distefano, "The Mechanics of a § 363 Sale" (2001) 30 *American Bankruptcy Institute Journal* 1.

[252] See nn 98-105.

[253] PA Schovanec, "Bankruptcy: The Sale of Property Under Section 363: The Validity of Sales Conducted Without Proper Notice" (1993) 46 *Oklahoma Law Review* 489, 498 fn 63. See also EB Rose, "Chocolate, Flowers, and § 363(b): The Opportunity for Sweetheart Deals Without Chapter 11 Protections" (2006) 23 *Emory Bankruptcy Developments Journal* 249, 272. Rose notes that the court will in some instances step in and approve private sales.

[254] JA Wilkerson, "Defending the Current State of Section 363 Sales" (2012) 86 *American Bankruptcy Law Journal* 591; Miller and Waisman, n 101.

[255] 11 USC § 363(k); R Orloff, "Chapter 11 Asset Sales: Will There Be a Chilling Effect on Section 363(k) Credit Bidding after in Re Fisker Automotive Holdings Llc?" (2014) 20 *Fordham Journal of Corporate and Financial Law* 269, 269-270. This is known as credit bidding, being "the process through which a secured creditor may offset the purchase price a creditor pays at auction by the face value of the lien securing the claim". See, eg, *RadLAX Gateway Hotel LLC v Amalgamated Bank* 132 S Ct 2065; 182 L Ed 2d 967 (2012).

[256] 11 USC § 363(f). The provision provides:

> The trustee may sell property … free and clear of any interest in such property of an entity other than the estate, only if–

with the needs of a debtor to restructure its business, including the need to divest itself of assets".[258] Finally, a bona fide purchaser takes the assets with knowledge that the sale cannot be reversed or modified on appeal.[259]

Under both VA and Chapter 11, the consolation prize for stakeholders in a company where reorganisation is impossible is the extraction of value through winding up. A distressed yet salvageable company may opt for a going concern sale, but under VA this can only be achieved in the case of creditor agreement giving rise to a DOCA and subsequent court approval under the broad power in s 447A.[260] On the contrary, Chapter 11 allows a debtor to sell all or substantially all of its assets outside the ordinary course of business without the need for creditor agreement. This is particularly useful where a debtor has no feasible reorganisation alternatives and an asset sale would be more fruitful for its stakeholders than would otherwise be the case if the company were to be placed in liquidation. It is contended that a provision equivalent to § 363 of the Code would be an advantage in Australia over the current regime for asset sales, primarily because it would allow the debtor to sell its business as a going concern without relying on creditor approval for the execution of a DOCA. The benefits of allowing for a "pre-positioned" sale prior to an insolvency appointment have also been recognised in Australia in the context of VA.[261] If the asset sale process under an Australian Chapter 11 equivalent were to be closely regulated, it would have the potential to provide a productive source of value maximisation for a company's stakeholders and be a viable alternative to traditional reorganisation.

As foreshadowed above, asset sales under § 363 have evolved into a customary practice in the US. Consistent with the proposition that Chapter 11 has multiple functions, Chief Judge Bernstein notes:

> [N]ot all Section 363 sales are necessarily bad or inconsistent with the objectives of Chapter 11. A sale doesn't mean that the auctioneer comes into the factory and sells the assets one light bulb at a time … [S]ales can transfer all, or substantially all, of the assets as a going concern. In that situation, the business continues to operate in the hands of a new owner, employing many or all of the debtor's former employees.[262]

Notwithstanding the benefits of § 363, its escape hatch function also imparts on it the label of an "exit strategy of choice in many Chapter 11 cases".[263] In recent times it has become commonplace for secured creditors to push for a quick sale of the debtor's assets, particularly where they are concerned that the value of their collateral will diminish over time.[264] In these situations, secured creditors will

(1) applicable nonbankruptcy law permits sale of such property free and clear of such interest;
(2) such entity consents;
(3) such interest is a lien and the price at which such property is to be sold is greater than the aggregate value of all liens on such property;
(4) such interest is in bona fide dispute; or
(5) such entity could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest.

