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Mr John Kluver
Executive Director
Corporations and Markets Advisory Committee
GPO Box 3967
SYDNEY NSW 2001

Dear John

REHABILITATING LARGE AND COMPLEX ENTERPRISES IN FINANCIAL DIFFICULTIES

I refer to the discussion paper published recently by the Committee. Due to my personal time restrictions (I am going on 2 weeks leave tonight), I am only make to make the following brief comments on the Discussion Paper.

In general terms, the problems facing the voluntary administration system when it comes to dealing with large and complex enterprises have been set out in the Discussion Paper. I only make the following comments in that regard:

1. Featherweight charges (referred to in the context of the U.K. at paragraph 1.47 of the Discussion Paper) are also used in Australia, although their effectiveness for the purposes of section 441A of the *Corporations Act* is not clear.

2. Even though part 5.3A has been operational for over 10 years, we still do not know what "substantial" means in section 441A, and it might be many years before a court has to give any guidance on that issue. Accordingly, we still do not know how extensive is the carve-out for secured creditors. Does "substantial" mean "effectively 100%" or does it mean "51%" or something in between?

3. The test in section 436A of the *Corporations Act* that the company must be "insolvent or is likely to become insolvent at some time" is more restrictive in practice than the legislative drafters seem to have intended. In practice, directors of companies have largely ignored the second part of that test, and have only appointed administrators once a company is insolvent. The meaning of the second part of the test is uncertain, and in practice it is only when all hope is gone that directors are prepared to say that the company is likely to become insolvent.

4. Secured creditors often take security over all the assets of a company purely in order to obtain the protection of section 441A, in circumstances where, in the absence of that section, the security would be over a more limited class of assets of the company. This means that those companies are needlessly restricted in their ability to raise further debt funding.

Debtor in Possession Reorganisation

Although any analysis of this issue must discuss Chapter 11, it would be preferable to concentrate on the use of the term "debtor in possession reorganisation". Firstly, other relevant jurisdictions have debtor in possession systems. Canada has operated such a system under the *Companies Creditors Arrangement Act* since 1936, and, more recently, Japan has implemented such systems under the Civil Rehabilitation Law and the Corporate Reorganisation Law. Secondly, Chapter 11 seems to carry an unfortunate stigma in the perception of some people which can distract from the underlying merits of a debtor in possession system. Stephen Cooper, the CEO of Enron, last week talked about the need to deal with "the voodoo of Chapter 11".

Important relevant aspects of the Australian financial system are different from those of the U.S. system, and accordingly any Australian system of debtor in possession reorganisation would need to differ significantly from the U.S. system. For example, the U.S. does not have the wealth of experience which is available to Australia in professional insolvency practitioners. The U.S. does not have a history of floating charges. The U.S. does not have a history of receiverships. I would suggest that any proposal or legislation be given the name "Debtor in Possession Reorganisation". The essentials of such a system are that there is a moratorium on all creditors, the company has a commercially sensible period within which to negotiate a reorganisation of its affairs, and that there is some form of supervision to ensure that the original appointment is not an abuse of process, that the company only continues to receive protection if a reconstruction remains viable, and that any reconstruction plan is not unfair or oppressive to a class of creditors. It is possible for a debtor in possession system to achieve these ends without using all the procedural aspects of Chapter 11, some of which can be slow and expensive. However, it should also be noted that recent experiences of companies in Chapter 11 indicate that there have been significant improvements in the efficient use of Chapter 11 in the U.S.

Grounds for Appointment

Companies can be in financial difficulties without being insolvent.

In the case of United Airlines, at the time it filed for Chapter 11 protection, it had been trading at a significant loss for many months, and was clearly in financial difficulties, but it was insolvent. It is important that a procedure is available to companies that are not yet insolvent, but are experiencing financial difficulties, and can show that their applications are made "in good faith". It is far more difficult to try and restructure a company that is already insolvent.

Who should be entitled to appoint.

If a debtor in possession reorganisation system is introduced, the order making the appointment would need to be made by the Court. The company could not merely pass a resolution, as happens with voluntary administration, because that would leave the system open to abuse if the directors are not also resolving that the company is insolvent. An independent party needs to confirm that the company is acting in good faith, because the protections afforded to the company will give it considerable competitive and negotiating advantages.

