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Challenges to voluntary administration for SME creditors

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Why focus on SME creditors?

Small to medium enterprises (SMEs) are defined by the Federal Government as businesses that have between 1 and 199 employees. SMEs are an important part of the economy and contribute to half of employment and over a third of economic activity. (1) The particular needs of SMEs are important to consider because they are numerous in number and sensitive to legal spend on insolvency matters. This means solicitors need to be strategic with the advice they give to SMEs.

The aim of this paper is to inform non-insolvency specialists about current practice in the area of voluntary administration.

Assumptions

All references to sections of statute or regulations refer to sections of the Corporations Act 2001 (Cth) or the Corporations Regulations 2001 (Cth) unless otherwise stated. For the purposes of this paper an administration is defined as ending when a company is wound up or a Deed of Company Arrangement (DOCA) is entered into. This paper supplements the seminar with more detailed information and references.

This paper assumes that readers have a basic knowledge of the voluntary administration process and the importance of expert control of insolvent companies together with the "breathing space" that the moratorium on claims gives to financially troubled businesses. If the reader requires a more detailed introductory explanation of voluntary administration the author recommends reading Chapter 21 "Introduction to Part 5.3A of the Corporations Act – Voluntary Administrations and Deeds of Company Arrangement" in Keay's Insolvency. (2)

Summary of discussion paper

Overview: Is the VA process fulfilling its purpose?
Steps to removal of an Administrator
Best interests of creditors and liquidation

Overview: Is the VA process fulfilling its purpose?

The voluntary administration regime was introduced into the Corporations Law in June 1993 and replaced the "official management" process. The voluntary administration process was introduced to protect the going-concern value of insolvent businesses by creating a flexible process with minimal court involvement. (3) Voluntary administration was introduced on the recommendation of the 1988 Harmer Report (4) to create an alternative to mitigate the loss of business value resulting from liquidations. The view taken by the Harmer Report was that existing insolvency processes lead to the liquidation of the wrong businesses that could have been saved through a more flexible insolvency process and this rationale was followed by the legislators. (5)

Comparing voluntary administration and Chapter 11
The voluntary administration process has a number of key differences to the Chapter 11 Bankruptcy Code process in the United States and it is useful to consider these differences. Both voluntary administration and Chapter 11 aim to preserve the going concern value of a financially trouble business. Whilst the process is under way both provide a moratorium against creditor claims so the company can have "breathing space" to reorganise.

Table 1: Key differences between voluntary administration and Chapter 11 processes

Element of process	Voluntary Administration	Chapter 11
Initiation	Directors (or chargeholder) appoint administrator	Court application by debtor petition
Appointment criteria	Insolvency	No insolvency pre-condition
Who has control of company?	Administrator (registered liquidator) assumes corporate powers in place of the directors	Debtor-in-possession (existing management retains control)
Supervision of Court	None	Ongoing supervision by Court
How long is the process?	Ends after vote at second meeting of creditors	120 days or as extended by Court
What about secured creditors?	Secured creditors can appoint a receiver during 10 day decision period	Secured creditors are subject to the same stay as unsecured creditors

There are a number of excellent case studies from the United States that describe the effects that a prolonged debtor-in-possession insolvency process (i.e. Chapter 11) might have on the economic value of the enterprise. The Weiss & Wruck (1998) case study of Eastern Airlines found that whilst the Chapter 11 process was on foot, the company's economic value dropped by 50% and this was caused by overly optimistic managers and misguided judicial oversight. (6)

The benefits of the tight timeframes, expert oversight and structured creditor voting processes may support an argument that voluntary administration provides a more efficient insolvency process than the Chapter 11 process. The voluntary administration process is set out in Part 5.3A of the Act. Section 435A sets out the objectives of the voluntary administration process:

The object of this Part is to provide for the business, property and affairs of an insolvent company to be administered in a way that:

> (a) maximises the chances of the company, or as much as possible of its business, continuing in existence; or
> (b) if it is not possible for the company or its business to continue in existence–results in a better return for the company's creditors and members than would result from an immediate winding up of the company.

The object of voluntary administration is therefore to firstly maximise the prospects of corporate rescue and, if salvage is not possible, to get a better return for creditors and members than would result from a liquidation.

