The Case for Further Reform to Strengthen Business Rescue in the UK and Australia: *A comparative approach*

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Overview

It is a fundamental policy tenet of the insolvency systems in both the United Kingdom and Australia that insolvency laws should be structured to help ‘save’ and restructure companies and businesses which, despite current financial distress, are viable and have a reasonable prospect of a return to successful trade.

This policy can be traced back to the 1982 CorkReport in the United Kingdom,[1] the recommendations of which became the foundation of the *Insolvency Act 1986* (UK) (“**Insolvency Act**”), and the 1988 Harmer Report in Australia,[2] which largely adopted the recommendations of the Cork Report and led to the subsequent corporate law reform program culminating in the passage of the *Corporationst Act 2001* (Cth) (“**Corporations Act**”).

Yet, despite the policy underpinning and the stated objectives of the Insolvency Act and the Corporations Act, in practice the achievement of corporate and business rescue for viable entities has been relatively limited. Notably, in both the United Kingdom and Australia, there has continued to be a lack of cooperation and collectivist action by creditors following the insolvency of a corporate debtor, with creditors typically preferring an individual enforcement approach (if possible), notwithstanding the progress made to advance informal restructuring under the London Approach principles that have gone on to shape informal workouts across the United Kingdom, Europe and Asia over the last decade.

This article commences by examining the recent reforms made by the *Corporate Insolvency and Governance Act 2020* (UK) (“**CIGA**”), which go some way towards advancing the prospect of corporate and business rescue in the United Kingdom, and noting the absence of similar mechanisms other than *ipso facto* enforcement prohibitions in Australia.

The article then focuses on two other areas of law reform that have an important role to play in cultivating a stronger business rescue culture in the United Kingdom and Australia: super-priority debtor-in-possession (“**DIP**”) financing and pre-pack business sales.

The CIGA Reforms

It is expected that the CIGA, which came into force on 26 June 2020, will play an important role in instilling a stronger rescue culture in the United Kingdom.

In particular, the CIGA introduces a new standalone pre-formal insolvency Part A1 moratorium, binding on secured and unsecured creditors as well as landlords for an initial 20 business day period,[3] where an ‘eligible’ insolvent entity (there is a broad list of excluded companies) requests the moratorium and, in the opinion of an independent monitor, the moratorium will likely result in the rescue of the entity as a going concern. The enforcement moratorium is designed to support informal rescue by preventing major secured creditors, suppliers and landlords from enforcing their strict rights and withdrawing critical assets that may be used by the distressed entity to return to viable trade in the long-term, an outcome in the best interests of all creditors. The moratorium was introduced as a temporary measure for a period which ended on 30 September 2020; this period has now been extended to 30 March 2021.[4]

Further, the CIGA introduces a new standalone Restructuring Plan, a formal rescue process contained in Part 26A of the *Companies Act 2006* (UK). Unlike the existing limitations of both a company voluntary arrangement (“**CVA**”) (which is not binding on secured creditors without their consent) and a scheme of arrangement (which requires the approval of 75 per cent in value and a majority in number of each class of creditors), the new Restructuring Plan introduces a ‘cross-class cram down’. This permits the court to approve a compromise or arrangement against the wishes of one or more classes of creditors, subject to certain conditions:

a. Condition A – members of the dissenting class would not be any worse off in the Restructuring Plan than they would be in the event of the relevant alternative to the Restructuring Plan (typically this will be liquidation, but could also be an alternative proposal); and

b. Condition B – the Restructuring Plan has been approved by 75 per cent in value of at least one class of creditors (or members), who would receive a payment or have a genuine economic interest in the company in the event of the relevant alternative.

The cross-class cram down is critical to prevent a single (usually out of the money) class of creditors from undermining a viable rescue attempt in the interests of all creditors.

Broader prohibitions on the enforcement of ipso facto contractual rights during formal insolvency are also introduced as part of the CIGA reforms. Together with the Part A1 moratorium, these new processes and rules aim to help preserve an entity’s going concern value while a restructuring attempt is negotiated or a source of new funding is negotiated.

