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# Improving outcomes for creditors: Balancing efficiency with creditor protections

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*The rationale for the latest changes in corporate insolvency laws was in part to improve outcomes for creditors by strengthening creditor protections and improving the efficiency of the insolvency process. To do so, four key areas were identified: enhancing employee entitlement protections; improving information to creditors; streamlining external administration by removing unnecessary procedural requirements; and introducing a statutory pooling process. It is contended, however, that the attainment of efficiency and strong creditor protections are divergent goals, made more so by the manner of regulating for such goals. The purpose of this article is to highlight, with examples from the latest changes in external administration laws, the divergent nature of both goals; show that the use of mandatory provisions, while achieving creditor protection, may be at the expense of procedural efficiency, depriving the external administrator of flexibility and that to maximise creditors' outcomes requires a continual balancing of the goals of creditor protection and efficiency.*

## INTRODUCTION

The latest amendments to the *Corporations Act 2001* (Cth) introduced a range of measures intended to modernise Australia's insolvency laws<sup>1</sup> as part of a long and protracted review of the Australian corporate insolvency framework.<sup>2</sup> While the review "generally endorsed the current insolvency system, at the same time [it] proposed measures to strengthen creditor protections and improve the efficiency of insolvency processes".<sup>3</sup> Four key areas were identified<sup>4</sup> as a means of achieving this outcome, two of which are considered in the article – enhanced protections for employee entitlements and the introduction of a statutory pooling process. It is contended, however, that the attainment of efficiency and strong creditor protections are divergent goals and therefore to obtain both is a balancing process.

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<sup>1</sup> Explanatory Statement to the Exposure Draft on *Corporations Amendment (Insolvency) Bill 2007* (Cth), November 2006, p 6.

<sup>2</sup> The reforms find their basis in the recommendations of the following reviews and inquiries: Treasury Department, *Review of the Regulation of Corporate Insolvency Practitioners* (Treasury Department, 1997), <http://www.treasury.gov.au/contentitem.asp?NavId=013&ContentID=295> viewed 14 August 2008; Corporations and Markets Advisory Committee (CAMAC), *Corporate Voluntary Administration* (CAMAC, 1998), [http://www.camac.gov.au/camac/camac.nsf/byHeadline/PDFFinal+Reports+1998/\\$file/Corporate\\_Voluntary\\_Administration\\_Final\\_Report\\_June\\_1998.pdf](http://www.camac.gov.au/camac/camac.nsf/byHeadline/PDFFinal+Reports+1998/$file/Corporate_Voluntary_Administration_Final_Report_June_1998.pdf) viewed 14 August 2008; Corporations and Markets Advisory Committee, *Corporate Groups* (CAMAC, 2000), [http://www.camac.gov.au/camac/camac.nsf/byHeadline/PDFFinal+Reports+2000/\\$file/Corporate\\_Groups\\_May\\_2000.pdf](http://www.camac.gov.au/camac/camac.nsf/byHeadline/PDFFinal+Reports+2000/$file/Corporate_Groups_May_2000.pdf) viewed 14 August 2008; Corporations and Markets Advisory Committee, *Rehabilitation of Large and Complex Enterprises* (CAMAC, 2004), [http://www.camac.gov.au/camac/camac.nsf/byHeadline/PDFFinal+Reports+2004/\\$file/Large\\_Enterprises\\_report\\_Oct04.pdf](http://www.camac.gov.au/camac/camac.nsf/byHeadline/PDFFinal+Reports+2004/$file/Large_Enterprises_report_Oct04.pdf) viewed 14 August 2008; Parliamentary Joint Committee on Corporations and Financial Services (PJC), *Corporate Insolvency Laws: A Stocktake* (PJC, 2004), <http://www.senatorchapman.com/MEDIA%20RELEASE%20Insolvency%201.pdf> viewed 14 August 2008.

<sup>3</sup> Explanatory Memorandum to the *Corporations Amendment (Insolvency) Bill 2007* (Cth), p 5.

<sup>4</sup> Explanatory Statement, n 1, p 6. The four key areas were (i) enhanced protections for employee entitlements; (ii) improved information to creditors; (iii) removal of unnecessary procedural requirements; and (iv) introduction of a statutory pooling process to facilitate the external administration of related companies.

Regulation of corporate insolvency may be achieved through two broad means – by adopting either “de-regulation policies”,<sup>5</sup> whereby the market is relied upon to ensure efficient realisation and distribution of the available assets of the insolvent company, with corporate insolvency laws assisting the market in this process; or corporate insolvency laws replace the market mechanism controlling or impeding its operation by imposing rules upon the market participants, known as “command and control regulation”.<sup>6</sup> Examples of both types of regulation can be found in the latest amendments to corporate insolvency laws which will be addressed below. It is not the intention of this article to determine which of either means is more appropriate, rather only that both means of regulation will be considered in terms of efficiency and creditor protection.

The purpose of this article is to determine whether the abovementioned measures introduced by the *Corporations Amendment (Insolvency) Act 2007* (Cth) achieve their stated aim. To that end, the article is in three parts:

- to consider the multiple purposes of corporate insolvency laws;
- to consider the meaning of efficiency and creditor protection; and
- to highlight with examples from the latest changes in external administration laws the divergent nature of the goals of efficiency and creditor protection and that to improve creditors’ outcomes requires a balancing of such goals.

### **MULTIPLE PURPOSES OF CORPORATE INSOLVENCY REGIME**

Australian corporate insolvency laws are chiefly concerned with providing an efficient process for the winding up of companies, the identification and punishment of wrongdoers, the realisation of available company assets in an orderly manner and the equitable distribution of the sale proceeds there to creditors and shareholders. Insolvent companies face one or more possible external administration procedures:

- liquidation;
- voluntary administration; or
- receivership.

Although the objectives of a voluntary administration are twofold this article’s focus is on the second objective.<sup>7</sup> Thus, regardless of which procedure is instituted, all have the common objective (in part) of obtaining the maximum return possible for creditors and members.

