CLAYTON UTZ

Voluntary Administration: The Australian Experience

CORPORATE INSOLVENCY 2008

Karen O'Flynn, Partner, Clayton Utz, Australia
Ray Mainsbridge, Partner, Blake Dawson, Australia

VOLUNTARY ADMINISTRATION: THE AUSTRALIAN EXPERIENCE

VOLUNTARY ADMINISTRATION: THE AUSTRALIAN EXPERIENCE 1

1. Introduction 2

2. The big picture 2

3. Legal issues 5

3.1 Formalities of appointment of a voluntary administrator 5

(a) Who appointed the directors? 6

(b) What did the directors do? 8

(c) Flying in the face of a winding up application 10

3.2 The conduct of administrators before a DOCA. 12

3.3 VA v Winding up 15

(a) Bona fides 16

(b) DOCA vote imminent 17

(c) No DOCA in view 18

(d) Killing off the administration 19

(e) Better early than late? 21

3.4 Voting 21

3.5 Attacking a DOCA 26

(a) Legislative background 26

(b) Informational deficiencies 27

(c) Votes of related creditors 29

(d) Contents of the DOCA 30

(e) Operation of the DOCA 34

(f) What happens to DOCA funds if the DOCA falls over? 35

4. Creditors' trusts 36

1. Introduction

In this presentation, we will not bore you with a detailed and comprehensive description of the statutory provisions underpinning the Australian voluntary administration system. The reason, quite simply, is that the New Zealand voluntary administration system is basically copied from the Australian one, so there would be little point in telling you what you already know.[1]

Rather, we will concentrate on the Australian experience of working with VAs since 1993. Much of what we have learnt over the last 15 years will be directly relevant to the New Zealand situation. We're not suggesting that we in Australia have worked out all the answers yet, but understanding the issues will be useful for NZ practitioners no matter which side they are on during a VA or DOCA.

One caveat: despite being designed as a court-free insolvency procedure, VAs and DOCAs have turned out to be a major source of litigation. Much of that was the normal settling process that follows every new legislative reform package. In the interests of keeping this presentation to a manageable length, we will not attempt to summarise every Australian court decision on VAs. Instead, we will concentrate on some of the more significant issues.

2. The big picture

Reading NZ commentaries on VA, it is clear that, if not exactly excited, NZ insolvency practitioners have been looking forward to this new regime. That enthusiasm appears to be based on the success of VA in Australia.

But is this correct? Has VA been a "success" in Australia?

Anecdotally, there is no doubt that Australian insolvency practitioners are pretty happy with VA. Hard evidence is somewhat more difficult to come by. Statistics are not much of a guide: changing economic conditions, overlapping insolvency administrations (eg, simultaneous appointment of receivers and liquidators) and changes to data collection and

[1] Our pointing out that New Zealand has adopted the Australian regime does not constitute another example of Aussie triumphalism. After all, you are in good company - the English copied our voluntary administration system a few years ago - and any hurt to Kiwi pride is nothing compared to that felt by Australians (lawyers in particular) at the recent appointment of a New Zealander to coach the Wallabies.

presentation methods make it extremely difficult to do a numerical analysis of the impact of VA on the mix of insolvency regimes. Overall, however, it can be said that:

- VA now ranks equal with court-ordered winding up and just ahead of creditors' voluntary winding up in terms of number of insolvency appointments;
- receiverships account for around 5% of new insolvency appointments.[2]

So, on the surface, this certainly looks like a case of "zero to hero". However, when one digs into the figures a little bit, that story needs to be qualified.

One important feature of VA is speed. In round terms, administrators have about a month to put together a rescue plan, in the form of a DOCA, or to arrive at the conclusion that the company should be voluntarily wound up. This means that it is possible to use ASIC insolvency statistics to track what happens to VAs when crunch time comes.

For example, in August 2007, 229 voluntary administrators were appointed. It is reasonable to expect that a large number of those would have reached the second creditors' meeting (or, as you call it, the watershed meeting) by the following month. When one looks at the September figures, one can therefore get a good rule of thumb picture of the eventual outcome of the August appointments. Those figures are very revealing: there were only 74 new DOCAs in that month. In other words, only 33% of August's VAs resulted in a rescue plan in the form of a DOCA. What happened to the other 66%? A few may have collapsed when a secured creditor sent in the receivers, but most probably ended up in creditors' voluntary winding up (the common default option when the creditors don't approve a DOCA). A similar pattern was observed in a 2004 Parliamentary report into Australia's insolvency laws.[3]

Does this mean that, far from being a success, VAs are really just a damp squib? Not necessarily: it must be remembered that s 435A of the Corporations Act 2001 (Cth) ("**Corporations Act**") states that the objective of the VA regime 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

[2] Source: Insolvency statistics, ASIC Digest.

[3] Parliamentary Joint Committee on Corporations and Financial Services: Corporate Insolvency Laws: a Stocktake, Canberra, June 2004.

(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."

So the mere fact that the company doesn't execute a DOCA doesn't mean that the VA was a failure. Unfortunately, even the Parliamentary report mentioned above was unable to point to any hard statistical evidence that the large number of VAs transitioning into winding up had resulted in a better return for creditors than would have occurred if the company had simply gone into winding up in the first place (the non-DOCA objective in s 435A(b)).

It is also interesting to remember that a DOCA is simply a statutory outcome. The mere fact that a company and its creditors have entered into a DOCA does not say anything about the practical outcomes of that DOCA.

As you know, Australia abolished Crown debt priority many years ago. This means that the Australian Taxation Office now lines up with other unsecured creditors when a company becomes insolvent. This has an unexpected benefit for researchers. Because many - if not most - insolvent companies have tax debts, the ATO is in a unique position to observe how the VA regime works over a wide number of companies.

The picture, if the ATO is to be believed, is not pretty. In its submission to the Parliamentary inquiry, it made a number of adverse comments about the VA regime:

> "[F]rom discussions with practitioners, other creditors and other anecdotal evidence, Tax Office staff believe that a number of Deed of Company Arrangements [sic] are defaulted on, leading to the company being wound up and creditors failing to receive the amounts pledged under the deed.
>
> The Tax Office is concerned that the provisions relating to Deeds of Company Arrangements [sic] are increasingly being used as a mechanism for companies to avoid paying their creditors. *It is the experience of the Tax Office that there are very few Deed of Company Arrangements [sic] that yield reasonable dividends to creditors.*" (emphasis added)

In the light of that last statement, it is hardly surprising that the ATO is sceptical about the use of bare statistics to demonstrate the success of VAs:

> "The Tax Office supports the Voluntary Administration process, but believes that success of the process should be measured by the quantity of Deed of Company

> Arrangements [sic] which are actually complied with, rather than the number that are proposed and accepted by creditors."[4]

In conclusion on this point, it must therefore be said that, while the introduction of voluntary administration has undoubtedly changed insolvency practice in Australia, it is not completely clear that it has achieved the statutory objective (noted above) of "a better return for the company's creditors".[5]

3. Legal issues

Leaving those empirical and policy issues aside, what has been the Australian experience with voluntary administration? In the balance of this paper, we will concentrate on a number of key issues that have arisen since 1993:

- formalities for appointment of a voluntary administrator;
- the conduct of administrators pre-DOCA;
- the appointment of administrators while a winding up application is pending;
- the use by administrators of casting votes;
- court attacks on DOCAs by creditors;
- creditors' trusts.

3.1 Formalities of appointment of a voluntary administrator

As in New Zealand, s 436A of the Corporations Act imposes certain requirements when an administrator is appointed by a company:

- by necessary inference, the appointment must be made by the board of the company; and
- before making the appointment, the directors must hold the opinion that the company "is insolvent or is likely to become insolvent at some future time".

[4] Comments from the Australian Taxation Office to the Parliamentary Joint Committee on Corporations and Financial Services: Inquiry into Australia's Insolvency Laws, Canberra, June 2004.

[5] As an aside, it is interesting that the statutory objective refers to "creditors" rather than to secured creditors or unsecured creditors: one interesting phenomenon (given that secured and unsecured creditors can sometimes have conflicting interests) in Australia is the apparent willingness of secured creditors to initiate VAs, rather than appointing receivers.

Both of these requirements have given rise to some interesting legal issues.

(a) Who appointed the directors?

It is by no means unknown for the purported appointment of an administrator to reveal that the directors of the company may not themselves have been acting validly (because their own appointments were defective, for example). This can and does result in litigation about the validity of the directors' actions, which requires the Court to delve back into corporate governance issues that predate the administration. Generally, the Courts have tended to use their powers under ss 447A or 1322 to validate the appointment of the administrator,[6] but the mere fact that the administrator (or someone else) has had to go to Court to get an order giving legal effect to his or her appointment goes against the underlying conception of voluntary administration as a Court-free insolvency procedure.