In contrast, in Australia, while there are existing ipso facto enforcement prohibitions similar to those introduced under the CIGA,[5] there is no enforcement moratorium available for an insolvent entity prior to the initiation of formal insolvency proceedings. There is also no cross-

1. Report of the Review Committee on Insolvency Law and Practice, Cmnd 8558, 1982.

2. General Insolvency Inquiry, ALRC Report 45, 13 December 1988.

3. This initial period is extendable for a further 20 business days by directors, for up to a year with creditor consent, or for longer with court approval.

4. CIGA, Schedule 4, section 1 set the original period. The Corporate Insolvency and Governance Act 2020 (Coronavirus) (Extension of Relevant Period Regulations 2020, which came into force on 29 September 2020, extended the period.

5. Corporations Act, sections 415D, 434J and 451E.

class cram down mechanism under a deed of company arrangement ("**DOCA**") executed by a company following a period of voluntary administration ("**VA**") or under a creditors' scheme of arrangement. While the court can order dissenting secured creditors, owners and landlords to be bound to a DOCA, such an order is conditional on those entities receiving 'adequate protection',[6] a concept borrowed from the United States Chapter 11 process, and the court accordingly has far less discretion than that afforded to United Kingdom courts under the Restructuring Plan cross-class cram down test. For a creditors' scheme of arrangement, a scheme, as with a CVA in the United Kingdom, cannot even reach the court approval stage unless it is approved by 75% in value and the majority in number of each class of creditors voting on the scheme.

There is currently strong support within the insolvency industry in Australia for a pre-formal insolvency enforcement moratorium and a cross-class cram down mechanism applicable during formal insolvency proceedings, whether under a DOCA, a creditors' scheme of arrangement or an entirely new rescue procedure as implemented by the CIGA, to be introduced under the Corporations Act. The Australian Government intends to consider structural corporate and insolvency law reforms as part of its economic recovery model for Australia in 2020 and 2021, following the expiry of interim relief measures such as the six month moratorium on insolvent trading liability for directors (similar to the moratorium introduced in that regard in the United Kingdom as part of the CIGA reforms).

The Need for Futher Reform – DIP Financing and Pre-Packs

Two other areas of focus for insolvency law reform in Australia are a dedicated court-sanctioned process for super-priority DIP financing during VA and a legislative process to permit pre-positioned sales (or 'pre-packs') for distressed businesses. Both reforms would materially contribute to a greater likelihood of the rescue of viable entities, an outcome that depends on access to critical working capital (in the form of new financing) and also flexible processes that support a going concern sale with the benefit of pre-insolvency positioning work (subject to suitable safeguards to protect the interests of employees and creditors).

DIP financing was not included as part of the CIGA reforms. And while, unlike in Australia, pre-packs are a common occurrence in the United Kingdom (resulting, at least in part, from more relaxed independence requirements for insolvency practitioners), debate continues in the United Kingdom about the utility of the existing self-regulated pre-pack model. It is interesting to note that the CIGA has revived the power, originally contained in the *Small Business, Enterprise and Employment Act 2015* (UK), enabling the Government to introduce regulations restricting the scope of pre-packs on or before 30 June 2021, a point returned to below.

6. Corporations Act, sections 444F(3) and 444F(5).

DIP Financing

Working capital is the lifeblood of any business. Insolvency, necessarily, results in endemic illiquidity. For entities that have a realistic prospect of resumed long-term trade under a viable business plan, new funding is indispensable to a successful restructuring. Depending on their level of exposure, existing creditors may often be reluctant to advance new money, and in any case any decision to provide additional funding is idiosyncratic and based on a creditor's broader loan and investment portfolio. DIP finance, with super-priority status for new lenders, provides an incentive that underpins an active rescue financing market and thereby supports a stronger rescue culture.

DIP financing is a common practice in the United States as part of the insolvency rescue framework in Chapter 11 of the Bankruptcy Code. There are a number of priority options for new funding under Chapter 11.

