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Insolvency law and practice with Ferrier Hodgson Corporate Recovery

Brave new world for secured creditors

The business environment has changed significantly for banks, financiers and other secured creditors since the end of 2007: record petrol prices; access to and cost of funding; spiralling interest rates and declining business and consumer sentiment have put the market on edge. It is an environment more influenced by fear than it has been for decades.

But there have been other structural changes to the business environment that have significant implications for secured creditors. Perhaps most importantly, there have been major amendments to the Corporations Act, which came into effect on December 31. In addition, the IPA has launched its Code of Professional Practice, there is growing interest in the issue of funded litigation and a new focus on the use of garnishee notices by the ATO.

Together these changes have significantly altered the playing field for all creditors and their impact need to be clearly understood by anyone operating in this space. In this month's Recovery@Ferriers we present the first in a two-part series examining some of the legal and practical issues emerging from these changes and how they are likely to affect secured creditors.

In this issue we look at five key changes brought about by the amendments to the Corporations Act and the launch of the IPA's Code of Professional Practice.

1 Borrowing funds during voluntary administration

Voluntary Administrators often require additional funding for working capital purposes, particularly where the success of a proposed Deed of Company Arrangement relies on the business continuing to trade. Prior to 31 December 2007, there was an obvious reluctance by post-administration lenders to advance funds on an unsecured basis unless they received priority treatment over pre-administration creditors.

The Corporations Act amendments effectively provide that priority and allow an Administrator to provide some comfort to a new lender that its funds will be repaid – but only if a pre-existing floating charge holder consents to the priority being given.

The amendments extend a Voluntary Administrator's personal liability for debts incurred to *"the repayment of money borrowed, interest in respect of money borrowed and borrowing costs."* An Administrator has a right to indemnity out of the company's property for such liabilities and a statutory lien to secure that indemnity. The Administrator's right to indemnity under S443E of the Corporations Act has priority over other unsecured debts of the company and, under certain conditions, over debts of the company secured by a floating charge. However, the right to indemnity does not take priority over debts of a pre-existing floating charge holder unless the chargee consents in writing.

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A further issue exists if the company subsequently transitions into liquidation and the creditors appoint an alternative Liquidator. In that instance the monies borrowed by the Administrator do receive priority under S556(1)(c) of the Corporations Act, but such a priority ranks behind the costs and expenses of the new Liquidator, including the costs and expenses in carrying on the company's business.

Administrators will exercise appropriate caution in incurring such debts given personal liability, and the above could impact on a Voluntary Administrator's decision whether to continue to trade or not. Post-appointment lenders should also exercise caution and avail themselves of all the facts surrounding the administration, in order to properly assess the likelihood that they will be repaid from the assets of the company if monies are advanced under those circumstances.

2. Extended decision period - Voluntary Administration

Prior to 31 December 2007, a secured creditor with a charge over the whole or substantially the whole of the property of a company was afforded a period of 10 business days following the appointment of a Voluntary Administrator, to enforce its charge. However, with the statutory timeframe for holding the first meeting of creditors being extended from five business days to eight business days, secured creditors would have had a window of only two business days to enforce their security. Accordingly, the decision period for secured creditors has been extended from 10 business days to 13 business days from when notice of the appointment is given to the secured creditor.

It is common practice, particularly in larger more complex administrations, to further extend the decision period with the Administrator's written consent under S440B(a) of the Corporations Act. This extension (usually by Deed) is generally until the date of the second meeting of creditors and allows the secured creditor to:

- Defer its enforcement decision until all relevant facts are known
- Properly consider the impact of any Deed of Company Arrangement that is to be proposed

3. Bankers' liens

The Corporations Act amendments have extensively overhauled the previous uncertain area of property that is subject to a lien or pledge. In essence the amendments:

- Allow the holder of the subject property to retain possession
- Prevent the holder from selling or enforcing the lien except with relevant consents
- Require the holder to give potential purchasers access to inspect or examine the property
- Allow the Administrator to sell the property under certain circumstances
- Provide protection to the security holders by requiring the Administrator to set aside net proceeds of sale and account, and provide security holders with the right to apply to Court

Under the amendments, bankers' liens and securities lodged as collateral with a clearing house are exempt from the moratorium imposed on lien holders.

In particular, where property held in the form of cash, negotiable instruments, securities or derivatives are subject to a lien or pledge and the holder is an ADI or operator of a clearing and settlement facility, the moratorium is not applicable (S440JA Corporations Act).