More important, however, is the question of the administrator's culpability in these circumstances. For example, who should bear the cost of the legal proceedings that consider the validity of the administrator's appointment? This issue arose in Deputy Commissioner of Taxation v Portinex (No 2) [2000] NSWSC 557.

There, the Deputy Commissioner of Taxation had initiated proceedings to have a DOCA set aside on the grounds, inter alia, that the board meeting which had purported to appoint the administrators had been invalid (because the articles under which the board was operating had not been validly adopted by the company in general meeting). The Court agreed that the meeting had been invalid, but validated that administrators' appointment. The Commissioner then argued that the administrators should bear the cost of the proceedings because they had not checked the validity of the resolution purporting to appoint them.

The Court dismissed the Commissioner's argument on the facts. As noted, the invalidity of the appointment stemmed from earlier events related to a general meeting of the company. There was, said the Court, nothing on the face of the board resolution which would have put the administrators on notice of the earlier problems.

Nevertheless, Austin J took the opportunity to lay down some rules about the extent to which an administrator is required to check the validity of his or her appointment. He said that a duty to check would arise in two situations:

[6] But see Sutherland v Take Seven Group Pty Ltd (1998) 29 ACSR 201, in which the Court was not asked to use its validating powers, and the issue was therefore whether the invalidly-appointed administrator was entitled to be paid for the services he had rendered during his period "in office".

(1) *On appointment* - immediately after appointment, an administrator must satisfy himself or herself that the resolution of the directors under s 436A authorising the appointment appears on the face of the minutes which record it to be a valid resolution (or if there are not yet any minutes of the resolution, that the facts and circumstances appear on their face to amount to a valid resolution). Additionally, the administrator should satisfy himself or herself that the instrument of appointment appears on its face to be valid. This doesn't mean that, upon appointment, an administrator has to "trawl back" through the records of the company to ensure that there is no defect prior to the resolution of appointment, if the resolution appears ex facie to be valid.

(2) *Subsequent to appointment* - during the course of the administration, the administrator has a duty to follow up lines of inquiry that might call into question the validity of his/her appointment. It appears from his Honour's reasons that such a duty would only arise if the administrator were put on inquiry.

His Honour revisited this issue in 2002, in Re Wood Parsons Pty Ltd [2002] NSWSC 1058. 18 months after administrators had been appointed, it was claimed that the directors who had purported to appoint them had not been validly appointed by the company (on the grounds that the general meeting had been inquorate). The administrators (who were now the company's liquidators) applied for a Court order to validate their appointment. Austin J granted the order, largely on the basis that the company was insolvent and had been in external administration for quite a long period before the validity of the administrators' appointment had been questioned. Nevertheless, he made it clear that there were countervailing factors that, in different circumstances, may have produced a different result:

> "A consideration pointing against granting the relief sought by the [administrators] is that, according to the evidence of Mr Duncan, very little trouble was taken by the [administrators] to investigate the adequacy of their purported appointment immediately after it took place. It seems that they relied on assurances given by Mr Powles, notwithstanding the state of ASIC's records. In my view they did not conduct adequate investigations." (at [60])

The directors who had purported to appoint the administrators did not appear on the ASIC records when the administrators consulted those records shortly after their appointment.

A slightly different situation was considered by the Supreme Court of Victoria in Mentha & Anor v Colorbus Pty Ltd (in liq) & Anor [2004] VSC 486. There, the administrators were aware - before their appointment - of problems in the legal status of the company's board. However, before the appointment was made, they were assured by the company's solicitors that those problems had been rectified.

They hadn't, and the administrators ended up in Court, seeking a validation order for their appointment. The Court said that the administrators' "failure ... to verify for themselves the existence of the legal foundation for their appointment may be legitimately criticised". Nevertheless, they had acted in good faith and it had not been "grossly unreasonable" of them to rely upon the experience of the company's solicitors, with whom they had an established professional association.

(b) What did the directors do?

As noted above, the directors must hold the opinion that the company "is insolvent or is likely to become insolvent at some future time". Despite the apparent vagueness of "likely to become insolvent at some future time", Australian Courts have taken a fairly strict approach to the formalities of appointment.

For example, it was early established that the resolution of appointment must incorporate the terms of the legislation. Within a year of the commencement of the voluntary administration regime, the Court made it clear that the ease and speed of appointment of an administrator was not a licence for informality on the part of the directors. In Wagner & Anor v International Health Promotions & Ors (1994) 12 ACLC 986, the directors purported to appoint an administrator during a telephone meeting, by passing the following resolution:

> "That the board of directors of International Health Promotions Pty Ltd resolve to appoint Mr Peter Walker, a partner of Ferrier Hodgson, to be the Administrator of the company."

The appointment was subsequently declared to have been invalid, but not because the meeting had been conducted by telephone. Rather, the Court held that the resolution of appointment had been invalid because it had not declared that the directors believed that the company was insolvent or likely to become so. This was despite the fact that the minutes of the meeting appeared to show that the matter of insolvency had been raised at the meeting:

> "The chairman informed the meeting that as a result of the company's successive years of declining trade and the fact that the company can't meet it's (sic) liabilities as and when they fall due, he had reason to believe that the company may be insolvent now or likely to become insolvent in the short term. He went further to add that the company's accountants and auditors shared this view.
>
> The chairman stated that as a director it was his responsibility, in view of the company's questionable solvency, and taking full account of section 436 (a)

(sic) of the Corporations Law, that he put forward the [resolution appointing an administrator] for the board's approval."

The Court said that, even if the statutory prerequisite (belief on the part of the directors) could be satisfied by evidence in the minutes, this entry would not have been sufficient, since it only showed that one director (the chairman) had had the requisite belief.

This aspect of Wagner has subsequently been followed without question by other Australian Courts. As a result, it is now general practice in Australia for the resolution of appointment to record the directors' belief that:

(a) the company is insolvent (or is likely to become so); and

(b) an administrator should be appointed.

We refrain from saying that this is a practice followed universally, since the more recent case of Panasystems Pty Ltd v Voodoo Tech Pty Ltd (2003) 21 ACLC 842 shows that there can still be disputes about what the directors actually resolved.

Before leaving this topic, we should mention a related - and arguably more fundamental - issue: did the directors actually believe that the company was insolvent? At first blush, it would be almost oxymoronic for directors to put the company into administration (a form of insolvency administration) if they didn't believe that the company was insolvent or likely to become insolvent. However, Cadwallader v Bajco [2001] NSWSC 1193 shows that even the directors of a solvent company may view the appointment of an administrator as the lesser of two evils. In that case, the directors appointed an administrator in an attempt to stymie a spill motion. The Court said that:

- a general meeting to consider a spill motion can still be held even if the directors have appointed an administrator after receiving notice of the motion;
- appointing an administrator to a solvent company in an attempt to frustrate a spill motion would be a misuse of directors' power under s 436A, with the result that such a resolution would be voidable.

Even leaving aside the possibility of a deliberate misuse of s 436A, the question of solvency v insolvency can be a tricky practical one for directors, as Kazar v Duus (1998) 88 FCR 218 shows. The Court there reviewed the authorities and concluded that s 436A requires that:

- the directors form a "genuine, bona fide and concluded opinion" as to insolvency, that is, the company is or is likely to be unable to pay its debts as and when they become due and payable;
- in forming the requisite opinion, the board should address the question formulated in the section and not err in law in doing so.

The second of these requirements means that the directors should turn their minds to the requirements of the section, so that a misunderstanding of what the section requires could vitiate their resolution. More significantly, the Court said that directors should not confuse a belief that the company is insolvent with an inability to determine that the company is insolvent:

> "An inability to determine whether a corporation is or is not solvent, without more, cannot found an opinion that it is or is not insolvent or likely to become insolvent."

In passing, it may be noted that this appears to expose a lacuna in Australia's corporate insolvency laws. Part 5.7B Div 3 of the Corporations Act imposes personal liability upon directors whose company incurs debts while insolvent (referred to as "insolvent trading"). One statutory defence available to a director is to prove that he or she had "reasonable grounds to expect, and did expect, that the company was solvent" when the debts were incurred (s 588H(2)). Another defence is that the director took action with a view to appointing an administrator (s 588H(5) and (6)). Indeed, this defence was specifically crafted to encourage directors to take prompt action in response to insolvency by appointing an administrator.

It has been long established that a director will not have reasonable grounds to expect that the company is solvent if the director is simply ignorant of the state of the company's finances.[7] Such a director could, therefore, be forced to rely on the defence of attempting to appoint an administrator. The problem then is that, on the basis of Kazar v Duus, a director who is ignorant of the company's finances would not be able to form the requisite opinion as to the state of the company's finances.