Individually, the best possible outcome for all creditors, whether secured or unsecured, preferential or non-preferential, faced with an insolvent company debtor is to maximise the amount of repayment of their debt in a timely manner.<sup>8</sup> The amount of repayment available to creditors is dependent upon the total distributable funds available to the external administrator. To a large extent this distributable fund is a discrete pool. The capacity of the administrator to enlarge this pool is limited but may be increased by:

- adopting efficient procedural methods so as to decrease external administration costs;
- allowing for greater discretionary power to be given to the administrator in decision-making so as to maximise returns from the disposal or non-disposal of insolvent company assets;
- injecting of external funds; and
- pursuing of claims against third parties for alleged wrongdoing.

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<sup>5</sup>Corbett A, “A Proposal for a More Responsive Approach to the Regulation of Corporate Governance”, (1995) 23 FLR277 at 279-280. Corbett argues that the use of command and control compensatory remedies can distort the regulation of directors’ duties, where other elements of the corporate governance system are at work, namely the securities market.

<sup>6</sup>Corbett, n 5.

<sup>7</sup>*Corporations Act 2001* (Cth), s 435A. The objective of the voluntary administration scheme is to administer the business, property and affairs of an insolvent company so as to maximise the chances of the company, or as much as possible of its business, continuing in existence or failing that, results in a better return for the company’s creditors and members than would result from an immediate winding up of the company.

<sup>8</sup>Particular categories of creditors such as employees may consider the continued existence of the company’s business in a restructured form part of this best possible outcome.

Given that the costs of administration reduce the amount of distributable funds,<sup>9</sup> any measures increasing the efficiency of the external administration should increase this pool of available funds, improving the outcome for all creditors. The removal of unnecessary procedural requirements and the introduction of a statutory pooling process should achieve greater availability of funds for creditors in general.

However, enhancing protections for employee entitlements will improve outcomes for employee creditors in the form of larger benefits being paid, but this may well be at the expense of other creditors or stakeholders.

## MEANING OF EFFICIENCY

Historically, economic analysis has sought to assess corporate governance laws on the basis of their efficiency, principally by minimising transaction costs.<sup>10</sup> Essentially, a company's separate legal personality accompanied by its limited liability<sup>11</sup> reduces transaction costs, whether those transaction costs arise from aggregating capital for business ventures; or subsequent monitoring costs once investment in a particular business venture has taken place. Economic efficiency is achieved by minimising such transaction costs; potential returns on investment in the business venture are then maximised and thereby enterprise is encouraged.

A similar analysis can be applied to corporate insolvency laws. The external administration laws applying to an insolvent company govern the possible reconstruction or winding up of the company and the distributions of its assets among its stakeholders. By minimising the transaction costs involved in the reconstruction or winding up process, economic efficiency is achieved, potential returns to creditors and other stakeholders are maximised, and the risk levels of investment and consequently, the cost of credit are minimised.

There are a variety of alternative measures of economic efficiency.<sup>12</sup> Two popular measures of efficiency previously used in the economic study of law are the Pareto measure and the Kaldor-Hicks measure. Pareto efficiency or Pareto optimality is that a situation is efficient or optimal where it is not possible to change the situation to make someone better off without making someone else worse off.<sup>13</sup> A more lenient measure, Kaldor-Hicks efficiency developed by two British 20th century economists, holds a change is efficient if in aggregate the benefits associated with the change exceed the costs of the change. Those who gain can compensate those who lose, although there is no need for compensation to occur under their model.<sup>14</sup> Both Pareto and Kaldor-Hicks measures of efficiency have been criticised as not necessarily resulting in a socially desirable distribution of resources, leading to inequities.<sup>15</sup>

A third measure of efficiency, adopted by Rizwaan Mokal,<sup>16</sup> which partly addresses the abovementioned criticisms, draws upon concepts developed by Oliver Williamson. Mokal's "transaction cost efficiency" labels "a method as efficient, given a particular amount of resources

<sup>9</sup> Preferential creditors include the costs of administration or liquidation including the administrator's or liquidator's remuneration. See *Corporations Act 2001* (Cth), s 556.

<sup>10</sup> Transaction cost is used in an economic context to include agency costs and opportunity costs. See Easterbrook F and Fischel D, *The Economic Structure of Corporate Law* (Harvard University Press, 1991) pp 9-11, 141.

<sup>11</sup> Easterbrook and Fischel, n 10.

<sup>12</sup> Examples of economic efficiency measures include Pareto; Kaldor-Hicks; X-efficiency; allocative efficiency; distributive efficiency; productive efficiency; optimisation of a social welfare function; utility maximisation.

<sup>13</sup> Polinsky AM, *An Introduction to Law and Economics* (Aspen Publishers 2003). Pareto efficiency was established by the Italian economist Vilfredo Pareto.

<sup>14</sup> Cheffins B, *Company Law: Theory, Structure and Operation* (Oxford University Press 1997) p 15.

<sup>15</sup> Zerbe R, *Economic Efficiency in Law and Economics* (Edward Elgar Publishing Ltd, 2001) p 6. This criticism arises because both Pareto's and Kaldor-Hicks's methods separate economic efficiency from the distributional effects of an allocative change as such distributional effects require interpersonal comparisons of utility which are not measurable.

<sup>16</sup> Mokal R, *Corporate Insolvency Law Theory and Application* (Oxford University Press, 2005) p 25. Mokal offers a number of criticisms of Pareto's and Kaldor-Hicks' concepts of "efficiency" as part justification for his "transaction cost efficiency".

dedicated towards its implementation, when it can implement the set of substantive goals to a greater degree than would be possible for any other feasible method".<sup>17</sup> Mokal argues that the attainment of transaction cost efficiency should be a procedural goal of every part of a morally defensible legal system.<sup>18</sup> Transaction costs are subdivided into coordination costs and motivation costs. Coordination costs are the costs to eliminate the informational asymmetries so that fuller, more uniform levels of information are available to all parties. Motivation costs are those resources expended so as to align the interests of all parties to pursue a set of coordinated substantive goals.<sup>19</sup>

This article adopts Mokal's analysis, such that a substantive goal of corporate insolvency laws is to provide creditor protection. A means of doing so, eg, is the provision of uniform levels of information to creditors, eliminating coordination costs and thereby achieving efficiency in the administration of current insolvency laws.