First, a debtor may, following a Chapter 11 filing, obtain additional unsecured credit as an administrative expense, so that it ranks alongside other such expenses as a first priority payment out of the debtor's unsecured property.[7] When obtained outside the ordinary course of business, as is invariably the case in the context of a restructuring attempt under Chapter 11, court approval is required.[8] Importantly, a creditor advancing funds on this basis does not obtain priority overany existing secured creditors.

Secondly, if a debtor cannot obtain funding on that basis, the court may authorise a debtor to obtain DIP funding that either receives priority over all administrative expenses, is secured by a lien over the debtor's unencumbered property or otherwise a junior lien (subordinate to existing security interests) over encumbered property.[9]

And finally, if a lender is not willing to provide funding on either of those bases, the court may order that the lender is entitled to a lien that is senior or equal to existing security interests over the debtor's encumbered property.[10] However, such an order is conditional on the secured creditors who are to be 'primed' by the grant of this super-priority security interest in favour of the new lender receiving 'adequate protection'. That protection may consist of replacement security, guaranteed principal and loan repayments (typically at the interest rate applicable prior to the Chapter 11 filing) or may otherwise be deemed to exist if existing secured creditors are 'over-secured' with a sufficient equity cushion with respect to their loans.

The United States DIP financing model was adopted in Singapore in March 2017 under a new scheme of arrangement rescue process introduced by the *Companies (Amendment) Act 2017*.

In the United Kingdom and Australia, while new funding provided during a period of administration, due to an administrator's personal liability for new borrowing, ranks as an expense of the administration (receiving priority over the administrator's remuneration, floating charge realisations and unsecured debts), there is no mechanism for the court to provide a new lender with super-priority status, with repayment of the funds advanced ranking ahead of existing fixed charge debts.

Rather, any such arrangement depends on private negotiation between existing lenders as part of a refinancing arrangement to support a rescue attempt. The dominant individual creditor enforcement culture in Australia has meant that such an outcome has been a rarity in practice. That has also been the case in the United Kingdom, notwithstanding a more active creditor cooperation experience to which the CIGA will give further impetus.

One option in Australia is for an administrator to apply to the court under section 447A of the Corporations Act for an order modifying the usual legislative provisions concerning creditors' rights during a period of voluntary administration. Potentially, an order could include the conferral of super-priority status on a creditor advancing new funds in support of the primary aim of voluntary administration to save the company, or as much of its business as possible, in the event of insolvency.[11]

Since the outbreak of COVID-19, the courts have shown a greater willingness to make broad-based orders under section 447A relieving administrators from personal liability for rental and loan payments and deferring the enforcement rights of creditors in an attempt to enhance the prospect of the successful restructure of entities that are shown, in evidence provided to the court, to have a reasonable likelihood of viable trade. Most recently, orders of that kind have been issued in various proceedings involving the restructure of Australia's second major airline, Virgin Australia.[12]

Yet section 447A provides only an ad hoc mechanism for orders to be made in an individual insolvency, and there is no specific facilitative provision to permit DIP finance with the benefit of a set of criteria similar to that adopted under Chapter 11 of the Bankruptcy Code. Ordering super-priority DIP finance would still be a big leap for a court, even in the context of the widespread economic and financial impact of COVID-19 across so many industries, and even if ordered in an individual matter, one-off cases examples are no substitute for clear, certain legislative criteria that reduces costs and improves efficiency and certainty in the interests of insolvency practitioners and creditors.

7. Corporations Act, sections 444F(3) and 444F(5).

8. Bankruptcy Code, section 364(b).

9. Bankruptcy Code, section 364(c).

10. Bankruptcy Code, section 364(d)(1).

11. Corporations Act, section 435A.

12. See, for example, *Re Virgin Australia Holdings (No 1) [2020] FCA 571; Re Virgin Australia Holdings Ltd (Administrators Appointed) (No 2)* [2020] FCA 717; *Re Virgin Australia Holdings Ltd (Administrators Appointed) (No 3)* [2020] FCA 726; and *Re Virgin Australia Holdings Ltd (Administrators Appointed) (No 4)* [2020] FCA 927.

