Helping companies restructure by improving schemes of arrangement

KPMG Submission

KPMG Australia

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Executive Summary

Thank you for the opportunity to provide a submission in relation to the consultation on improving schemes of arrangements to better support insolvent companies.

As a leading professional services firm, KPMG Australia (KPMG) is committed to meeting the requirements of all our stakeholders – not only the organisations we audit and advise, but also employees, governments, regulators and the wider community. We strive to contribute to debate that seeks to develop a strong and prosperous economy and welcome the opportunity to provide a submission to this inquiry.

KPMG has one of the largest restructuring services practices in Australia and around the world. We provide restructuring, turnaround and insolvency services to a wide range of clients from small and medium businesses to large institutional and multi-national organisations. We strive to contribute to the development of reliable and practical insolvency and restructuring procedures to assist Australian businesses facing financial difficulty so that they may contribute to a strong and prosperous economy.

KPMG understands that the consultation paper is requesting feedback as to "whether the lack of a moratorium during the consideration and formation of a scheme is impacting the utility and usefulness of schemes as a means of restructuring insolvent companies". In responding to the consultation paper, KPMG notes the following:

- Schemes of arrangement are designed to restructure companies that are currently solvent. The introduction of an automatic moratorium would fundamentally change the nature of a scheme, making it more akin to an insolvent restructuring process, however without the necessary checks and balances which are in place for Australian insolvency processes.
- A moratorium against any action or civil proceeding is already available by order of the Court pursuant to section 411(16) of the Corporations Act (2001).

Introducing an automatic moratorium would not increase the uptake or utility of the current regime for the following reasons:

- The key inhibiter for companies considering using the scheme of arrangement regime is the substantial cost of court led restructuring. This limits the regime to large companies, of which Australia is a considerably smaller market relative to other jurisdictions.
- Schemes are mostly used to restructure complicated debt structures and are rarely used to compromise the claims of trade creditors. The use of non-bank lending and private credit by large Australian companies is relatively small compared to other jurisdictions. Additionally, an automatic moratorium would only be useful for this type of restructuring in circumstances where lenders have not agreed to a consensual standstill, which in our experience is rare in relation to viable businesses.
- A moratorium is a considerable impost on the rights of creditors which requires supervision by either the court or an expert appointed to represent the interests of the creditors (as occurs in the voluntary administration regime). The cost of court supervision is prohibitive to small and medium sized creditors, who do not have the resources necessary for legal representation in the scheme process. In other jurisdictions, the debtor company is required to cover the advisor costs of the creditor groups (including legal costs). If this is adopted as a solution, it would further increase to the cost of the scheme process and limit the number of potential candidates.

- In our experience1, suppliers with outstanding debts that are subject to a moratorium are unwilling to extend further credit during the moratorium period. This generally requires a substantial increase in the amount of working capital to continue operating and may result in major disruptions to the business operations. Accordingly, an automatic moratorium that applies to trade creditors has the potential to accelerate the level of distress, rather than provide breathing space.

Overall, introducing an automatic moratorium in isolation from a complete review of the appropriateness and policy intention of the scheme of arrangement regime is likely to result in more complexity, cost that may exceed any benefit derived.

We have sought to answer the consultation questions set out in the discussion paper in this response. If you would like to discuss this letter or related restructuring policy at any stage, please don't hesitate to reach out.

Yours sincerely,

James Stewart
Partner
National Leader,
Restructuring Services
KPMG Australia

Robyn Duggan
Special Adviser,
Restructuring Services
KPMG Australia

Liam Creedon
Director,
Restructuring Services
KPMG Australia

[1] *Based on the moratorium in the voluntary administration regime*

Background

About KPMG

KPMG is a global organisation of independent professional firms, providing a full range of services to organisations across a wide range of industries, governments and not-for-profit sectors. We operate in 146 countries and territories and have more than 227,000 people working in member firms around the world. In Australia, KPMG has a long tradition of professionalism and integrity combined with our dynamic approach to advising clients in a digital-driven world.

KPMG Restructuring Services

KPMG has one of the largest restructuring services practices in Australia and around the world. We provide restructuring, turnaround and insolvency services to a wide range of clients from small and medium businesses to large institutional and multi-national organisations. We strive to contribute to the development of reliable and practical insolvency and restructuring procedures to assist Australian businesses facing financial difficulty so that they may contribute to a strong and prosperous economy.

Section 1: KPMG recommendations

In order to meet the Commonwealth's intention of increasing the utility and usefulness of schemes, KPMG recommends that:

Recommendation 1:

Consideration should be given to how independent experts can be used to replace the role of the Court in certain aspects of schemes of arrangement, which may allow for the overall cost to be reduced.