(c) Flying in the face of a winding up application

One recurring issue in Australia is the appointment of an administrator after the making of an application to wind up the company.

[7] See, for example, Morley v Statewide Tobacco Services Ltd [1993] 1 VR 423.

Sometimes this happens on the eve (literally) of the Court hearing of the winding up application. The New Zealand legislation attempts to prevent this phenomenon, through s 239I(4):

> "(4) If an application has been filed for the appointment of a liquidator of the company by the Court under section 241(2)(c), the company may only appoint an administrator if the administrator is appointed within 10 working days after service on the company of the application."

While this may reduce the incidence of "last minute" appointments, it is unlikely completely to dispose of the phenomenon of "trumping" winding up applications. It may, therefore, be instructive to examine how Australian Courts have approached this issue.

A major objective of appointing a voluntary administrator in these circumstances may be to secure the protection of ss 440A(2) and 440D(1):

> "440A(2) 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."
>
> "440D(1) During the administration of a company, a proceeding in a court against the company or in relation to any of its property cannot be begun or proceeded with, except:
>
> (a) with the administrator's written consent; or
> (b) with the leave of the Court and in accordance with such terms (if any) as the Court imposes."

There has been a body of case law built up in Australia on the issue of the exercise of the Court's discretion in these circumstances. That case law is discussed below, under the heading of "VA v Winding up".

(It may be noted that there appears to be an overlap between ss 440A(2) and 440D(1). Since these provisions parallel ss 239ABV and 239ABE in New Zealand, it is worth knowing that Australian Courts have tended to take the view that s 440A(2) is the only applicable provision where the proceeding against the company is a winding up application.)

3.2 The conduct of administrators before a DOCA

In the period leading up to the second creditors' meeting, the administrator has a threefold function:

- keeping the company in operation;
- gathering information about the company;
- producing a recommendation for the creditors to consider.

The first of these is largely self-evident. The second and third are closely linked, since the administrator's ultimate recommendation to the creditors must, of course, be based on an assessment of the company's present and prospective financial position, as is made clear by s 438A:

> "As soon as practicable after the administration of a company begins, the administrator must:
>
> > (a) investigate the company's business, property, affairs and financial circumstances; and
> >
> > (b) form an opinion about each of the following matters:
> >
> > > (i) whether it would be in the interests of the company's creditors for the company to execute a deed of company arrangement;
> > > (ii) whether it would be in the creditors' interests for the administration to end;
> > > (iii) whether it would be in the creditors' interests for the company to be wound up."

Not uncommonly, the financial records of companies that are in financial difficulties are not always in the best of conditions. This is exacerbated by two factors:

- the short timeframes within which the administrator is required to work (recently expanded in Australia, from 21 calendar days to 20 business days); and
- the possibility of litigation that might improve the company's financial position through an award of damages or other monetary recovery.

The second of these can be quite problematic for administrators. It is often the case that the company's major (if not only) assets may be the potential for recovery actions through litigation (for example, against the directors for breach of duty or against creditors to recover voidable preferences). The administrator faces the difficult task of assessing the likelihood of success of such claims and the recoverable quantum before making his or her recommendation to the creditors. If the company has few other assets and no hope of a workout, the administrator's task may be relatively straightforward, since the creditors may not be any worse off if they vote to put the company into liquidation. In practice, the picture is not always that simple: the administrator may be required to evaluate the possible return from litigation in a winding up against a DOCA that has been proposed by a third party. You will not be shocked to hear that such DOCAs have commonly been proposed by the company's directors or parties associated with them.

What is the administrator to do in such a situation? It can often be a case of a bird in the hand versus two in the bush. There is the possibility of a DOCA that injects cash into the company, thus guaranteeing a definite return for creditors. Against that is the possibility of winding up in the hope - but not the assurance - of successful litigation.

Luckily for administrators, Australian Courts have been sympathetic to their plight:

> "The intention [of the voluntary administration regime] was, as has been indicated in several cases, to provide a more expeditious and less expensive way of assisting those creditors and members than under the greater formality of a winding-up or of the entry into a scheme of arrangement. One result, however, is that *an administrator, constrained as he or she is by the time limits imposed under the Part, cannot carry out a detailed investigation of a company in the same way as can a liquidator, and accordingly the administrator's actions must be looked at in the light of that more restricted range of activities which are available to him*. A further result, when dealing with a deed of company arrangement under Part 5.3A, is that the amount of detailed information which would be given to creditors in a scheme of arrangement under s 411 of the Corporations Law is not available, again because of time restrictions and the need to have material sent to the creditors quickly." (Hagenvale Pty Ltd v Depela Pty Ltd (1995) 13 ACLC 885 at 890, emphasis added)

Similar considerations have been held to justify a holding that an administrator would not normally be expected to avail him or herself of the court examination powers:

> "While it might be theoretically possible, as counsel for the applicant submitted, for an administrator to use the powers of compulsory examination by the Court (ss 596A and 596B) that would involve giving notice of an application, waiting for the Court to deal with the application for an order and then if an order were

> made, waiting for an appointment for the examination, conducting the examination and reviewing the transcript thereof. With respect, the suggestion seems to me to be somewhat unrealistic." (Deputy Commissioner of Taxation v Pddam Pty Ltd and Anor (1996) 14 ACLC 659 at 668)

The same case also shows that the doctrine of proportionality may be taken into account when determining the extent of the administrator's duty to investigate:

> "In the present case the investigation concerned a business with about 18 employees operating from the one premises. On the spectrum of manufacturing enterprises, it would be small rather than medium or large. The company had already been in receivership for over three months and under the informal supervision of its bankers for some five months prior to that. The nature of the investigation and the time spent and cost seem to me to be within the limits of practical proportionality in the circumstances." (ibid at 668-669)

Reference should also be made to Cresvale Far East Ltd (in liq) v Cresvale Securities Ltd and Others [2001] NSWSC 89 and Kirwan v Cresvale Far East Ltd (in liq) (2003) 21 ACLC 371. In the first case, Austin J said that "the balance between speed and accuracy of investigation is a delicate one". He then went on to find that the administrator in the case before him had not made an adequate investigation:

> "Given the size of the transaction and therefore the potential recovery to Securities, [the administrator] should have made at least some further inquiries into the circumstances surrounding it. In particular, he should have inquired into the relationship of Mr Kirwan to Virotec at the time of the transaction and subsequently, and Mr Kirwan's state of knowledge about matters material to the price or value of shares in Virotec. In light of those further inquiries, he should have obtained his own legal advice as administrator.
>
> ... In my opinion, by failing to make any significant inquiries or obtain his own legal advice on such a major issue as the Virotec transaction, Mr Gould fell far short of making an adequate preliminary investigation.
>
> I do not suggest that the known facts establish any breach of duty or statute by Mr Kirwan, or even that they give rise to a prima facie case of breach. The submissions by the [administrator], concentrating on the absence of evidence of wrongdoing, rather missed the point. The point is that a reasonable administrator... would have been sufficiently suspicious, in view of the known circumstances, that he would have made further inquiries and obtained legal advice, notwithstanding the exigencies of the administration process." (at [137-139])

Just how delicate the balance is was clearly illustrated when this decision went on appeal - and was reversed:

> " There are, it seems to me, some difficulties in this reasoning. In essence, it is said that [the administrator] acted improperly in failing to make an adequate preliminary investigation into any breach of duty or statute by Mr Kirwan, even though the facts known at the time of the proceedings did not even give rise to a prima facie case of breach of duty or statute. Why, in those circumstances, is [the administrator's] view to be taken as the fortuitously correct outcome of an inadequate preliminary investigation, rather than a correct forecast from a sufficient preliminary investigation? As his Honour said, the balance is a delicate one, and adequacy of preliminary investigation is a matter of degree. In the result, [the administrator] got the balance and the degree right.
>
> Importantly, at no time in his cross- examination was it put to [the administrator] that he should have done more by way of preliminary investigation, that he had failed to consider breach of fiduciary or statutory duties as distinct from preference or that his investigation was inadequate to permit him to vote in favour of the DCA." (Kirwan v Cresvale Far East Ltd (in liq) (2003) 21 ACLC 371 at [212-213])

3.3 VA v Winding up

As noted above, the appointment of an administrator will allow a Court to stay or prevent the continuation of a winding up application against the company.

The job facing the Court in such a situation is an extremely complex one:

- should it look at the state of the company’s solvency (and at any rescue plans in the form of a proposed DOCA) and decide which offers the better alternative for creditors?

- should it take the view that the fate of the company is best left to its creditors, and so postpone the hearing of the winding up application until after the creditors have had a chance to consider its future (at the second creditors' meeting)?