## MEANING OF CREDITOR PROTECTION

Creditors obtain protection for their debt in various ways. Secured creditors as a matter of contract agree with the debtor prior to insolvency, that they have first priority of repayment from the proceeds of the sale of the fixed charge asset.

Employees enjoy preferential status as unsecured creditors in the distribution of an insolvent company's property. This priority afforded to employee entitlements in the distribution of an insolvent company's property also applies to the repayment of debts by a receiver appointed under a floating charge and is now a mandatory default provision (unless specifically excluded ) under a deed of company arrangement (DOCA) in a voluntary administration.<sup>20</sup>

Depending upon the category of employee entitlement,<sup>21</sup> such entitlements rank highly in the statutory order of payment.<sup>22</sup> Except for administration costs, employee entitlements have priority over the claims of a floating charge,<sup>23</sup> as well as all other unsecured creditors.

The protection afforded to the employee, as creditor, is based on public policy grounds.<sup>24</sup> Such preferential rights are in contradiction to the fundamental principle of *pari passu*;<sup>25</sup> however, support for the need to protect employee entitlements through priority of payment exists at an international level.<sup>26</sup> In the majority of international jurisdictions, priority creditor status is conferred on employees in the event of corporate insolvency.<sup>27</sup>

Employees require protection because they lack the ability to diversify their risk, unlike other unsecured creditors and stakeholders. Other unsecured creditors may diversify their risk by having a large customer base, or seek additional security such as a personal guarantee. Shareholders may

<sup>17</sup> Mokal, n 16, p 26.

<sup>18</sup> Mokal, n 16, p 26.

<sup>19</sup> Mokal, n 16, p 26.

<sup>20</sup> *Corporations Act 2001* (Cth), s 433(3).

<sup>21</sup> Including unpaid wages and superannuation contributions and superannuation guarantee charge; amounts due in respect of injury compensation; accrued annual leave and accrued long service leave; or retrenchment payments.

<sup>22</sup> *Corporations Act 2001* (Cth), s 556.

<sup>23</sup> *Corporations Act 2001* (Cth), s 561.

<sup>24</sup> Keay A and Walton P, "The Preferential Debts Regime in Liquidation Law: In the Public Interest?" (1999) *Company, Financial and Insolvency Law Review* 84 at 90.

<sup>25</sup> The principle of *pari passu* requires under insolvency law that unsecured creditors should rank equally. Where insufficient assets exist to cover all liabilities, then such unsecured creditors should share equally in a proportionate distribution of the available assets.

<sup>26</sup> Australia is a signatory to the International Labour Organisation Convention concerning the *Protection of Workers' Claims in the Event of the Insolvency of their Employer*. See <http://www.ilo.org/ilolex/english/convdisp1.htm> viewed 26 August 2008.

<sup>27</sup> Whelan J and Zirer L, *Employee Entitlements and Corporate Insolvency and Reconstruction*, [http://www.cclsr.law.unimelb.edu.au/research-papers/Protection%20of%20employee%20entitlements%20\\_final\\_1.pdf](http://www.cclsr.law.unimelb.edu.au/research-papers/Protection%20of%20employee%20entitlements%20_final_1.pdf) viewed 26 August 2008.

diversify their investment portfolio to hedge against risk. Employees generally have one employer and are therefore exposed to potential loss of all unpaid wages, superannuation, leave or redundancy payments on the employer's insolvency.<sup>28</sup> Thus employees are considered to be in a more vulnerable position unable to influence the terms of lending and lacking the ability to monitor their employer-debtor's prospects, such that they require greater protection than those unsecured creditors better able to deal with their loss.

## CREDITOR PROTECTION PRIORITY

### Mandatory priority rule for employee entitlements (including the superannuation guarantee charge)

By virtue of the latest amendments embodied in the *Corporations Amendment (Insolvency) Act 2007* (Cth) this mandatory priority repayment of employee entitlements is included in every deed of company arrangement (DOCA) unless the eligible employee creditors pass a resolution agreeing to the non-inclusion of such a provision or the court makes an order approving the non-inclusion of such a provision.<sup>29</sup>

The statutory priority of employee entitlements has been amended<sup>30</sup> so as to include the superannuation guarantee charge where it has accrued because of the non-payment by the employer of the required superannuation guarantee payment relating to services rendered by employees prior to the relevant date.<sup>31</sup> With the accompanying changes to the *Superannuation Guarantee (Administration) Act 1992* (Cth), consistency of treatment is achieved such that superannuation guarantee charges are thereby given employee entitlement priority status whether the company's external administration is a liquidation, receivership, voluntary administration or deed of company arrangement.

Where the superannuation guarantee charge has accrued because of the non-payment by the employer of the required superannuation guarantee payment relating to services rendered by employees after the relevant date it is to be treated as an expense of preserving, realising or getting in property of the company, or in carrying on the company's business under s 556(1)(a) of the *Corporations Act 2001* (Cth).<sup>32</sup>

As well, the compulsory maximum amount to be paid to directors as a priority employee entitlement includes the superannuation guarantee charge and is now recognised in the *Superannuation Guarantee (Administration) Act 1992* (Cth).<sup>33</sup>

These changes address a problem first identified in *Ansett Australia Ground Staff Superannuation Plan Pty Ltd v Ansett Australia Ltd* (2002) 174 FLR 1; [2002] VSC 576 where the court held that superannuation contributions made by Ansett during the course of its administration did not attract priority under s 556(1) of the *Corporations Act 2001* (Cth) and instead constituted a debt provable in the administration of Ansett.

