# SHOULD AUSTRALIA ADOPT AN INSOLVENCY REGIME BASED ON THE US CHAPTER 11 BANKRUPTCY CODE?

Following the collapse of Ansett, there have been increasing calls for the introduction in Australia of an insolvency regime based on Chapter 11 of the United States Bankruptcy Code. Recently, the Corporations and Markets Advisory Committee issued a discussion paper entitled *"Rehabilitating Large and Complex Enterprises in Financial Difficulty"*, in which it called for comment on whether Australia should adopt a new system of corporate rehabilitation based on Chapter 11 of the United States Bankruptcy Code.

This paper suggests that attempts to adopt a new insolvency regime based on Chapter 11 in place of the voluntary administration regime in Part 5.3A of the Corporations Act 2001 ("the Act") ought to be rejected.

## Principal features of Chapter 11 of the United States Bankruptcy Code[1]

- Companies petition for bankruptcy of their own volition. There is no requirement that the debtor company be in financial distress before filing a petition.

- Immediately upon the filing of a petition, there is an automatic stay of recovery attempts by all creditors.

- Upon filing a petition the debtor company is given 120 days to produce to the Bankruptcy Court a proposed plan of reorganisation which addresses the claims of creditors and enables the company to continue to trade. This period may be extended at the court's discretion. If no plan presented by the debtor is approved by the court during this period, creditors have 60 days in which to present an alternative reorganisation plan for approval.

- During the 120 day period the debtor's management remains in control unless creditors are able to show cause, for example evidence of fraud, as to why an independent trustee ought to be appointed. The Chapter 11 insolvency regime is described as a "debtor in possession" regime.

- The Bankruptcy Court in the United States has a substantial role at every step of the reorganisation process.

## Criticisms of Chapter 11

Chapter 11 has been the subject of considerable criticism.[2] A summary of the major criticisms is set out below.

- Most debtors under Chapter 11 fail to achieve long term rehabilitation.[3] Only about 6.5% of debtors under Chapter 11 are successfully rehabilitated[4].

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[1] For a more detailed description of the Chapter 11 procedures see L Griggs, "Voluntary Administration and Chapter 11 of the Bankruptcy Code (US)", (1994) 2 Insolv LJ 94; B McCabe, "Official Management v Reorganisation Under Chapter 11 of the United States Bankruptcy Code: In Defence of Official Management" (1992) 20 ABLR 320 at 327, 328 and TCG Fisher and J Martel, "Should we abolish Chapter 11? Evidence from Canada", CIRANO (Scientific Series), Montreal, 1996.

[2] L Griggs, "*Voluntary Administration and Chapter 11 of the Bankruptcy Code (US)*", (1994) 2 Insolv LJ, (1994) 93 at 94.

[3] K Lightman, *"Voluntary Administration: The New Wave or the New Waif in Insolvency Law?"* Insolv LJ, (1994) 2 59 at 72.

[4] S Jensen-Conklin, "*Do Confirmed Chapter 11 Plans Consummate? The Results of a Study and Analysis of the Law"* (1992) 97 Commercial Law Journal 297 at 325.

- Leaving management in control is *"akin to leaving the fox in charge of the henhouse"*. [5]In other words the persons seen to be responsible for causing the company to petition for bankruptcy relief are the very same persons who seek to manage the company in the rehabilitation process.

- Management who originally caused the company to go into financial difficulties have the power or authority to initiate high risk strategies on the basis that they have nothing to lose and a lot to gain by speculative investment of the company's resources.[6]

- Under the Chapter 11 regime the beneficiaries of the corporate reorganisation procedure is management rather than the creditors.