Recommendation 2:

The Commonwealth consider a broader review of the formal restructuring regimes available to insolvent but viable businesses to determine which types of Australian companies do not currently have access to the necessary mechanisms to restructure and continue operating in a manner which is fair to both the debtor and creditors.

Recommendation 3:

As part of the above, or in isolation, a wholesale review of the entire scheme of arrangement process should be undertaken prior to implementing an automatic moratorium that effectively allows schemes of arrangement to be used as a restructuring regime for insolvent companies.

If an automatic moratorium is introduced KPMG recommends the following:

Recommendation 4:

The Commonwealth include a legislative review process or a sunset clause to ensure the moratorium is reviewed to ensure it is working as intended.

Recommendation 5:

A moratorium should be targeted at only the creditors or classes of creditors that the proposed scheme seeks to compromise. If a proposed scheme does not seek to compromise trade creditors, then trade creditors should not be subject to any moratorium. Consideration should also be given to how the moratorium is overseen in the scheme context, and whether the Court should solely be able to grant exceptions to the moratorium, or if an independent monitor could also perform that function.

Recommendation 6:

An automatic moratorium should last for no longer than 20 business days, unless extended by the Court. This is largely consistent with voluntary administration.

Recommendation 7:

To incentivise the provision of credit during an automatic moratorium, credit extended during the moratorium period should receive a priority status under any subsequent liquidation of the company.

Section 2: KPMG Insights

Introduction

KPMG has experience in the various aspects of the schemes of arrangement, including as the advisor to scheme proponents, as independent experts and as scheme administrators. In our experience, the very limited adoption of the schemes of arrangement is due to:

- The considerable cost of schemes which makes them suitable only to large companies;
- The timeframe required to implement a scheme requires the company to decide to undertake the restructure while still having sufficient resources to support the business (i.e. being solvent) for periods of up to six months. In our experience, management of businesses (other than for companies with professional directors) facing a potential financial crisis often will fail to recognise the circumstances early enough to provide the necessary runway to implement a scheme (and often there are insufficient resources to fund a voluntary administration, notwithstanding the moratorium on outstanding debts);
- Schemes are primarily used as a deleveraging tool, often through a debt for equity exchange. Only a small collection of creditors (e.g. hedge funds) are willing to accept this form of compromise. Australian banks and trade creditors are generally unwilling to accept equity in exchange for their debts; and
- Schemes (and formal restructuring processes in general) are not well understood by trade creditors who generally do not have the resources to understand the complicated and lengthy explanatory material. There have been few examples of schemes seeking to compromise trade creditor claims in Australia recently. However, in similar circumstances for companies in voluntary administration, this often results in trade creditors ceasing to supply or offer credit, creating further problems for the distressed business. Accordingly, schemes are generally better suited to restructuring financial debts, rather than trade suppliers.

KPMG notes that the Productivity Commission recommended that the Corporations Act be amended to create a moratorium on creditor enforcement during the formation of schemes of arrangement and that this moratorium be aligned with the approach used in voluntary administration. It also recommended that Courts be given the explicit powers to lift all or part of the moratorium in circumstances where its application would lead to unjust outcomes. However, the Commission also noted that "*while the Commission considers that moratoriums will assist the formation of schemes, they could also lead to some abuse of schemes, and potentially negative impacts on some creditors*". In our view, the practical implications of the Commission's recommendation needs to be carefully reviewed.

Response to consultation questions

We have considered the questions and have provided responses separated into two sections:

- **Key response:** this is our response in line with our recommendations.
- **Secondary comments:** these are additional comments should the Commonwealth proceed to implement an automatic moratorium.

Question 1: Should an automatic moratorium apply from the time that a company proposes a scheme of arrangement? Should the automatic moratorium apply to debt incurred by the company in the automatic moratorium period?

Key response

KPMG's view is that an automatic moratorium would not enhance the scheme of arrangement regime.

It is rare that a scheme seeks to compromise trade creditors, which is where an automatic moratorium would have the most impact. However, other than through their vote, the scheme of arrangement regime provides little protection for trade creditors due to most not having the means to be heard or represented in a court restructuring.

In relation to financial creditors, if a business is facing an event of default or circumstance where its facilities may mature without a suitable alternative form of finance being in place, it is common practice for distressed borrowers to seek a temporary waiver of relevant defaults or a standstill agreement with its lenders to provide time to implement a restructure. This type of consensual moratorium is usually provided in circumstances of increased transparency by the borrower of its circumstances and the opportunity to maintain a viable business. Accordingly, we expect there would be limited utility in replacing a consensual moratorium agreement with a non-consensual moratorium, except in circumstances where the borrower may have a complex debt structure and the financiers are not aligned.

Secondary comments

If a moratorium was introduced to the scheme of arrangement regime, the moratorium should not apply to debts incurred during the moratorium period.