The first approach is supported by the line of authority starting with the Queensland Court of Appeal decision in Creevey & Another v Deputy Commissioner of Taxation (1996) 19 ACSR 456:

> "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." (at 457)

The broader view is arguably found in cases such as Emanuel Exports Pty Ltd v United Farmers International [1998] FCA 1090:

> "There is evidence before me that a deed of proposal will be considered at tomorrow's meeting which includes within it an offer from the director to contribute $10,000 and an undertaking from the director and his father that they will not prove their debts in any such distribution. I am satisfied that it is in the interests of the Company's creditors that they have an opportunity to at least consider that proposition. To the extent that the proposition may be susceptible to attack or may be perceived to be inadequate under closer examination, it is appropriate that the creditors of the Company have the opportunity to make that assessment rather than the Court. In making their assessment the creditors may, of course, be able to rely upon matters which were not apparent in the evidence before me." (at [6])

Generally speaking, the Creevey approach is the more common of the two. In order to illustrate how this issue is approached in practice, we will look at some recent case studies.

(a) Bona fides

The first point to be made is that the Courts do not approach this issue with any presumption that there is something suspicious about the appointment of an administrator after the serving of a winding up application, even if the appointment is consequential upon, rather than merely subsequent to, the winding up application:

> "It often happens that directors resort to Part 5.3A administration in the face of an application for a winding up order by a creditor whose statutory demand has not been satisfied. In many cases, such action by directors will represent an entirely reasonable and responsible response. I repeat here what I said in St Leonards Property Pty Ltd v Ambridge Investments Pty Ltd (2004) 50 ASCR 443 at 446:
>
> > 'I hasten to say that it is not, of itself, reflective of improper purpose for directors faced with a winding up application to cause the

> company to go into Part 5.3A administration. Indeed, in many cases that will be the proper and responsible thing for directors to do. In some cases, the demands of a creditor and the indication that the creditor will pursue a winding up application will so focus the minds of directors that they become able to take stock of the company's position more critically and, realising that the company is insolvent, to see resort to the Part 5.3A procedure as the appropriate course. In those cases, such action is entirely responsible and proper.'" (McDonald v Deputy Commissioner of Taxation [2005] NSWSC 2 per Barrett J at [47])

(b) DOCA vote imminent

In Deputy Commissioner of Taxation, Re Managenet Pty Ltd v Managenet Pty Ltd [2005] FCA 1903, the Federal Court was asked to decide if a winding up application by the Australian Tax Office should be adjourned. This occurred five days before the company's creditors were due to vote on a DOCA.

The company appeared to have virtually no assets and there is little information about the proposed DOCA in the judgment. However, it appears to have been a type of DOCA which is commonly encountered:

> "First of all, there is a promised cash contribution which would enable payment out of priority creditors and would enable a modest amount to be paid to other creditors. Secondly, a deferral of some of the creditors is proposed, so as to improve the position of creditors who are not deferred. The net result is that the priority creditors would be advantaged very greatly and other creditors would receive some advantage."

The ATO argued that the winding up application should not be adjourned, for a number of reasons:

- the administrator's support for the DOCA had been expressed "without adequate investigation";
- the DOCA deferred, rather than cancelled, some of the deferred debts;
- it was against the public interest to allow an insolvent company to continue to trade (if that was what was being contemplated).

The Court held that the public interest point was "misconceived" in a case "where we are considering only either a deed of company arrangement being entered into or an inevitable liquidation if the vote is lost." (at [6])

The ATO's other arguments were not given any judicial consideration, and the adjournment was granted:

> “It seems to me that creditors, as a whole, are advantaged by being able to consider the benefits offered here, which are not otherwise available, and to compare those benefits with the potential result of a liquidation. In my opinion, that is a matter for creditors to consider and they should be permitted to exercise the power given to them by the Act to vote at the second creditors [sic] meeting.” (at [6])

(c) No DOCA in view

Watts v Albany Marine Centre Pty Ltd [2006] WASC 22 concerned an application for the appointment of a provisional liquidator.

EM Heenan J adopted the test laid down by Austin J in Lubavitch Mazal v Yeshiva Properties (No 1) [2003] NSWSC 535, a decision in which Austin J followed the principles laid down in Creevey (supra). EM Heenan J cast the issue in these terms:

> "In these cases the emphasis is plainly upon the comparative advantages for the creditors of the company for a continuation of an administration as opposed to the immediate appointment of a liquidator. In one passage ([74]) Austin J draws attention to the most influential factor being the prospect that a deed of company arrangement might emerge that would give the creditors a quicker or better dividend in a winding-up."(at [8])

EM Heenan J then examined, in considerable detail, the factual background to the case before him. The hearing was conducted just a week after the administrator had been appointed, and there did not appear to be a proposal for a DOCA on the table. However, it was said that one of the directors was "prepared to do what he can to attempt to resuscitate the business on a smaller scale and from smaller premises which he would underwrite and to pursue the possibility of recovering an indemnity from the insurer." That offer would not be made if a provisional liquidator were appointed.

The Court agreed with the applicant creditor that there was not much information about the proposed resuscitation plan. The creditor described it as "merely speculative and unrealistic". The Court was more diplomatic, preferring to talk about the "paucity of information" and "uncertainty". Notwithstanding this, the Court decided to adjourn the application of the appointment of a provisional liquidator. It took the view that even the

"slight" hope of a recovery plan was preferable to the immediate snuffing out of all hope that would follow the appointment of a provisional liquidator:

> "I am satisfied that the immediate appointment of a provisional liquidator would, for practical purposes, extinguish any prospect, however remote, of significant financial advantage being derived from such vestigial goodwill as may remain. According to the affidavits, Mr Howden would not be prepared to undertake any role in preserving the business opportunities of the company if a liquidator were to be appointed. On the other hand, if the administration is allowed to continue, Mr Howden is prepared to do what he can to attempt to resuscitate the business on a smaller scale and from smaller premises which he would underwrite and to pursue the possibility of recovering an indemnity from the insurer.
>
> Mr Hershowitz, not unreasonably, characterises those aspirations as merely speculative and unrealistic, but I am not sure that they should be condemned quite so tersely at this point. They are the only initiatives which offer any prospect of financial recovery, and it is difficult to see how the company would be prejudiced if a reasonable opportunity were to be allowed for them to be explored.
>
> It seems to me, therefore, that it is in the interests of the company's creditors for the company to continue under the present administration rather than have a provisional liquidator appointed with another change of control and with another level of fees being incurred. It seems to be better for all if the administrator presently appointed can explore these opportunities, slight though they may be." (at [20]-[22])

(d) Killing off the administration

Balancing these two cases are those in which the Court preferred immediate winding up to the continuation of the administration.

Deputy Commissioner of Taxation v KJ Consulting Pty Ltd [2005] FCA 1827 saw the question of the adjournment of the winding up application being heard on the day before the creditors were due to vote on a DOCA.

The company was insolvent. Its major asset appeared to be claims in debt against related companies. The proposed DOCA appeared to include an 18 month moratorium on recovery of those claims and an offer of a cash injection by related parties.

The Court refused to adjourn the winding up application. It gave four reasons:

- the DOCA might be passed on the casting vote of the administrator (because the vote against by the majority creditors by value might be counterbalanced by a vote in favour by the majority by number). This was a consideration which reduced the importance that would normally be given to allowing the matter to be decided by the creditors;
- given that the company's only asset was debts, a DOCA offered no advantage over a winding up. An administrator would not be in any better position than a liquidator to recover those debts;
- because of opposition by the majority value creditors, the offer of a cash injection needed to be carefully scrutinised. In effect, it was a purchase of a moratorium on recovery action against the related companies. That would not necessarily improve the chances of recovery and might even give the related companies "leeway to avoid responsibilities";
- with so many transactions involving related parties, it was not absurd to consider that there was the possibility of proceedings against those related parties for breaches of the law. A liquidator would be in a better position than an administrator to pursue this.

Deputy Commissioner of Taxation v Woomax Pty Ltd [2006] FCA 118 was another case heard relatively late in the piece. It involved the hearing of a winding up application and it does not appear that the Court was specifically asked to adjourn the winding up application. Rather, a director of the company opposed the winding up application on the grounds that a proposed DOCA was a preferable alternative. That proposed DOCA apparently involved a debt for equity swap.