The Explanatory Memoranda notes that the voluntary administration process was designed to achieve 4 primary objectives (7):

> i. Speed, and ease of commencement of administration;
> ii. Minimisation of expense and time-consuming Court involvement and formal meeting procedures;
> iii. Flexibility of action at key stages in the administration process; and

iv. Ease of transition to other insolvency solutions where an administration does not by itself offer all the answers.

The alternative rationales: Economic value or equity?

The efficient allocation of resources is not the legislated primary objective of voluntary administration but rather the rehabilitation or rescue of a business is the primary objective. Eow (2006) refers to the theory of value maximisation as a justifiable aim of insolvency law in the alternative to rehabilitation. (8) This may not solely involve a better return for creditors but a recognition that a business should only continue if reorganisation produces a more efficient use of resources than liquidation. This alternative rationale for insolvency law relates to the equitable redistribution of value to claimants that arises out of the insolvency process.

What does abuse of the voluntary administration process look like?

Eow (2006) considered the question of whether voluntary administration was an enabler of strategic behaviour or abuse and identified 6 forms of abuse (i.e. wrong or improper use) of the voluntary administration process. (9) These instances of abuse included:

i. Delay creditors: Using the process to delay creditor action
ii. Litigation tactic: Staying winding up applications or other causes of action
iii. Director's escape valve: Avoiding investigations that may follow a liquidation
iv. Control of the company: resolution of internal disputes
v. Employees: Stifle enterprise bargaining
vi. Future complaints: Avoid compensating future claimants
vii. Relation-back period deferred

The ASC (as predecessor to the ASIC) reported the outcomes of empirical research into the reasons that directors appointed a voluntary administrator. (10) The ASC study found that of 55 voluntary administrations the motivation behind the appointment of an administrator included:

i. To restructure (33%)
ii. To avoid consequences of liquidation (20%)
iii. For liquidation (20%)
iv. To avoid directors' liability for withholding company tax (7%)

What empirical findings are out there?

Overall, there is a paucity of empirical research into the voluntary administration process. (11) Routledge (2002) commented that "despite the extensive use by distressed companies of the reorganisation provision, there has been little empirical research that has examined its operation."12 This paper does not seek to discuss whether as a matter of economic efficiency or equity the voluntary administration process leads to optimal outcomes, other than to make point out the observations made by other stakeholders. It is important to consider how we measure the "success" of the voluntary administration process so that it can be evaluated. The architect of the process, Ron Harmer was glowing in his praise of the process and this is reflected in his comments to a parliamentary committee:

"On an international or comparative level there is little doubt that in terms of the important fundamentals the Australian model meets every fundamental requirement. I think its greatest strengths are that it is an efficient and
relatively easy procedure to invoke. Cost wise, I think it compares more favourably with similar regimes in other
countries. It has the great benefit of flexibility and, above all, it does truly enable the possibility of the

rehabilitation or
rescue of a corporation that is in financial difficulty." (13)

On the other hand, in submissions to the same parliamentary committee, the Australian Tax Office was critical of voluntary administration for the following reasons:

i. There are too many non-viable deeds of company arrangement being accepted
ii. Deeds of company arrangement are increasingly used as a means for avoiding paying some unsecured creditors
iii. Inadequate reconstruction of company accounts by administrators to a standard sufficient to facilitate the
performance of their duties
iv. The quality of reporting to creditors by administrators
v. An absence of impartiality on the part of some administrators
vi. The use of phoenix companies (14)

There is significant empirical evidence to support concern about the voluntary administration process. In its submissions to a parliamentary inquiry the ASIC reported that between 1993 and 1997 of the 5760 companies that entered into voluntary administration, only 10% resumed "normal trading".15 Further, the ASIC published findings in 2008 of a review of administrators' reports to creditors (pursuant to section 439A) and asserted that the administrators did not generally "undertake an adequate investigation or fully report to creditors on the results of the investigations".16 Routledge and Morrison (2009) concluded it is a considerable risk for creditors if the administrators are not properly reporting. They hypothesised that possible causes were a lack of funding to conduct investigations and a paucity of books and records that is typical in insolvency scenarios but they did not refer to possible abuse as a cause. (17)

Steps for removal of an Administrator

The alternatives for removing an Administrator are:

i. Replacing the administrator at the first meeting of creditors (s436E)
ii. Proceeding with a winding up application (s 440A)
iii. Adverse vote at second meeting of creditors (s446A)
iv. Termination by Court order for abuse of process (s447A(2))

Replacing the administrator at the first meeting (s436E)

The first meeting of creditors is held within 8 business days of the administration beginning, and does not usually include the administrator's report to creditors. The creditors, however, have the right to pass a resolution to remove and replace the administrator.