We have extensive experience dealing with suppliers during the voluntary administration process that have outstanding debts that are subject to a moratorium. The debts incurred during the voluntary administration process benefit from:

- Not being subject to the moratorium;
- Having priority status as costs of the administration; and
- The voluntary administrator being personally liable for their payment.

Notwithstanding the above benefits, it is often difficult to obtain credit from suppliers to allow the business to continue to trade. A moratorium on debts incurred during a scheme moratorium period would likely exacerbate the level of distress, rather than alleviating it.

Considerable attention needs to be given to the increase in working capital required by a company that has announced plans to propose a scheme of arrangement as suppliers are likely to reduce their credit terms or only offer to supply if paid cash on delivery.

Question 2: Would the moratorium applied during voluntary administration be a suitable model on which to base an automatic moratorium applied during a scheme of arrangement? Are any adjustments to this regime required to account for the scheme context? Should the Court be granted the power to modify or vary the automatic stay?

Key response

The voluntary administration moratorium is a broad moratorium which applies to all creditors of a company. The moratorium limits the ability of creditors or third parties to take steps in relation to secured property or property owned by the third party.

Schemes of arrangement generally target specific creditors or a class of creditors. The broad nature of the voluntary administration moratorium makes it unsuitable to the specific nature of scheme of arrangement restructurings.

Secondary comments

If a moratorium is to be introduced to the scheme of arrangement process, it should be targeted at only the creditors or classes of creditors that the proposed scheme seeks to compromise. If a proposed scheme does not seek to compromise trade creditors, as is the case in most schemes, then trade creditors should not be subject to any moratorium.

In the voluntary administration context, both the voluntary administrator and the court have power in relation to the moratorium, and the voluntary administrator can provide consent for a creditor to exercise a right that is otherwise prevented by the moratorium. Consideration should be given to how the moratorium is overseen in the scheme context, and whether the court should solely be able to grant exceptions to the moratorium, or if an independent monitor could also perform that function.

An independent monitor may allow for a reduction in costs associated with the moratorium. It may also provide an avenue for creditors to be heard who otherwise may not have the financial resources to be represented in a court process.

The court should be granted the power vary or modify the moratorium. This is required to prevent abuse or the deliberate prejudicing of certain creditors. It is also required to end the moratorium when in the opinion of the court, it is evident that a successful scheme of arrangement cannot be achieved.

Question 3: When should the automatic moratorium commence and terminate? Are complementary measures (for example, further requirements to notify creditors) necessary to support its commencement?

Key response

KPMG's view is that an automatic moratorium would not enhance the scheme of arrangement regime.

Secondary comments

If an automatic moratorium is introduced to the scheme of arrangement process, it should commence following the publication of a notice to the scheme creditors of the intention to propose a scheme.

In relation to the company publishing its intention to propose a scheme of arrangement, the moratorium should not commence until the notification has been published on the ASIC published notices website. Written notification to the proposed scheme creditors should also be required within a defined period, such as five business days.

The moratorium should terminate at the earlier of:

- The defined period for the automatic moratorium (unless extended by the Court);
- An order by the Court that the moratorium terminate;
- The creditors voting against the proposed scheme of arrangement;
- The scheme of arrangement completing; or
- The scheme of arrangement being terminated by the scheme administrator.

Question 4: How long should the automatic moratorium last? Should its continued application be reviewed by the Court at each hearing?

Key response

KPMG's view is that an automatic moratorium would not enhance the scheme of arrangement regime.

Secondary comments

If an automatic moratorium is introduced to the scheme of arrangement process, it should last for no longer than 20 business days, unless extended by the Court. This is largely consistent with the voluntary administration regime.

The moratorium should be considered at each Court hearing. We expect it should only be rare circumstances that the Court makes orders to advance the scheme of arrangement but does not continue the moratorium.

Question 5: Are additional protections against liability for insolvent trading required to support any automatic moratorium?

Key response

KPMG's view is that an automatic moratorium would not enhance the scheme of arrangement regime.

Secondary comments

Directors have the benefit of the safe harbour defences to insolvent trading in section 588GA if certain criteria are satisfied, which we expect would be achieved in most, if not all, good faith attempts to implement a scheme of arrangement of a viable business.

We note that an independent review of the safe harbour legislation has also been announced. The outcome of that review should inform whether additional protections are required or whether the current regime is providing enough comfort to directors to pursue the best path for all stakeholders.

We also note there is precedent for additional protections, as exists under the small business restructuring regime.2 However, this regime includes the oversight of a small business restructuring practitioner, who has obligations to creditors.

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[2] *Section 588GAAB*

Question 6: What, if any, additional safeguards should be introduced to protect creditors who extend credit to the Company during the automatic moratorium period?

Key response

The Australian insolvency regimes have a clear policy intention that all creditors should be treated on a pari passu basis, with limited exceptions. However, without additional protections, we expect businesses will be unable to obtain credit during a moratorium, which would cause greater damage to the business.