The Court preferred a winding up (and ordered accordingly):

> "It seems to me that a proposition which ultimately involves creditors being invited to substitute their dollar value debts (provable debts) for a shareholding in a company ranking differently, having different classes of rights, and having no precise and documented formulation of the proposal is one which ought not, in the interests of the creditors generally, be accepted." (at [20])

Other cases in which winding up has been preferred to administration include:

- Karimbla Properties (No 3) Pty Ltd v Questra [2006] NSWSC 181 - where, after a number of variations on the DOCA proposal had been floated up to the Court over a series of cases, the Court declined to adjourn the winding up application

on the grounds that the proposed DOCA was ambiguous and contained "substantial discrepancies";

- Bechara v Sotrip Pty Ltd [2006] NSWSC 208 - which shows that, while the Court will tend to look favourably on a DOCA that would, on its face, provide a better return than an immediate winding up, that favour will evaporate in the face of evidence that the injection of cash into the DOCA is, at best, doubtful:

> "If one has regard purely to mathematics, creditors could be said to be better off under a deed of company arrangement providing $50,000 for them than they would be under a winding up where there was a nil return (as will be the case in a winding up of this company). But, on the evidence before me, I cannot be satisfied that the $50,000 will ever be forthcoming. I cannot be satisfied that there is even a reasonable likelihood of its becoming available. The draft deed of company arrangement, as presented, is based on false premises, involves funds said to be coming from an indeterminate source by unidentified means and entails uncertainties of timing that have no apparent solutions. The supposed creditors who expressed support for it did so on the basis of a wholly misleading description of it. Their supposed support can safely be ignored." (at [15])

(e) Better early than late?

No clear pattern emerges from these and other cases. Perhaps the most that can be said is that, in the early stages of the administration, the Court may be prepared to allow the company and the administrator greater latitude when deciding whether to adjourn the winding up application. Conversely, the closer the company gets to the vote on the DOCA, the more closely the Court will examine the proposed plan and compare it with the potential picture under the alternative of winding up.

From the point of view of an applicant for a winding up order, this is not a hugely inconvenient situation: the relatively short time frame within which the DOCA has to be assembled and put to the vote is not likely to cause significant problems for either the creditor or for commercial morality as a whole.

3.4 Voting

There is an interesting difference between Australia and New Zealand as regards the voting thresholds for a DOCA.

The Australian position is that a DOCA will come into force if it receives the support of:

- more than 50% of the number of creditors who vote at the meeting; and
- more than 50% of the value of debts voted at the meeting. (Reg 5.6.19–5.6.21)

Where only one threshold is reached, the DOCA is defeated, unless the administrator uses his or her casting vote in favour of the DOCA.

The New Zealand position is identical, except that the threshold for value of debts is 75%, rather than 50% (s 239AK(2)).

The administrator's casting vote has assumed some importance in Australia, because it is fairly common to find that the DOCA enjoys the support of a majority in number of creditors, but not the support of the larger or largest creditors (among whom the ATO will often feature).

There is no statutory direction on the factors to be taken into account by the administrator before exercising the casting vote. At one time, the professional body, the Insolvency Practitioners Association of Australia, advised its members to vote with the value:

> "Where a deadlock exists in the voting after a poll has been demanded, and the Chairman elects to cast his vote, he should have regard to the wishes of creditors with the greatest pecuniary interest (including secured creditors for their gross debts) in the likely outcome of the administration. The casting vote provided to the administrator is a very powerful tool and protecting it by ensuring practitioners do not abuse the use of it, is an essential element to the on-going success of voluntary administrations." (Guidelines for Voluntary Administrations, IPAA, 1995)

However, this was the subject of some judicial criticism by Austin J in Cresvale:

> "I doubt that there is a general rule that the administrator should exercise the casting vote to prefer the view of the majority in value over the view of the majority in number." (at [115])

The IPAA has subsequently revised its advice to members, and has issued a list of factors to be taken into consideration before exercising the casting vote.[8]

[8] "Some matters for consideration when exercising a casting vote are, but not limited to:

- Do creditors with a majority in value however not in number have an overwhelming interest over those in number?
- What opinion, if any, was proffered by the member in support or opposition of the resolution in any report to creditors or otherwise?
- Has any information come to the member's attention since the member formed his or her opinion that might require a change in support of that opinion?

(It should be noted that the administrator cannot simply sidestep the issue by declining to exercise his vote:

> "It would be going too far to say that a person to whom a casting vote is entrusted must always exercise it. Clearly, there is a discretion. But the discretion cannot be regarded as unfettered. I am of the opinion that the person should proceed to exercise the casting vote and resolve the deadlock (thereby resorting to the power for the purpose for which it exists) unless there is some good reason to refrain from doing so; also that failure to exercise the casting vote for some irrational or irrelevant reason is inconsistent with the person's duty. That person plays, in the context, an administrative decision-making role attracting a duty to take into account relevant matters and to leave out of account irrelevant matters – with questions of relevance determined according to the purpose for which the power exists and the context in which it becomes exercisable.")[9]

These issues arise because there is specific legislative provision for a court challenge to the exercise of a casting vote:

- s 600B allows a person who voted against a resolution to approve a DOCA to ask the Court to overturn or vary a resolution that was passed on the casting vote;
- if a resolution to approve a DOCA was defeated on the casting vote (or because the casting vote was not exercised), s 600C allows a person who voted in favour of the resolution to ask the Court to declare that the resolution was passed.

• What level of influence is direct or indirect opportunity of financial reward having upon the member's intention to exercise the casting vote?

• Of those creditor(s) opposing the member's opinion, do any have a motive that may not be considered to be in the best interests of the population of creditors and/or contrary to the purpose and objectives of the appointment?

• Are those creditors opposing the member's opinion making an informed and unbiased decision?

• Can the purpose for exercising the casting vote be substantiated by independent, objective and impartial reasoning?

• Will any unfair advantages accrue to the directors by exercising a casting vote in favour of the member's opinion?

• Should the member seek to adjourn the meeting for the purpose of further consideration or taking advice?

• What proxies have been given on the basis that the member would vote in accordance with his recommendation?" (Statement of Best Practice: Calling and Conducting Creditors' Meetings, IPAA, July 2005)

[9] Ausino International Pty Ltd v Apex Sports Pty Ltd [2007] NSWSC 289.

Obviously, the circumstances in which a casting vote will be exercised will vary greatly. It is, therefore, useful that a judge recently surveyed the leading cases and extracted a statement of principles:

> " (1) Good faith alone will not necessarily shield the resolution from a setting aside (or variation) under s 600B (Cresvale 37 ACSR 394 at [111]);
>
> (2) A factor that may justify setting aside the resolution is a statement in or omission from the administrator's report under s 439A that is apt to have misled creditors when they cast their deliberative vote (Blue Ring [2006] WASC 245);
>
> (3) Inadequacy and superficiality of an administrator's investigation of the company's business, property, affairs and financial circumstances, at least as disclosed by the evidence before the Court, may warrant a setting aside of the resolution (Bartlett 12 ACSR 707; Cresvale 37 ACSR 394 at [113]);
>
> (4) There is no presumption in favour of the majority in value, although any large disproportion between the values of the debts of the numerical minority and the numerical majority will be a factor to be taken into account (Coaleen 30 ACSR 200; Cresvale 37 ACSR 394 at [115]); and
>
> (5) Payment of a premium to the creditors who supported the DOCA but not to a dissident creditor will justify a setting aside by the court (Young v Sherman 170 FLR 86)."[10]

One item not on this list is any personal interest that the administrator may have in the outcome of the vote. The general pattern of events is that the second meeting of creditors produces one of two results:

- a DOCA, which is usually administered by the same person who was the administrator during the voluntary administration; or
- a creditors' voluntary winding up, in which the administrator of the company becomes its liquidator.[11]

In practical terms, both offer the possibility of remuneration to the administrator, so there may be no economic advantage to the administrator in one or the other outcome. Sometimes, however, the DOCA may be constructed in such a way as to confer some

[10] Deputy Commissioner of Taxation v Wellnora Pty Ltd [2007] FCA 1234 at [218]

[11] A third, but relatively rare, prospect is that the company exits from administration and returns to the control of its directors. The fourth, and somewhat specialised, possible outcome is a creditors' trust: see below.

benefits on the administrator. These do not automatically disqualify the administrator from voting:

> "The liquidator is going to charge fees, and is entitled to charge fees, for every act he does in the course of the liquidation. So, if he is gathering assets, selling a property or pursuing an action, he is going to charge fees and is entitled to be paid with priority over other creditors. I consider that that fact should not preclude him from exercising his judgment in all kinds of matters, including the casting vote in issue here. In the absence of any authority at all, I am not willing to make new law and say that the liquidator, as in this case, who is owed fees for past work, and hoping to get paid for future work, is thereby debarred from making a casting vote on a matter which has divided the creditors. I consider the liquidator has not been guilty of fraud; that has not been alleged. It cannot be demonstrated that his discretion was exercised mala fide and it cannot be said that he has acted in a way in which no reasonable liquidator would have acted. In the absence of any of these things, I am willing to assume that he acted properly as an officer of the court in casting a vote for a resolution which offered reasonable prospects of recovering money for the benefit of all the creditors, even though it incidentally offered the prospect of recovering money to pay his fees."[12]

Similarly, if the administrator reasonably believes that it is in the interests of creditors, the administrator is entitled to use the casting vote against a resolution that would replace him with another administrator: Kirwan v Cresvale Far East (supra).