Proceeding with a winding up application (s 440A)

Most winding up applications proceed under section 459P where the applicant relies on the failure of a debtor company to comply with a Statutory Demand. Many practitioners assume their clients cannot commence winding up proceedings once a debtor company goes into administration without leave of the Court. However, a creditor may still commence winding up proceedings whilst a company is in administration because the statutory moratorium does not apply to winding up proceedings. (18)
If a winding up application is on foot, a company may place itself into administration. This will trigger a Court's consideration of the interests of creditors (Section 440A) before adjourning a winding up petition. If a winding up petition is adjourned until after the second meeting of creditors and the creditors vote in favour of a DOCA, then the DOCA will supersede the winding up proceedings. It is therefore important for a winding up

application to be determined before a second meeting of creditors or the application may become irrelevant. The “best” interests of creditors is also considered further below.

Adverse vote at second meeting of creditors (s446A)

The voting at first instance is carried on voices. However if a poll is demanded for a resolution to be carried, a majority of creditors voting and a majority in value of the debts must be reached.19 If no result is reached the administrator may exercise a casting vote. If the creditors resolve that the company be wound up, then the administration will end and the company will be placed in liquidation.

Termination by Court order for solvency or abuse of process (s447A(2))

Section 447A provides a basis for Court application by a creditor for the administration to end:

> (1) The Court may make such order as it thinks appropriate about how this Part is to operate in relation to a
> particular company.
> (2) For example, if the Court is satisfied that the administration of a company should end:
>
> > (a) because the company is solvent; or
> > (b) because provisions of this Part are being abused; or
> > (c) for some other reason;

The Court may order under subsection (1) that the administration is to end.
The issue for advisers of SMEs is that this is likely to be an expensive process and there may be little or no commercial benefit to this action. In examining whether to commence an application for the termination of the administration the following points may be considered:

i. Proving that the appointor’s predominant purpose was improper may be required. In examples Courts have considered whether the appointor’s predominant purpose was to avoid potential claims by a liquidator20 and whether the intention was to stifle separate actions against the company. (21)
ii. The benefits to creditors of an earlier relation-back date resulting from the termination of an administration is not likely to be a sufficient reason for termination. (22) In a relevant case the applicant argued that there would be greater recoveries for creditors if the Court made the order terminating the administration. The relation back date would be an earlier date as a result of section 513A(e) but this was not found by Justice Barrett to be a sufficient reason for terminating the administration.
iii. A Court will not make order to improve commercial prospects of outcome. In a case on point a sole shareholder and
director asserted he could get better asset prices than the administrator but this failed to move the Court. (23)

Best interests of creditors and liquidation.

When a creditor has a winding up petition on foot and the debtor company appoints an administrator, this triggers section 440A below and the Court is required to consider whether it is in the interests of creditors to allow the administration to come to a conclusion through a second meeting of creditors (which therefore supersede the winding up application).

Section 440A(2) provides:

The Court is to adjourn the hearing of an application for an order to wind up a company if the company is under administration and the Court is satisfied that it is in the interests of the company's creditors for the company to continue under administration rather than be wound up.

The first step taken by a solicitor acting for an SME creditor should be to contact the administrator to discuss its approach and carefully read the report to creditors with the administrator's recommendation. Does the administrator have adequate funding and intention to investigate matters? It will be a warning sign to creditors if the administrator lacks funding to properly investigate the company's affairs.

In the Queensland Court of Appeal case of Creevey v DCT (1996) 32 ATR 632; 19 ACSR 456, McPherson J (with whom Davies and Pincus JJ agreed) considered what the interests of creditors in a s440A(2) application may be (at 457):

"The question of whether an administration should continue, rather than that there be a winding up, is obviously closely related to the further question of whether the creditors could hope to get more by way of payment of their debts from one form of process or administration than from the other. In order to satisfy the court of the matter referred to in s 440A(2) of the Corporations Law, one would expect that there would have to be some persuasive evidence to enable it to be seen that there were assets which, if realised under one form of administration rather than the other, would produce a larger dividend, or at least an accelerated dividend for the creditors."