[257] On an analysis of the rights of secured creditors in asset sales, see BB Erens and DA Hall, "Secured Lender Rights in 363 Sales and Related Issues of Lender Consent" (2010) 18 *American Bankruptcy Institute Law Review* 535; GW Kuney, "Misinterpreting Bankruptcy Code Section 363(f) and Undermining the Chapter 11 Process" (2002) 76 *American Bankruptcy Law Journal* 235.

[258] Erens and Hall, n 257, 537. See, eg, *Re Terrace Gardens Park Partnership* 96 BR 707, 715 (1989).

[259] 11 USC § 363(m); Wilkerson, n 254.

[260] Murray and Harris, n 11, 675, [19.445]. See generally RP Austin, *Restructuring Companies in Trouble: Director and Creditor Perspectives – An Introductory Essay* (NSW Supreme Court Annual Corporate Law Conference, 24 August 2010); *Dallinger v Halcha Holdings Pty Ltd (admin apptd)* (1995) 60 FCR 594, 601; [1995] FCA 1058 (Sundberg J).

[261] Australian Government, *Business Set-up Transfer and Closure Inquiry Report*, n 4, 387-394. See also H Lloyd and M O'Brien, "Pre-packaged Transactions in Administration – Strategy and Application" (2009) 9 *Insolvency Law Bulletin* 110.

[262] Katsoris, Soden and Bernstein, n 64, 18.

[263] Katsoris, Soden and Bernstein, n 64, 16, quoting Miller and Waisman, n 87, 194-195.

[264] Miller and Waisman, n 87, 182-185.

impose rigorous payment deadlines and conditions in the debtor-in-possession financing agreement.[265] More often than not this impacts adversely on the protection afforded to unsecured creditors, who stand to recover less value from the estate than they would have under a traditional reorganisation. In the US, the process used by the court in approving an asset sale is different to the process used to approve a reorganisation plan under the Code. In the former case, the court is under no obligation to have regard to the "cramdown" provisions in § 1129, which are discussed at length below.[266] Instead, a judge must find in all the circumstances "a good business reason" to approve the sale.[267] In the ABI's view, this standard is "much different and arguably lower" than that employed in approving a reorganisation plan.[268]

In many cases, urgency and the lower standard required to consummate an asset sale – compared to approving a reorganisation plan – is deleterious to stakeholders wishing to extract value from an insolvent debtor.[269] Concerns regarding the short time period in which asset sales are approved can be allayed by imposing a moratorium on such sales, as recommended by the ABI Report.[270] A court having regard to the cramdown provisions in § 1129 in the context of asset sales is a proposal that also warrants further consideration in Australia.[271] It would allow the debtor

> sufficient time to explore a stand-alone reorganization or other restructuring alternatives, and [to] take advantage of a decline in the applicable markets without giving parties in interest a reasonable time to assess the likelihood that such markets will rebound during the pendency of the debtor's chapter 11 case.[272]

Unsecured creditors naturally have a vested interest in seeing that the debtor's actions do not reduce the pool of funds available to a distressed company's stakeholders. Both of the above measures, if implemented within an asset sale regime under an Australian Chapter 11 equivalent, would ensure that the value in the estate recoverable by unsecured creditors is not eroded by haste or unscrupulousness in the conduct of an asset sale.

Impeding the enforceability of ipso facto clauses

The enforcement of an ipso facto clause against a company that has entered VA has the potential to destroy any prospect of that company reorganising its financial affairs or selling its business as a going concern.[273] The cited rationale for enabling parties to enforce ipso facto clauses is that "it is reasonable for businesses to take steps … to avoid involvement in the financial affairs of failed enterprises" and that such clauses "may improve managers' incentive to take steps to avoid financial difficulty".[274] The reality, however, is that the termination of a company's supplier contracts,

[265] Miller and Waisman, n 87, 182-185. J Uziel, "Section 363(b) Restructuring Meets the Sound Business Purpose Test with Bite: An Opportunity to Rebalance the Competing Interests of Bankruptcy Law" (2011) 159 *University of Pennsylvania Law Review* 1189, 1214.

[266] Whilst an evaluation of § 1129 is outside the ambit of this article, the broader implications of a Chapter 11 regime on creditors are examined below.

