



# Ending a Means to an End: Transition from the Voluntary Administration Process to a Deed of Company Arrangement or Liquidation

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## Introduction

The voluntary administration<sup>1</sup> procedure is a temporary one in the life of a company. It is a means to an end. That end is represented in the outcomes of the process. Part 5.3A of the Corporations Act provides that there will be three possible outcomes from the administration. They are liquidation, the entering into a deed of company arrangement or a return of the company to its pre-administration situation.<sup>2</sup> Voluntary administration is ultimately a means by which the insolvent corporate entity may get to a position where a plan of reconstruction or reorganisation will be put in place or the company will enter liquidation.<sup>3</sup> In addition the court may terminate the administration in certain circumstances.<sup>4</sup> These outcomes are worthy of a study in themselves but it is beyond the scope of this article to deal with these other forms of administration in detail. The focus of this article is the transition to these other stages in the life of the insolvent company. It is argued that this transition is a positive feature of the overall Part 5.3A processes but that there are some gaps in the legislation that require consideration in the evaluation of Part 5.3A.

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<sup>1</sup> Under Part 5.3A of the *Corporations Act 2001* (Cth). All sections mentioned in the article are to this Act unless noted otherwise.

<sup>2</sup> Section 439C and s 435C(2). It is not intended here to consider the final alternative mentioned in s 439C. This is because it does not create any issue and importantly the outcome is rarely chosen.

<sup>3</sup> Again ignoring the final alternative in s 439C.

<sup>4</sup> See s 435C. As this article is focused upon the voluntary administration process the outcomes are dealt with briefly as they are a separate set of procedures to those which operate in a voluntary administration.

In one sense the outcomes of the voluntary administration might be seen in the objectives for Part 5.3A.<sup>5</sup> These enunciate that the objects are to save as much of the business as possible and if that is not feasible to gain a better return to creditors than would have been available in an immediate winding up. It is however the specific results that are measured against these criteria rather than the voluntary administration itself. Too much emphasis on the procedure leading to the outcomes may detract from an examination of the outcomes themselves. Accordingly, it is necessary to examine the transition to determine how well the process of voluntary administration facilitates the achievement of the objectives. This article will cover issues that relate to the transition to the deed of company arrangement and the winding up of the company following voluntary administration. In so doing it is demonstrated that the transition to these other insolvency regimes is less regulated and less clear than the relatively methodical legislative regime for the administration itself. It is shown that the lack of legislative direction has resulted in the courts attempting to fill in the gaps. It is suggested that this does not always result in the best solution. These matters are subsequently related to theory about the voluntary administration process based on the economics and law paradigm.<sup>6</sup> The article makes several suggestions for law reform in these areas.

### **The intention of the *Harmer Report* as regards outcomes of the administration**

The *General Insolvency Inquiry* (the *Harmer Report*) was concerned that the approach to insolvency be constructive<sup>7</sup> in the sense that the possibility of saving a business is focused upon and that a procedure 'encourage and offer a reasonable prospect of achieving that result'.<sup>8</sup> It went on to state generally that the meeting of creditors should offer creditors the option of resolving that the company is to be wound up or accept a deed of company arrangement or simply cease to be under administration.<sup>9</sup> It is interesting to note that the recommendation for the winding up of the company was that the company would be wound up if

<sup>5</sup> Section 435A.

<sup>6</sup> This article does not attempt to deal comprehensively with all of the issues that arise in the context of a company under a deed of company arrangement just as it does not deal with liquidation in any detail.

<sup>7</sup> Australian Law Reform Commission, *General Insolvency Inquiry*, Report No. 45 (1988) [52]-[53].

<sup>8</sup> *Ibid* [53].

<sup>9</sup> *Ibid* [56].

such were the resolution of the creditors 'as if an order of the court to that effect had been made on the day that the company became a company under administration'.<sup>10</sup> This suggests that the *Harmer Report* contemplated the winding up to be a court ordered winding up, presumably in insolvency under Part 5.4, rather than the provisions of a creditors' voluntary winding up under Part 5.5. In relation to the deed of company arrangement, the *Harmer Report* stated that:

If a deed of company arrangement is agreed, it will be a simplified document of much less size and complexity than the present forms of 'scheme documents' that oppress creditors and others. The deed will incorporate (by simple reference) standard provisions contained in a schedule to the companies legislation, as well as many provisions of the legislation dealing with, for example, admissible claims, order of distribution to creditors and avoidance of antecedent transactions (such as preferences and similar voidable transactions).<sup>11</sup>

This contains a curious reference to the fact that the 'scheme documents' as they then existed 'oppress creditors and others'. It is not entirely clear what is meant by the term 'oppress' in this context. Oppression is a term used in the *Corporations Act* when dealing with shareholder remedies.<sup>12</sup> It is generally associated with a notion of gross unfairness in the exercise of a majority power.<sup>13</sup> The mere fact that a document is lengthy and complex does not cause it to be oppressive in this sense. The word 'oppressive' is therefore more likely to have been used in a general sense merely to emphasise the need for a simple document. If that was the aim it is not clear that it has been achieved. The complexity of a business and its financial structure is likely to determine the level of complexity of the deed. There is a degree of flexibility in the provisions in Part 5.3A in relation to the content of the deed but this should not be assumed to equate with simplicity. Nor is there an apparent reason as to why simplicity should be an overriding goal. The aim of the legislation is to maximise the chances of the company surviving, or failing that, getting

<sup>10</sup> Ibid.

<sup>11</sup> Ibid.

<sup>12</sup> Now contained in Part 2F.1.

<sup>13</sup> Examples given in relation to Part 2F.1 are illustrated in H Ford, R Austin, and I Ramsay, *Ford's Principles Of Corporations Law* (2000) [11.440]:

Acts such as: abuse of voting power by the majority in altering the constitution; improperly condoning a wrong done to the company; or an abuse of power by the directors (such as an improper issue of shares), are redressable on the application of a member.

better returns to creditors.<sup>14</sup> It is not appropriate that simplicity should be a reason to liquidate rather than enter into a deed.

The *Harmer Report* did not provide much detail regarding the manner in which a deed may be drawn up. It referred to the 'professional investigation' that would precede the report by the administrator and that, if it were proposed that a deed be entered into, a statement of the particulars of the proposed arrangement should be given.<sup>15</sup> The Report went on to detail some aspects of the deed procedure. For example, it stated that the creditors appoint the administrator of the deed who need not be the administrator under the voluntary administration. Therefore the 'creditors exercise control, not only by their collective power to accept or reject a proposal for an arrangement but also by their right to appoint the administrator of the deed'.<sup>16</sup> In implementing these recommendations in the legislation it was stated that:

One of the most common results of the administration process will be that the company and its creditors will enter into a 'deed of company arrangement'. The contents of this deed will vary according to the need of the particular company and its creditors, though it might often be expected to provide for some form of compromise of debts, such as repayment of debts by delayed instalments. In exchange, the activities of company management might be subjected to supervision by the creditors. The new Part 5.3A does not seek to limit in any way the scope for a company and its creditors to reach an arrangement suitable to all parties.<sup>17</sup>

This passage suggests the deed will be a common outcome of the administration. It has not been the case however that it is the most frequent outcome of administration. It would seem from the limited amount of available data<sup>18</sup> that the most common outcome of the

<sup>14</sup> Section 435A.

<sup>15</sup> ALRC, *General Insolvency Inquiry* above n 7 [110].

<sup>16</sup> *Ibid* [115].

<sup>17</sup> Explanatory Memorandum to *Corporate Law Reform Bill 1992* Australian Government Printing Service.

<sup>18</sup> See for example Australian Securities Commission *ASC Research Paper 98/01* (1998), Appendix II [5.3]. It states there that :

Data lodged with the Australian Securities Commission indicates that there have been 5,760 companies between 23 June 1993 and 30 June 1997, which have entered into Voluntary Administration....Of these companies 2,162 (or 38%) have proceeded to a Deed of Company Arrangement (DCA), 3,080 (or 53%) went straight into liquidation, 37 companies appear to have resumed normal trading without entering into a DCA (Pathway 1), 23 companies were immediately deregistered and 458 (or 8%) remain under administration.

It may be noted that a much smaller survey in the initial year of operation of Part 5.3A showed that 50.3% of voluntary administrations ended in a deed of company arrangement: S Coad, 'The Australian Society of CPA's Survey of the First Year of

administration process is liquidation. Again the intention of the legislature was that flexibility be available in relation to what form that the deed will take. As explained below it is possible that in seeking to leave the deed to be as flexible as possible, the legislation may have failed to provide sufficient clarity as to how it may operate.