- The bankruptcy stay is open to abuse. Debtors seek the protection of Chapter 11 in order to avoid imminent action for recovery by creditors or to avoid the effect of onerous contracts. For example, Continental Airlines filed for bankruptcy to avoid onerous labour contracts with its employees. Chapter 11 has been used to lessen the impact of massive tort liability and awards of punitive damages.[7]

- The substantial role of the Bankruptcy Court in Chapter 11 causes enormous professional costs and is a major contributor to the time spent by a debtor company in bankruptcy.[8]

**Should Australia adopt Chapter 11?**

Following the collapse of Ansett, some commentators in Australia appear to have suggested that if Australia had a Chapter 11 insolvency regime Ansett would have continued to fly and creditors would have been better off.[9] In support of this view commentators point to instances in the United States where airline companies have filed for protection under Chapter 11 and continued to fly under a plan for reorganisation. A recent example often quoted is that of United Airlines. No one has ever explained exactly how Ansett would have been saved using Chapter 11.[10] Interestingly, the administrators of Ansett, Messrs Korda and Mentha have stated[11]:

> *"Our examination of the Chapter 11 process in the US convinces us that such a system would not have saved Ansett. Moreover, Chapter 11 can be administratively more expensive and relegates employee entitlements in a way that may not be acceptable in the Australian environment."*

There have also been substantial failures where airlines companies have filed for relief under Chapter 11. For example, creditors of Eastern Airlines lost more than $600 million in an attempt to keep the airline running.[12]

Those advocating the use of a Chapter 11 style insolvency regime in Australia point to the short time frames stipulated in Part 5.3A of the Act in which an administrator may present a plan for reorganisation to creditors and suggest that the short time frames are unsuitable for large and complex companies such as Ansett.[13] However, in the Ansett and Pasminco administrations the

[5] D Cowling, *"Australian Regime Has Proved Its Worth",* The Australian Financial Review, 9 December 2003.
[6] L Griggs, op cit n 1 at 98.
[7] Ibid at 94.
[8] Administration under Chapter 11 takes 20 to 22 months see Jensen – Conklin, *"Do Confirmed Chapter 11 Plans Consummate? The results of a study and analysis of the Law"* (1992) 97 Commercial Law Journal 297.
[9] G Sutherland, *"Australia Needs Chapter 11 Code"*, The Australian Financial Review, 11 December 2002.
[10] D Cowling, op cit n 5.
[11] M Korda & M Mentha, *"Chapter 11 doesn't Fit Australian Story"* The Australian Financial Review, 3 June 2003.
[12] K Lightman, op cit n 3 at 72.
[13] G Sutherland, op cit n 9 at 59.

courts used the existing Part 5.3A procedure with great effect to extend the time for administrators to present reorganisation plans and to enable the businesses to continue to operate.

In the post HIH environment where corporate governance has become a watchword of heightened importance, adopting a debtor in possession regime such as Chapter 11 would be inconsistent with attempts to promote greater corporate governance,

Consistent with its debtor friendly status, Chapter 11 contains no equivalent to the prohibition on insolvent trading by directors found in the Act. It is difficult to see the rationale for adopting an insolvency regime which lacks such a fundamental principle of Australian insolvency law.

The limited supervisory role of the courts under Part 5.3A was a deliberate outcome recommended by the Harmer Report following its review of the previous Official Management insolvency regime. Adopting a Chapter 11 type regime would fly in the face of the well accepted need to minimise the role of the courts.

Chapter 11 has repeatedly been shown to produce too few rehabilitated companies in the long term, to be very expensive and take an inordinate amount of time to administer. Even if greater use was made of "pre-packaged" Chapter 11 proposals where companies and creditors first reach agreement on a reorganisation plan prior to submitting it to the court for approval[14], apart from reducing the time and costs normally associated with Chapter 11, the other failings of Chapter 11 would persist. In any event, it remains to be shown how the pre-packaged Chapter 11 is a more useful tool for corporate re-organisation than the deed of company arrangement in Part 5.3A.

In the circumstances, Part 5.3A is working well and there seems little merit in Australia adopting an insolvency regime based on Chapter 11 of the United States Bankruptcy Code.

[14] J Farrar, *"Corporate Group Insolvencies, Reform and the United States Experience"*, (2000) 8 Insolv LJ 148 at 153.