Warren J was bound by the words of s 556(1) and specifically s 556(1)(e) which limited the ambit of the priority conferred on superannuation contributions such that "there was no legislative command

<sup>28</sup> In terms of Oliver Williamson's transaction-cost economics model, such employees have made a transaction specific investment in the firm, being specific human capital so that they are at risk of opportunistic behaviour. Williamson OE and Winter SG (eds), *The Nature of the Firm: Origins, Evolution and Development* (Oxford University Press, 1993).

<sup>29</sup> *Corporations Act 2001* (Cth), s 444DA(1) and 444DA(2).

<sup>30</sup> *Corporations Act 2001* (Cth), s 556(1AB) to 556(1AF). The payments are apportioned on the basis of services rendered by employees before and after the appointment of the liquidator. Those payments relating to services rendered before the relevant date are given priority under s 556(1)(e) and those payments relating to services rendered after the relevant date are given higher priority under s 556(1)(a).

<sup>31</sup> Relevant date is defined in the *Corporations Act 2001* (Cth), s 9 to mean in relation to a winding up, the day on which the winding up is taken to have begun under Div 1A of Pt 5.6.

<sup>32</sup> *Corporations Act 2001* (Cth), ss 556(1AC)(f), 556(1AD), 556(1AE)(g) and 556(1AF)(g).

<sup>33</sup> *Corporations Act 2001* (Cth), s 556(1A) of \$2000 per "excluded employee" and s 64B(3A) *Superannuation Guarantee (Administration) Act 1992* (Cth).

to indicate that superannuation contribution obligations incurred after the relevant date (generally the date of the commencement of the liquidation) fell within the subsection” (at [6,649]). The latest amendments found in s 556(1A) to s 556(1AF) now give such legislative command.

Coupled with the mandatory priority rule for employee entitlements is the General Employee Entitlements and Redundancy Scheme (GEERS) which is a taxpayer-funded safety-net scheme for employee entitlements, such that the government to a limited extent is guarantor of employee entitlements.<sup>34</sup> This scheme is regulated by the Department of Education, Employment and Workplace Relations (DEWR). Employees of insolvent corporations can claim their entitlements<sup>35</sup> within 12 months of the employees’ employment being terminated. The DEWR makes a payment directly to the insolvency practitioner who forwards it to employees. The DEWR is then subrogated to the rights of employee for the amount advanced.<sup>36</sup> Of importance, under GEERS, employees are not entitled to benefits if the DOCA does not include the employee entitlement priorities specified in the *Corporations Act* to be paid on liquidation.<sup>37</sup>

Giving employee entitlements priority has the effect of depriving other unsecured creditors of their claim to a share of available assets. However, employees’ interests are to a large extent protected by the ongoing operation of and enhancements to the GEERS,<sup>38</sup> although only if the government retains priority as a preferential creditor. Even so, the government has not been successful in recouping its entitlements as a subrogated creditor.<sup>39</sup> The giving of priority payment status to the payment of the superannuation charge as either an employee entitlement or cost of administration increases the security of this particular employee entitlement. Unlike other employee entitlements, superannuation and the superannuation charge are not included under GEERS and therefore there is a stronger case for these amounts to be protected for the benefit of employees as a substantive goal.

If the priority given to employee entitlements can be considered part of the substantive goal of providing for creditor protection, then the question to consider is whether the imposition of a mandatory rule granting such priority in s 444DA(1) of the *Corporations Act* is the most efficient means of ensuring this equity. The benefits of the mandatory provision are that it is not a significant departure from previous current practice; it increases the voice of employees’ interests in negotiating a DOCA; without such a mandatory provision it is possible that the DOCA may alter the employee entitlements leaving employees with no access to GEERS, their only avenue then being to initiate court action for recovery of outstanding entitlements, at a considerable burden and cost.<sup>40</sup>

The cost of the mandatory rule in s 444DA(1) of the *Corporations Act*, an example of “command and control regulation”, is the reduction in discretion afforded to the voluntary administrator as it is unlikely that employees would waive their priority under s 444DA(2) of the *Corporations Act*.<sup>41</sup> Thus to a large extent, the administrator’s hands are tied with respect to the priority of payments to creditors under the DOCA. In this regard, the adoption of the mandatory provision is to some extent

<sup>34</sup> General Employee Entitlements and Redundancy Scheme, *How Your GEERS Claim will be Assessed*, <http://www.workplace.gov.au/workplace/Programmes/EmployeeEntitlements/GEERSV2/HowyourGEERSclaimwillbeassessed.htm> viewed 17 June 2008.

<sup>35</sup> Entitlements include all unpaid wages, all unpaid annual leave, all unpaid pay in lieu of notice, up to 16 weeks’ redundancy pay, all long service leave, superannuation up to capped amounts.

<sup>36</sup> *Corporations Act 2001* (Cth), s 560.

<sup>37</sup> See cl 8(a) of the GEERS Operational Arrangements which states that eligible entitlements for GEERS are those payable as priority payments under *Corporations Act 2001* (Cth), s 556(1)(e) to s 556(1)(h).

<sup>38</sup> By virtue of the newly amended *Corporations Act 2001* (Cth), s 560, GEERS then becomes a subrogated creditor with the same priority of payment entitlements whether the administration of the estate is one of receivership, deed of company arrangement or liquidation.

<sup>39</sup> Whelan and Zirer, n 27, p 23, identify that the government, although vigorously pursuing employees claims, has only been able to recoup 6.56% of the entitlements it has provided as a safety net (such figures exclude Ansett).

<sup>40</sup> Explanatory Memorandum, n 3, pp 11-12.

<sup>41</sup> Explanatory Memorandum, n 3, p 12.

short-sighted as it favours the competing public policy of protecting employee entitlements over the desirability of encouraging business rescues, which in the long term would possibly mean the protection of employee entitlements in any case.

