THE STRATEGIC VIEW

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Corporate Restructuring 2016

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Corporate Restructuring 2016

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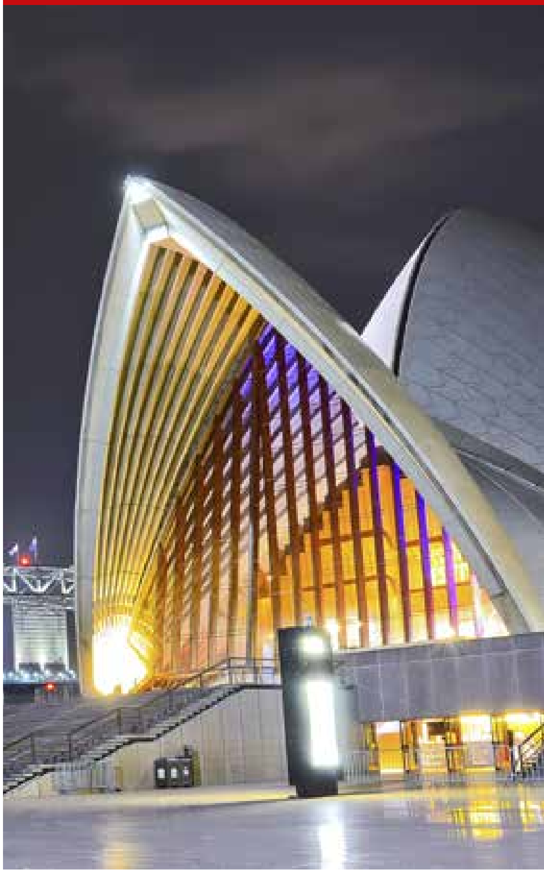

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AUSTRALIA

Dominic Emmett and Jessica Arscott provide a detailed analysis of the insolvency and restructuring market in Australia, the key tools and emerging innovative processes for effecting restructures in Australia, as well as an update on the Federal Government's insolvency law reform agenda.

1. What trends, in terms of activity levels, affected industries or investor focus, have you seen in the restructuring and insolvency market in your jurisdiction over the last 12 months?

The corporate restructuring market has been relatively quiet in 2015. Restructuring advisors and insolvency practitioners have not been stretched, and workout teams within leading lending institutions are the leanest in living memory.

Most of the activity which has occurred has been seen in the energy, mining and mining services sectors. However, even within those sectors, many of the groups, which would otherwise be expected to be in distress two or three years ago, were able to access US markets and obtain debt with longer tenor and lighter covenants, i.e. relative to that available in the local Australian market. Further, many of the other companies with local funding have been able to amend and/or extend, with a view to riding out the cycle.

Amending and extending with existing financiers has been supplemented by an ever increasing number of recapitalisations involving mezzanine funding accompanied by a variety of forms of equity. The providers of such mezzanine funding tend to be based offshore, although recently some have established a limited local presence.

To meet the demands of such providers and credit funds generally, many of the full blown restructurings which took place over the last year have involved a number of innovative and groundbreaking structures not seen before.

- Finally, the relatively new arrival of advisory firms such as Moelis and Houlihan Lokey continues to make an ever increasing impact on the market. Where such firms will sit relative to the likes of Ferrier Hodgson, McGrath Nicol, PPB Advisory and Korda Mentha (along with the big four accountancy firms) remains to be seen.

2. What is the market view on prospects for the coming year?

The consensus in the Australian market is that 2016 will be a busier year for restructuring professionals.

There is a widely held view that the energy, mining and mining services sectors will continue to deteriorate, particularly if commodity prices generally stay where they are, if not worsen. Similarly, and as a result, commodity trading houses will come under increasing pressure.

Evidence of the credit funds' increasing activity in Australia is seen, as a number of them are establishing and increasing their presence locally. Whilst the more traditional lending institutions continue to dominate the corporate lending market in Australia, those institutions are becoming increasingly concerned about the impact of impaired loans on their cost of capital. This increased focus will no doubt result in such institutions considering the option of selling their positions earlier and more frequently, and it is expected that this will lead to a greater number of sales of both liquid and illiquid positions.

The expected increase in activity will also result in these lending institutions looking to recruit into their workout teams either by direct hiring or secondments from restructuring advisory and insolvency practitioner firms.

3. What are the key tools available in your jurisdiction to achieve a corporate restructuring – are they primarily formal, court-driven processes, or are informal out-of-court restructurings possible? Do you feel that the tools you have available are effective in terms of providing speedy, fair and predictable outcomes?