[267] *Committee of Equity Security Holders v Lionel Corp* 722 F 2d 1063, 1071 (1983); *Re Boston Generating LLC* 440 BR 302, 321 (2010); *Re General Motors Corp* 407 BR 463, 489 (2009); *Re Motors Liquidation Co* 430 BR 65 (2010).

[268] American Bankruptcy Institute, *ABI Report*, n 88, 205.

[269] American Bankruptcy Institute, *ABI Report*, n 88, 86; Anderson, n 130. One exception is what the ABI refers to as "melting ice cubes", which are "assets subject to rapid decline because of the nature of such assets (often referred to as 'perishable' assets) or unique, exigent circumstances that cannot otherwise be avoided". In the ABI's view, these exceptions should not define the rules. See also *Re Gulf Coast Oil Corp* 404 BR 407, 423 (2009).

[270] American Bankruptcy Institute, *ABI Report*, n 88, 83-87. The ABI adds that the proposed 60-day moratorium can only be circumvented by "the most extraordinary of circumstances, which must be established by clear and convincing evidence at the hearing on the motion requesting an expedited sale process".

[271] American Bankruptcy Institute, *ABI Report*, n 88, 206. In short, a cramdown in a Chapter 11 case involves the court imposing a reorganisation plan on all creditors, notwithstanding dissenting creditor classes.

[272] American Bankruptcy Institute, *ABI Report*, n 88, 87.

[273] Australian Government, *Business Set-up Transfer and Closure Inquiry Report*, n 4, 394-398.

[274] Parliamentary Joint Committee on Corporations and Financial Services, *Corporate Insolvency Laws: A Stocktake*, n 45, 217.

commercial leases and facility agreements leaves it even more vulnerable than it was prior to entering VA, thereby diminishing its value for stakeholders. This consequence is magnified if the company is one that relies heavily on keeping its contracts on foot.[275] Calls to render ipso facto clauses unenforceable in Australian VAs[276] – in an attempt to align corporate insolvency law with personal bankruptcy law[277] – have generally fallen on deaf ears.[278]

In the US, where individual bankruptcies and corporate insolvencies are treated identically under the Code, ipso facto clauses are generally unenforceable under § 365(e)(1) of the Code.[279] However, this provision as a whole has been labelled "one of, if not the, most convoluted sections of the Code" largely due to the perplexity surrounding the meaning of an "executory" contract and the consequences of rejecting such contracts.[280] Its extensive breadth has also resulted in numerous exceptions that have been subject to flimsy judicial interpretation.[281] Mirzai expounds the confusion regarding § 365 as follows:

> [The provision] is static and applies generally across all relevant contracts whereas both the drafting style and subject matter of commercial agreements are forever changing. The general application of the provision has additionally been held to go too far in the other direction, that is, the complete abolition of recognising ipso facto clauses significantly and unfairly distorts a creditor's proprietary rights and hence holds itself out for improper use and exploitation.[282]

Given the emphasis on reorganisation that would underpin an Australian Chapter 11 equivalent, it only seems logical that ipso facto clauses should be struck down.[283] The question, however, is the means by which this end should be achieved. An alternative to legislating rigidly for the abolition or unenforceability of ipso facto clauses is to impose a moratorium that would prevent parties from modifying or terminating their contracts with a company that files for the procedure. The moratorium

[275] Australian Restructuring Insolvency and Turnaround Association, ARITA Discussion Paper, n 64, 18-19.

[276] See, eg, Parliamentary Joint Committee on Corporations and Financial Services, *Corporate Insolvency Laws: A Stocktake*, n 45, 217; Australian Government, *Financial System Inquiry*, n 4, 266; Australian Restructuring Insolvency and Turnaround Association, ARITA Discussion Paper, n 64, 18; ALRC, Harmer Report, n 4, [703]-[705].

[277] See *Bankruptcy Act 1966* (Cth) s 301; Mirzai, n 63. Mirzai observes that the s 301 of the *Bankruptcy Act 1966* (Cth) extends well beyond the protection afforded by s 600F of the *Corporations Act 2001* (Cth), which only prevents the termination of an "essential service" such as electricity, gas, water or a carriage service: at 10.

