Creditors' schemes of arrangement in Australia

A key part of the international scheme landscape

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The use of creditors' schemes of arrangement is on the rise in Australia (as we discussed in our previous article - Update on Creditors Schemes of Arrangement in Australia). Along the way the Australian courts have made valuable contributions to international scheme jurisprudence. In this article we look at some of these contributions and then explore how Australian law might be further developed to remain a leading jurisdiction for creditors' schemes.

Advantages of schemes as a restructuring tool

As a brief recap, in Australia a creditors' scheme of arrangement is a formal debt restructuring mechanism which involves a compromise or arrangement to vary the terms of debts or claims between the company and a creditor or class of creditors (including secured creditors).

The procedure for implementing a creditors' scheme of arrangement is outlined in Part 5.1 of the Corporations Act 2001 (Cth) and essentially involves the convening of a meeting of creditors to approve the scheme. Provided requisite majority votes are obtained, the scheme proposal is then reviewed by the court, which will sanction the scheme if satisfied it is fair and reasonable to creditors.

Voluntary administration followed by a deed of company arrangement (DOCA) is generally the preferred restructuring mechanism in Australia due to its speed and efficiency and the potential to avoid court involvement. However, a creditors' scheme of arrangement offers various advantages to a DOCA, such as:

- a scheme need only be voted on by those classes of creditors whose rights are affected by it, whereas a DOCA must be voted on and approved by all secured and unsecured creditors as one homogenous group;
- a successful scheme can bind dissenting secured creditors, but a DOCA generally only binds those secured creditors who vote in favor of it; and
- a DOCA is not generally able to include effective releases given by creditors in favor of third parties, whereas a scheme can.

The most significant of these advantages is the ability to alter secured creditors' rights without their consent.

Creditor rights governed by foreign law

Two key questions arise in relation to a scheme which seeks to compromise debts governed by a foreign law. Firstly, will the court tasked with sanctioning the scheme accept jurisdiction to do so? Secondly, if the scheme is sanctioned, will the effects of the scheme be recognized and therefore effective in the foreign jurisdictions in which dissenting creditors may seek to take enforcement action against the debtor?
The efficacy of a scheme can be significantly impacted if the compromise of debts under it will not be effective in all jurisdictions where dissentient creditors may seek to enforce their debt or security. Where the debts to be compromised are governed by a foreign law the effect of the compromise in that foreign jurisdiction will be particularly relevant. This is a key issue for courts to consider when deciding whether to sanction a scheme.

The rule in Gibbs\(^1\), is an English common law principle which states, in essence, that a debt may only be discharged by the governing law of that debt. The rule is important because many international finance arrangements which one might wish to compromise via a scheme are governed by English law, and because, at least historically, other commonwealth jurisdictions have also adopted the rule. The rule has been subject to some criticism but, at least for now, it remains good law in England.

Despite the rule, courts internationally\(^2\) have felt able, in certain circumstances, to accept jurisdiction to sanction a scheme of arrangement which seeks to compromise foreign law debts. The Australian courts did so in *Re Bulong Nickel Pty Ltd* [2002] WASC 226, with Heenan J finding that Australian courts have jurisdiction to approve a scheme of arrangement that would have the effect of modifying the rights of parties to a contract governed by a foreign law, in that case New York law. While Heenan J recognized that as a matter of contract the law governing the contract would be applied in determining whether the contract or debt was discharged, the court held that different rules apply in the case of insolvency of a party to a contract or in relation to schemes of arrangement. The court held that s 411 of the Corporations Act confers on Australian courts a power to approve a compromise or arrangement even if the effect of the scheme of arrangement would be to modify or discharge obligations existing between the company concerned and third parties under a contract which stipulates that it is to be governed by a foreign system of law.

More recently, the Singapore courts took a similar approach in *Pacific Andes Resources Development Ltd* [2016] SGHC 210, where the court was willing to accept jurisdiction to sanction a scheme which would compromise English and Hong Kong law governed debts. Indeed, in reaching this position, the High Court in Singapore noted that it was “fortified” in its view by “the approach in Australia which does not see the principle in Gibbs as an obstacle to asserting jurisdiction in Australia.”\(^3\)

**Conditional schemes**

Conditional schemes of arrangement are another area where Australia has provided guidance which has been adopted internationally. In *Re NRMA Insurance Ltd* [2000] NSWSC 82, the Court held that s 411(6) of the Corporations Act expressly contemplates the prospect of conditional schemes of arrangement by permitting the court to approve an arrangement subject to conditions. A conditional scheme will however only be approved if the conditions simply bring about termination of the scheme and a return to the status quo. A scheme which contains machinery that could lead to a variation of its terms is not permitted. The court and the creditors must know, with clarity and certainty, what it is that they are being asked to approve.