### **The Legal Issues surrounding the Deed**

There are a large number of matters that have arisen in relation to the deed of company arrangement. It must first be recognised that when the deed comes into effect the administration of the company ceases.<sup>19</sup> This creates a number of changes to the rights of the various company stakeholders during the administration. These include:

- most of the powers of the administrator in the administration do not automatically pass on to the administrator of the deed<sup>20</sup> with control of the company reverting to those who controlled the company before the administration commenced unless there were changes during the administration or there are specific provision in the deed;
- the administrator of the deed does not automatically receive any indemnity in relation to debts incurred unlike the administrator in the administration;<sup>21</sup> and
- the secured creditors, owners of property in the possession of the company<sup>22</sup> and a creditor of the company who has a guarantee with respect to their debt from directors<sup>23</sup> may all enforce their respective rights subject to certain limitations.<sup>24</sup>

Voluntary Administrations' in J Lessing and J Corkery (eds) *Corporate Insolvency Law* (1995) 54. The ASC data is more comprehensive and does not rely on survey responses.

<sup>19</sup> Section 435C.

<sup>20</sup> Examples include the powers given in Division 3 of Part 5.3A to exclusively control the company and its business, to deal exclusively with the company's property, to act as the company's agent. The powers of the officers of the company are only suspended during the administration. See also the discussion in relation to liquidation being revived when an administration ends in *Mercy & Sons Pty Ltd v Wanari Pty Ltd* (2000) 157 FLR 107.

<sup>21</sup> Under Division 9 of Part 5.3A the administrator under an administration has rights to be indemnified out of the assets of the company as well as being personally liable for the debts incurred.

<sup>22</sup> Section 444D.

<sup>23</sup> *M & G Oyster Supplies Pty Ltd v Nonchalont Pty Ltd* (1995) 19 ACSR 27.

<sup>24</sup> In the case of secured creditors and owners or lessors of property, an administrator (either under the administration or the deed administrator) may apply under s 444F for an order of the court to limit the rights to enforce the security or take possession of the property.

Therefore the manner of the change from voluntary administration to operations under a deed is important because the failure to effect such a change properly can have disastrous consequences for any rescue bid.<sup>25</sup>

The legislation is vague in its references to the development of the deed. For example, there is no specific reference as to the position if a company were already in liquidation at the time that a deed was approved. This arises in the situation where a liquidator appointed an administrator under s 436B. In such cases it has been held that a court ordered liquidation is not terminated by the entering into a deed<sup>26</sup> but further that the creditors may not cause the company to enter into a voluntary winding up either. The position where a company is in voluntary liquidation prior to the administration appears to be similar.<sup>27</sup> This interpretation of the legislation raises questions as to what creditors may decide at the second meeting. Presumably they may terminate the administration and therefore resume the court ordered or voluntary winding up, or they may choose a deed of company arrangement. If the latter is chosen but the winding up continues the effect of the deed is unclear. It appears from the *Mercy & Sons*<sup>28</sup> case that the court retains its power to set aside the deed though upon what basis it should do so seems uncertain.

#### **Who proposes the deed?**

The legislation outlines the deed in s 444A. That section makes it clear that the administrator in the voluntary administration will be the administrator of the deed unless the creditors resolve to appoint someone else. It seems likely that the creditors will not often change administrators given their knowledge of the company and the document that has been developed. However it is clear that the administrator of the deed must prepare the instrument that sets out the terms of the deed.<sup>29</sup> This does not explain who should develop the rescue proposal. In contrast, the *Bankruptcy Code 1978* (US) states clearly that only the debtor may propose a plan for the first 120 days after the filing for protection under Chapter 11.<sup>30</sup> Under the Australian provisions, there is implicitly a different approach. It is implicit because nowhere does the legislation state specifically that the responsibility for developing a plan rests with

<sup>25</sup> To some extent this is ameliorated by the ability to apply under s 447A. See *Australasian Memory Pty Ltd v Brien* (2000) 200 CLR 270.

<sup>26</sup> *Mercy & Sons Pty Ltd v Wanari Pty Ltd* (2000) 35 ACSR 70.

<sup>27</sup> *Re Nardell Coal Pty Ltd* (2004) 49 ACSR 110.

<sup>28</sup> *Mercy & Sons Pty Ltd v Wanari Pty Ltd* (2000) 35 ACSR 70.

<sup>29</sup> s 444A(3).

<sup>30</sup> Unless a trustee is appointed: see *Bankruptcy Code 1978* (US) s 1121.

the administrator. Under s 438A, the administrator in a voluntary administration has the obligation to investigate the company's property, business and financial circumstances and form an opinion about each of the matters that must be decided by the creditors at the second meeting under s 439A. Specifically, this includes an opinion as to whether it would be in the interests of the company's creditors for the company to execute a deed of company arrangement. These opinions must then be communicated to the creditors by way of a report prior to the meeting.<sup>31</sup> It does not state who may develop the plan or whether it is possible for there to be comment on more than one plan. It is likely that in the Australian context there is such a short period in which to propose a deed that the chances of more than one serious rescue plan being developed are low. This can be seen as a possible limitation on the procedure. The limits of the US approach have been also recognised:

The debtor's exclusive right under § 1121 to propose a plan for the first 120 days of the Chapter 11 case and to obtain acceptance of it within an additional 60 days, together with the court's discretionary authority to grant extensions of those periods under § 1121(d) is of great strategic importance to the debtor in its plan negotiations. So long as exclusivity remains intact, time is on the side of the debtor. If the exclusivity periods are extended over a substantial period of time, creditors may feel compelled to accept an unfavourable plan of the debtor when, absent exclusivity, they might have been able to propose their own plan—one more favourable to their interests.<sup>32</sup>

The Australian approach has an advantage compared to the US system because the administrator is in a position to represent the creditors' interests and seek a 'better' plan if the debtor proposes something that is inadequate. In addition, the shorter period in Australia is likely to mean there will not be pressure to accept something unfavourable simply to get a prompt payment of some amount. However, the Australian approach has the possible flaw of having, in most cases, too short a period to allow for the development of a deed by anyone other than the debtor (albeit that it is done through the administrator).

#### **How much of the deed is available to creditors before they approve it?**

The deed is the outcome of negotiation and often compromise amongst the creditors and other stakeholders in the company. This has raised questions in some instances as to whether the deed accurately reflects the bargain that creditors believed they were voting for. This arises because

<sup>31</sup> Under s 439A(4).

<sup>32</sup> W Warren and D Bussel, *Bankruptcy* (6<sup>th</sup> ed, 2002) 646.

there is no requirement that the complete deed be put to the creditors at the meeting under s 439A. Under the current legislation the requirement is only that an administrator circulates before the second meeting of creditors 'a statement setting out details of the proposed deed'.<sup>33</sup> It has been held that this does not require a complete deed to be forwarded to creditors.<sup>34</sup> It is not clear how closely the details of the final deed must mirror this statement. This issue has been a source of criticism of the procedure;<sup>35</sup> it is a possibility that creditors believe they are agreeing to one arrangement but find that the deed reflects something quite different. The precise obligation of the administrator in relation to what must be put forward to creditors remains something for judicial consideration. There is little case law reflecting this issue despite the apparent concern discussed in various reports.<sup>36</sup> Creditors who are dissatisfied with the deed as it is drawn up have two avenues of remedy. First it would be possible to apply to the court to have the deed set aside under s 445D.<sup>37</sup> An alternative is to require the administrator to call a meeting of creditors under s 445F to consider a variation of the deed. Each of these could be costly for the creditor. What this reflects is a general lack of specification in the legislation about the deed when a company seeks that alternative. Whilst flexible approaches are generally desirable in this area, they must be undertaken within a framework that provides some certainty as to how the practical steps should progress.

The *Corporate Voluntary Administration Final Report* discussed the need to have the deed reflect creditor wishes in some detail<sup>38</sup> but rejected the

<sup>33</sup> Section 439A(4)(c).

<sup>34</sup> *Deputy Commissioner of Taxation (Cth) v Comcorp Australia Ltd* (1995) 13 ACLC 1671 and on appeal (1996) 21 ACSR 590. However see also *M & S Butler Investments Ltd v Granny May's Franchising* (1997) 24 ACSR 695 where it was made clear that the administrator must make material details available to creditors.