A pre-pack, in essence, involves the informal negotiation of the sale of the business of a financially distressed company with involvement from the company's directors and an insolvency practitioner

In the United Kingdom, absent any specific legislative regime for DIP financing, the only existing option is for an administrator to enter into a new contract having super-priority under paragraph 99(4) of Schedule B1 of the Insolvency Act. Although liabilities pursuant to new contracts do not gain priority over fixed charge holders, they do rank above floating charge holders by virtue of paragraph 99(3) of Schedule B1. In appropriate cases, it is possible for that super-priority to include a roll-up of pre-administration debt, provided the roll-up can be regarded as an expense 'properly incurred' within the meaning of rule 3.51(2) of the Insolvency Rules 2016 (UK), and provided further that it is a liability restated under the new contract, entered into as a result of a 'positive and conscious act' of the administrator.[13] This is in effect a limited 'back door' DIP financing process in the United Kingdom.

Pre-Packs

A pre-pack, in essence, involves the informal negotiation of the sale of the business of a financially distressed company with involvement from the company's directors and an insolvency practitioner, followed by the appointment of that same practitioner as the company's administrator and the implementation of the previously negotiated sale by the administrator.

A pre-pack can improve efficiency and substantially lower the costs that would be incurred in a protracted administration process, while also cutting short the delay that risks secured creditors, landlords and major suppliers enforcing their rights during administration (subject to the limited scope of the existing enforcement moratoria in both the United Kingdom and Australia) in a manner that renders a rescue attempt impossible.

A successful going concern sale also ensures the optimal investment of capital in value-creating, viable businesses in the interests of broader economic efficiency. However, fairness concerns arise from the potential for a sale to be made to related parties, as well as a possible conflict of interest which may arise due to the completion of a quick sale upon appointment without proper investigation of possible breaches of duty by directors that have appointed a 'friendly administrator'.

In July 2013, the United Kingdom Government commissioned a review into the pre-pack process. *The Graham Review into Pre-Pack Administration* ("**Graham Review**") was completed in June 2014, and found that pre-packs enhance the prospect of rescuing viable businesses, thereby preserving jobs, while avoiding the substantial cost of formal insolvency measures.[14] However, to ensure appropriate transparency and a robust sale process maximising the return achieved for the sale of the business, the Graham Review recommended:

a. the creation of a 'pre-pack pool' consisting of a pool of independent experts, with purchasers of a business having a connection with the existing controllers able to, on a voluntary basis, approach the pool to give an opinion about the sale (the pre-pack pool was subsequently established by the United Kingdom Government on 2 November 2015);

b. the ability for connected purchasers, again on a purely voluntary basis, to complete a 'viability review' of the business; and

c. a self-regulation model, under which insolvency practitioners would be required to conduct a pre-pack sale in accordance with six principles of good marketing and to commission an independent valuation, with compliance to be monitored by recognised professional bodies.[15]

The Graham Review also recommended that the United Kingdom Government 'consider legislating' if these recommendations did not have the 'desired impact'.[16] As noted above, a reserve power was created to enable the Secretary of State to introduce such legislation, in its discretion, under the *Small Business, Enterprise and Employment Act 2015* (UK). There was an

13. *Laverty v British Gas Trading Ltd* [2015] 1 BCLC 295 at [64].

14. Graham Review, 6-7.

15. Graham Review, 10.

16. Graham Review, 10.

original sunset date of 25 May 2020 applying to this reserve power that has now been extended until 30 June 2021 as part of the *CIGA* reforms. The reserve power has not, since its original introduction, been resorted to by the Secretary of State.

Views differed widely on the effectiveness of the United Kingdom pool process. Some took the view that it is enough to comply with the provisions of SIP 16, which sets out the principles and took standards with which an insolvency practitioner must comply when dealing with a pre-pack sale. Others took the view that the mere availability of the pre-pack pool, and even more so its use, is vital to keep pre-packs under scrutiny, and to ensure that they are effective.