Secondary comments

To incentivise the provision of credit, credit extended during the moratorium period should receive a priority status under any subsequent liquidation of the company. This priority should not extend over any other priority currently established in section 556, but rather be a priority immediately prior to any other unsecured claim which was not incurred during the moratorium period.

For comparison, the voluntary administration regime treats debts incurred during the moratorium as 'costs of the administration' which provides creditors with senior priority relative to any other claim that can be satisfied if the company transitions into liquidation.3 Notwithstanding this protection for creditors, in our experience there is still significant resistance from suppliers to extend credit during the voluntary administration process.

The position contrasts with the small business restructuring regime which does not provide protections to creditors who extend credit following the appointment of the small business restructuring practitioner. KPMG has not yet accepted appointments under this regime and cannot comment on supplier attitudes to extending credit under these circumstances.

Question 7: Should the insolvency practitioners assisting the Company with the scheme of arrangement be permitted to act as the Voluntary Administrators of the Company on scheme failure?

Key response

KPMG restructuring partners are members of the Australian Restructuring, Insolvency and Turnaround Association and subject to its Code of Professional Practice. Accepting a role as voluntary administrator after advising a company in relation to a scheme of arrangement would be a breach of independence under the code. This is due to the requirement of the voluntary administrator to undertake investigations into the circumstances of the scheme's failure, and potentially investigate their own actions or advice.

We note there are some advantages to the insolvency practitioner acting in both roles. In our experience, the voluntary administration process is usually faster and more cost effective if the insolvency practitioner appointed has detailed knowledge of the business' operations, management team, reasons for the failure and turnaround potential. These advantages translate into savings in the form of voluntary administration costs and generally maximises the chances for a successful restructure. In these circumstances, the insolvency practitioner should be permitted to act in both roles, but only if provisions are made which allow the Court to consent to the appointment.

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[3] *Section 556(1)(a)*

Question 8: Is the current threshold for creditor approval of a scheme appropriate? If not, what would be an appropriate threshold?

Key response

The creditor threshold for schemes of arrangement do not align with creditor approval thresholds in the voluntary administration / deed of company arrangement regime, which only requires majority in value and in number. This arguably makes a compromise easier to achieve under a deed of company arrangement compared to a scheme of arrangement.

However, we note the creditor thresholds for schemes align with comparable jurisdictions and that schemes are designed to compromise the rights of creditors of solvent companies, where additional hurdles should be required.

We do not believe the threshold should change without a clear policy directive to change balance of debtor and creditor rights in Australian restructuring.

Question 9: Should rescue, or 'debtor-in-possession', finance be considered in the Australian creditors' scheme context?

Key response

We have experience borrowing funds for restructure financing during the voluntary administration process and have seen how this has maximised outcomes through providing flexibility in the restructure process.

There is scope for the introduction of 'debtor-in-possession' or restructure financing in conjunction with the scheme of arrangement process. *However, this is a complicated topic which requires significant and detailed consultation with the restructuring and credit industries.*

The introduction of this financing would have significant implications for stakeholders, particularly financiers that already hold a security interest over assets that may be pledged to the new financier. There is likely to be significant opposition to priming the security interests of lenders in the scheme context, which may limit the utility or availability of restructure financing. Consideration needs to be given to the impact on credit markets if priming of security interests is permitted to increase the utility and availability of restructure financing.

A significant suite of safeguards and oversight are required if this form of financing is introduced.

Question 10: What other issues should be considered to improve creditors' schemes?

Key response

The cost of the scheme process is a significant barrier to medium size companies seeking to access the regime. Consideration should be given to how independent experts can be used to replace the role of the Court in certain aspects, which may allow for the overall cost to be reduced. This would be akin to the oversight and powers afforded voluntary administrators, with the Court providing an oversight and dispute resolution role, rather than being asked to approve a commercial outcome for stakeholders.

Question 11: Are there any other potential impacts that should be considered, for example on particular parties or programs? If so, are additional safeguards required in response to those impacts?

Key response

In general, KPMG does not support the use of the Fair Entitlement Guarantee (FEG) program or any other government support program to fund recoveries to creditors as part of a scheme of arrangement in circumstances where the scheme has actively quarantined those creditor claims from the ongoing business and assets.

Schemes of arrangement should be used to restructure viable businesses and should not allow for restructuring that transfers assets away from creditor claims in entities which will be liquidated and rely on the FEG program to repay creditors.

Key authors and contacts

James Stewart
Partner,
National Leader Restructuring Services

Liam Creedon
Director,
Restructuring Services

Robyn Duggan
Director,
Restructuring Services,
National Head of Technical
and Professional Development

Sophie Finemore
Associate Director,
Regulatory Affairs

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