[278] See, eg, Australian Government, *CAMAC Final Report*, n 4, 71. In 2016, the Australian Government released a Proposal Paper entitled "Improving Bankruptcy and Insolvency Laws", which discusses the prospect of rendering unenforceable ipso facto clauses upon the occurrence of an insolvency event. It is hoped that this Proposal Paper initiates debate that results in purposeful legislative reform in this area.

[279] 11 USC § 365(e)(1). The provision is framed in the following terms:

> Notwithstanding a provision in an executory contract or unexpired lease, or in applicable law, an executory contract or unexpired lease of the debtor may not be terminated or modified, and any right or obligation under such contract or lease may not be terminated or modified, at any time after the commencement of the case solely because of a provision in such contract or lease that is conditioned on–
> (A) the insolvency or financial condition of the debtor at any time before the closing of the case;
> (B) the commencement of a case under this title; or
> (C) the appointment of or taking possession by a trustee in a case under this title or a custodian before such commencement.

See also H Karwowski, "Can the Invalidation of Ipso Facto Clauses Apply to Prepetition Termination?" (2010) 29 *American Bankruptcy Institute Journal* 54.

[280] C Pickerill, "Executory Contracts Re-Revisited" (2009) 83 *American Bankruptcy Law Journal* 63, 63-64.

[281] 11 USC § 362. See also K Schroeder-Simpson, "Fifth Circuit's Executory Contract Standards Deconstructed" (2006) 26 *Mississippi College Law Review* 225, 252.

[282] Mirzai, n 63, 11 (citation omitted).

[283] See Australian Government, *Business Set-up Transfer and Closure Inquiry Report*, n 4, 25. The Productivity Commission recommends that the Act be amended "such that ipso facto clauses are void (unless otherwise directed by a court) when a business is controlled by an administrator (as already applies if a person is in bankruptcy)".

may operate in a standalone fashion, as has been suggested in the past,[284] or as an extension of the original moratorium that activates at the outset of the procedure. To preserve a party's right to terminate a contract for a cause other than a company's financial distress, a purposive test may be adopted to identify the underlying intention of an ipso facto clause prior to a specialised court deciding whether the clause should be subject to the moratorium.[285] In its entirety, this proposal dispenses with the need for courts to grapple with contractual issues outside the scope of insolvency legislation. It also takes one step towards looking "beyond the strict concept of protecting the creditor to a broader class of stakeholders including equity holders, customers, suppliers and the undeniable benefits of rehabilitating general businesses"[286] while averting the pitfalls that have transpired in this area in the US.

Treatment of creditors

The treatment of creditors under Chapter 11 has drawn criticism from many in Australia's insolvency circles, the logic being that a debtor-oriented system inescapably comes at the expense of creditors.[287] However, the protection afforded to debtors under Chapter 11 does not mean that creditors are simply "locked out" of the procedure. The underlying purpose of the Code is to provide fair and equal treatment to creditors and debtors.[288] With this in mind, there are features of Chapter 11 that equip potentially vulnerable creditors – who tend to act as a unified constituency[289] – with the powers necessary to ensure that their interests are not compromised.

Under Chapter 11, creditors are designated into classes generally based on similarities between their claims.[290] Those creditors whose claims have been "impaired" can vote by class to decide whether to accept the debtor's reorganisation plan.[291] The Code defines thresholds that must be met in order for holders in a class to be deemed to have accepted the plan.[292] Those creditors with unimpaired claims under the proposed plan are deemed to have accepted the plan without voting.[293] All things considered, "only those with skin in the game will vote on the outcome".[294] Where one or more creditor classes oppose the plan, the court may nonetheless "cram down" the plan if at least one impaired creditor class accepts the plan.[295] This is analogous to the operation of a creditors' scheme of

[284] See, eg, Arnold Bloch Leibler, Submission to the Productivity Commission, *Inquiry into Business Set-up, Transfer and Closure*, 25 February 2015, [3.22].

[285] Australian Government, *Business Set-up Transfer and Closure Inquiry Report*, n 4, 395.