<sup>35</sup> See Australian Securities Commission, *ASC Research Paper 98/01* (1998) [2.112] and [7.305]; Legal Committee of the Companies and Securities Advisory Committee, *Corporate Voluntary Administration Final Report* (1998) [2.98] to [2.112]; Parliamentary Joint Committee on Corporations and Financial Services, Parliament of Australia, *Improving Australia's Corporate Insolvency Laws: Issues Paper* (2003) [1.135] accessed available: <[www.aph.gov.au/senate/committee/corporations\\_ctte/ail/issuespaper.doc](http://www.aph.gov.au/senate/committee/corporations_ctte/ail/issuespaper.doc)>.

<sup>36</sup> As noted in the footnote above. The matter was raised but not discussed in *In the Matter of Tony Michael Mechanical P/L (under administration)* [2003] QSC 141. The issue that arose in this case was in relation to the date specified in the deed before which claims must have arisen in order to be bound.

<sup>37</sup> Specifically under s 445D(1)(a) or (b) on the basis that information that was provided to creditors was false or misleading or that there was a material omission from a report or statement.

<sup>38</sup> Legal Committee of the Companies and Securities Advisory Committee *Corporate Voluntary Administration Final Report* (1998) [2.98 to 2.112].



proposal that administrators be required to table a copy of a draft deed at the meeting and make it available for inspection. This was rejected on the basis that it may not be settled at that time and it may be subject to change by the meeting anyway. Instead it was suggested that the legislation should provide for two situations.<sup>39</sup> Where a draft deed is approved at the second meeting of creditors, it was considered that the legislation should require execution by the company within 15 days of approval unless extended by the court.<sup>40</sup> Where the deed in draft form was prepared after the second meeting, the administrator need prepare the deed within 10 business days of the meeting. Creditors would then have three business days to inspect the deed. Then the company and the administrator should execute the deed within a further two days after the end of the inspection period. The court would have the power to extend these periods.<sup>41</sup> This approach goes some way to addressing the issue, as creditors would be able to inspect the deed before it is executed and they are put on notice about the prospect of variation from the draft documents that appear at the meeting. This also shortens the period in which the document must be prepared and executed. This of itself may assist by way of enabling creditors to act more quickly where there is a problem with the deed.<sup>42</sup>

Nevertheless the underlying problem will remain as long as the administrator is not required to produce the deed prior to the meeting. The nature of the process with such a short period of administration may not enable the preparation of a deed and it is a difficulty which must be recognised as a trade-off for creditors being able to move on to a subsequent phase for the company. Given that the deed must be executed within 21 days of the vote<sup>43</sup> a possible reform would be the option to adjourn the meeting where the deed cannot be produced.<sup>44</sup> Some allowance could be made for situations where the meeting alters the proposed deed in the manner described by the CASAC Report. Under the current provisions, it is possible for the period in which to execute the

<sup>39</sup> Ibid [2.100].

<sup>40</sup> Ibid [2.101].

<sup>41</sup> Ibid [2.112].

<sup>42</sup> Delay is generally taken into account by the court in deciding whether to exercise its discretion under s 445D and set aside a deed for one of the reasons set out there: *Khoury v Zambena Pty Ltd* (1997) 23 ACSR 344.

<sup>43</sup> See s 444B.

<sup>44</sup> Although this is possible now under the general power to extend the relevant periods by way of an application to the court under s 439A(6) or by adjourning the meeting under s 439A(2), a specific section could entitle the administrator to extend the convening period by another 14 days where a deed will be proposed but is unable to be presented.

deed to be extended.<sup>45</sup> It has been stated that the approach of the court where such an application is made is to balance the possible advantages of the deed against the consequences if the deed is not executed and the company is automatically placed in liquidation.<sup>46</sup> It makes much more sense to enable the extension to be granted prior to the vote of creditors.

### **What type of a document is the deed?**

The development of the deed is one factor but the need to establish the nature of the deed once it comes into effect has also been an important issue in the courts. The nature of the 'deed' has been examined in a number of different contexts. Importantly in *MYT Engineering Pty Ltd v Mulcon Pty Ltd*,<sup>47</sup> the majority of the High Court were of the view that a deed of company arrangement did not require execution as a deed.<sup>48</sup> The majority stated that:

The use of the term 'deed of company arrangement' can be explained as an allusion to the earlier forms of arrangement made, on the insolvency of individuals, by deed of arrangement. Those instruments have long been called 'deeds of arrangement', but they have not always been made by deed. The nineteenth century United Kingdom statutes that provided for their registration made plain that the instruments to be registered were instruments that affected any of several kinds of arrangement with creditors, whether or not the instrument concerned was under seal.<sup>49</sup>

This of itself is significant, but perhaps of more interest is the consideration of the nature of the arrangement and how this may affect its operation. The majority went on to explain that the assent of the company was of critical importance in the creation of a binding plan:

A company can make a deed of company arrangement only while it is in administration. By requiring that 'the company' execute the instrument, which upon execution by both the company and the administrator becomes a deed of company arrangement, Pt 5.3A requires a visible expression of the company's assent to the terms that are recorded in the instrument. Further, by providing that the instrument becomes a deed of company arrangement

<sup>45</sup> See s 444B(2).

<sup>46</sup> *Sydney Ringtread Tyres Pty Ltd (administrator appointed)* (2001) 38 ACSR 221; *Cvitanovic v Jolly Roger Exports Pty Ltd* [2003] NSWSC 729.

<sup>47</sup> (1999) 195 CLR 636; 30 ACSR 705.

<sup>48</sup> It should be noted that Kirby J was of the view that the legislation required execution as a deed. This view was based on a number of factors including the use of the word deed in both the legislation and the *Harmer Report*, the manner in which it operates, and the various provisions relating to it that are consistent with the document being a deed: *MYT Engineering Pty Ltd v Mulcon Pty Ltd* [1999] HCA 34 [43] to [52].

<sup>49</sup> [1999] HCA 34 (Gleeson CJ, Gaudron, Gummow and Hayne JJ) [13].

when executed by both the company and the administrator, the legislation reveals an intention that the company's transition from being subject to administration to being subject to a deed of company arrangement should not depend exclusively on the wish of the creditors and the assent of the administrator. And indeed the provision in s 446A (1) (b) for what is to happen if the company contravenes s 444B (2) and does not execute the instrument within time (coupled with the explicit reference to this consequence in s 444B (7)) can only reinforce that conclusion.<sup>50</sup>

Whilst this may follow from the provisions as analysed by the Court, it is unclear why such consent is necessary. The company at that stage is under the complete control of the administrator by virtue of s 437A, thus to suggest that there is any real consent by the company is artificial because in practical terms it is largely a different entity. The shareholders play no part in the decision making process as to the acceptance of the deed. The officers of the company have no power at that stage due to the operation of s 437C and hence the 'company' can be only those with the residual interest, essentially the creditors. They are the ones who have approved the deed. The administrator is also required to execute the deed, so it is curious that the company need execute it at all. Further, if the consent is to be considered anything more than a formality it is difficult to see in what circumstances the company could withhold its 'consent' if the creditors approved the deed and the administrator had executed it.

The fact that the company is required to 'consent' to the deed does emphasise the contractual nature of the deed, however as the passage below indicates, it is the legislation that binds the creditors as well.<sup>51</sup>

It may be, however, that the deed of company arrangement is not simply a contract. No doubt a deed of company arrangement will contain stipulations and promises of a kind found in contracts between parties. But a deed of company arrangement is more than a set of promises between those who are parties to it (the only essential parties to a deed of company arrangement are the company and the deed administrator.) First, it is a document that, on execution, effects a change in status of the company, from a company under administration to a company subject to a deed of company arrangement. Secondly, it is a document that contains

<sup>50</sup> *MYT Engineering Pty Ltd v Mulcon Pty Ltd* [1999] HCA 34 (Gleeson CJ, Gaudron, Gummow and Hayne JJ) [18].

<sup>51</sup> *MYT Engineering Pty Ltd v Mulcon Pty Ltd* [1999] HCA 34 (Gleeson CJ, Gaudron, Gummow and Hayne JJ) [25]. This nature of the deed as a contract was also acknowledged in *Derwinto v Lewis* [2002] NSWSC 731 [42] where Austin J speaking of a deed stated that it 'binds creditors, the company and the administrators in contract, to the extent that they are parties to it, and by statutory extensions of the contract under ss 444D and 444G'.

terms that bind all creditors of the company 'so far as concerns claims arising on or before the day specified in the deed under paragraph 444A(4)(i)'. Those obligations stem from the combined operation of the deed of company arrangement and the law, not from any contractual bargain between the persons bound, and are imposed on all creditors, not just those who voted in favour of any composition or moratorium reflected in the deed of company arrangement.