In particular, a pool member is able to offer an opinion on the purchase of a business and/or its assets with a connected party (within the meaning of section 435 of the Insolvency Act). The benefit of approval by the pool is that it is an imprimatur of reasonableness, of sorts. That said, the pool member has no powers. He or she will issue an opinion on the reasonableness of the grounds of the proposed pre-pack sale, but will not determine whether the sale can proceed. The pool member can issue one of three opinions (nothing found to suggest that the grounds for the proposed pre-pack are unreasonable, evidence provided has been limited in some areas but otherwise nothing has been found to suggest that the grounds for the proposed pre-pack are unreasonable, or there is a lack of evidence to support a statement that the grounds for the proposed pre-pack are reasonable). No reasons for a decision are given and there is no basis on which to appeal the decision of a pool member. The administrator can, of course, supplement the evidence after the submission to the pool, and in any event the decision remains with the administrator to determine whether the sale is reasonable or not as an incident of the administrator's ordinary powers and duties under the Insolvency Act andat general law.

Only about 10 per cent of eligible cases are referred to the pool. This relatively low take up probably resulted from the general view that insolvency practitioners were happy to take views on pre-packs without the extra comfort of a pool opinion. However, on 8 October 2020 the Government stepped in. It has now proposed new regulations to ensure that more cases are referred to the pool. The draft regulations propose a new regulatory framework that will apply in any case where there is a disposal in administration of all or a substantial part of a company's assets. In such a case, an administrator will be unable to dispose of property of a company to a person connected with the company within the first eight weeks of the administration without either the approval of creditors or an independent written opinion. The connected party purchaser will be required to obtain the written opinion. The provider of the opinion is required to be independent of the connected party purchaser, the company, and the administrator and is required to meet certain eligibility requirements. The administrator must have no reason to believe that the opinion provider is not independent of the connected party or does not meet the eligibility requirements. The opinion provider will provide a written report to state that either the case is made for the disposal or that the case is not made. A connected party purchaser may obtain more than one report. An administrator must consider a report from an opinion provider. Where a report states that the case is not made for the disposal, an administrator can still proceed with the disposal but will be required to provide a statement setting out the reasons for doing so. An administrator will be required to send a copy of the report(s) to creditors of the company and to Companies House. It is intended that these new regulations will come into force as soon as possible, and in any event before June 2021.

In addition to the draft regulations, the Government has made it clear that it intends to work with the industry to provide guidance and update SIP 16 to provide more information to creditors. In particular, the Government has

identified a wish to ensure that there is greater adherence to the principles of marketing (or that where no marketing has been undertaken that this is fully explained by the administrator and any explanation probed by the regulator where necessary). The Government also wishes to ensure that there is a continued increase in compliance with the reporting requirements under SIP16. It even has its eye on viability reports, asking why they are not being completed and how this could be improved. If that voluntary guidance is not adhered to, and if the quality of the information provided to creditors and the transparency of pre-pack sales in administration does not noticeably increase, the Government has already indicated that it will consider whether supplementary legislative changes are necessary.

So much change, cost, and additional compliance requirements are therefore on their way in the UK. Whether this is really needed is another question. The reality is that creditors are often critical of a pre-pack. But that does not mean that pre-packs are by their very nature suspicious or wrong. Proper compliance with SIP 16 and effective insolvency practitioner oversight and integrity should really be sufficient. However, it seems clear that such a route will no longer be countenanced. Increased legislative control is plainly on its way.

In Australia, pre-packs have been a rare occurrence in practice. This is primarily due to strict independence requirements, with the traditional approach taken by the courts that administrators cannot have any actual or perceived conflict of interest, and any substantial involvement with a company and its directors prior to administration unlikely to meet that standard.[17]

Nevertheless, in a 2017 decision, *Re Korda; Ten Network Holdings Ltd (Administrators Appointed) (Receivers and Managers Appointed)*[18] (‘***Ten Network***’), the Federal Court of Australia held that substantial prior involvement is not, of itself, cause for a reasonable apprehension of bias on the part of an administrator. Rather, if substantial involvement in pre-positioning work enhances value for creditors, through reduced costs and a fair sale price, and appropriate safeguards are put in place such as full disclosure of the pre-positioning work undertaken and the costs involved, as well as the possible court-ordered appointment of a special purpose administrator to investigate the primary administrator’s conduct and the circumstances of the sale (as occurred in *Ten Network* itself), a court may be willing to find that the independence requirements are met.

