— Opinion

Fix Australia's restructuring laws to let viable companies live

Three key targeted law reform tweaks might help unwell, injured or overleveraged companies get back in the race for the benefit of all their stakeholders.

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Cyclone Trump is unsettling the world's economic weather. Recession clouds are darkening. Insolvencies have already increased by 25 per cent since the pandemic. Australian companies will increasingly be buffeted and restructuring laws will be needed more often.

Right now, those laws too often favour putting viable businesses under. It's time to adjust them so that they are more rehabilitative than punitive, more restorative than value destructive. Reforms in 2017 took us only part of the way.

Schemes of arrangement are the alternative to insolvency administrations. **David Rowe**

Corporate insolvency administrations damage reputations, dislocate key executives, harm directors and entangle lenders. The economic interest in the company moves to the creditors. Liquidators, receivers, or administrators take control away from those with intimate knowledge of the business. In cases of dishonesty or incompetence it is appropriate: but not otherwise. The insolvency process destroys value and is expensive.

Schemes of arrangement are the alternative to insolvency administrations. They are generally a solvent regime that facilitates a restructure while the board and management remain in control or continuous possession of the company. Schemes can be used by a company in the twilight zone of solvency.

They are also flexible, allowing companies to deliver survival-focused outcomes such as debt-for-equity swaps, balance sheet restructures and debt restructuring. Anything that can be done by contract can be done by

scheme.

Yet, the salvation offered by a scheme process is underused.

First, unlike voluntary administration, schemes lack an automatic statutory moratorium – a protection device that stops creditors suing, before the court has considered the scheme. In the US, the Chapter 11 process protects the company with automatic stay of all claims against it.

Only those with skin in the game should determine the fate of a distressed company.

Second, modern debt structures often mean companies have a mix of secured and unsecured creditors. Often the ordinary unsecured creditors are "out of the money" because they sit behind the secured and priority creditors. But these unsecured creditors with no skin in the game still seek to play a role in the scheme process.

Third, affected creditors with different legal rights vote in separate classes on whether to approve a scheme. If any single class does not vote for the scheme, the scheme topples.

Fourth, to pass, schemes require approval from 75 per cent of creditors by value and 50 per cent by number in each class. This gives a small group – holding just 25 per cent of debt – an effective veto. That threshold, first set in Britain in 1862, is no longer fit for purpose.

Targeted law reform can fix this. Three key tweaks would move the dial.

An automatic moratorium should be available to a distressed company that is in "safe harbour" and proposing a scheme. To qualify for safe harbour, the employee and tax-reporting obligations of the company must be up-to-date. And appropriately qualified experts must have advised the company that the scheme is better for creditors than an immediate insolvent administration. Breathing space is needed to facilitate an economically viable restructure. This would align the scheme of arrangement process with the moratorium currently available in voluntary administration.

The courts have the power to grant this relief now, but because of the uncertainties of court processes, and complexities when seeking injunctive relief, companies have rarely invoked the scheme process when severely distressed.

Only those with skin in the game should determine the fate of a distressed company.

Punitive attitude

Creditor claims with no economic value ought to be able to be extinguished by a secured creditors scheme, so long as other rights of unsecured creditors, such as property rights in a lease, are otherwise preserved. Ultimately, the court must view a scheme as fair and reasonable to creditors as a whole.

Creditors who are out of the money are not adversely affected by a secured creditors scheme because they would not receive any return were the

company to enter voluntary administration or liquidation.

If the secured debt is trading at less than 100¢ in the dollar, that should be prima facie evidence that the enterprise value is lower than the secured debt and unsecured creditors' claims have no economic value.

A practical, business-like approach would limit the right to vote on a scheme to those creditors with an economic interest in the company. It would align the interests of voters with the company's goal of survival and maximising returns to creditors and shareholders.

This can be done by the courts using existing powers – or via targeted legislative reform.

The 75 per cent value threshold should be reduced to 66 per cent. It's being questioned even in its jurisdiction of origin, the UK.

Our restructuring laws emanate from a history in which corporate or personal financial failure was punished. By contrast, the US bankruptcy laws arose from a culture in which corporate failure was recognised as part of a capitalist society.

A two-thirds majority is quickly becoming the norm in the US, Canada and parts of the EU.

Alternatively, the legislature should grant courts a greater discretion to fix the requisite scheme majorities, as current New Zealand law provides.

Restructuring law is capitalism's way of assessing how, and in what shape, unwell, injured or overleveraged companies might get back in the race for the benefit of all its stakeholders.

Australia's legal framework can be amended to help more of them not only do it but do it without relinquishing possession to outsiders.

Unless we act, Australia will be less prepared for choppy waters ahead, and a less attractive port for the globe's highly mobile – and choosy – debt-restructuring capital and capital generally.