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Law reform: biggest changes in
over 20 years... and more to come

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STATE OF THE
PROFESSION
SURVEY



LIQUIDATORS'
CGT OBLIGATIONS



RON GAUCI
AND THE ART OF
TRANSFORMATION



USING VA TO
DILUTE MINORITY
SHAREHOLDINGS



PPS INTERESTS
IN LEASED
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legal update

USING VOLUNTARY ADMINISTRATION TO DILUTE MINORITY SHAREHOLDINGS

The New Bounty case and using a DOCA to dilute minority shareholdings as part of a distressed M&A strategy.

Voluntary administration (VA) was introduced in the early 1990s in order to provide a mechanism to save businesses in financial distress, or if that was not possible to provide breathing space during the administration to facilitate a better result for creditors and members than an immediate liquidation. These goals are set out in s 435A of the Corporations Act 2001 (Cth).

The numbers of companies in voluntary administration peaked in the FY05-06 with 2,784 companies entering VA (which made up 35 percent of all companies entering external administration that year). Since that time, and particularly since the 2007 changes made creditors' voluntary liquidations easier, the numbers of companies using voluntary administration have declined dramatically and they now make up just 13.5 percent of all companies entering external administration (1,248 in FY14-15).¹

Some have questioned whether voluntary administration is still effective and whether it needs a

fundamental reform. However, declining appointment numbers do not indicate that VA is no longer useful or that it will not provide a flexible and effective solution for certain types of situations faced by distressed businesses and their advisors.

Distressed mergers and acquisitions (M&A) are an important area of business for ARITA members, with recent matters such as Mirabela Nickel and Nexus Energy producing a great deal of attention in the press and the general business community.²

There are of course many ways to structure a distressed M&A deal, but one common tool is to use a debt for equity swap.³ This article considers the use of a debt for equity swap in the recent case of *Re New Bounty Pty Ltd; Winpar Holdings Ltd v Baron Corporation Pty Ltd* [2015] NSWSC 1060 (decided by Sackville AJA on 5 August 2015).

This case involved a DOCA being entered into for the purpose of swapping debt for over 1.5 billion shares. The share issue resulted in the DOCA proponent (the major

secured creditor of the company) and its associates owning 99.4 percent of the voting shares in the company, with minority shareholders diluted from 9.3 percent of the shares in the company down to 0.6 percent.

What is interesting in this case is that despite the court holding that:

- the shares were issued for an improper purpose
- the administration produced no practical benefit to the company or its creditors
- the share issue was made to dilute minority shareholders; and
- the administration was for an improper purpose

the administration was not set aside.

This article examines the *New Bounty* case and discusses how, following the case, voluntary administrations and DOCAs can be used to dilute minority shareholdings as part of a distressed M&A strategy. However, before considering the *New Bounty* case it is useful to review how the appointment of an administrator affects the issue of shares.

¹ Source: ASIC *Insolvency Statistics*, Series 1 (companies entering EXAD), September 2015. ² *Re Mirabela Nickel Ltd* [2014] NSWSC 836; *Re Nexus Energy* [2014] 105 ACSR 246; [2014] NSWSC 1910. See also Edwards and Tucker, 'Mirabela Nickel-resurrected, rescued and relisted' [2014] 26(2) A Insol J 12; Crittenden and Bowden, 'The Nexus administration: court sanctioned share transfer the last step in the company's restructure via a DOCA' [2015] 16 *Insolvency Law Bulletin* 70. ³ See further Howard and Hedger, *Restructuring Law and Practice*, 2nd ed, 2013, LexisNexis Butterworths, Ch 6 pp. 321-404; Clowry 'Debt for equity swaps' in Larkin (ed), *Restructuring and Workouts*, 2nd ed, 2013, Globe Law and Business, Ch 3 pp. 29-58.

ISSUING SHARES DURING VOLUNTARY ADMINISTRATION

Readers of the *Journal* are no doubt familiar with the effect of voluntary administration on the operation of the company, however a brief summary is useful.

The appointment of an administrator will suspend the powers of the directors of the company: Corporations Act s 437C. This prevents the directors from exercising their management power (pursuant to s 198A) to issue shares under s 254A.

Furthermore, only the administrator can deal with the company's property: s 437D. Transfers of shares during administration are prohibited under s 437F. However, each of these prohibitions are subject to an exception where the administrator gives written consent prior to the exercise of power or dealing with the company's property.

Given the directors are not automatically removed by the appointment of the administrator,⁴ it is open to the administrator to allow the directors to issue new shares during the administration of the company. The management power given to the administrator under s 437A is broad enough to allow the administrator to issue shares in the company under s 254A.⁵

It is not possible for an administrator or the directors to transfer shares of existing members without their permission,⁶ although some closely held companies may have arrangements in place to require minority shareholders to sell their shares through compulsory acquisitions or options to purchase in the constitution, or through 'drag along' provisions in a shareholders'

Whoever issues the shares, either during administration or a during a DOCA, the power must be exercised for a proper purpose under s 181 of the Corporations Act.

agreement.⁷ This is unlikely in large publicly listed companies however.