However, it may be considered that the administrator or the court<sup>42</sup> is in a better position to challenge the priority of employee entitlements in those rare cases where the re-organisation or restructure of the business should proceed at the cost of employee entitlements.<sup>43</sup> “The proposed approach is for the administrator to first secure the agreement of a majority (by number and value) of eligible employee creditors where the DOCA does not observe the priority. Creditors as a whole would then conduct a vote on whether the deed should be executed at a s 439A meeting.”<sup>44</sup> The court may approve on the application by the administrator<sup>45</sup> an alteration of employee priorities in a DOCA if satisfied that the alteration is “likely to result in the same or a better outcome for eligible employee creditors than would result from an immediate winding up of the company”,<sup>46</sup> such as in the case of business rescues.

#### Part IV facilitating pooling in external administration

“Prior to the latest amendments to the *Corporations Act* there was no direct power in the court to authorise the pooling of assets in an external administration.”<sup>47</sup> “Attempts have been made by insolvency practitioners to utilise existing *Corporations Act* provisions to achieve aggregation or ‘pooling’ of the assets of companies in either liquidation or under Pt 5.3A.”<sup>48</sup> The court was and still is empowered to sanction situations where effectively the creditors agree<sup>49</sup> to have a pooling arrangement put in place.<sup>50</sup> The majority of such methods, however, involve substantive procedural costs being incurred by the external administrator which inevitably reduce funds otherwise available for creditors.

Division 8 of Pt 5.6 of the *Corporations Act* now provides for two separate methods of pooling: voluntary pooling and court-ordered pooling. Both methods are only available in a liquidation. Thus, the introduction of the pooling provisions is a good example of the balancing of efficiency in administering insolvent companies against the need for strong creditor protection. Nowhere was this balancing more evident than the decision of Goldberg J in *Re Ansett Australia Ltd* (2006) 151 FCR 41; 24 ACLC 386 where the administrators applied for directions pursuant to s 447A and s 447D of the *Corporations Act* in relation to a proposal to pool the assets and liabilities of the Ansett Group

<sup>42</sup> The court can alter employee entitlement priorities in the deed of company arrangement by virtue of the *Corporations Act 2001* (Cth), s 444DA(2) and s 444DA(5).

<sup>43</sup> See *Lam Soon Australia Pty Ltd v Molit (No 55) Pty Ltd* (1996) 70 FCR 34; 14 ACLC 1,737 as an example of a DOCA which provided that claims of creditors of the viable portion of a company’s business were to be paid in full, but the majority creditor of the discontinued division was paid only a proportionate amount.

<sup>44</sup> Explanatory Memorandum, n 3, p 13.

<sup>45</sup> Or eligible employee creditor or any interested person: *Corporations Act 2001* (Cth), s 444DA(6).

<sup>46</sup> *Corporations Act 2001* (Cth), s 444DA(5).

<sup>47</sup> *Re Black Stump Enterprises Pty Ltd* (2005) 228 ALR 591 at [16] (Young CJ). However, in the same case Bryson JA was less certain of the position when he stated at [41]: “It is not clear to me that the court has any such power. I do not have a clear view to the contrary effect, that is, there is no such power.” The views of Young CJ were referred to with approval by Barrett J in *Re Whittingham* (2006) ACSR 559; [2006] NSWSC 1070 at [20] as quoted in Dickfos J, Anderson C and Morrison D, “The Insolvency Implications for Corporate Groups in Australia – Recent Events & Initiatives” (2007) 16(2) *International Insolvency Review* 103 at 106

<sup>48</sup> “Pooling” is the term commonly used to identify the aggregation of the assets of a corporate group such that they would in total be available to meet all of the corporate group’s obligations as quoted in Dickfos et al, n 47

<sup>49</sup> Or at least the requisite majority agree.

<sup>50</sup> For a discussion of the six existing statutory procedural means by which consolidation of a corporate group in insolvency might be effected see Dickfos et al, n 47 at 103, 106-108 and Harris J, “Corporate Group Insolvencies: Charting the Past, Present and Future of Pooling Arrangements” (2007) 15(2) *Insolv LJ* 78 at 81-91.

companies. The administrators argued<sup>51</sup> that pooling would save significant amounts of time and costs and thus the administration (including distributions) would advance more quickly. The cost savings would also maximise the pool of moneys available to creditors. Goldberg J denied giving directions as there were a number of creditors of one or more companies which would be significantly disadvantaged. It was not considered sufficient grounds for a pooling order that the administration or liquidation was complex or that the identity of creditors was difficult to determine.

### **Procedural cost savings**

The pooling determination process will obviate the need in some cases for liquidators to apply to the court for directions under s 479(3) or s 511 of the *Corporations Act*. In *Re Charter Travel Co Ltd* (1997) 25 ACSR 337, the court made orders on the application of the liquidators under s 479 of the *Corporations Act* that a combined meeting of known creditors of each of the companies within the group be convened together with the relevant administrative directions for conducting such a meeting. By virtue of s 579L of the *Corporations Act* once a pooling determination or pooling order is in force, consolidated meetings of creditors are to be convened by the liquidators unless the court orders otherwise. Similarly the regulations will then provide for specific procedural matters in relation to the convening of a consolidated meeting including the sending of notices, quorum requirements, and manner of voting.<sup>52</sup> Streamlining of procedural meeting matters, however, is only available once the pooling order or pooling determination is in effect. Until then, separate meetings of group companies' creditors are to be held which may result in logistical difficulties for those who are creditors of more than one group company.

The restriction of pooling determinations or pooling orders to companies in liquidation may be recognition that the existing voluntary administration and deed of company arrangement procedures enable creditors to efficiently determine whether or not to pool.<sup>53</sup> The IPAA has stated:

Currently administrators can seek to pool a group of companies in a Voluntary Administration by taking a vote of creditors at the second meeting in respect of proposed "Pooling Deeds". These resolutions are passed by a simple majority. Some administrators seek the approval of the Court for the pooling arrangement under s 447A, some choose not to.<sup>54</sup>

Certainly administrators may still need to apply to the court for directions under s 447D. For example, in *Mentha v GE Capital Ltd* (1997) 154 ALR 565, the administrators sought a direction that it was proper for them to execute and give effect to three deeds, the effect of which was to transfer their assets to one company, and for that company to assume all the liabilities of the other companies within the group. Where such court applications continue, there are still valid arguments for regulating a pooling procedure within a voluntary administration, deed of company arrangement scenario.