It is difficult to accept why the binding nature of the deed should be seen as contractual in the sense of persons being legally bound by an agreement, given that the persons bound are bound because of the legislation and irrespective of their agreement.<sup>52</sup>

The reference to the contractual nature of the deed in *MYT Engineering*<sup>53</sup> has resulted in some difficulties. In *Surber v Lean*,<sup>54</sup> the court stated that the administrator must grant his or her consent for any variation in a deed where such variation was approved by the creditors. This presents the administrator with a power of veto over the decisions of the creditors. This does not reflect the underlying nature of the scheme in Part 5.3A. It is for the creditors to decide their own fate in terms of the deed. Clearly the administrator should have the power to approach the court but this is something less than what was granted to the administrator in this case. It has been suggested<sup>55</sup> that because of the contractual nature of the deed, it may not restrict rights of appeal. In *Derwinto v Lewis*, Austin J stated:

In my view the correct construction of these provisions is that the statutory right of appeal under s 1321 cannot be restricted by a provision of the deed. Section 444D, according to which creditors are bound by the deed, must be read subject to other provisions of the Act. The Court ought not to adopt a

<sup>52</sup> See here also *Sutherland v Rahme Enterprises* [2003] NSWSC 673 [13] where Barrett J comments that:

Under s 444D of the Corporations Act, a deed of company arrangement binds all creditors so far as concerns claims arising on or before the day specified in the deed pursuant to s 444A (4) (i), in this case 19 December 2002. Under s 444G, a deed of company arrangement also binds the company, its officers and members and the deed's administrator. The deed's binding force, as regards all such persons, is wholly statutory and derives from the two acts of execution which, by s 444B (6), cause a particular instrument to be a deed of company arrangement. These matters are discussed and confirmed in the High Court's decision in *MYT Engineering Pty Ltd v Mulcon Pty Ltd* (1999) 195 CLR 636. The binding force of a deed of company arrangement, being wholly statutory, is therefore of conceptually the same kind as the binding force of a scheme of arrangement under s 411.

<sup>53</sup> *MYT Engineering Pty Ltd v Mulcon Pty Ltd* [1999] HCA 34.

<sup>54</sup> (2000) 36 ACSR 176.

<sup>55</sup> Ford, Austin and Ramsay, *Ford's Principles of Corporations Law* above n 13 [26 270].

construction that would permit a right of appeal to be restricted, unless the relevant provisions are clearly intended to have that effect.<sup>56</sup>

It is not obvious why this issue should be regarded as following from the contractual nature of the deed. Surely it is as a result of the deed being part of a statutory scheme. So in reading the statute as a whole there is no basis for allowing one part to be read as limiting another provision without explicit wording indicating that that is so.

Therefore, as a result of the *MYT Engineering* decision, the deed is seen as a document under which the parties are bound because of their agreement or if they do not agree are bound because of statutory provisions. This seems a rather unnecessary complication in respect of the procedure. Whether an unsecured creditor agrees or does not agree to the deed is essentially irrelevant once the deed has been approved in accordance with the legislative requirements.<sup>57</sup> In the case of a secured creditor or owner or lessor of property, they will be bound only if they vote in favour of the deed or the court orders them to be so bound.<sup>58</sup> These can be seen simply as the impact of statutory provisions giving effect to the statutory scheme without the results that emphasising the contractual nature of the deed brings. Where a person has guaranteed a debt of the company and the company has entered into a deed of company arrangement, it will generally be the case<sup>59</sup> that the guarantor is liable under the guarantee. Thus, in relation to the impact of the deed on a guarantee it has been said that:

The scheme (sic) of arrangement prevented the respondent from exercising the procedural rights stipulated in [the deed], save that legal proceedings and enforcement process could still be brought with leave of the court. But it did not render debts that had become due and payable no longer due and payable.<sup>60</sup>

In essence, creditors' enforcement rights were converted by the scheme into rights to prove and to participate in the Pooled Fund.

This again indicates the legislative basis of the deed as it converts rights from those pre-existing under the contract to a right to participate in the returns under the deed. The development of these rights is surely founded in the legislative provisions and not in the agreement between the parties.

<sup>56</sup> *Derwinto v Lewis* [2002] NSWSC 731 [44].

<sup>57</sup> Section 444D(1).

<sup>58</sup> Sections 444D and 444F.

<sup>59</sup> The exception being if the guarantee exempts the liability in the circumstances.

<sup>60</sup> *Helou v Mulligan Pty Limited* [2003] NSWCA 92 [27] to [28].

**Lack of detail about the deed**

The emphasis in the legislation on flexibility was argued as the basis for Part 5.3A not prescribing the matters that a deed must contain. As a result the deed has been left to develop its own framework based upon the ingenuity of the drafters. There are however some broad parameters as well as a set of default provisions. This approach is a practical one but the consequences of having inadequate coverage in the legislation dealing with the deed can be illustrated by *Dean Willcocks v ACG Engineering Pty Ltd*.<sup>61</sup> In that case the company went into a deed of company arrangement but the control of the company was placed with the board. The administrator of the deed received an amount of money which under the deed was to be distributed pro-rata amongst the deed creditors. Before this could be done, the company became insolvent again and the directors passed a resolution to that effect. Under the deed this automatically placed the company in liquidation with the deed administrator becoming the liquidator. The liquidator applied to the court for directions as to what should be done with the funds received. Specifically, the issue was whether the amounts should be held exclusively for the deed creditors or whether it was an asset of the company such that it should be distributed amongst all creditors, both those who were creditors at the beginning of the voluntary administration and those who became creditors later before the liquidation. Austin J held in this case that the fund was held on trust because the terms of the deed applied to deed creditors only and hence the post deed creditors were not entitled to access. He said:

As a matter of the plain and natural meaning of the DCA [the] words seem to me to create a trust of the amount of the Administration Fund held in the Administration Account for the benefit of, inter alios, the Participating Creditors identified in clause 5.5 (d). The trust arises because clause 5.4(a) imposes on the Deed Administrator an obligation to 'hold' the Administration Fund in accordance with the terms of the DCA, and clause 5.5(d) requires that the balance after certain deductions be distributed pro rata to the Participating Creditors. Where property is vested in a person subject to a legally enforceable obligation to 'hold' that property so as to make a distribution to someone else, the natural conclusion, under our law, is that a trust of that property has been created. As I have said, I regard the conclusion that there is a trust as a conclusion flowing from the wording of the DCA. There is very little in the Corporations Act to assist in the construction.<sup>62</sup>

<sup>61</sup> *Dean-Willcocks v ACG Engineering* [2003] NSWSC 353.

<sup>62</sup> *Dean-Willcocks v ACG Engineering* [2003] NSWSC 353 [15] to [16].

The lack of assistance from the *Act's* wording is noteworthy of itself, however the significant impact of this decision is that the wording in the deed appears to be the determining factor as to where the funds would go when the company becomes insolvent when it is under a deed of company arrangement.

Austin J distinguished this situation from an earlier decision of Santow J in *Re Spargold Enterprises Pty Ltd (subject to deed of company arrangement); Ex parte McDonald*<sup>63</sup> where the duty was explained as follows:

Drawing on the analogy of a voluntary liquidator, which I consider is apposite also to a DCA administrator, a voluntary liquidator has a duty to act impartially as between creditors...Such a voluntary liquidator is not a trustee but is in a fiduciary position.<sup>64</sup>

Hence it was held in that case that the court could order the deed to be terminated because of the prospect of there being nothing left for post deed creditors. Santow J was prepared to apply s 447E to such a case stating that:

There is nothing in that subsection to suggest that the court would only intervene where there is prejudice to pre-DCA creditors and would not intervene where the prejudice is to post-DCA creditors. To the contrary, if as appears 'creditors' include both categories, it would be surprising indeed that the court has this statutory power to intervene by reason of prejudice (here) to post-DCA creditors yet the administrator would have no duty of impartiality towards them but rather a duty owed exclusively to pre-DCA creditors; a duty leading the DCA administrator to distribute only to them, leaving post-DCA creditors lamenting.<sup>65</sup>

The basis for not following *Re Spargold* was that there was no provision in the deed in that situation that created a trust for the pre existing creditors.<sup>66</sup>

There are a number of unfortunate consequences of the approach of the court in the *ACG Engineering* case. First, it would follow that it is critical that creditors covered by the deed examine the wording of the deed to ensure that a trust has been created for the funds. This would protect them to that extent in the event of a subsequent liquidation. Again this

<sup>63</sup> (1999) 32 ACSR 363.