[286] Mirzai, n 63, 11.

[287] Parliamentary Joint Committee on Corporations and Financial Services, *Corporate Insolvency Laws: A Stocktake*, n 45, 85-88; ALRC, Harmer Report, n 4, [98]; Australian Government, *CAMAC Final Report*, n 4, 15-16; Griggs, n 4, 95; Keay, n 74, 150-151.

[288] *Re Sanchez*, 20 BR 431, 433 (1982).

[289] KM Ayotte and ER Morrison, "Creditor Control and Conflict in Chapter 11" (2009) 1 *Journal of Legal Analysis* 511, 512.

[290] 11 USC § 1122 states:

> (a) Except as provided in subsection (b) of this section, a plan may place a claim or an interest in a particular class only if such claim or interest is substantially similar to the other claims or interests of such class.
>
> (b) A plan may designate a separate class of claims consisting only of every unsecured claim that is less than or reduced to an amount that the court approves as reasonable and necessary for administrative convenience.

See also E Warren, *Chapter 11: Reorganizing American Businesses: The Essentials* (Aspen, 2008). On this provision, Warren observes that "[t]he battle lines are clear, but the Code provides little guidance": at 150. See also American Bankruptcy Institute, *ABI Report*, n 88, 257. The ABI states that "a debtor or plan proponent attempts to group similarly situated creditors in the same class, though strategic considerations may complicate this analysis".

[291] See 11 USC § 1124(1). A creditor's claim is impaired where their proposed treatment under the plan alters the legal, equitable and contractual rights entitled by that claim.

[292] 11 USC § 1126(c)-(d). For creditors, the requisite thresholds are 66% in amount and 50% in number of allowed claims of those voting. For other interest holders, the threshold is 66% in amount of the allowed interests of those voting.

[293] 11 USC § 1129(a)(8).

[294] Warren, n 290, 151.

[295] 11 USC § 1129(b).

arrangement in Australia,[296] which "operates by virtue of the court order, rather than as a contract between the creditors and the company".[297] Accordingly, a confirmed plan under Chapter 11 binds all creditors, discharging the debtor from prepetition claims and formally bringing Chapter 11 to an end.[298] Where the debtor is unable to confirm a plan, the court may dismiss the Chapter 11 case or convert it to a liquidation case under Ch 7.[299]

As a starting point, the key protection provided to all creditors under Chapter 11 is the "best interests of creditors" test.[300] A proposed plan must show that each creditor, barring any that consents to lesser treatment, is to receive a return under the plan that is at least as much as it would receive in Ch 7 liquidation.[301] Under VA this consideration inevitably crosses the mind of an administrator who is required to express an opinion to creditors about the company's future,[302] bearing in mind that "a better return … than would result from an immediate winding up" is one of VA's aims if reorganisation is not possible.[303]

In large Chapter 11 cases, the unsecured creditors with the seven largest claims against the debtor are appointed to a creditors' committee.[304] The committee usually comprises lawyers, accountants and other professionals who oversee the debtor's activities. The committee may consult with the debtor throughout the process, investigate the debtor, participate in formulating the reorganisation plan, and, where appropriate, move to replace the debtor or recommend liquidation.[305] The VA regime also allows for the formation of a creditors' committee with powers to consult with the administrator and review reports, but not give directions to the administrator.[306] The role of a committee in VA is one of oversight, which renders it innocuous compared to its American counterpart.[307] Warren highlights that the committee in Chapter 11 has strong leverage in informal negotiations and, from a practical viewpoint, is regarded as "critical to the successful confirmation of the plan".[308] This acts as a necessary counterbalance to the debtor-in-possession model and offers to unsecured creditors an instrument of greater influence than is the case in VA.[309] The downside, however, is that all professional expenses incurred by a committee under Chapter 11 are reviewed by the court and, if warranted, paid out of the estate as an administrative expense.[310] The formation of a committee in small business Chapter 11 cases where coffers are shallow is therefore not mandatory,[311] but it is submitted that SME cases under an Australian Chapter 11 equivalent may benefit from retaining the current powers of VA creditors' committees in order to foster a cost-effective process.