There are two key tools for restructuring Australian companies:

- deeds of company arrangement (**DOCA**); and
- schemes of arrangements.

Deeds of Company Arrangement

A DOCA is a creditor approved arrangement governing how a company's affairs will be restructured. It is one of three possible outcomes of a company entering voluntary administration. Voluntary administration is a short-term process involving the appointment of an independent administrator who is required to investigate the affairs of a company, convene two creditors' meetings and report to creditors at the second creditors' meeting with an opinion regarding the best outcome to maximise their returns. Administrators may be appointed by a company's board of directors (if they believe the company is, or is likely to become, insolvent), a liquidator or provisional liquidator, or a secured creditor with security over the whole, or substantially the whole, of the company's assets, if that security has become and remains enforceable.

Once a company is in voluntary administration, a DOCA may be proposed by anyone with an interest in the company. If accepted at the second creditors' meeting by the requisite majority of creditors (50% in number and value), a DOCA will bind the company, its shareholders, directors and unsecured creditors. Secured creditors and owners and lessors of property (in relation to that property) do not need to vote at the second creditors' meeting and are only bound by the DOCA if they voted in favour of its execution.

Restructuring via a DOCA has the benefit of being highly flexible in terms of what it can deliver (e.g. rescheduling of debts, debt-for-equity swaps, compromises), fast (i.e., can take as little as three weeks to implement) and subject to low voting thresholds. The statutory moratorium which applies during the preceding administration period also provides the company with some very welcome breathing space whilst the restructure is being planned. Court approval is not required for a DOCA to be implemented (however, the court's leave is required for a compulsory share transfer pursuant to s444GA of the *Corporations Act 2001* (Cth) (the **Act**) and dissatisfied creditors can also apply to the court to set aside a DOCA on various grounds). That said, as DOCAs cannot bind secured creditors, owners and lessors in respect of their property (unless they vote in favour of its execution) and cannot release third party claims, the utility of a DOCA as a restructuring tool can be somewhat limited.

Schemes of Arrangement

A scheme of arrangement is a court-approved agreement which binds a company's creditors and/or members to some form of rearrangement or compromise of their pre-existing rights and obligations. A creditor's scheme of arrangement can be implemented without the commencement of a formal insolvency process. As such, the company and its directors can remain in control of the business during the proposal and approval phase (and also, depending on the terms of the scheme itself, after its implementation).

The approval process is heavily regulated and involves a number of steps, including the preparation of explanatory statements and scheme booklets, notification to the Australian Securities & Investment Commission (**ASIC**), an application

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to court for approval to convene scheme meetings, the holding of those meetings, a second application to court for approval of the scheme and, finally, the filing with ASIC of the court order approving the scheme. The timeline for scheme approval is typically three months (but more likely four to six months) from the commencement to the final approval phase.

A creditor's scheme must be approved by at least 75% in value and 50% in number of creditors in each class of affected creditor. Classes are determined by reference to commonality of legal rights and only those creditors whose rights will be compromised or affected by the scheme need be included. As noted above, it must also be approved by the court in order to become effective. Unlike a DOCA, a scheme of arrangement can bind secured creditors who vote against the scheme and release third party claims.

There are a number of limiting factors associated with the scheme process, including cost, complexity of arrangements (e.g. class issues), uncertainty of implementation, timing issues (i.e. because it must be approved by the court and is therefore subject to the court timetable and cannot be expedited), and the overriding requirement for court approval (i.e. a court may exercise its discretion not to approve a scheme of arrangement, despite a successful vote, if it is of the view that the scheme of arrangement is not equitable). These factors explain why schemes tend only to be undertaken in large corporate restructures and in scenarios where timing is not critical to the restructuring.

4. In terms of intercreditor dynamics, where does the balance of power lie as between the shareholders and creditors, and as between senior lenders and junior/mezzanine lenders? In particular, how do valuation disputes between different stakeholders tend to play out?

Under Australian law, there is no concept of equitable subordination. Accordingly, shareholder loans generally rank equally with unsecured claims. The only shareholder claims that are subordinated to unsecured claims are:

- claims for a debt owed to a shareholder in that person's capacity as a shareholder; and
- claims arising from the buying, holding, selling or other dealing in shares of the company.

Otherwise the relationship between creditor groups is very much a function of contract and Australian courts will generally give effect to whatever contractual and/or structural subordination arrangements a company and its creditors have agreed to, even where doing so leaves whole creditor groups out of the money.