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4. Maximum flexibility for company restructuring

An essential component of any restructuring, and of significance to a secured creditor who is to remain as the company's financier, is the issue of who will ultimately control the company.

Prior to 31 December 2007, any transfer of shares in a company or alteration in the status of members of a company during the administration was void. This situation arguably restricted the efficient operation of Part 5.3A of the Corporations Act.

Under the amendments an Administrator may consent to a transfer of shares in a company under administration where the Administrator is satisfied that it is in the interests of the creditors as a whole. Further, an Administrator of a Deed of Company Arrangement now has a compulsory sale power, with the approval of the Court, to enable a transfer of shares considered fundamental to a company's restructuring.

Further enhancing the ability to restructure a company is the removal of the application of the fundraising provisions of the Corporations Act to Deeds of Company Arrangement. In essence, a Deed Administrator need not comply with the disclosure requirements if:

- An offer is made to any or all of the company's creditors under a Deed of Company Arrangement
- The transaction is a debt-for-equity swap
- All relevant information was provided to creditors in a statement issued with the notice of meeting
- The statement clearly sets out that it is not a prospectus and may contain less information than a prospectus

These changes provide greater options and increased flexibility for restructuring troubled companies. In particular, there may now be greater opportunities for secured creditors to agree to a conversion of their debt (or a portion thereof) into an equity position in the company.

5. Launch of Code of Professional Practice

In early 2008 the IPA released its Code of Professional Practice. The Code is the fundamental building block upon which the insolvency profession sets and manages standards of professional conduct.

The primary purposes of the Code are to:

- Enhance standards of conduct for insolvency professionals
- Inform and educate IPA members as to the standards of conduct required of them in the discharge of their professional responsibilities
- Provide a reference for stakeholders against which they can gauge the conduct of IPA members

Declaration of Independence and Relevant Relationships and Indemnities ("DIRRI")

The Code's independence requirements provide for a DIRRI to be prepared and provided to creditors for all corporate and personal insolvency appointments (excluding receiverships and members' voluntary liquidations), at the earliest practical opportunity.



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The DIRRI must comprise a number of declarations and includes:

- A declaration setting out certain relationships in the past 24 months, with:
 - The insolvent or an associate of the insolvent
 - A former insolvency practitioner of the insolvent
 - A person who has a charge on the whole or substantially the whole of the insolvent's property

The above disclosure obviously includes a secured creditor who is a regular work provider to the Practitioner. A concise summary of the relationship is required as well as a statement as to why the relationships do not preclude the acceptance of an appointment.

Conclusion

In this brave new world, secured creditors have greater flexibility and a much improved likelihood of extracting maximum value from an entity in which they have an interest. It is a better environment – a more workable template – for fixing problems and maximising returns for all stakeholders, including secured creditors. But anyone wanting to take full advantage of the utility these changes offer needs to have an excellent understanding of the changes and what they mean.

Ferrier Hodgson played a key consultative role in the formation of the changes to the Corporations Act and the IPA's new Code of Professional Practice. Our Corporate Recovery partners have extensive hands-on experience with an understanding of the case law that keeps this sector constantly evolving. For advice on how these changes affect you, don't hesitate to contact us directly.



Martin Lewis

Partner, Adelaide
phone: +61 8 8100 7657
email: mdlewis@sa.fh.com.au



David Kidman

Partner, Adelaide
phone: +61 8 8100 7675
email: dwkidman@sa.fh.com.au

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If you have any questions or comments about Recovery@Ferriers please email [Ferrier Hodgson](mailto:Recovery@ferrierhodgson.com)

For more information,
please contact:

Sydney: John Melliush
+61 2 9286 9963
john.melliush@fh.com.au

Melbourne: John Lindholm
+61 3 9604 5106
john.lindholm@fh.com.au
Adrian Brown
+61 3 9604 5104
adrian.brown@fh.com.au

Adelaide: Martin Lewis
+61 8 8100 7657
mdlewis@sa.fh.com.au
David Kidman
+61 8 8100 7675
dwkidman@sa.fh.com.au

Brisbane: Will Colwell
+61 7 3831 4833
wcolwell@qld.fh.com.au

Perth: Martin Jones
+61 8 9214 1444
mjones@perth.fh.com.au

Newcastle: James Shaw
+61 2 4908 4403
jshaw@fhnewcastle.com.au

Or find out more at:
www.ferrierhodgson.com

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