<sup>64</sup> *Re Spargold Enterprises Pty Ltd (subject to a deed of company arrangement); Ex parte McDonald* (1999) 32 ACSR 363 365.

<sup>65</sup> *Re Spargold Enterprises Pty Ltd (subject to a deed of company arrangement); Ex parte McDonald* (1999) 32 ACSR 363 364-5.

<sup>66</sup> With respect to Austin J it is not entirely clear how his Honour knew this was correct in the *Spargold Enterprises* case.

emphasises the point made above as to the importance to creditors of having the exact wording of the deed prior to approving it at the meeting under s 439A. On the other hand a post deed creditor might need to determine if it is wise to provide credit to the company in these circumstances. From a policy perspective it may be questioned whether the issue is not something to be covered in the legislation. This is because a post deed creditor is at the mercy of the drafter of the deed in relation to what assets may be available. It would be preferable if the uncertainty were reduced if it is desired that creditors have confidence in the company that is subject to the deed. In many cases a company will only be able to continue in business with the support of creditors whose debts come into existence after the deed is entered into. If the funds available to these creditors may be reduced it will inhibit the major aim of Part 5.3A to encourage the continuity of the business.

The approach of Austin J stems from, as he put it, a lack of assistance from the legislation. The legislation fails to set out sufficiently how the deed and the various stakeholders' rights are to operate once the company is no longer in administration. A clearer statement of the application of the principle laid down in s 447E would assist in this specific instance.

#### **Setting aside the deed based on what was done in the voluntary administration**

It is necessary to look briefly at the basis on which the deed may be set aside because the deed is drafted as part of the administration procedure.<sup>67</sup> Several of the grounds upon which the court may terminate the deed are based upon actions taken during the voluntary administration process. The basis of the setting aside of the deed under s 445D<sup>68</sup> includes where 'there was misleading information or a material omission in statements or reports to creditors';<sup>69</sup> or 'the deed is oppressive or unfairly prejudicial to or unfairly discriminatory against one or more creditors or contrary to the interests of the creditors as a whole.'<sup>70</sup>

Each of these grounds is founded in the behaviour of the administrator during the administration or the drafting of the deed that is done during the administration. In addition, the court may void a deed based on a

<sup>67</sup> This article does not cover detailed aspects of the operation of the deed of company arrangement.

<sup>68</sup> Specifically under s 445D (1)(a), (b), (c) and (f).

<sup>69</sup> Ford, Austin, and Ramsay, *Ford's Principles Of Corporations Law* above n 13 [26 380].

<sup>70</sup> This is covered in s 445D(1)(f).



failure of the deed to have been entered into in 'accordance with this Part' under s 445G.

The requirement for the creditors to be informed is fundamental to the Part 5.3A process.<sup>71</sup> This ground was suggested by the *Harmer Report* as a factor that goes 'to the heart of the effective operation of the legislation'.<sup>72</sup> The point to be made here is that a decision as to what information is to be presented to creditors may impact on the survival of the deed. Detailed consideration of the type of information and the circumstances in which that information should be provided has been given in a number of cases.<sup>73</sup> These cases demonstrate that the courts are willing to recognise the time limits imposed on administrators and the need to report to creditors in a timely fashion.

As was pointed out by Austin J in *DCT v Portinex*,<sup>74</sup> the *Harmer Report* did not suggest that the court be entitled to set aside the deed on the basis of oppression or unfair prejudice. It was inserted by the legislature without any statement as to the policy basis for it. This provision was inserted in order to protect against the inappropriate use of the majority power given that voting is not conducted by classes of creditors.<sup>75</sup>

The meaning of an oppressive or unfairly discriminatory deed was discussed in *Sydney Land Corp Pty Ltd v Kalon Pty Ltd*.<sup>76</sup> Young J held that:

when one is looking at what is oppressive or unfairly prejudicial under s 445D, one looks at it in the background of the general right of a creditor to be paid or to wind the company up, or to have the company administered by the administrator under the deed in a way which keeps the company's business going and will see the creditor paid something out of the property

<sup>71</sup> This is because the creditors must be informed in order to make a proper decision.

<sup>72</sup> Australian Law Reform Commission, *General Insolvency Inquiry* AGPS, above n 7 [123].

<sup>73</sup> See *Hagenvale Pty Ltd v Depela Pty Ltd* (1995) 17 ACSR 139; *Deputy Commissioner of Taxation v Comcorp Australia Ltd* (1996) 21 ACSR 590; *M & S Butler Investments Pty Ltd v Granny May's Franchising Pty Ltd* (1997) 24 ACSR 695; *Deputy Federal Commissioner of Taxation v Pddam Pty Ltd* (1996) 14 ACLC 659; *Velkovski v Ryan* (1996) 19 ACSR 514; *Bathurst City Council v Event Management Specialist Pty Ltd (admin apptd)* (2001) 36 ACSR 732.

<sup>74</sup> *DCT v Portinex/Silindale/Dalvale* [2000] NSWSC 99.

<sup>75</sup> The pragmatic approach to decision making that pervades the procedure is evident in the manner that voting is structured as it is a simple majority and there are no classes. In addition the remedy for disgruntled creditors is limited to applying to the court after the decision is made and then only limited grounds: see s445D and ss600A-600C.

<sup>76</sup> (1997) 26 ACSR 427 and approved of on appeal *Kalon Pty Ltd v Sydney Land Corp Pty Ltd [No2]* (1998) 26 ACSR 593.

of the company. If a scheme in a deed deviates from that, then the creditor is more easily able to say that it is operating oppressively, than otherwise.<sup>77</sup>

It is difficult to see why the creditor is entitled to have the company administered in a way that keeps the company going, as the objects of the Part do not require that as such.<sup>78</sup> Even if the continuity of the business were the only justification for a deed, it is not apparent how this necessarily relates to oppression or unfairly prejudicial conduct as it does not imply unfairness. His Honour concluded by outlining the relevant factors to take into account:

I then do have to consider, because all the authorities say that it is a relevant matter, the comparable position of the plaintiff on a winding up, compared with its position under the deed. I do not think, on the balance of probabilities, that the plaintiff has shown that it is worse off under the scheme than it would have been in a winding up. I think the evidence really only goes to show that it is fairly close to line ball one way or the other. In each case there are various imponderables. However, it seems to me that one must add in other facts, namely

- (a) that the plaintiff, and indeed the other creditors, are not likely to be better off under the deed;
- (b) that there is a collateral benefit to the shareholders in APH;
- (c) that the plaintiff has to continue to have a commercial relationship with people in whom it has no confidence;
- (d) that the assets are shares and the subsidiaries are effectively removed from the control of the administrator; and
- (e) that the claim of the creditor is really not against the administrator any more, but against APH direct.<sup>79</sup>

There are a number of matters that arise from this statement. One is that the basis of the comparison with the winding up alternative has a sound policy basis. It would be unfortunate if the only reason why the comparison was made were because 'authorities say it is a relevant matter'. It seems quite contradictory that the creditor had not shown that it was worse off under the deed than under a winding up yet in paragraph (a) it is said that the creditors are 'not likely to be better off under the deed'. More importantly, the fact that there are collateral benefits to the shareholders again does not explain why that makes the deed oppressive

<sup>77</sup> (1997) 26 ACSR 427, 430.

<sup>78</sup> Rather s 435A states that if continuity of the company's business is not possible, it is sufficient that there be a better return than that which would be available in an immediate winding up.