For companies that enter into a DOCA the deed administrator does not have the benefit of s 437A (as administration has ended at that point: s 435C(2)(a)), but is given a default power to 'enter into and complete any contract for the sale of shares in the company' under Sch 8A of the Corporations Regulations 2001 (Cth) cl 2(zc). This has been held by the courts to not include the power to issue new shares.⁸

A deed administrator can only transfer shares held by existing shareholders without their consent by obtaining court approval under s 444GA. The powers conferred on deed administrators by default under Sch 8A are more specific than the broad statutory power of management under s 437A and do not provide a general management power that would allow new share issues to be made.

The default provisions in Sch 8A can be replaced by an arrangement where existing management are expressly given some power (including the power to issue shares): s 444A(5); Reg 5.3A.06. If the DOCA does not exclude the management powers of the directors then they retain the power to issue shares, although being bound by the DOCA they must not do

so inconsistently with the operation of the DOCA: s 444G.⁹

Whoever issues the shares, either during administration or a during a DOCA, the power must be exercised for a proper purpose under s 181. It has been held that it is not necessarily an improper purpose to issue shares in order to obtain control of a company where the transaction is providing necessary capital to the company in exchange for the share issue, particularly if there are no other funding sources.

In the *Cresvale* appeal,¹⁰ Young (CJ in equity) explained:

if a company has need of capital and there is only one avenue of obtaining that capital, then even though the person who is subscribing the extra capital and has a dominant purpose in obtaining control and even though that person is a director of the company, there would be no improper purpose in making the allotment. The rules set out in the authorities and the textbooks are rules that apply in ordinary circumstances (if they ever exist) and are not to be applied unthinkingly to every situation. One must judge each case as to whether in all the circumstances of the case there was an equitable fraud in the exercise of the power to issue shares.¹¹

⁴ Although the administrator has the power to remove and replace directors: s 442A. ⁵ See O'Donovan, *Company Receivers and Administrators* (loose leaf and online), Westlaw AU, [54.550]. ⁶ It is possible that the compulsory acquisition powers in Corporations Act Pt 6A.2 may be available, but the timing limitations and the dispute resolution procedure for dissenting shareholders would require a lengthy extension of the convening period that would make this option unlikely. ⁷ See further Damon, 'The legal aspects of venture capital agreements: Part 1' (2007) 25 *Company and Securities Law Journal* 43. ⁸ *Cresvale Far East Ltd v Cresvale Securities Ltd* (2001) 37 ACSR 394; [2001] NSWSC 89 (overturned in part, although not concerning this finding: *Kirwin v Cresvale Far East Ltd* (2002) 44 ACSR 21; [2002] NSWCA 395). See also Murray and Taylor, *Australian Insolvency Management Practice Commentary* (loose leaf and online), CCH IntelliConnect, [56-630]. ⁹ See further *Cresvale Far East Ltd v Cresvale Securities Ltd* (2001) 37 ACSR 394; [2001] NSWSC 89. ¹⁰ *Kirwin v Cresvale Far East Ltd* (2002) 44 ACSR 21; [2002] NSWCA 395. ¹¹ At [302].

The DOCA also involved the deed administrators causing the company to issue more than 1.5 billion shares in New Bounty to Baron Corp at one quarter of 1 cent per share.

It should be borne in mind though that whoever issues the shares will have equitable duties imposed on the power to issue shares which allow an individual shareholder to challenge the share issue as an equitable fraud on a power if exercised for an improper purpose.¹²

With these points in mind, let's now discuss the recent case of *New Bounty* where the deed administrator issued 1.5 billion shares as part of a DOCA in order for the DOCA proponent to take over the business by controlling 99 percent of the shares.

THE NEW BOUNTY CASE

New Bounty Pty Ltd was part of a group of companies controlled by textile businessman Phil Bart. New Bounty had previously been a publicly listed company called National Textiles Ltd, which should be well known to ARITA members as the company that gave rise to government support of employee entitlements in insolvent companies, now covered by the Fair Entitlements Guarantee Act 2012 (Cth).¹³

Mr Bart was a major shareholder in National Textiles prior to its collapse and then increased his shares to nearly 90 percent of the company (through a range of controlled entities) following its

insolvency. Mr Bart then changed its name and took it private, although the company maintained approximately 10 percent outside shareholders.