[296] See *Re Terri Co Pty Ltd* (1987) 12 ACLR 457.

[297] Langley, n 67, 72; see n 12.

[298] 11 USC § 1141.

[299] 11 USC § 1112(b).

[300] 11 USC § 1129(a)(7)(A)(ii). See, eg, *Re Board of Directors of Multicanal SA* 340 BR 154 (2006).

[301] *Re Travelstead* 227 BR 638 (1998).

[302] *Corporations Act 2001* (Cth) s 439A(4)(b).

[303] *Corporations Act 2001* (Cth) s 435A(b). See, eg, *JA Pty Ltd v Jonco Holdings Pty Ltd* (2000) 33 ACSR 691, 715; [2000] NSWSC 147 (Santow J).

[304] 11 USC §§ 1102(a)(1), 1103(a).

[305] 11 USC §§ 1103(c)(1)-(4), 1109(b), 1112(b).

[306] *Corporations Act 2001* (Cth) ss 436F, 436G. See, eg, *Re Eisa Ltd; Application of Love* (2000) 34 ACSR 394. See generally L Powers, "The Liability of Members of Editor Committees – the Price for Staying Close to the Action?" (2005) 13 Insolv LJ 195.

[307] D Perkis, n 109, 194-195, fn 61-62.

[308] Warren, n 290, 151.

[309] In VA, unsecured creditors are limited to making an application under ss 447A or 1321 of the Act. See generally C Anderson, "Decision-making in a Voluntary Administration" (2004) 22 C&SLJ 163.

[310] 11 USC § 507(a)(2). See also MM Harner and J Marincic, "Committee Capture? An Empirical Analysis of the Role of Creditors' Committees in Business Reorganizations" (2011) 64 *Vanderbilt Law Review* 749.

[311] 11 USC § 1102(a)(3).

Another vulnerable creditor under Chapter 11 is the one that finds itself subject to a "cramdown" after opposing the debtor's reorganisation plan. As explained above, a cramdown is where the court confirms the plan notwithstanding a dissenting creditor class.[312] The caveat to a cramdown, however, is that it must be "fair and equitable" without discriminating unfairly in respect of each dissenting class.[313] The meaning of "fair and equitable" differs depending on whether the class is one of secured or unsecured claims: secured creditors must be able to retain their lien to the extent of their claim and receive deferred cash payments totalling the amount of the secured claims at present value,[314] while unsecured creditors that are junior to any dissenting class will not receive or retain any property under the plan.[315] The latter situation – known as the "absolute priority rule" – ensures that a dissenting class of creditors is paid in full before junior classes may receive any distributions under the plan.[316] Viewed as a core tenet of bankruptcy law in the US, Dick comments that the absolute priority rule

> serves as an important safeguard for creditors by ensuring that, unless their claims are paid in full or they agree otherwise, the Chapter 11 plan will – with limited exceptions – respect the relative collection rights of creditors under state law.[317]

In addition to onerous disclosure requirements[318] the plan must also be unlikely to lead to liquidation or any further reorganisation attempts,[319] satisfying the court that the reorganised debtor can stand on its own two feet.[320]

In view of the way that the US regime treats creditors, what implications would adopting a comparable procedure have for Australia's insolvency system? A widely touted yet divisive benefit of VA is that the procedure appropriately balances the rights of creditors against the benefits of reorganisation.[321] This observation is reinforced by a proposition to the effect that VA "closes the right businesses".[322] If one were to accept this view, even without the support of empirical evidence, then Australian insolvency law would be regarded as championing public policy by assuming a "survival of the fittest" function.[323] Such a view arguably favours the interests of creditors over the broader economic and social benefits of corporate rescue and largely disregards the interests of shareholders and employees.[324] Chapter 11, on the other hand, undeniably encroaches on the rights of each individual creditor to a greater extent compared to VA. However, it is asserted that this encroachment is justified when one considers the broader policy dimensions at play.[325] The measures provided to creditors under Chapter 11 also suggest that a shift towards protecting debtors' interests would perhaps not be so extreme as to sacrifice creditors' interests. Indeed, this article is replete with instances in which creditors are afforded protection in Chapter 11. Despite Chapter 11's protection of the debtor

[312] 11 USC § 1129.