Before leaving the topic of casting votes, reference should be made to the problematic situation which can be created by group administrations.

Australia recently legislated to allow a pseudo-pooling regime for companies in winding up. ("Pseudo", because what is allowed is not "pooling" as that term is commonly understood: the Australian legislature thought that the merger of group companies' assets and liabilities would run counter to the doctrine that each company has a separate legal personality and so would be a bridge too far.) There is no statutory form of pooling (of any kind) available for groups that are in administration, but Australian Courts will, on occasion, allow a set of DOCAs to achieve the same outcome. As a recent case shows, this can create some conceptual problems for administrators.

The case involved the collapsed Ansett airlines group (yes, it collapsed in 2001 and the administration is still continuing: not all administrations are done and dusted within a few

[12] Hawkwood Holdings Pty Ltd & Anor v Williamson (the Liquidator of Merlino Construction Services Pty Ltd (in liq) (Receivers and Managers Appointed)) [2000] WASC 73 at [12].

weeks!).[13] The same practitioners were appointed to all the group companies. The administrators came up with a pooling proposal via a DOCA. As is common in group insolvencies, there were many intra-group debts and liabilities. Because of those intra-group debts and liabilities, each group of creditors that voted on a group company's DOCA would include the administrators, voting in relation to that company's intra group debts. The administrators asked the Federal Court for directions in relation to those meetings. One issue which troubled the Court was the prospect of the administrators voting as creditors. If pooling were to disadvantage the creditors of one group company, could the administrators, voting in respect of intra-group debts, still vote in favour of pooling? The Court did not think so:

> "So to vote, in the case of the meetings of the asset owning companies and trusts is to vote in a manner adverse to the interests of a number of creditors of those companies and beneficiaries of those trusts. Although the casting of such a vote is intended and calculated to bring about a pooling of all the assets and liabilities of the companies and trusts in the Ansett Group, it is not appropriate in all the circumstances to which I have referred to give the Administrators the power to achieve that exceptional situation."[14]

The Court adjourned the hearing. What happened next is unclear. The Court later made orders allowing the administrators to vote intra-company debts, but no reasons appear to have been published. According to the administrators' subsequent report to the creditors, "the Federal Court granted the orders sought by the Administrators because it was satisfied, based on the evidence presented by the Administrators in the pooling application, that no creditor of any of those companies would be disadvantaged by the pooling".[15]

3.5 Attacking a DOCA

(a) Legislative background

You will not be surprised to hear that litigation does not stop when a DOCA has been executed.

Section 239ADD of the New Zealand Act is largely identical to s 445D of the Corporations Act. Each allows the Court to terminate a DOCA on a wide range of grounds. If the New

[13] Indeed, the longevity of the Ansett administration resulted in a special reference to the Corporations and Markets Advisory Committee, which was asked to investigate if, among other things, voluntary administration is unsuitable for large companies. CAMAC concluded that voluntary administration is not inherently unsuitable for large companies: Rehabilitating large and complex enterprises in financial difficulties, October, 2004.

[14] In the matter of Ansett Australia Limited (ACN 004 209 410) and others [2006] FCA 277 at 121.

[15] Ansett Group (Subject To Deeds Of Company Arrangement) Seventh Report to Creditors at p 24.

Zealand experience mirrors the Australian, the section will be frequently sighted (and cited) in your Courts.

Again, because each DOCA - and its factual matrix - is different, any Court decision on an application to terminate a DOCA will depend heavily upon the individual facts of the matter. Nevertheless, it is possible to extract some general principles that have emerged in Australia.

Applications to terminate a DOCA fall into four broad categories:

- alleged informational deficiencies in the process leading up to the approval and execution of the DOCA;
- the DOCA coming into force on the votes of creditors related to a particular creditor (s 600A);
- applications based on the contents of the DOCA;
- applications based on the operation of the DOCA.

(b) Informational deficiencies

We discussed above the issue of the administrator's duty to investigate the affairs of the company during the period of administration. This leads into a discussion of the informational deficiencies that can be relied upon to terminate a deed:

> "(1) The Court may make an order terminating a deed of company arrangement if satisfied that:
>
> > (a) information about the company’s business, property, affairs or financial circumstances that:
> >
> > > (i) was false or misleading; and
> > >
> > > (ii) can reasonably be expected to have been material to creditors of the company in deciding whether to vote in favour of the resolution that the company execute the deed;
> >
> > was given to the administrator of the company or to such creditors; or
> >
> > (b) such information was contained in a report or statement under subsection 439A(4) that accompanied a notice of the meeting at which the resolution was passed; or

(c) there was an omission from such a report or statement and the omission can reasonably be expected to have been material to such creditors in so deciding ... ."[16]

To the extent that these grounds apply to an administrator's report, alleged informational failings by the administrator have been discussed above. The leading decision on the other elements of these provisions is Bidald Consulting v Miles Special Builders; Bidald Consulting v Miles Special Builders [2005] NSWSC 1235.

The Court in Bidald made the point that s 445D(1)(a) is in the passive voice. In other words, a person applying for an order under s 445D(1) does not have to prove that a particular person gave the misleading information to the administrator or creditors - only that it was given to the administrator or creditors.

The Court also laid down some general propositions about the "false or misleading" test in s 445D(1)(a) and (b):

- the expression in s 445D looks at an objective quality of the information, not at whether anyone was actually misled;
- the expression in s 445D looks at whether the information was actually false or misleading, not whether anyone intended it to be false or misleading, or did not care whether or not it was false or misleading;
- whether the information is false or misleading is judged at the time of the hearing, not on the basis of information available at the time of giving the information;
- statements about future events can be false or misleading (for example, see para 162, where the court says that estimates about the size of recoverable debts would be false or misleading if the level of uncertainty about recovering the debts was above average and the estimates didn't refer to that fact).

The Court said that you can't change the fact that a statement was false or misleading by later sending out a correction to the creditors. However, the extent to which that correction was successfully communicated to the creditors is a matter to be taken into account when the Court exercises its discretion under s 445D. Reference should also be made to Ausino International Pty Ltd v Apex Sports Pty Ltd [2006] NSWSC 986. There, rather than immediately setting aside the DOCA, the Court allowed the administrators to hold a new meeting of creditors which would address the original information deficiencies.

[16] S 445D(1)(a)-(c).

What is "material"? In answering this question, the Court in Bidald looked at two issues:

- *information considered as a whole* - in determining whether misleading pre-meeting information was "material" under s 445D(1), the Court will consider all of the misleading information together. Thus, although some individual items of misleading information may not themselves be material, when the Court applies s 445D, it will take those items into account along with the material misleading information.
- *material to whom?* - the test is "material to creditors". This does not mean that the information must have been material to all the creditors. However, in Bidald, the Court also appears to eschew the idea that "material to creditors" means "material to any creditor": "In the present case, there were enough creditors who fell into the class of employees and suppliers to satisfy me that the false or misleading information that the Company would continue to trade passes the materiality test."

(c) Votes of related creditors

Section 600A allows a Court to overturn a DOCA vote that was carried or lost on the basis of votes by creditors who stand to take an unreasonable benefit from the DOCA.

The actual provision is considerably more detailed than this, but its purpose is to prevent a large creditor (the "related creditor") and its related entities from using their voting power to secure a DOCA resolution that, in the words of the section:

> "(i) is contrary to the interests of the creditors as a whole or of [a] class of creditors as a whole, as the case may be; or
>
> (ii) has prejudiced, or is reasonably likely to prejudice, the interests of the creditors who voted against the proposed resolution, or for it, as the case may be, to an extent that is unreasonable having regard to:
>
>> (A) the benefits resulting to the related creditor, or to some or all of the related creditors, from the resolution, or from the failure to pass the proposed resolution, as the case may be; and
>>
>> (B) the nature of the relationship between the related creditor and the company or body, or of the respective relationships between the related creditors and the company or body; and

(C) any other relevant matter."

Section 600A may be regarded as an adjunct s 445D. Indeed, attacks on a DOCA commonly rely on both provisions - s 600A and s 445D(1)(f) in particular: see below.

(d) Contents of the DOCA

The other most common ground for a creditor attacking a DOCA is that it is unfair to that creditor. Such applications rely on the following provisions of s 445D(1):

> "(e) effect cannot be given to the deed without injustice or undue delay; or
>
> (f) the deed or a provision of it is, an act or omission done or made under the deed was, or an act or omission proposed to be so done or made would be:
>
> > (i) oppressive or unfairly prejudicial to, or unfairly discriminatory against, one or more such creditors; or
> >
> > (ii) contrary to the interests of the creditors of the company as a whole ... ."