The obtaining of a voluntary pooling determination or granting of court, ordered pooling does not mean the recognition of a separate corporate group entity with associated group liability or the lifting of the corporate veil in relation to those companies within the corporate group. The separate legal entity status of each company and its associated limited liability is of paramount importance to the

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<sup>51</sup> The administrators advanced a long list of reasons for the need for pooling see *Re Ansett Australia Ltd* (2006) 151 FCR 41; 24 ACLC 386 at [26] (Goldberg J).

<sup>52</sup> *Corporations Act 2001* (Cth), s 579L(2).

<sup>53</sup> Australian Bankers' Association (ABA), Submission on the Exposure Draft to *Corporations Amendment (Insolvency) Bill 2007* (Cth), p 2. The ABA considers the existing deed of company arrangement procedure contains sufficient flexibility to deal with substantive matters such as which debts and claims are pooled, which assets are available to meet those claims; procedural matters such as creditor meeting procedures and the submission and adjudication of proofs of debts in a pooled company scenario; and a right of recourse to the courts.

<sup>54</sup> Insolvency Practitioners Association of Australia (IPAA), Submission on Exposure Draft to *Corporations Amendment (Insolvency) Bill 2007* (Cth), p 11.

protection of shareholders and creditors<sup>55</sup> and is therefore retained. Rather, the joint and several liability arising among the companies within the pooled group and the administration of such liability on a joint basis is a means of reducing complexities within group insolvencies, and thereby enhancing returns to creditors.

### **Voluntary pooling by the liquidator**

Section 571 sets out the general consequences of a pooling determination and grants the liquidator/s the power to make a pooling determination<sup>56</sup> which comes into force on approval by the eligible unsecured creditors of each company in the group.<sup>57</sup>

Without the necessary approval the pooling determination is cancelled.<sup>58</sup> Prima facie, eligible unsecured creditors are the external unsecured creditors (excludes intra-group companies) of the companies within the group.<sup>59</sup>

The general effect of a pooling determination is:

- each company in the group is taken to be jointly and severally liable for each provable debt payable by and each provable claim against, each other company in the group;
- inter-group company debts and claims are extinguished;
- the pooling determination does not alter the order of priority under ss 556, 560 and 561 for each company in the group;
- the pooling determination does not affect a secured creditor's interest as long as the secured debt is not an inter-group debt.<sup>60</sup>

A balancing of creditor protection and efficiency (in terms of the liquidator's flexibility in making pooling arrangements) is evident in that although the liquidator has a wide discretion in determining the manner of pooling proposed,<sup>61</sup> certain priorities are maintained, such as employee entitlements<sup>62</sup> and secured debts.<sup>63</sup> The liquidator may modify the above general consequences of a pooling determination on fairness grounds based on what is "just and equitable" between the various creditors of the group companies. The pooling determinations are aimed to be flexible and reflect the specific circumstances of the companies in the particular pooling group.<sup>64</sup>

Before unsecured creditors vote on the pooling determination, the liquidator must give them her or his written report, setting out the extent to which particular eligible unsecured creditors and particular companies in the group are likely to be disadvantaged as well as the likely return to eligible

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<sup>55</sup> Hansmann H and Kraakman R, "The Essential Role of Organizational Law" (2000) 110 Yale LJ 387, 394. Hansmann and Kraakman label a company with limited liability as enjoying affirmative asset partitioning as the "corporation's creditors have a prior claim on corporate assets, and if a shareholder becomes insolvent the shareholder's personal creditors cannot force liquidation of corporate assets to satisfy their claims upon exhausting the shareholder's personal assets".

<sup>56</sup> *Corporations Act 2001* (Cth), s 571(1).

<sup>57</sup> *Corporations Act 2001* (Cth), ss 577 and 578(1). Approval is gained by the passing of a resolution at each company's meeting of eligible unsecured creditors. The resolution must be passed by a majority of creditors in number and 75% in value of the total amount of the debts and claims of the eligible unsecured creditors present and voting in person or by proxy at each meeting.

<sup>58</sup> *Corporations Act 2001* (Cth), s 577(3).

<sup>59</sup> *Corporations Act 2001* (Cth), s 579Q(1)(a) and 579Q(1)(b). However, the regulations provide for the exclusion or inclusion of a specific creditor within the definition.

<sup>60</sup> *Corporations Act 2001* (Cth), s 571(2) to s 571(9) (pooling determination), *Corporations Act 2001* (Cth), s 579E(2) to s 579E(9) (pooling order).

<sup>61</sup> *Corporations Act 2001* (Cth), s 571(1)(d).

<sup>62</sup> *Corporations Act 2001* (Cth), ss 556, 560 and 561.

<sup>63</sup> *Corporations Act 2001* (Cth), s 571(2) and 571(9). External secured creditors' rights are unaffected by the proposed pooling determinations unless the secured creditor surrenders their security to the administrator for the benefit of creditors of the companies in the group generally. The debt is then no longer secured and is recoverable jointly and severally from all companies within the group.

