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# AUSTRALIAN INSOLVENCY LAW REFORM – EXPECTATIONS FOR THE FUTURE

On 1 September 2017, the remaining tranche of the Government's insolvency law reform package, the *Insolvency Law Reform Act 2016 (Cth)* (**ILRA**), took effect. The ILRA comprises the most significant developments to Australian insolvency law in 20 years.

**Key issues**

- The ILRA took complete effect from 1 September 2017
- External administrators have an ability to sell new statutory legal rights of action to third parties
- Creditors have increased powers that could potentially be used by 'activist creditors' to influence the administration
- The ILRA is likely to result in a number of changes to the insolvency landscape, one of which may be an increase in the number of disputes.

## ILRA purpose

The ILRA aims to promote competition, communication and increased efficiency in Australian insolvencies. This briefing note considers some of the key reforms made by the ILRA, including external administrators' power to sell a company's legal rights of action, and increased powers of creditors to remove external administrators and make requests for information. We also provide our expectations for the future following the reforms.

The advent of these changes follows the first tranches of reforms introduced by the ILRA in 1 March 2017, which focused on registration of, and disciplinary action against, registered liquidators and registered trustees.

## Sale of legal rights

Prior to the ILRA, an external administrator of a company could sell the company's common law rights of action such as its trading debts due and payable by debtors, and statutory rights of action available to the company itself, such as breaches of director's duties (while the former was and remains common, the sale of statutory rights of action is not, given the complexities of pursuing these actions without the power to gather information). However, a number of legal rights of action could not previously be sold.

The ILRA expands the universe of legal rights of action available for sale by an external administrator to virtually all legal rights of action available to the company, including types of claims not previously assignable. Examples include liquidators' voidable preference actions (where a liquidator seeks to recover certain monies paid to creditors pre-appointment) and actions relating to uncommercial transactions (where a liquidator seeks to set aside a transaction entered into by the company pre-appointment). These rights were previously available only to liquidators under the *Corporations Act.*

The ability to sell additional legal rights of action is intended to increase the returns to creditors on the basis that external administrators will sell legal rights of action that they may not otherwise have been pursued.

Despite the ILRA, certain statutory claims for damages can only be made by the person that suffers the loss (for e.g. misleading or deceptive conduct under the *Corporations Act*, the *ASIC Act* or the *Australian Consumer Law*) and the Courts have developed a general rule that these claims cannot be assigned. However, while the ILRA does not change the 'general rule', there is emerging (but conflicting) authority that liquidators may have a special exemption to be able to assign these claims. This emerging authority, if developed further, will add to the claims available for sale by external administrators.

## Expectations for the future

In our view, the ILRA changes regarding the sale of legal claims will likely result in:

- increased insolvency-related litigation. Claims that may not otherwise have been brought due to lack of funds are now more likely. The willingness of law firms to work on these cases on a speculative fee basis may also increase;
- litigation funders and other third parties acquiring causes of action previously reserved for liquidators, most likely through SPVs. Funders are well positioned to assess risk and value the potential claims and are very familiar with these types of actions. While a shift from sitting in the background of litigation, to becoming a plaintiff, the potential returns may be difficult to pass by in an increasingly competitive market;
- portfolio-type arrangements. We think it likely that liquidators will sell portfolios of potential claims and there being some type of factoring arrangement. Given the effort and expense involved in assessing potential claims, and documenting their sale, we think it would be unlikely that liquidators would be willing to sell individual claims *ad hoc*;
- the scope for practical complications will increase, including with respect to privilege issues at the due diligence stage, information sharing, preparation of specialist reports (e.g. insolvency reports), etc. This will complicate the plaintiffs' task and will likely be factored into pricing; and
- more risk for external administrators, who have a duty under s 420A of the *Corporations Act 2001* (Cth) to get the best price reasonably obtainable upon the sale of assets. Effectively pricing legal claims, by virtue of all of the variables involved, will likely be a more complicated process than pricing other asset classes and will likely favour a competitive market approach.

## Creditors' power to remove external administrator

The ILRA provides the creditors of an externally administered company with the ability to remove an external administrator without the need for the creditors to obtain Court approval. This is a significant new power.

In essence, creditors seeking the removal of an external administrator can now compel a meeting to be convened for the purposes of a resolution to remove the external administrator. If the resolution (requiring a majority of creditors in number and value) is passed, the creditors can then resolve to appoint another person as the external administrator.

An incumbent external administrator can resist removal by:

- refusing to convene the meeting of creditors on the basis that convening a meeting is not *"reasonable"*; or
- if the resolution has passed, by seeking reappointment by the Court.

While the external administrator has general discretion as to whether to hold a meeting of creditors, there are several circumstances where the meeting must be called (providing that it is reasonable to do so) including where a direction to do so is made:

- by any committee of inspection;
- by creditors passing a resolution;
- in writing by 75% (in value) of creditors; or
- in writing by 25% (in value) of creditors who provide security for the costs of holding the meeting.

An external administrator who is removed and applies to the Court for reappointment must show that their removal was an *"improper use of powers"* by one or more of the creditors. While the ILRA does not identify what may be an improper use of powers, it may apply in circumstances where a creditor seeks to impede an investigation by the external administrator that may be detrimental to that particular creditor.

## Creditors' requests for information

The ILRA provides creditors of an insolvent company with additional powers to request information and documents from external administrators in addition to the existing obligations of an external administrator to report to creditors. By default, an external administrator must respond to a creditor's request for information within five business days unless:

- the information is not relevant to the administration of the company;
- the information would breach the external administrators' duties; or
- compliance with the request is "*otherwise not reasonable".*

An external administrator who refuses to comply with a request for information may be subject to a direction by ASIC that the requested information be produced. If an external administrator refuses to comply with a direction made by ASIC, then ASIC or the requesting creditor may seek orders from the Court for the requested information to be produced.

The new powers to request information attempt to balance creditors' rights to information with the time and costs associated with providing information, but they also represent a clear gain to creditors' powers.

## What is reasonable?

There is no strict definition provided by the ILRA as to what is considered "*reasonable*" in each of the above contexts. The decision is left to the external administrator who must decide, in good faith, by reference to factors such as: whether compliance would be prejudicial to another party, whether there are sufficient funds available in the administration to comply with the request or direction, whether the requested information may be privileged, whether disclosure of the requested information may breach confidence and whether the request or direction is vexatious.

When an external administrator considers a direction 'unreasonable', written notice of, and reasons for, the decision must be provided.

## Further expectations for the future

In our view, the ILRA changes regarding the sale of legal claims will likely result in:

1. increasingly activist creditors, keen to exercise greater control over the external administration. Query whether in particular circumstances secured creditors, typically holding the largest voting rights by valuation, might consider surrendering their security to exercise such control;
2. an increase in disputes between stakeholders, given the subjective nature of the standard of "reasonableness" incorporated into the ILRA;
3. in general, an increasing administrative burden on insolvency practitioners in considering and responding to requests for information;
4. a greater focus by insolvency practitioners on major creditors' views, lest those stakeholders withdraw their support for their appointment; and
5. the scope for litigation or arbitration claims to be disrupted if the creditors do not like the approach being take to the running of the claim by the external administrator or their failures in interlocutory skirmishes.

## Conclusion

We expect the ILRA will result in noticeable changes in the insolvency landscape, including by achieving its aims of increasing competition, communication and increased efficiency in Australian insolvencies. The ways that those aims will find their expression in reality, however, remains to be observed.

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