A close reading of s 445D(1)(f) will quickly show that mere unfairness to a creditor is unlikely to result in the termination of the deed. What is required is "injustice", "oppression", "*unfair* prejudice" or "*unfair* discrimination" (emphasis added). It has been said that this reflects the legislative policy behind the voluntary administration regime:

> "The mere fact that a creditor is prejudiced by the operation of the deed will not be sufficient because the mere existence of the deed procedure usually means that some creditors will gain something and some creditors will lose something out of the rearrangement: Lam Soon case on appeal (1996) 14 ACLC 1,737; (1996) 22 ACSR 169." [17]

However, the relevant statements in Lam Soon are not quite as broad as this:

> "Where the basis of a deed of company arrangement is a proposal that an unprofitable part of a company's business will be closed and a profitable part continued, it would be surprising to find that the deed did not discriminate between those creditors who were likely to have a continuing relationship with the company and those who, because their connection was only with the part of

[17] Khoury v Zambena Pty Ltd (1997) 15 ACLC 620 per Young J at 627.

the business to be closed, were unlikely to do so. There is authority which supports the proposition, which seems to us clearly correct, that some degree of discrimination in such circumstances is not necessarily unfair:

In circumstances where a deed of company arrangement involves the closure of part of a business and the continuation of another part, and a consequent discrimination between groups of creditors, it may be expected that the creditors whose connection is with the continuing business will receive, if not all that they are owed, then at least more than they would receive in a winding-up. The alternative to a deed being liquidation, it is likely that the creditors whose connection is solely with the business to be closed will justifiably claim to be unfairly discriminated against, or unfairly prejudiced, if the scheme gives them less than they would have in a winding-up. But if the continuing creditors are to be paid more than they would have in a winding-up, it is likely that funding from some external source — perhaps, as here, a parent with adequate resources — will be required in order to enable the others to be dealt with in a way that does not involve unfair prejudice or discrimination. *We cannot see why fairness necessarily demands that significantly more be contributed than the amount necessary to ensure that all creditors receive benefits of a value at least equal to those which they would receive if the deed were not executed.*" (at 1748-1749, emphasis added)

What Lam Soon suggests, therefore, is that prejudice is not ipso facto unfair simply because the prejudiced creditor receives, under the DOCA, what it would have received in a winding up, even if other creditors receive proportionally more than that creditor.

Conversely, there will be unfair prejudice if the DOCA offers creditors a smaller return than in a winding up:

"Young J found that SLC and indeed the other creditors were not likely to be better off under the deed and that there was a collateral benefit to the (existing) shareholders in APH. Thus the deed failed to achieve the object set out in s435A(b), that is to say in the situation where it was not possible for Kalon or its business to continue in existence, the deed did not achieve a better return for Kalon's creditors and members than would result from an immediate winding up of the company. The deed was oppressive because not only were the creditors not advantaged by it, but the shareholders of a third party, APH, some of them but not all of them creditors, obtained a collateral advantage. Young J was right

> to conclude that the deed was oppressive with respect to SLC and to make the orders that he did." [18]

Where a DOCA is attacked on this basis, those who oppose the application bear the onus of demonstrating that it would produce a better return for creditors than a winding up: JA Pty Ltd v Jonco Holdings Pty Ltd (2000) 33 ACSR 691; Bidald (supra); Mondello Farms Pty Ltd v Annatom Pty Ltd (subject to a deed of company arrangement) and Others [2007] SASC 296.

Of course, not everyone is treated equally in a winding up: the doctrine of pari passu is heavily qualified by statutory provisions which accord a priority to certain classes of creditors and debts (employees and insolvency expenses, for example). Is there a requirement to preserve the statutory order of priorities in a DOCA? There is no clear judicial answer on this question. In Expile Pty Ltd v Jabb's Excavations Pty Ltd & Anor (2004) 22 ACLC 667 it was said that:

> "where a creditor would have a particular priority under the Corporations Act or other legislation if a company were to be wound up in insolvency, the Court, as a general rule, does not approve or permit any other regime of distribution of the company's assets which would disturb that priority. Essentially this is so because the legislature has indicated, in the statutory priorities for distribution in a winding-up, which claims should be preferred where there are insufficient for all creditors to be satisfied." (at [45])[19]

However, in Commonwealth of Australia v Rocklea Spinning Mills Pty Ltd (Receivers and Managers Appointed) (Subject To A Deed of Company Arrangement) [2005] FCA 902 a more nuanced approach was preferred. Finkelstein J said that, if the DOCA were simply a "de facto winding up", one would normally expect the company's funds to be distributed in accordance with the statutory order of priorities.

By "de facto winding up", he meant "the orderly realisation of a company's assets followed by the distribution of the proceeds between creditors". He contrasted this with the common situation of a DOCA which involved the injection of funds by a third party. In that situation, he said, creditors should not expect a priority entitlement to funds that they would not receive in a winding up. He also distinguished a "de facto winding up" from a corporate reorganisation (although it may be commented that the number of corporate

---

[18] Kalon Pty Ltd v Sydney Land Corporation Pty Ltd (No 2) (1998) 26 ACSR 593 per the NSW Court of Appeal at 598.

[19] See also Re Ansett Australia Ltd and Mentha (2002) 40 ACSR 389.

reorganisations by DOCA which do not involve the provision of third party funds is so small that there may not be any significant difference between the two situations):

> "I incline to the view that it would be difficult for creditors (or others) to insist that third party funds should be distributed in that way. The reason why that position should be different is that, at least in the examples I have chosen, the third party funds would not be available to creditors in a winding up and there is no good reason why all creditors should be better off under a deed. The true position is that whether or not such a deed is open to attack will depend upon a whole host of factors and it is simply not possible to lay down any general rule.
>
> The situation is, in any event, different when the purpose of the deed is to keep the company afloat. I can put to one side a deed whose sole object is to impose a moratorium on claims. There the issue now under consideration will not arise. When the object of the deed is to preserve the company's business, the legislation does not assume that the creditors will be paid in full. To the contrary Pt 5.3A assumes that it might often be necessary to extinguish by composition or bar certain claims. And it makes no assumption that the creditors will be treated equally or that they will be given the same priority as in a winding up. The reason it makes no such assumption is that the equal treatment of creditors or the maintenance of priorities when there is not enough money for everyone can easily thwart the attempt to revive an ailing company. A few simple examples taken from common experience will make the point. Assume that a company is trading from leased premises that are particularly attractive. The premises may be purpose-built or in an ideal location. A rational businessperson wishing to save the business may think it necessary to pay all arrears of rent to prevent a forfeiture of the lease and pay other creditors a proportion of their claim. If the creditors also believe this to be necessary, and so provide in a deed, their decision should not be "second guessed" by a judge. Another example that comes to mind is of a business that engages both skilled and unskilled workers. The skilled workers may be difficult to replace. A businessperson wishing to keep the skilled workers without whom the business may not survive is likely to find the money to pay out their arrears of wages but let the others go. If the creditors of an insolvent company decide that the same approach should be taken through the medium of a deed, why should that decision be overturned? A judge is hardly the appropriate person to say whether or not the decision is sound." (at [29] - [30])

Interestingly, the legislature commented on this issue in the Explanatory Memorandum to the recently-enacted Corporations Amendment (Insolvency) Act 2007. There, it was stated that:

> "It is implicit in the current law that the priority provided for in a liquidation under section 556 will generally be observed in a deed of company arrangement (DOCA)."

Despite this, the legislature stopped short of stating that a departure from the priority rules would be unfairly prejudicial:

> "The [priority rules] may be displaced by the meeting of creditors. To address the possibility that some creditors may be unfairly treated at the meeting of creditors the law allows creditors who consider a particular deed is oppressive or unfairly prejudicial or discriminatory to initiate proceedings in the Supreme Court or the Federal Court to have the deed overturned."

These comments were made in the context of amendments which make it mandatory for a DOCA to preserve the priority available to employee creditors in a winding up unless employees agree to waive their priority (new s 444DA).

(e) Operation of the DOCA

When the Court is asked to terminate a DOCA under s 445D, it is required to look at the present operation of the DOCA. If circumstances have changed between the date of creditor approval of the DOCA and the Court hearing and those circumstances affect the operation of the DOCA, it is the way the DOCA currently operates and not simply its terms that the Court will consider:

> "[I]n an application under s.445D(1) the Court is required to consider the operation of the Deed as it appears on the day of hearing and not at some anterior time. Clearly, what the creditors believed to be in their commercial interests when they voted for the Deed will be a very relevant and weighty factor for the Court's consideration. However, it must be borne in mind that it is possible that information may come to hand after the creditors' meeting which throws further light upon how the Deed will operate."[20]

[20] University of Sydney v Australian Photonics Pty Ltd (subject to a deed of company arrangement) & Another [2005] NSWSC 412 at [24].