<sup>64</sup> Explanatory Memorandum to Pt 4 – Facilitating Pooling in External Administration, *Corporations Amendment (Insolvency) Bill 2001* (Cth), pp 4, 251.

unsecured creditors if the determination comes into force or if it does not.<sup>65</sup> In making his or her determination the *Corporations Act* recognises that the liquidator is acting for the benefit of the creditors of the companies in the group as a whole and therefore gives the liquidator immunity from a possible breach of statutory or fiduciary duties owed by the liquidator to individual group companies.<sup>66</sup>

The court has the power to vary or terminate the pooling determination on the application of a group creditor, group member where a member's voluntary winding up exists (excluding a company group member) or any other interested person such as a group company director or ASIC.<sup>67</sup> A listing of the various grounds is given in the provision.<sup>68</sup> These provisions seek to protect smaller creditors who might otherwise be disadvantaged by the 75% majority over the 25% minority. However, such protection of smaller creditors may not be efficient. Applications by creditors to vary or terminate the pooling determination inevitably delay the liquidation of the company, thus incurring ongoing procedural costs. However, it is at the court's discretion whether the pooling order is varied or terminated. The court also has the power to cancel or confirm the variation as well as to make void or to validate the pooling determination.<sup>69</sup>

### Court ordered pooling

The court also has the power to make pooling orders on the application of the liquidator/s where it is satisfied that it is just and equitable to do so.<sup>70</sup> The matters which the court must take into consideration in making the order are open-ended and include those factors originally identified by the Harmer Report as justification for court-ordered pooling<sup>71</sup> as:

- i) the extent to which a company in the group and its officers or employees were involved in the management or operations of any of the other companies in the group;
- ii) the conduct of a company and its officers or employees within the group towards the creditors of any of the other companies in the group;
- iii) the extent to which the circumstances giving rise to the winding up of any of the companies in the group are directly or indirectly attributable to the acts or omissions of any of the other companies in the group or their officers or employees;
- iv) the extent to which the activities and business of the companies in the group have been intermingled;
- v) the extent to which creditors of any of the companies in the group may be advantaged or disadvantaged by the making of the order; and
- vi) any other relevant matters.

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<sup>65</sup> *Corporations Act 2001* (Cth), s 574(3) and 574(4). Where there is a members' voluntary winding up, the *Corporations Act 2001* (Cth), s 575 requires a copy of this statement to be given to each member of the company, excluding group company members within five business days after convening the meeting. If eligible unsecured creditors are disadvantaged, the liquidator must also give her or his reasons, why they should vote for a resolution approving the determination.

<sup>66</sup> *Corporations Act 2001* (Cth), s 579(2).

<sup>67</sup> *Corporations Act 2001* (Cth), s 579A(2).

<sup>68</sup> *Corporations Act 2001* (Cth), s 579A(1)(a) to 579A(1)(h) including on the application of an unsecured creditor, if the pooling determination would materially disadvantage such applicant, or the pooling determination would be oppressive or unfairly discriminatory or unfairly prejudicial to the eligible unsecured creditor applicant, or the pooling determination would be contrary to the interests of the creditors of the companies in the group, considered as a whole.

<sup>69</sup> *Corporations Act 2001* (Cth), ss 579B and 579C.

<sup>70</sup> *Corporations Act 2001* (Cth), s 579E(1) and 579E(11).

<sup>71</sup> The Law Reform Commission Report No 45, *General Insolvency Inquiry* 1988 (known as Harmer Report) 855 <http://www.austlii.edu.au/au/other/alrc/publications/reports/45> viewed at 26 August 2008.

Savings in transaction costs are not specifically identified as one of the relevant factors for obtaining a pooling order. However, it has been suggested that such savings are included in “any other relevant matters” as similarities can be drawn between the Australian and New Zealand pooling provisions.<sup>72</sup>

New Zealand case law suggests in relation to the corresponding provision in that jurisdiction that costs savings are indirectly taken into account, as “other relevant matters”. The argument being that if no pooling orders are made and separate legal proceedings are pursued the cost and length of the liquidation may considerably increase and thereby deplete funds otherwise available for creditors.<sup>73</sup>

Cost savings alone are not sufficient justification for the granting of a pooling order by the court. Rather, the use of the expression “just and equitable” as opposed to “just and beneficial” ensures that the need for creditor protection is also to be taken into consideration.<sup>74</sup>

In contrast whether it is “just and equitable” to make a pooling order takes into account the relative positions of the unsecured creditors within the group of companies vis-à-vis themselves, [as outlined in factor (v) above], and the respective shareholders of those companies given the management practices of those companies; the degree of intermingling of business and management between companies; and the creditors’ knowledge thereof. The term just and equitable is used in the corresponding New Zealand provisions and Farrar has suggested that the term provides the court with the “widest discretion to affect a result which accords with common notions of fairness in all the circumstances”.<sup>75</sup>

As illustrated above, the divergence between the goals of creditor protection and procedural efficiency are also clearly evident in the mandatory obligation on the court not to make a pooling order where the non-consenting unsecured creditor would be materially disadvantaged.<sup>76</sup> Thus the amendments have adopted the Harmer Report’s proposal to balance administrative efficiency with an equitable distribution of the insolvent companies’ pooled property.

The consequences of a court pooling order are the same as those of a liquidator’s pooling determination. To reduce administrative duplication and associated transaction costs a liquidator may open a single bank account, known as a liquidator’s general account for the pooled group, for the deposit of moneys received on the liquidation of the pooled companies.<sup>77</sup> The liquidator can then make payments out of this general account by cheque or electronic transfer.<sup>78</sup>

### **Increasing the pool of available funds**

One of the three objectives of pooling orders recognised by the Corporations and Securities Advisory Committee(CASAC) was enhancing returns to unsecured creditors.<sup>79</sup> Although it is apparent from the above discussion that pooling can mean substantial savings in transaction costs, the ability to generate

<sup>72</sup> See *Companies Act 1993* (NZ), s 271(1)(b). However, the application for pooling in New Zealand can be lodged by not only the liquidator but a creditor or shareholder and the New Zealand provision does not include factor (v) above.

<sup>73</sup> See *Re Dalhoff and King Holdings Ltd* (1991) 5 NZCLC 66,959 and *Re Pacific Syndicates (NA) Ltd* (1989) 4 NZCLC 64,757 at 64,768 as quoted in Dickfos et al, n 47 at 16, 103, 116.