<sup>79</sup> (1997) 26 ACSR 427, 432.

or unfairly prejudicial to the *creditor*. The basis of the Part 5.3A procedure is to move away from the focus on selling up assets in a winding up to give a conservative return. The simple statement that there is a benefit to one stakeholder does not of itself imply oppression to others. Again, the statements that claims cannot be made against the administrator or that the assets are no longer under the control of the administrator do not of themselves suggest unfairness as in any workout it would be expected that assets be handed back. The legislation makes a point of ending the administrator's liability for the debts incurred when the voluntary administration ceases. The factors raised by Young J were accepted by the Court of Appeal.<sup>80</sup>

**Points of comparison when evaluating the deed:**

The approval of the deed requires that the creditors evaluate it. The obvious comparison is with the position in a winding up. This is what the Act specifically requires in s 439A(4). However is it necessary to make comparison not only with winding up but some other deed with different provisions? The difficulty of this approach is obvious in that it would seem possible to postulate an array of situations with which comparisons would need to be drawn. Nevertheless this appears to be the approach in some cases. In *Khoury v Zambena Pty Limited*, Davies AJA proposes this as appropriate:

The trial Judge agreed with the submission stating, 'if one analyses the position under the deed and the position under a liquidation, the position of the plaintiffs is not materially different; indeed, it may be that so far as the order for costs is concerned, they obtain more under the deed than they would in a liquidation.' However, this approach misses the point. The creditors were not limited in their options to either approving the deed put forward or voting for liquidation: see s 439C. It was the terms of the particular scheme that prejudiced Capitol and Harry Sarkis and his family, because its effect was to operate in a discriminatory manner upon those debts. The interests of those creditors were prejudiced to an extent that was unreasonable because the scheme discriminated. It was not fair to all creditors. Had the related creditors been dealt with in a similar way in which the debts due to Capitol, Harry Sarkis, his wife and his parents were dealt with, then, although there may still have been prejudice because the scheme would have precluded recovery of the debts, nevertheless, the prejudice would not have been unreasonable. The scheme would then have applied equally to creditors who voted in favour of the scheme, including the related creditors, as it did to those who voted against the scheme.<sup>81</sup>

<sup>80</sup> *Kalon Pty Ltd v Sydney Land Corp Pty Ltd [No2]* (1998) 26 ACSR 593 at 598-599.

<sup>81</sup> [1999] NSWCA 402 at [109] (Davies AJA).

Also in the same case:

Secondly, the Court should not encourage the notion that 'anything goes' provided only that that a deed of company arrangement provides some benefit for dissatisfied creditors. Commonly, companies proposing deeds of company arrangement are insolvent and what is proposed involves some benefit for unsecured creditors. That cannot be permitted to be used by those who promote such proposals as a critical factor which warrants the Court's refusal to terminate or declare void such deeds, especially when different groups of unsecured creditors are treated differently.<sup>82</sup>

This position has also been taken by Austin J in *DCT v Portinex*:

The issue seems to be whether one or more creditors has been unfairly prejudiced by the conduct, compared with the position they would have been likely to occupy if the conduct had not occurred. The latter position may have been that of creditors in a winding up, but it may be reasonable to conclude on the facts that some other outcome would have been reached.<sup>83</sup>

The courts are justified in taking into account the various factors that may have been relevant to the creditors' decision and where it is clear that relevant matters were not revealed, to terminate the deed. However, it seems difficult for the court to posit a number of other scenarios that may have happened if another proposal was put forward. The estimation of the returns from a winding up compared to those under the deed is part of the fundamental reporting that the administrator undertakes. As explained above, the legislation is vague as to how the deed is developed and whether there is room for alternative proposals to be fully considered. Therefore it will often be a speculative venture for a court to decide how creditors may have voted or if their financial position may have been 'better' if another avenue was taken. Such speculation is inappropriate in a procedure designed to be voluntary and based upon a majority of creditors deciding the fate of their claims against the company.

### **Legal issues relating to the transition to winding up**

As part of the *Harmer Report* recommendations<sup>84</sup> the legislation provides for the ready transition to winding up through Division 12 of Part 5.3A. The conversion to a winding up may result from a decision of the meeting of creditors under s 439A.<sup>85</sup> It may also result without the intention of the

<sup>82</sup> *Khoury v Zambena Pty Limited* [1999] NSWCA 402 [80] (Fitzgerald JA).

<sup>83</sup> *DCT v Portinex/Silindale/Dalvale* (2000) 34 ACSR 391; [2000] NSWSC 99.

<sup>84</sup> Australian Law Reform Commission *Report No. 45 General Insolvency Inquiry* AGPS, 1988, at para [56].

<sup>85</sup> Also by way of a meeting under s 445F where creditors resolve to terminate the deed as a result of a meeting called to consider a variation to the deed or termination of it.

creditors being manifested in that way.<sup>86</sup> However where a winding up was already in place prior to the winding up, this choice is not available to the creditors.<sup>87</sup>

One fundamental issue arising is the nature of the winding up resulting from s 446A. Clearly the winding up is one always connected to the voluntary administration. But how far should this go? In *Gibbons v Liberty One Ltd (in liq)* Austin J suggested that:

It is noticeable that s 446A does not adopt the regime for creditors' voluntary winding up in an absolute or unrestricted fashion...the winding up emerging from the application of s 446A is made to fit into the creditors' voluntary winding up regime only by the operation of deeming provisions...the deeming provisions... 'borrow' Part 5.5 and adapt it to circumstances arising out of a voluntary administration.<sup>88</sup>

In *Re One-Tel*, it would seem that the approach was taken one step further when Barrett J made the following comment:

The species of winding up brought about by s 446A may thus be regarded as a product of that section itself, rather than of the events which cause the provisions with respect to creditors' voluntary winding up to apply and operate of their own force.. all those steps are lacking and, to the extent that their existence is integral to the initiation and conduct of the system of insolvent administration disregarded creditors' voluntary winding up, they are either dispensed with altogether or in some way deemed to exist.<sup>89</sup>

By causing s 482 to apply (albeit in a modified way) in relation to the winding up as if it were a winding up by the court, s 446A imports its own method of effecting a stay or termination of the winding up, being a method that is not available in relation to a creditors' voluntary winding up brought about by the steps with which s 446A dispenses. Once activated, s 446A becomes the source of a winding up regime different from the regime that comes to apply by the taking of the steps dispensed with. One may therefore properly regard s 446A as having an ongoing and sustaining operation for the duration of the winding up regime it has created. It is not, as it were, exhausted and spent once the winding up regime is in place.

<sup>86</sup> This may be a result of the company's failure to execute a deed within the required period (s 446A(1)(b) or from the operation of reg 5.3A.07 for example where the court terminates a deed under s 445D: s 446B(1).

<sup>87</sup> See above n 20

<sup>88</sup> [2002] NSWSC 274

<sup>89</sup> [2002] NSWSC 1081 {need pinpoint}

The reliance placed upon s 482 here as being an indication that the winding up to be differentiated from creditors' voluntary winding up is, with respect, arguable. It would appear that s 482 is generally seen as being applicable in a voluntary winding up because of s 511(1).<sup>90</sup> Therefore it seems difficult to see the relevance of the reference to s 482 in s 446A to the argument that the section creates its own winding up.

The implication of the case law is that there is now a third type of winding up. There is winding up by the court, voluntary winding up as effected through Part 5.5, and winding up as a result of s 446A. It is not entirely clear that the intention to create a third means of winding up was what the legislature envisaged when Part 5.3A was introduced.<sup>91</sup> But in addition there are practical implications. Specifically, because of the ongoing impact of s 446A,<sup>92</sup> s 447A may be utilised in a winding up that is the outcome of a voluntary administration. For example in *Gibbons v LibertyOne Ltd (in liq)*<sup>93</sup> the liquidator applied for relief from the requirement to hold a meeting under s 508. The application centred upon the issue as to whether s 447A could be applied.<sup>94</sup> In the course of the judgment, Austin J stated that it was:

[c]ontended s 447A cannot be used to implement a regime different from the regime contemplated by another part of the Corporations Act, in this case the regime for a creditors' voluntary administration under Part 5.5 [it was] submitted that to modify the operation of s 508 (1) (b) would be to give s 447A an operation going beyond Part 5.3A, and operation offensive to the specific imperative of s 508 (1) (b). He said that s 508 is a mandatory

<sup>90</sup> See Keay, *McPherson The Law of Company Liquidation* (4<sup>th</sup> ed 1999) 661 where it is stated that 'There can be no doubt that s 482 of the Corporations Law applies to voluntary winding up, as well as compulsory winding up' This was based upon the cases cited therein as well as the wording of the section which states that it may be applied at any time during the winding up of the company as well as the fact that the section is under the heading the general powers of the court in Division 3 of Part 5.4B

<sup>91</sup> There is little in the Explanatory Memorandum to the *Corporate Law Reform Bill 1992* that indicates the nature of the winding up but it does deal with transition to winding up, see para 772. In addition the discussion above regarding the *Harmer Report* indicated that a court ordered winding up was envisaged.