Australian jurisprudence on conditional schemes of arrangement has been internationally influential, with the English High Court in *Re Lombard Medical Technologies Plc* [2014] EWHC 2457 (Ch) citing *Re NRMA* to assist it in finding that a condition precedent, which prevented a scheme coming into operation unless satisfied, may be acceptable (aside from the fact that each case must always be considered by its own merits). The *Lombard* case set out some useful principles, along similar lines to *Re NRMA*, noting that:

> “Examples of the kind of condition which the court may be willing to sanction, even if they are unsatisfied at the date of the hearing, are outstanding requirements for foreign regulatory approval which there is no reason to suppose will not be granted. Further, the terms of the scheme itself may provide that it will cease to have effect in certain circumstances, for example if the steps contemplated are not taken before a specified long-stop date. By contrast, the court would be most unlikely to sanction a scheme if the outstanding condition was one which in effect conferred on a third party the right to decide whether, or when, the scheme should come into operation, or which enabled the terms of the scheme to be varied in some material respect. The objection then would be that the court was not truly in a position to consider the merits of the scheme, so it could not properly exercise the jurisdiction conferred on it by Parliament to approve the scheme on behalf of all members of the relevant class or classes of shareholders.”

Both the *Re NRMA* and Lombard decisions have been subsequently cited with approval. For example, the
Singapore High Court was significantly guided by both cases in *Re Conchubar Aromatics Ltd and another matter* [2016] SGHC 279 as there was no local authority on the point. As such, the cases have contributed a valuable piece of jurisprudence to the global community.

**Cross-class cram down**

Australia has been at the forefront in many areas of scheme jurisprudential development, but one of the key areas in which the law would benefit from development is consideration of a cross-class cram down mechanism for creditors' schemes to avoid a dissenting class of creditors from derailing a scheme. Under the current law where multiple classes of creditors are affected by a proposed scheme, the requisite majority approval must be obtained from each of the classes. This allows one dissenting class the ability to block the scheme. The underlying rationale for allowing each class of creditors an equally powerful right to vote down a scheme is to ensure that minority interests are adequately protected. However, this safeguard can be exploited by the dissenting class (for example, by holding the company hostage on the scheme until demands for more favorable conditions are met).

To address this issue, Australia could follow the lead of other jurisdictions (such as the US, Singapore, China and Japan) and implement a cross-class cram down mechanism which would empower the court to approve a scheme regardless of whether one or more classes voted against it.

Europe has recently recognized the need for such a mechanism to promote successful restructurings, by including a cross-class cram down as one of the minimum standards which EU member states will be required to incorporate into their national restructuring laws in order to comply with the recently approved Directive on Restructuring and Insolvency.⁴

The court's integral role in the scheme approval process and the wide discretion offered to the court in determining whether a scheme should be approved would provide a level of protection to a dissenting class of creditors. If this is not considered to be sufficient protection, provisions requiring valuation exercises to be carried out and for dissenting creditors not to be worse off under the scheme than they would be in a liquidation (assuming that is the alternative to a scheme, which in most creditor schemes it will be) could be considered.

Alternatively, for schemes affecting multiple classes, consideration could be given to reforms which broaden class composition in order to reduce the number of classes voting on the scheme, and thereby lessen the likelihood of a dissenting class being able to hold others to ransom.

**Conclusion**

Schemes of arrangement are becoming a more frequently used restructuring tool given the reach they can have, including on third parties and given the avoidance of any formal insolvency process. We expect that with the increase in the use of schemes there will also be a commensurate increase in judicial consideration of issues that need to be addressed in order to ensure schemes continue to be a useful, practical and workable solution for companies looking to restructure. We anticipate that, like foreign jurisdictions, Australia will favor a more flexible, novel and broad approach to schemes than we may have seen in the past.

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¹ So named as it derives from the English Court of Appeal decision in *Antony Gibbs & Sons v La Société Industrielle et Commerciale des Métaux* (1890) LR 25 QBD 399.

² Including the English Courts see for example *Re Magyar Telecom BV* [2013] EWHC 3800 (Ch).

³ *Pacific Andes Resources Development Ltd* [2016] SGHC 210, 27 [49(a)].