For an example of a court decision to terminate a DOCA in these circumstances, see Bidald (supra). There, the DOCA was being administered in a way that differed from what was presented to creditors at the time of their vote:

> "[W]hat is being put into effect is not the proposal which was put to the creditors, but rather an ad hoc improvisation which has had a historical starting point in the proposal which was put to the creditors." (at [269])

(f) What happens to DOCA funds if the DOCA falls over?

DOCAs not uncommonly fail. This can happen because the DOCA is terminated by the Court or because the creditors themselves vote to terminate the DOCA.

A recurring issue in this situation is the fate of any money paid into the DOCA by a third party.

DOCAs often incorporate a mechanism by which a third party pays money into an "Administration Fund". This fund is applied by the administrator in paying out particular classes of creditors as provided for by the DOCA (eg, employees). If there is still money in the Administration Fund when the DOCA is terminated (and the company is, as in most cases, in winding up) how is the money in the Fund to be treated:

- is it part of the general property of the company and therefore available for distribution under the normal rules applying in winding up; or
- is it held on trust or in some other way to be treated as available only for payment to the particular classes of creditors for whose benefit it was established?

There are two judicial schools of thought on this issue. The weight of judicial opinion favours the former approach: Purchas, in the matter of Estore Pty Limited (in liq) [2006] FCA 1222; Federal Commissioner of Taxation v All Suburbs Car Repairs Pty Ltd (1994) 14 ACSR 753; Lombe v Wagga Leagues Club Ltd (2006) 56 ACSR 387. However, there are not inconsiderable judgments in favour of the latter position: Dean-Willcocks v ACG Engineering Pty Ltd (in liq) (2003) 45 ACSR 290; Shepard & Another v Sports Mondial of Australia Pty Ltd (in liquidation) [2005] NSWSC 432.

In Sports Mondial, the Court went on to say that, if the "deed creditors" claims against the company were not extinguished by the DOCA, they would be entitled to claim in the winding up for the balance of their debts after payment out of the Administration Fund.

4. Creditors' trusts

One interesting phenomenon which has arisen under the Australian voluntary administration regime is the creditors' trust. This is a mechanism designed to allow a company to make a quick debt-free exit from administration, while providing creditor benefits on a par with those in a DOCA.

Under a creditors' trust, the company's liabilities are hived off into a separate trust which is established with a source of funds for those liabilities. The trust funds can be provided by a straight injection of cash; alternatively, the funds may be provided under a funding arrangement (eg, an undertaking to make an annual payment out of the company's post-administration profits). Debts owed to the company's creditors are extinguished and the creditors become beneficiaries under the trust.

It is no coincidence that creditors' trusts first made their appearance in Western Australia. That State is home to a very large number of SME mining and exploration companies. The nature of their business means that, despite being SMEs, many of them are also listed. By allowing the excision of a company from its debts, the use of creditors' trusts for such companies means that administrators can offer the company for sale as a listed shell. Creditors' trusts can also be useful where there is a potential buyer for the company's business as a going concern.

Perhaps because they were initially associated with the mining industry or perhaps because they require creditors to give up the statutory protections they enjoy in administration and a DOCA, there has been some resistance to creditors' trusts. There is an underlying "feeling" that a creditors' trust could leave creditors high and dry if the trust funds aren't forthcoming and the extinguishment of the creditors' debts against the company has denied the creditors any statutory avenues of redress.

In reality, these concerns are probably over-emphasised. As we noted at the beginning of this paper, Australia's most significant creditor, the ATO, believes that "there are very few Deed of Company Arrangements [sic] that yield reasonable dividends to creditors" and that a number of DOCAs are simply defaulted upon. It is therefore quite possible to argue that, in that respect, creditors don't face any heightened risks in opting for a creditors' trust. Realism would suggest, also, that the availability of legal redress - whether in a statutory action or in a private action - is probably more theoretical than real for many creditors in any event.

On the other hand, a creditors' trust can definitely provide an upside for creditors. It is predicated upon the existence of a willing buyer for the company. There is, therefore, likely

to be a larger sum available for the creditors than under a firesale of the company's component assets and businesses.

In 2005, the Australian Securities and Investment Commission (ASIC) responded to the growth in creditors' trusts by issuing a policy statement.[21] The statement's overall flavour is evident in its opening paragraphs:

> "We consider that DCA proposals should not involve creditors' trusts unless administrators have adequately considered the appropriateness of using a creditors' trust in the particular case, and the advantages and disadvantages for the company, the creditors and the administrator.
>
> DCAs involving a creditors' trust create special risks for creditors. Further, using a creditors' trust in a DCA in some cases may be an abuse of the Part 5.3A process or be otherwise contrary to the public interest. As a result, our view is that while the use of a creditors' trust in a DCA may occasionally be justified by the circumstances of a particular company, indiscriminate use of creditors' trusts in DCAs is not appropriate." (at [5]-[6])

The policy then goes on to threaten court action if administrators do not follow the steps set out in the ASIC document before recommending a creditors' trust to the second creditors' meeting.

In large measure, those steps simply reflect what one would expect of a competent administrator in any case: adequate research and ensuring that creditors make a fully-informed choice. The policy also suggests that "there are some circumstances where an administrator should not recommend that creditors approve a DOCA proposal involving a creditors' trust." By itself, that is not an exceptional statement. The policy then goes on to list examples of what ASIC has in mind:

- the proposed value of the creditors' trust funds cannot be reasonably estimated at the time the proposal will be voted on by the creditors;
- there is reason for concern about whether the trustee will receive all of the trust fund or have appropriate security before the DOCA terminates and creditors' rights are extinguished;

[21] Regulatory Guide 82: External administration: Deeds of company arrangement involving a creditors' trust, May 2005.

- the DOCA or trust deed allows a trustee to be appointed who may lack the necessary skills and experience. ASIC suggests that this can be overcome by ensuring that the trustee is a registered liquidator;
- there is reason for concern about whether the trustee will have adequate civil liability insurance;
- the DOCA and/or the trust deed do not provide the beneficiaries with processes and rights that are at least as favourable as the process and rights of creditors under the Act; and
- concrete details about the proposed structure and terms of the DOCA and trust deed cannot be provided.[22]

Again, many of these are unexceptional. Indeed, one would expect that the same standards would be applied to any "standard" DOCA proposal. However, the "requirement" that the creditors' trust provide creditors/beneficiaries with "processes and rights that are at least as favourable to the beneficiaries as the processes for and rights of creditors under the Act" is problematic. An administrator who was recommending a DOCA would normally have considered whether it was "better" for the creditors than an immediate winding up. Because the winding up process and creditors' rights in a winding up are not the same as in a DOCA, an administrator in a "normal" administration, would take the comparative advantages and disadvantages of a DOCA and a winding up into consideration before concluding which, on balance, was in the creditors' interests. It is hoped that ASIC is not suggesting that the process of comparing a DOCA/winding up with a creditors' trust requires the administrator to take an atomistic approach in which every element of the process and rights in the DOCA/winding up must be matched (if not bettered) by a corresponding element in the creditors' trust.

Certainly, the Courts appear to have taken a more sanguine approach to creditors' trusts. There have been a number of cases, both before and after ASIC released its policy, in which the court has approved the use of a creditors' trust.[23]

[22] At para 1.22.

[23] Re Trustees Act 1962; Francis (Trustee of Western Australian Shed Commercial Pty Ltd) Creditors Trust Deed (Plaintiff) [2003] WASC 39; Re Open Telecommunications Ltd (subject to a deed of company arrangement) [2003] NSWSC 1198; Rupert Co Ltd v Chameleon Mining NL [2006] NSWSC 415.

Sydney

Level 34
No. 1 O'Connell Street
Sydney NSW 2000
T +61 2 9353 4000
F +61 2 8220 6700

Melbourne

Level 18
333 Collins Street
Melbourne VIC 3000
T +61 3 9286 6000
F +61 3 9629 8488

Brisbane

Level 28
Riparian Plaza
71 Eagle Street
Brisbane QLD 4000
T +61 7 3292 7000
F +61 7 3221 9669

Perth

Level 27
QV1 Building
250 St. George's Terrace
Perth WA 6000
T +61 8 9426 8000
F +61 8 9481 3095

Canberra

Level 8
Canberra House
40 Marcus Clarke Street
Canberra ACT 2601
T +61 2 6279 4000
F +61 2 6279 4099

Darwin

17–19 Lindsay Street
Darwin NT 0800
T +61 8 8943 2555
F +61 8 8943 2500

www.claytonutz.com

Persons listed may not be admitted in all states. This document is intended to provide general information. The contents do not constitute legal advice and should not be relied upon as such.
© Clayton Utz 2008