<sup>92</sup> See the comments of Barrett J in *Re One.Tel Ltd* [2002] NSWSC 1081 at [56]

<sup>93</sup> [2002] NSWSC 274 ; see also *Re Walker & anor* [2002] NSWSC 705 at [19]; *re Love (as liquidator of ACN 077 368 257 Limited)* [2003] NSWSC 58 and *re Love (as liquidator of ACN 077 368 257 Limited)* [2003] NSWSC 149

<sup>94</sup> This utilisation of s 447A whilst the company is being wound up may take its operation further than is suggested by some of the statements in *Australasian Memory Pty Ltd v Brien* [2000] HCA 30. There the court emphasised the relation back to the administration but added that the ability to reinstate an administration may have ended once the company enters into liquidation (see [28]). It is one thing to have the rectification of a liquidation where the parties had proceeded on that basis it is taking the legislation further to apply s 447A to alter how the liquidation may operate

provision in specific terms, which should not be supplemented or qualified by a general provision such as s 447A. He relied upon the principle in *David Grant & Co Pty Ltd v Westpac Banking Corporation* (1995) 184 CLR 265.<sup>95</sup>

These submissions misconceive the nature of the plaintiff's application. The plaintiff does not seek to modify a mandatory statutory provision applicable to a creditors' voluntary winding up. Rather, the plaintiff seeks to qualify the extent to which a deeming provision of Part 5.3A operates, in circumstances where the winding up falls within Part 5.5 not because a creditors' voluntary winding up has been selected in the normal fashion, but because the creditors have taken a decision of another kind in the context of voluntary administration.

The outcome of this way of viewing the liquidation arising from a voluntary administration creates the possibility of parties utilising the procedure for the purposes of gaining a more flexible liquidation. If a company in insolvent circumstances were considering a creditors' voluntary liquidation it may well be advised to proceed with a voluntary administration because of the ability to use s 447A. Such flexibility as s 447A produces is not evident in Part 5.5.

### **Analysing outcomes from a theoretical perspective**

One of the elements lacking in the literature on Australian insolvency law is a strong theoretical framework within which to evaluate the law.<sup>96</sup> Whilst other theory may be used to evaluate insolvency legislation, one model that has been used extensively in the United States is the economics and law approach. It is interesting to place the Australian legislation under the scrutiny of this approach as it differs to the American approach to corporate rescue in many ways. The nature of the formulation of a deed (or plan) has been analysed extensively in the law and economics literature in the United States. Roe has suggested that

Three ... mechanisms [can]...accomplish a corporate reorganisation:

- (1) a *bargain* among creditors and stockholders;
- (2) litigation in which the court imposes an *administered* solution and capital structure; and

<sup>95</sup> *Gibbons v LibertyOne Ltd (in liq)* [2002] NSWSC 274 at [47]–[49].

<sup>96</sup> There have been some exceptions to this but for the most part there is little debate from within any particular theoretical model. Rather the debate tends to proceed either without considering any framework or on broad contradictory aims that are not useful as a means of evaluation and focuses in on technical issues.

(3) use of the market.<sup>97</sup>

The approach favoured by most in the economics and law literature is the use of the market. By this they generally encompass some form of auction or sale of the firm as a going concern at the time of insolvency.<sup>98</sup> The argument is based on the concept that a firm's assets are properly valued by the market and that this return should be paid out to the creditors to recover their funds. In certain circumstances that will be possible under the Australian provisions as they allow for the administrator to dispose of the whole or part of the company's business.<sup>99</sup> However, if that were the only option for the administrator without any other limitation, the sale that would take place will have to consider the power of creditors or others to apply for the winding up.<sup>100</sup> A lack of information about many smaller firms raises doubts as to whether they could be properly valued in a market anyway. The sale in these circumstances is likely to be strategically manipulated by various stakeholders even though that is what the advocates of the system seek to avoid.<sup>101</sup> The costs of holding a sale in these circumstances might also be considerable<sup>102</sup> and, whilst there is no way of judging if the costs are lower in the current managed procedure as in Australia, there is no evidence that they are higher either.<sup>103</sup>

<sup>97</sup> M Roe, *Corporate Reorganization and Bankruptcy: Legal and Financial Materials* (2000) 579.

<sup>98</sup> For example D Baird, 'The Uneasy Case for Corporate reorganization' (1986) 15 *Journal of Legal Studies* 127; L Bebchuck, 'A New Approach to Corporate Reorganizations' (1988) 101 *Harvard Law Review* 775; M Roe, *Corporate Reorganization and Bankruptcy: Legal and Financial Materials* (2000) 578; B Adler B, 'Bankruptcy and Risk Allocation' (1992) 77 *Cornell Law Review* 439.

<sup>99</sup> Section 437A and *Brash Holdings Ltd v Shafir* (1994) 12 ACLC 619.

<sup>100</sup> Some parties may achieve as much in the immediate winding up as they do from the restructure so that they will have little incentive to allow a reorganisation: see M White, 'The Corporate Bankruptcy Decision' in J Bhandari and L Weiss (eds), *Corporate Bankruptcy- Economic and Legal Perspectives* (1996) 207.

<sup>101</sup> This could be done through matters such as timing extent of advertising and grouping of assets to be sold etc.

<sup>102</sup> It has been estimated that the direct costs of bankruptcy in the United States are about 3% of the firm's assets: see L Weiss, 'Direct costs and violation of priority of claims' in J Bhandari and L Weiss (eds), *Corporate Bankruptcy- Economic and Legal Perspectives* (1996) 260. There are no corresponding figures in Australia that the author is aware of.

<sup>103</sup> F Easterbrook, 'Is Corporate Bankruptcy Efficient?' in J Bhandari and L Weiss (eds), *Corporate bankruptcy- Economic and legal perspectives* (1996) at 408. This article presents a strong intuitive argument that the costs of the auction may be higher than the current US system in Chapter 11.



**What is the means of achieving reorganisation in Part 5.3A?**

The legislation in the United States is seen as having a period of bargaining followed by a court imposed reorganisation. The Australian system can be seen in this context as really one of bargain amongst the creditors. In general, because the legislation allows the drafting of a deed with few limitations, the creditors as a group may be seen to be in a position to bargain as they might do without legislation as regards matters such as the role of the administrator in a deed, as well as their return compared to other creditors. The lack of legislation governing the deed's operation was contrasted above with the voluntary administration which is more closely regulated by the *Corporations Act*.<sup>104</sup> This is reflective then of a negotiated solution to the company's insolvency that is agreed by the parties affected; for example, in relation to the role of the administrator under the deed. The role here can be one that involves day to day control of the company or it could simply be one of checking that the deed is complied with and day to day running of the company returned to the directors. The creditors can evaluate the risk of insufficient supervision and the attendant costs with the out of pocket costs of greater control by the independent administrator.

However, this analysis must be limited somewhat by the practical realities of the detailed legislation. The unsecured creditors are, because of the voting method, bound by majority votes or perhaps by the casting vote of the administrator when a meeting is held under s 439A. The courts may see that the nature of the deed is contractual but the bottom line is that all unsecured creditors are bound by the deed even if they did not agree to it. In addition, the procedure of the development of the deed is such that there is a short time period for the deed to be negotiated. The legislation lacks clarity as to who should have input into the formulating the deed. Thus the likelihood is that the deed may be essentially created by the administrator albeit with the consideration that it must be passed at the second creditors' meeting.

**Influence of management in the Australian procedure**

The Australian procedure does overcome the bias towards management and shareholders that is found in some other jurisdictions. The basis of much criticism of the Chapter 11 procedure in the United States rests on the power of the management.<sup>105</sup> This was explained by White<sup>106</sup> as being based upon such matters as:

<sup>104</sup> For example in Division 3 setting out the powers of the administrator.

<sup>105</sup> Perhaps in coalition with last minute financiers and shareholders.

- the exclusive right to propose a plan during the first six months;
- the threat to transfer a bankruptcy filing under Chapter 11 to a liquidation where the returns to unsecured creditors are likely to be diminished;
- the debtor in possession basis for the Chapter 11 procedure so that the management has control of the assets of the company during the period; and
- the focus of management on the procedure can be contrasted with the diverse interests of the creditors who may lack the incentive to form interest groups.

In the Australian system, a number of these aspects are not present. The management does not control the corporation during the administration. There is no exclusivity on the proposal for a deed and the administrator should be the real controller of the situation. So what are the incentives in the Australian procedure on this type of analysis? It would seem likely that the role of the administrator and other aspects of the deed are perhaps going to foremost reflect the interest of the administrator as he or she has the greatest degree of control. This raises the important facet of the Australian voluntary administration regime that the administrator's interests must reflect those of the creditors.