An alternative to Court approval would be to create an "A List" of 3 or 4 of the most senior and experienced insolvency practitioners in Sydney (with the same system in place in other cities) who would have the power to approve the commencement of debtor in possession relief. However, the voluntary administration system has shown that the integrity of administrators can be impugned from circumstances surrounding their appointment, and in my view it would be preferable for the relief to be granted by the Court, but with a requirement that the company provide a report to the Court by a member of the A List so that the Court has some independent basis to assess the good faith of the company. Such a report would be available to the public and would be open to cross

examination by interested parties, such as secured creditors, although that would be on a limited basis as the Court would need to deal with any such application urgently.

Reducing the rights of secured creditors

For large and complex enterprises, the rights of secured creditors are of less general practical importance than they are for small and medium enterprises. Most large and complex financial organisations do not have secured creditors. Instead their lenders tend to rely on negative pledges. Furthermore, those that do have secured creditors usually do not have one secured creditor with security over all assets.

Companies that do have secured creditors over all assets are usually in a position where the amount of those facilities are likely to swamp any other creditors and so any restructuring will have to be with the approval of the secured creditors in any event.

It is essential to any debtor in possession reorganisation system that secured creditors can be restrained.

Time limits

The existing time limits for the voluntary administration procedure are important in order to provide a swift resolution procedure for small and medium enterprises, but they are clearly inadequate for large and complex enterprises, with the consequence that regular court applications are needed to obtain extensions of time. In the meantime, the administrators, the company and the creditors have the problem that they do not have certainty as to how much time will be available.

Debtor in possession financing

It is essential to the voluntary administration system that the administrator incurs personal liability for debts incurred on behalf of the company. The reasons for this requirement were set out in the Harmer Report. However, it is not commercially realistic to expect administrators to incur personal liability for borrowings of the magnitude required to finance a large and complex enterprise during a reorganisation. In the case of Air Canada, it had cash on hand of US$375 million and had arranged debtor in possession financing of US$700 million when it obtained CCAA protection on 1 April 2003. Enron had arranged debtor in possession financing of US$1.5 billion, as had United Airlines. World Com/MCI obtained debtor in possession financing of US$1.1 billion. It is not realistic to expect partners in accounting firms to accept joint and several liability for such amounts, but in the absence of debtor in possession financing, the ability of a company to restructure is extremely limited. If companies are to be able to restructure, they must be able to obtain finance. For large and complex enterprises this is only feasible by having a debtor in possession system which affords superpriority to debtors in possession financiers.

The use of debtor in possession financing in Canada was reinforced by the report of the Senate of Canada Banking, Trade and Commerce Committee released in the first week of 5 November 2003.

Court supervision

Under Chapter 11 the U.S. Bankruptcy Court has extensive involvement in the administration of a company during Chapter 11. In Australia we have the advantage of highly experienced and independent insolvency practitioners. In Canada, where the experience of those practitioners is also available, the Court appoints a leading insolvency practitioner as a "monitor" to report to the Court on the affairs and progress of the Company.

In Australia, a company with debtor in possession protection could have a leading insolvency practitioner (or, depending upon the circumstances of the company, a senior and experienced investment banker) appointed by the Court as a reporting officer to review the activities and finances of the Company, and to report to creditors and to the Court. This could either be by way of a full report, or by way of a commentary upon reports provided directly by the company itself. This would give the reporting officer some de facto approval powers, because the company would usually want to ensure in advance that the insolvency practitioner would not subsequently make adverse comments on any major initiatives of the company.

The reporting officer would have full access to the company's books and records, and would be able to apply to the Court to terminate the debtor in possession orders and appoint an administrator or provisional liquidator if the reporting officer was not obtaining full assistance from the company.

The practical effect of the appointment of a reporting officer would be to reduce the need for expensive and time consuming court applications, and for the need for the considerable expense of the types of creditors' committees that exist as it occurs under the Chapter 11 system.

Australia has the ability to introduce a debtor in possession system which would provide much greater opportunities for large and complex enterprises to survive and restructure, by taking advantage of the resources that are available in Australia, and learning from the experience of debtor in possession systems overseas.

Yours sincerely

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