Most restructurings, whether by way of a scheme of arrangement or otherwise, tend to play out against the backdrop of the prospect of an external administration, i.e. receivership, administration or liquidation. As such, the power of senior secured creditors to place a group into receivership and/or administration (and thereby deny subsequent ranking creditors such rights as they would have if the group was to continue as a going concern) does tend to provide senior secured creditors with significant bargaining power. The decision for the senior ranking secured creditors will often be between receivership/administration and offering those subsequent ranking secured creditors enough to have them vote in favour of their separately constituted class as part of a scheme of arrangement.

In a scheme, an aggrieved creditor would always have the ability to seek to not have a scheme approved on the grounds of fairness. The onus is on a creditor to bring such an action, and one ground for doing so would be if the enterprise value of the group was greater than that which the proponent of the scheme was suggesting.

5. Have there been any changes in the capital structures of companies based in your jurisdiction over recent years caused by the retreat of banks from loan origination? In particular, have you found that capital structures now increasingly comprise debt governed by different laws (such as New York law governed high yield bonds)? If so, how do you expect these changes to impact on restructurings in the future?

In Australia, the retreat of banks from loan origination has not been as marked as it has been in Europe and the United States. However, having said that, given the cost of capital and other issues mentioned above, there has been some retreat.

There has also been an increase in the number of raisings in the US by Australian corporates.

A relatively new trend in the Australian market is the adoption of US-style combined asset-backed loan (**ABL**) and term loan funding arrangements, with separate security pools being made available to ABL providers and term loan providers. How such structures would play out in a restructuring and enforcement scenario has yet to be truly tested in Australia.

6. Is there significant activity on the part distressed debt funds in your jurisdiction? How successful have they been in entering the market, and how much has market practice (or law) evolved in response? If funds have not successfully entered the market, can you identify reasons why?

There has been significant activity on the part of credit funds in the Australian market over the last seven or eight years, particularly on the larger more liquid names. Such activity is also on the increase both in the context of such funds providing mezzanine finance, in both liquid and illiquid situations, and in purchasing and financing the acquisition of bilateral positions held by traditional lenders in the Australian market.

Given the nature and flexibility of these credit funds as compared with the relative inflexibility of some of the more traditional lending institutions, advisors in the Australian market have had to look at ways to replicate here in Australia that which credit funds have been able to achieve in their home jurisdictions. Put another way, in recent years a variety of different processes have been used to provide credit funds with control or at least the ability to take control not previously seen in the Australian market.

Some good examples of where such innovation has been brought to bear include:

- Mirabela Nickel, which paved the way for creditors of a listed company to pursue debt-for-equity transactions without shareholder approval through the entry into a DOCA, coupled with a court application for leave for a deed administrator to transfer shares pursuant to section 444GA of the Act;
- the Billabong restructure, which following Oaktree and Centerbridge's successful challenge of Altamont's competing restructure proposal in the Takeovers Panel, involved investors using offers combining debt and equity to delever a distressed company's balance sheet and take control; and
- Top Ryde, where Blackstone purchased the secured debt of a company already in receivership (at a significant discount to par) and continues to hold the asset in receivership to recoup its costs, without the downside of having to pay the stamp duty that would have been payable if Blackstone had purchased the asset outright.

Another example is the scheme of arrangement effected in relation to Nine Entertainment. While schemes are not new to the Australian market, effecting a change of control in respect of a large group such as Nine Entertainment through to a secured lender group dominated by credit funds had rarely been seen before in the Australian market.

7. Are there any unusual features of your insolvency or restructuring law that an external investor should be aware of (such as equitable subordination or substantive consolidation)?

Directors' personal liability for insolvent trading

A director or officer of a company may be held liable under the Act for civil and criminal penalties or to compensate the company if he/she allows the company to incur a debt whilst insolvent (otherwise known as insolvent trading).

Section 588H provides directors with a number of possible defences to insolvent trading claims. Directors will not be liable if they can establish (*inter alia*) that:

- they had reasonable grounds to expect that the company was solvent; and/or

- they took all reasonable steps to prevent the company from incurring the debt. In this context, the Act states specifically that matters to be taken into account when considering this defence include any action the director took with a view to appointing a voluntary administrator, when such action was taken and the results of that action.

For creditors or special situation funds looking to restructure the company, early engagement with the company is critical, as the premature appointment of voluntary administrators by directors trying to avoid personal liability for insolvent trading can often result in significant value destruction within the business, derail out-of-court restructuring negotiations and foreclose other opportunities.

One way to help manage a board of directors' concerns about insolvent trading is for the company to enter into forbearance arrangements with its creditors. Doing so provides the company with an opportunity to restructure what might otherwise be current debt obligations.