[313] 11 USC § 1129(b)(1).

[314] 11 USC § 1129(b)(2)(A)(i).

[315] 11 USC § 1129(b)(2)(B).

[316] American Bankruptcy Institute, *ABI Report*, n 88. The evaluation of the absolute priority rule is beyond the ambit of this paper. It will suffice to note that the rule has been labelled inflexible and a barrier to successful reorganisation. See generally Ayotte and Morrison, n 289, 523.

[317] Dick, n 163, 2284 (citations omitted).

[318] 11 USC § 1129(a)(5).

[319] 11 USC § 1129(a)(11).

[320] *Re SCC Kyle Partners, Ltd* 518 BR 393 (2014). But see LM LoPucki, "The Trouble with Chapter 11" (1993) *Wisconsin Law Review* 729, 731, quoted in Griggs, n 4, 93.

[321] See, eg, Australian Restructuring Insolvency and Turnaround Association, ARITA Discussion Paper, n 64; Parliamentary Joint Committee on Corporations and Financial Services, *Corporate Insolvency Laws: A Stocktake*, n 45; Australian Government, *CAMAC Final Report*, n 4.

[322] Australian Government, *Business Failure and Change Paper*, n 5, 93; D Perkis, n 109, 193-194.

[323] B McCabe, "Official Management v Reorganisation under Chapter 11 of the United States Bankruptcy Code: In Defence of Official Management" (1992) 20 ABLR 320, 325; Lightman, n 69, 71.

[324] Bickerdyke, Lattimore and Madge, n 67.

[325] Cf Anderson, n 130, 241-242.

from the outset, it is submitted that creditors under the system may be fortified with enough bulwarks to preserve their interests without impeding the debtor's freedom to reorganise. In this way, it stands to reason that the adoption of a Chapter 11 equivalent in Australia would not obviate the creditor-oriented philosophy underpinning Australian insolvency law, but rather adapt it in order to foster corporate rescue.

CONCLUSION

The proposed framework for an Australian Chapter 11 equivalent is broached in this article from a practical perspective, the premise being that there is merit in examining aspects of Chapter 11 at a time when corporate rescue is a focal point of discussion in Australian insolvency circles. A distressed company looking to reorganise under such a system may be expected to find solace in the debtor-in-possession model. Instead of an external insolvency practitioner coordinating the procedure, a Chapter 11-type system would protect those who are most familiar with the company's operations by enabling them to formulate a reorganisation plan without the imminent threat of creditors hampering the process. In order to quell concerns about the procedure being abused, this article points to existing and proposed safeguards under statute, at common law and in equity. In cases where reorganisation is unattainable, Chapter 11 also presents a clear path for debtors to conduct an asset sale in an attempt to extract as much value as possible for its stakeholders. Criticisms surrounding the perceived high costs and protracted cases under Chapter 11 are also eased throughout this article with practical solutions, such as caps and budgets on the fees and expenses incurred by an estate neutral, the implementation of a legislative fees schedule to reduce cost unpredictability and preserving the current consultative model for creditors' committees in SME cases.

From a systemic perspective, an Australian Chapter 11 equivalent would, by virtue of a good faith entry requirement, lower the bar to reorganisation for distressed albeit solvent companies and enable courts to discard bad faith filings. If both the constitutional and institutional barriers to establishing a specialised court system were overcome, there would exist a means for an independent court to oversee the process and make timely commercial decisions that would otherwise be disparaged under the current VA regime. Moreover, the implementation of a specialist SME procedure – namely, by the use of an estate neutral and requirements for a tailored reorganisation plan – would ensure that the interests of distressed SME debtors and unsecured creditors are not overlooked. Indeed, a cardinal proposition in this article is that a debtor-oriented regime does not automatically translate into diminished creditor rights. In fact, the balance struck between stakeholder interests in Chapter 11 is such that its debtor-oriented nature necessitates a counterweight in the form of creditor protection, the measures of which are discussed at length in this article.