**Should the court set aside a deed on the basis of comparison with other scenarios?**

In analysing when the courts have set aside deeds on the basis of unfair prejudice, one argument has been that it is not enough to say that the return is better than under a winding up. This argument, that the deed as presented to creditors should not be considered the only option to compare with winding up, demonstrates the difficulty when the criteria for judging a proper deed becomes vague and unclear. Much of the concern of the courts seems to be that there is imbalance in the return to various groups of creditors who would in a winding up rank pro rata. The pro rata return to creditors in winding up (which is also described as the *pari passu* principle) has been explained as the 'most fundamental principle of insolvency law'.<sup>107</sup> However the treatment of the principle in the context of a corporate rescue procedure is open to question.<sup>108</sup> Goode argues that:

<sup>106</sup> White, 'The Corporate Bankruptcy Decision' above n 99 218.

<sup>107</sup> R M Goode, *Principles of Corporate Insolvency Law* (1997) 141.

<sup>108</sup> The principle was rejected by the *CASAC Report* as being relevant to a deed of company arrangement: see Legal Committee of the Companies and Securities

Since the *pari passu* principle is concerned to ensure an equitable distribution of the company's estate among its creditors, it is confined to liquidation, for that is the only collective insolvency process which involves the distribution of assets among the general body of creditors.<sup>109</sup>

The economic basis for ignoring the *pari passu* principle lies in the nature of the deed itself. The question that the courts need to ask is whether the deed can make some creditors better off without making the other creditors worse off. The focus in the procedure needs to be on improving the return to creditors but this does not exclude the possibility of improving returns to other stakeholders<sup>110</sup> at the same time. A successful corporate rescue suggests that the benefits are likely to be gained by the shareholders or management group as well as the creditors. The issue of who gains the most from any surplus of rescue over winding up is one that is better left to the negotiation of the parties. The fact that some creditors may receive less than others does not of itself justify interference in the distribution of any reorganisation surplus.

#### **What is the position of secured creditors and owners of property?**

The interests of the secured creditors and the owners or lessors of property should also be accurately considered in the deed as they have the option of staying outside of it.<sup>111</sup> They will only be bound to terms that they specifically agree to. As was indicated above their position is diminished to the extent that the administration is prolonged but the Australian procedure is much shorter than the open ended North American models. Their position is much stronger than most of the unsecured creditors. This is consistent with a contractual basis for the deed and in this sense it will represent a negotiated outcome.

#### **Information about the content of the deed**

The development of a deed that reflects creditors' wishes will depend to some extent on the skill of the administrator. Information asymmetry is an important reason for the appointment of an administrator and therefore the need to provide information to the creditors is fundamental. A starting point for this is for the administrator to provide adequate information about the company's position and its prospects. The basis of any decision by the creditors though must be information about the terms of the deed

Advisory Committee, *Corporate Voluntary Administration Final Report* (1998) [5.38] to [5.45].

<sup>109</sup> Goode, *Principles of Corporate Insolvency Law* above n 106 143.

<sup>110</sup> Such as shareholders.

<sup>111</sup> Subject to any court order under s 444F.

itself. Therefore, the fact that there is little in the *Act* that compels the deed to be available before the meeting of creditors is a failure to ensure the integrity of the procedure. What the economic model suggests is that the creditors will agree to be bound to a deed that allows for improved returns over liquidation and they will have confidence that the plan is valid because of the independence of the administrator. Creditors may of course trust the administrator to develop a deed that reflects their wishes because of the administrator's independence and professional standing. However, as noted above, the criticism of this aspect of the procedure shows that some change to the legislation may assist in engendering confidence in the procedure plus improve the decision making of the creditors.

#### **The implication of the winding up alternative**

The ability to move from voluntary administration to liquidation was considered in the *Harmer Report* to be an important improvement in our insolvency legislation. Generally it is apparent that the ability of creditors to select liquidation as an option at the meeting delivers a powerful incentive for management and other related stakeholders to develop a deed that provides benefits to at least the majority of creditors. Further, the option of liquidation enables a quick resolution of the insolvency if a deed is not supported.

It was recommended that creditors' voluntary liquidation procedures be abandoned.<sup>112</sup> This was not adopted but subsequently the *CASAC Report* again recommended that it be removed.<sup>113</sup> There are sound policy reasons for doing so. It was shown above how the courts have come to recognise a liquidation that follows a winding up as being a different type of liquidation and it is not a case of applying the provisions of the creditors' voluntary winding up in total. The existence of the three types of winding up for an insolvent corporation in the legislation creates an opportunity for strategic behaviour by stakeholders. Reducing the opportunity to engage in this behaviour is beneficial to all because it will reduce the

<sup>112</sup> Australian Law Reform Commission, *General Insolvency Inquiry* AGPS, above n 7[57].

<sup>113</sup> Legal Committee of the Companies and Securities Advisory Committee, *Corporate Voluntary Administration Final Report* (1998) [8.70] to [8.78]. Note however that this was rejected by a parliamentary committee see, Parliamentary Joint Committee on Corporations and Financial Services, Parliament of Australia, *Corporate Insolvency Laws: a Stocktake* (2004).

costs of borrowing.<sup>114</sup> Some of the arguments against the abolition of the creditors' voluntary winding up rest on the assumed greater costs associated with the voluntary administration.<sup>115</sup> However, it is by no means certain that the voluntary administration followed by a liquidation is a more expensive option than the current voluntary liquidation procedure where the company is insolvent. There is no data on the relative costs of the various procedures and an intuitive argument may be made that the voluntary administration does not add to the costs of a liquidation.

### Conclusions

This article has examined the outcomes of the voluntary administration process, not to provide a detailed commentary on all of the matters relevant to the options available, but to analyse how this impacts upon the voluntary administration process itself. The voluntary administration procedure is limited and shaped by the nature of the results or outcomes that flow from it. It has been shown that not all of the *Harmer Report's* suggestions were taken up by the legislation in the area of winding up in particular.

The legislation has proceeded on the basis that there should be minimal control by way of direction with respect to deeds of company arrangement. The basis of this being that the creditors should be left to respond to particular circumstances in the manner appropriate to achieve the best outcome. This has resulted in a general lack of clarity about the nature of the deed of company arrangement and how it should operate. It has been left to the courts to fill in what is required and what should be the parameters of the procedure. Given the anticipated law reform in the area of corporate insolvency this is one area that is in need of review.

Areas such as who develops the deed, what comparisons need to be made by the administrator when making his or her report and what powers exist in relation to not assenting to the deed are all matters that have been left unclear in the legislation. As the above argument suggests these could be covered in the legislation to improve its effectiveness. Specifically it was also questioned as to whether the priority of creditors under a deed over those who become creditors after the deed is entered into should be

<sup>114</sup> For an analysis of the costs of having multiple enforcement procedures see D Baird, 'Loss distribution, forum shopping and bankruptcy: A reply to Warren' (1987) 54 *University of Chicago Law Review* 815.

<sup>115</sup> See the discussion in the CASAC Report Legal Committee of the Companies and Securities Advisory Committee *Corporate Voluntary Administration Final Report* June 1998 at para 8.73.

determined by the words of the deed itself. This is something better dealt with by the legislation given the importance of encouraging creditors to support a company that is subject to a deed of company arrangement. The development of the case law goes some way to clarifying the law but has not provided an effective solution. It would be preferable if the legislation stated that creditors whose debts arise after the deed was entered into be given equal claim on the available assets in the event of a liquidation and that it not depend upon particular wording in the deed itself.

The powers that the court has in relation to setting aside the deed will impact on the development of it in the voluntary administration and it was shown that not all of the approaches by the courts are consistent with the aims of the legislation in this regard.

Generally the procedure does provide some opportunity for creditors to negotiate a reorganisation in the light of the insolvency of the firm. In this respect it goes some way to being consistent with economic theory. It is in this respect an improvement over the North American model. It does not meet the demand of some theorists though who argue that the procedure be based on direct sale or offer of the firm as a going concern in order to justify any deviation from liquidation processes. This article has shown some gaps in the procedure which could be eliminated thus making the achievement of the objectives in Part 5.3A more likely as a result of the voluntary administration procedure. As a result of the report<sup>116</sup> by the *Joint Parliamentary Committee on Corporations and Financial Services* there may be some legislative changes in the near future in the area of corporate insolvency and this is one aspect that may be reviewed.

<sup>116</sup> Parliamentary Joint Committee on Corporations and Financial Services, *Corporate Insolvency Laws: a Stocktake* above n 112.