ASIC Class Order 98/1418 Deed of Cross Guarantee

In Australia, it is possible for the wholly owned subsidiaries of public companies and large proprietary companies to obtain certain reporting relief by entering into ASIC Class Order 98/1418 deeds of cross-guarantee with their parent entity and filing such deeds with ASIC. The terms of these deeds are standardised and their existence can often only be determined by a careful perusal of a company's ASIC search. Under these deeds, the group entities that sign up to the deed guarantee the payment of each other's debts, with such guarantee becoming enforceable upon the winding up of the group entity under certain provisions of the Act, or otherwise in the event that after six months any creditor has not been paid in full. The potential impact of these deeds of cross-guarantee should not be overlooked.

Pooling

Division 8 Pt 5.6 of the Act provides for two kinds of pooling:

- voluntary pooling, where the liquidator makes a determination that pooling is appropriate and then submits that determination for approval by separate meetings of the unsecured creditors of each company. Voluntary pooling only proceeds if the requisite majority of unsecured creditors of each company proposed to be pooled (75% in value and 50% in number) approve the making of the determination. If an eligible unsecured creditor objects to the determination, that creditor may apply to the court to have the determination terminated or varied on the grounds (*inter alia*) that the determination would materially prejudice that creditor; and
- court ordered, where on application to the court under s579E, the court makes a pooling order.

Once a pooling determination or pooling order comes into force in relation to a group of companies:

- each company in the group is taken to be jointly and severally liable for each debt payable by, and each claim against, each of the other companies in the group; and
- all intra-group debts and claims are extinguished.

In relation to a company in liquidation, the court may also make orders for the transfer of assets from a winding up in Australia to an external administration outside of Australia, pursuant to either section 581 of the Act or the UNCITRAL Model Law, incorporated into Australian law by the *Cross-Border Insolvency Act 2008* (Cth).

8. Are there any proposals for reform of the legal framework that governs insolvency and restructurings in your jurisdiction?

On 7 December 2015, the Federal Government released its National Innovation and Science Agenda, which included (*inter alia*) a commitment to reform Australia's insolvency laws, specifically to:

- introduce a "safe harbour" rule to protect directors from personal liability for insolvent trading if they appoint a restructuring adviser to develop a turnaround plan for the company;
- make "*ipso facto*" clauses, which allow contracts to be terminated solely due to an insolvency event, unenforceable if a company is undertaking a restructure; and
- reduce the default bankruptcy period from three years to one year.

It is expected that a proposal paper will be released in the first half of 2016, with legislation to follow in mid-2017.

In addition to the abovementioned reforms (which, as noted above, have been specifically picked up by the Federal Government), the Productivity Commission has recommended the following specific reforms:

- within one month of appointment, an administrator must certify that he or she has reasonable grounds to believe that the company (or a large component entity of it that may emerge following a restructure) is capable of being a "viable" business. If the administrator is unable to do this, then they will be under a duty (enforceable by ASIC) to convert the administration to a liquidation;
- amendments that allow for "pre-positioned" sales (i.e. sales negotiated and/or effected prior to a formal insolvency appointment);
- introduction of a voluntary administration style moratorium on creditor enforcement action during the formation of schemes of arrangement; and

- introduction of a simplified "small liquidation" process for companies with liabilities to unrelated parties of less than $250,000.

The Productivity Commission also recommended an independent review of the provisions of the Act relating to receivers and the practices of receivers in the market.

9. If it was up to you, what changes would you make?

We would support the changes referred to in question 8 above making "*ipso facto*" clauses unenforceable. However, we would suggest that the introduction of a "safe harbour" rule does not go far enough. Rather than giving directors an extra defence to insolvent trading claims, the threshold for breaching the duty to prevent insolvent trading should be lowered and be consistent with that seen in the United Kingdom. Directors ought only be liable if there exists a less than reasonable prospect of the company avoiding insolvent liquidation.

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Dominic specialises in non-contentious restructuring and insolvency work for banks and financial institutions, as well as special situation groups and distressed debt funds. His expertise includes preparing and negotiating standstill and forbearance arrangements, debt restructuring and schemes of arrangement, structured administration and receivership sales, and providing advice to directors, receivers, administrators and liquidators.

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Jessica specialises in non-contentious restructuring and insolvency work for banks, insolvency practitioners, special situation and distressed debt funds, debtors and company directors.

Her experience includes advising on debt and security restructuring and enforcement, the *Personal Property Securities Act 2009* (Cth), the sale and purchase of distressed assets and debts, negotiating forbearance and other restructuring documentation, advising on debt funding and intercreditor issues, advice to directors, and advising on all aspects of receivership, administration and liquidation.

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