Central to discussing the application of Chapter 11's features in Australia are the major limitations and obstacles to their implementation. At a cultural level, one would surmise that embracing aspects of a debtor-oriented regime in Australia would jolt the current creditor-oriented insolvency system in this jurisdiction. However, it remains to examine whether the magnitude of this change would throw into disarray the prevailing Australian philosophy towards insolvency. This challenge is compounded by the lack of evidence about the workings of Australia's insolvency system, which from the outset leaves one unable to conclude without conjecture whether Australia's external administration regime causes otherwise viable businesses to fail.[326] mplementing a debtor-in-possession model would also have systemic consequences with respect to insolvent trading, private receivership and secured credit generally. Given the intersections between insolvency and taxation issues,[327] in addition to the potential impact of the above proposals on the ATO, it may also require concomitant reform to Australia's taxation laws.

The crux of recent commentary in the US is that Chapter 11 has gradually shifted towards becoming a creditor-oriented regime, as evidenced by the diminishing rate of successful reorganisations and high rate of liquidations or asset sales in lieu. This is not to say that the

[326] Australian Government, *Financial System Inquiry*, n 4, 265-266.

[327] See Morrison, n 162.

consideration of Chapter 11's key elements in Australia's present-day economy would be futile. As Warren observes, the reasons for a company's failure may be varied, and Chapter 11 for the most part acts as a mechanism for "sorting out the winners from the losers in reasonably short periods of time".[328] In that sense, short of empirical evidence that sheds light on which of the two procedures are more successful at rescuing distressed companies,[329] it is submitted that the propounded benefits of Chapter 11 at the very least render it a superior "sorting mechanism" compared to VA, reinforced by: Chapter 11's debtor-in-possession model, which halts creditors from imminently enforcing their rights against the debtor; the ample time provided to the debtor to formulate a reorganisation plan or negotiate the mechanics of an asset sale; and the active role of an independent court in discarding those cases with no prospect of reorganising.

Whilst it is almost irrefutable that Australia's insolvency and reorganisation laws are due for reform, this article does not intend to put the proverbial cart before the horse. A great deal of inquiry and consultation between stakeholders is necessary,[330] and it is incumbent on the government to anticipate and later attenuate teething problems that may arise from any comprehensive change. The decline in VA's use, coupled with the perceived inadequacies of the procedure that have emerged over time, suggest that corporate rescue deserves a place at the apex of the agenda for insolvency reform.[331]

At a time when the statutory regime for reorganisation is seen to be posing challenges to many distressed yet salvageable companies, traversing Australia's borders may yet prove the key to developing a forgiving corporate rescue culture that promotes entrepreneurialism, fuels economic growth and eventually yields wider societal benefits. It is conceived that, as a framework for insolvency reform, Chapter 11 has been denounced all too easily by its detractors. The intention of this article is not to consider discrete advantages of Chapter 11 that could be tacked on to the current system. Nor is it proposed that the legislature replicates Chapter 11 and adopts it wholesale in Australia. The core assertion is that adopting a procedure that possesses the central features of Chapter 11, with modifications where appropriate, warrants close consideration if Australian insolvency law intends to accommodate for an efficacious corporate rescue culture.

[328] Warren and Westbrook, n 102, 631.

[329] See Wellard, n 24, 16; Warren and Westbrook, n 102, 611. Warren and Westbrook argue that a confirmed plan of reorganisation is the central measure of Chapter 11's "success". Cf Dickerson, n 105; LoPucki, n 105. Dickerson and LoPucki allude to a broader view of success, which entails a consideration of whether a distressed company has achieved an outcome in Chapter 11 that is appropriate to its predicament. This may, depending on the company's circumstances, be an asset sale or liquidation.

[330] See generally C Anderson, "Editorial" (2014) 22 Insolv LJ 113; Martin, n 76, 76; Schaffer, n 27, 161.

[331] With the stage set for corporate insolvency reform in 2017, the Australian Government has announced that it will legislate to implement, among other things, a safe harbour for directors and render ipso facto clauses unenforceable. In addition to gauging the long-term effects of these proposals, it is hoped that Chapter 11's features will be duly considered. See Australian Government, Treasury, "Improving Bankruptcy and Insolvency Laws" (Proposals Paper, 2016).