In considering whether the interests of creditors are solely determined by the amount of the dividend in a DOCA, Hamilton J in TCS Management Pty Ltd v CTTI Solutions Pty Ltd [2001] NSWSC 830 at [15] cautioned against applying the statements of McPherson J too strictly:

"The sole consideration is the interests of the creditors, and the interests of the creditors is a concept wider than an arithmetical comparison of the amounts available."

Alternatively, there was a more purposive approach advocated by Young J in DCT v Choice Design Homes Pty Ltd [1999]
NSWSC 589. His Honour approached the issue by asking four questions similar to those applicable in deciding whether to
appoint a liquidator as administrator under s 436B(2). The questions to be answered by the Court were according to Young
J at [6]:

(1) Is the company insolvent?
(2) Is the company salvageable?
(3) Is the proposed salvation in the interests of creditors? and
(4) Is the proposed salvation in the public interest?

If an SME creditor decides to oppose the adjournment application procedural aspects of the application that need to be considered are:

i. Short adjournments: It is likely that a Court will allow shorter adjournments until just before the second meeting of creditors to allow the parties to prepare evidence. Short adjournments are also granted to give creditors the opportunity to consider a DOCA proposal.24
ii. Onus of proof: The onus is on the company's administrator to show that the continuation of the administration is in the best interests of the creditors.25 However, if the creditor applicant wishes to succeed it is advised to put evidence in favour of its proposition that the continuation of the administration is not in the interests of creditors.
iii. Evidence: The matter will be heard in the Supreme Court or Federal Court and the normal rules of evidence apply to these applications. The deponents of any affidavits may be called to be cross-examined.
iv. Weight of evidence: The evidence must be more than "mere optimistic speculation".26

v. Hearing: If the matter is in the Supreme Court of NSW it may be called before the Registrar's list but then referred to the Corporations Judge.

The issue of what evidence a creditor applicant should tender is an open question that goes down to basic persuasion through an interpretation of the facts in a matter. The advice provided by McMurdo J of the Queensland Supreme Court (who adopted the following remarks of Campbell J in DC of T v Bradley Keeling Management Pty Ltd (2003) 44 ACSR 377 at 380) was:

"[18] Ultimately what the court needs to do is to be persuaded. The amount of proof which can result in persuasion, differs with the circumstances in which litigation comes before the court. It is common enough, in applications under s440A, for an administrator to need to seek an adjournment very soon after his or her appointment, at a time when he or she knows very little about the affairs of the company. In that sort of situation, comparatively little material might be needed to justify a short adjournment. As time goes on, however, and the occasion that there has been for the collecting of evidence increases, so the amount of material which might need to be put before the court before it is persuaded, will increase."

What if the company in administration is no longer trading?

A number of cases have found that an administration should not continue as the company is no longer trading.27 However, there are also cases where the Court has found that notwithstanding the fact the company is not trading, it is in the interests of creditors to consider a DOCA proposal. Clawback of voidable transactions and insolvent trading lost in a DOCA One of the main benefits of a liquidation over a deed of company arrangement is that a liquidator can make claims for unfair preferences28, uncommercial transactions29 and other voidable transactions30 whilst a deed administrator (and administrator) cannot.

What about related party creditors who participate?

There are frequently scenarios where related party creditors are able to control voting at a creditors meeting. The issue of whether a Court is to consider related party creditors in voting and distribution arrangements are not to be considered in exercise of judgment. In DCT v Alternative Business Solutions (Aust) Pty Ltd (Admin Apptd) (2006) 24 ACLC 435; [2006] FCA 400 seven of the creditors (owed a total of $932,200) were willing to support a deed of company arrangement and forgo the recovery of their debts. The Court acknowledged that there was nothing untoward in this, but for the purposes of the section, it was not in their financial or commercial interests to forgo the recovery of the debts. The only other creditor whose interest remained to be considered was the Commission of Taxation who was in favour of winding up the company.

In ordering the company be wound up Lindgren J at [9] stated that:

"When s 440A speaks of "the interests of creditors" it is referring to the creditors' interests as creditors, that is to say, to their interests in recovering what is owed to them, not to "interests" arising from family relationships, friendship or emotional attachment."

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