<sup>74</sup> The expression “just and beneficial”, used in the *Corporations Act 2001* (Cth), s 511, which allows the court to determine a particular question or exercise all or any of the court’s winding up powers if satisfied that to do so would be “just and beneficial”, appears to take into consideration elements of cost and efficiency of function. Young J in *Dean-Willcocks v Soluble Solution Hydroponics Pty Ltd* (1997) 24 ACSR 79 at 81 considered that if “the court can summarily solve the difficulty that has arisen in the liquidation by an order under the section in a cheap and efficient manner ... It is ‘just and beneficial to exercise the power’”, as quoted in Dickfos et al, n 47 at 16, 103, 116.

<sup>75</sup> Farrar J, *Corporate Governance: Theories, Principles and Practice* Oxford University Press (2005) p 264, referring to Casey J, in *Re Home Loans Funds (NZ) Ltd* (1983) 1 NZCLC 95073 as quoted in Dickfos et al, n 47 at 16, 103, 116.

<sup>76</sup> See *Corporations Act 2001* (Cth), s 579K(10)(a) or s 579K(10)(b). For example, if one of the companies in the group is being wound up under a members’ voluntary winding up and the court is satisfied the order would materially disadvantage a non-company group member who has not consented to the making of the order.

<sup>77</sup> *Corporations Amendment Regulations 2007 (No 13)*, regs 5.6.06(2) and 5.6.07

<sup>78</sup> *Corporations Amendment Regulations 2007 (No 13)*, reg 5.6.10(1). Electronic transfer is preferable in relation to bulk transactions as it is “less costly, provides a computerised record of the transaction and reduces the chance of conversion or misappropriation”. Explanatory Statement to *Corporations Amendment Regulations 2007 (No 13)*, 4.

<sup>79</sup> Companies and Securities Advisory Committee, *Corporate Groups Final Report* (2000) at [6], [93].

greater resources to insolvent group members is limited because of the manner of defining the companies to be included in the pool and the denial of contribution orders among corporate group members.

The legislation places limits on when companies may be placed in the pool<sup>80</sup> but provides no formal definition of a corporate group. It has been contended that the failure of the Australian provisions to define a corporate group as arising when the separate business of each company is not readily identifiable (as exists within the New Zealand legislation) will result in potential pooling circumstances being overlooked.

In the New Zealand legislation, the circumstances of being a related company include where the activity is carried on in a way that the separate business of each company is not readily identifiable. In contrast, the Australian provision sets out more specific requirements relating to owning or operating property that is used in a joint undertaking. While the specific requirements may cover a wide variety of situations, particular unanticipated circumstances may cause difficulty and result in the pooling provisions not being able to be utilised. For example, if a company in the “group” has only a contractual link to the others so it owns no “property” or if the records are such that it is not possible to find which company actually owned or operated the property, doubts may arise as to whether the provisions apply.<sup>81</sup>

In addition, the “fact that only companies in liquidation are able to be part of the pooling process suggests that creditors could potentially be disadvantaged where (to the extent that it is commercially possible) assets are available in a solvent company that is part of the group”.<sup>82</sup> Division 8 of Pt 5.6 of the *Corporations Act* excludes solvent companies. CAMAC’s recommendation 41 that “solvent group companies should be permitted to enter into an administration with other group companies where at least one of those companies satisfies the voluntary administration prerequisite”<sup>83</sup> was not adopted. Giving the example of where a solvent group company relies on information technology or other logistical or financial support from an insolvent group company, CAMAC identified the circumstances where the affairs of the solvent group company are so intertwined with those of other group companies that pooling within the voluntary administration may be beneficial. Despite this recommendation, the draft Bill’s Explanatory Memorandum argued that this potential benefit is outweighed by the need to protect the interests of the solvent company’s shareholders<sup>84</sup> and the solvent company’s unsecured creditors, once again illustrating the diverse goals of efficiency in insolvency administration and the goal of providing creditor protection.

## CONCLUSION

The majority of the latest amendments to the *Corporations Act* found in Pts 1 to 4 of the *Corporations Amendment (Insolvency) Act 2007* (Cth) do achieve their stated aim of improving creditors’ outcomes. To do so means the external administration procedures must be efficient so as to maximise the proceeds from the reconstruction or winding up of the company and the distribution of its assets among creditors. At the same time, the transaction costs of reconstructing or winding up and distributing the assets should be minimised. The result means greater returns to creditors with the resultant lowering of risk of investment and cost of credit.

The adoption of voluntary pooling and court-ordered pooling in liquidation gives rise to savings in transaction costs. With respect to the remaining measures however, procedural efficiency runs counter to the substantive goal of creditor protection. An illustration is provided by the mandatory priority rule applying to the payment of employee entitlements (including superannuation guarantee charge), regardless of the form of external administration which, while generating benefits for specific employee creditors, may not improve creditors’ outcomes generally, but may have the opposite effect.

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<sup>80</sup> *Corporations Act 2001* (Cth), s 571(1), (pooling determinations) and *Corporations Act 2001* (Cth), s 579E, (pooling orders).

<sup>81</sup> Dickfos et al, n 47 at 122.

<sup>82</sup> Dickfos et al, n 47 at 121.

<sup>83</sup> Corporations and Markets Advisory Committee, n 2 at 6.4.2.

<sup>84</sup> Explanatory Memorandum to Pt 4 – Facilitating Pooling in External Administration, *Corporations Amendment (Insolvency) Bill 2007* (Cth), 53.

Similarly, limiting pooling to “insolvent companies” in specifically defined group relationships denies the availability of contribution orders from solvent companies where such orders may also be of benefit to unsecured creditors.

Where corporate insolvency regulation is achieved through the implementation of mandatory provisions, creditor protection is achieved but sometimes at the cost of procedural efficiency, where the external administrator is deprived of flexibility in realising and distributing the available assets of the insolvent companies.

The measures outlined from the recent amendments to the *Corporations Act 2001* (Cth) are illustrative of the continual balancing of the substantive goal of creditor protection with the goal of achieving procedural efficiency in corporate insolvency. The achievement of both goals is necessary to ensure that creditors maximise their outcomes in insolvency.