However, the decision in *Ten Network* was made in the context not of a ‘traditional’ pre-pack (completed without the involvement of creditors and with the counter-party already identified by the time of the administration) but rather a ‘planned insolvency’ in which the pre-positioning work involved an informal restructure attempt with broad-based negotiations with substantial creditors, before formal insolvency proceedings were commenced only when those negotiations broke down. Justice O’Callaghan expressly noted that ‘it would be difficult to imagine a situation where an insolvency practitioner would be permitted to take an appointment’ following involvement in a traditional pre-pack.[19]

Accordingly, there continues to be a lack of confidence from administrators to attempt a pre-pack in Australia.

A pre-positioned sale framework, based on a model proposed by the Australian Restructuring, Insolvency and Turnaround Association (‘**ARITA**’), under which an advisor involved in the pre-positioning work could not be subsequently appointed as a company’s administrator and the sale negotiated would be subject to statutory review,[20] was endorsed by the Australian Productivity Commission in 2015[21] but was not introduced by the Australian Government. This is the model that has most industry support in Australia and is likely to be the Government’s first preference in the structural reform process in 2020 to 2021.

17. See, for example, *Commonwealth v Irving* (1996) 144 ALR 172; *Domino Hire Pty Ltd v Pioneer Park Pty Ltd* [2000] NSWSC 1046.

18. (2017) 252 FCR 519.

19. *Ten Network*, 526.

20. Australian Restructuring, Insolvency and Turnaround Association, Policy Positions, February 2015, Policy 15-11 (Pre-Positioned Sales), 17.

21. Australian Government, Productivity Commission, *Business Set-Up, Transfer and Closure*, Final Report, 7 December 2015, 37.

Conclusion

With the expected influx of new insolvency matters globally in the remainder of 2020 and in 2021, there is a need for insolvency laws that balance fairness for creditors with efficiency and flexibility. A key priority in that regard is having an insolvency system that maximises the prospect of a distressed company or business that is viable, notwithstanding current financial distress, being restructured so that it can continue to trade in the long-term for the benefit of all creditors, as well as shareholders and the broader community.

The CIGA reforms have positioned the United Kingdom as a leader of flexible and effective informal and formal restructuring processes, and these reforms are already serving as a best practice model in the law reform process in other jurisdictions across the world, including Australia and in the Asia-Pacific.

An additional measure, currently absent from the insolvency regimes in both the United Kingdom and Australia, that would enhance the prospect of corporate and business rescue for viable entities is a DIP super-priority financing system modelled on the United States Chapter 11 process (which was also recently adopted in Singapore). Given the difficulty of obtaining new financing in a distressed asset scenario, a DIP financing regime would help to incentivise new working capital critical to the success of a rescue attempt. Further, Australia would benefit from a pre-pack regime – already an established feature of the insolvency process in the United Kingdom – to improve the cost-effectiveness, timeliness and viability of a rescue attempt. However, while the United Kingdom is likely to continue its existing self-regulated model pursuant to the provisions of SIP 16 and the voluntary pre-pack pool process, rather than introduce mandatory regulatory measures, in Australia the long-held industry and court mistrust over the pre-pack process will likely see a mandatory compliance model introduced if pre-packs are included within the scope of the Australian Government's structural reform process in 2020 to 2021.At a minimum, that model will likely prevent a practitioner involved in the pre-pack sale process from accepting a subsequent appointment as administrator, as well as require a sale to be subjected to a mandatory review. On that basis, the contrast in the regulatory approaches to pre-packs in the United Kingdom and Australia will not change soon. ■

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