Mr Bart tried unsuccessfully over the years to acquire the shares of minority shareholders and then in 2012 resorted (through a controlled entity Baron Corp) to using the compulsory acquisition powers under Pt 6A of the Corporations Act 2001 (Cth), which allow 90 percent holders to serve compulsory acquisition notices on the minority, albeit with processes for dealing with opposition.

Several shareholders lodged objections to the proposal and proceedings were commenced in the Tasmanian Supreme Court seeking approval of the acquisition.

Companies controlled by Mr Bart had long provided secured loan facilities to New Bounty and other companies in the group. One of these creditors, Baron Corp Pty Ltd, took an assignment of a secured loan that was originally extended to New Bounty by another company controlled by Mr Bart more than 10 years before.

Various group loans were also consolidated into a single facility held by New Bart. Importantly, the original loans did not automatically include interest, although they allowed for interest to be charged on non-payment

or where the lender gave written notice that interest would be charged.

Changes to the New Bounty loans by a deed of variation in 2011 resulted in interest being chargeable from the date of the first loan (made in 1999). In 2013, after the compulsory acquisition was launched, the New Bounty loan was assigned from New Bart to Baron Corp.

After delays in resolving the compulsory acquisition proposal Mr Bart decided that another course of action may be preferable. That course of action involved discussions with an insolvency practitioner about the potential for a voluntary administration for New Bounty which could result in a DOCA that involved swapping interest on the loan from Baron Corp for shares in New Bounty that would heavily dilute existing minority shareholdings.

Thereafter New Bart sold its shares in New Bounty to Baron Corp, which then became the 90 percent holder and launched the compulsory acquisition process. Thus, Baron Corp was both the major secured creditor and the majority shareholder of New Bounty. At this time, an independent valuation of New Bounty valued its shares at nil. While the company had some assets and had low levels of non-group debts, the continued trading of the company depended upon continued funding from Mr Bart's companies.

The major asset of New Bounty was an intra group loan that was unlikely to be repaid due to restructuring of the group's operations and a significant environmental remediation order imposed on the borrower to the New Bounty loan. Clearly, if Mr Bart did

¹² See *Residues Treatment & Trading Co Ltd v Southern Resources Ltd* [1988] 14 ACLR 569. ¹³ See Anderson, *The protection of employee entitlements in insolvency*, 2014, MUP.

not wish to continue financial support these companies would need to enter liquidation as they would be insolvent.

Shortly after seeing an insolvency practitioner to seek advice on voluntary administration Mr Bart informed the other New Bounty director that he was going to resign and Baron Corp would call its loan in. Mr Bart then resigned as a director of New Bounty and Baron Corp issued a notice of demand on New Bounty for repayment of more than \$4.5 million, which was owed under the secured loan of almost \$800,000 with the balance being interest.

The following day the sole remaining director of New Bounty placed the company into voluntary administration as it was unable to pay the amount and was (in his view) insolvent.

The administration lasted for just over a month and on 12 May 2014 the creditors resolved for the company to enter into a deed of company arrangement proposed by Baron Corp. Under the DOCA, all creditors' claims would be paid in full (by a DOCA fund provided by Baron Corp), although there were few non-related party creditors and the company had sufficient cash reserves to pay these debts in full anyway.

The DOCA also involved the deed administrators causing the company to issue more than 1.5 billion shares in New Bounty to Baron Corp at one quarter of 1 cent per share. The consideration for the share issue was for Baron Corp to forgive New Bounty's loan interest (but not principal) of \$3.7 million. However, the company would need the support of Baron Corp to remain solvent.

The share issue resulted in increasing Baron Corp's shares

in New Bounty from 90.7 percent to 99.4 percent. The minority shareholders had their shares decreased from 9.3 percent to 0.6 percent. Winpar Holdings Ltd held two-thirds of the minority shares.

After the DOCA terminated due to its completion, Mr Bart was reappointed to the New Bounty board. Winpar then commenced proceedings in the NSW Supreme Court seeking various orders under s 447A and s 1324 so as to reverse the issue of shares. This was an attempt to vary the DOCA so as to preserve the DOCA fund but to prevent the shares being issued.

Winpar argued that Mr Bart had abused his position as a director in order to gain improper benefits for himself and for Baron Corp. Winpar also argued that the appointment of the administrator was for an improper purpose and that the DOCA was being used to circumvent the procedures set out in Pt 6A of the Corporations Act. Winpar did not allege any misconduct by the administrators.

ISSUES

The issues before the court were:

1. Was the administration an abuse of Pt 5.3A?
2. Could s 447A orders be used to undo the share issue?
3. Would the court order the company to undo the share issue?

The court answered these questions: yes, no and no.

DECISION

Abuse of Pt 5.3A

Mr Bart admitted that he acted to make the company insolvent but claimed that there were a range of commercial advantages that

motivated the transactions, including returning New Bounty to solvency, obtaining tax benefits, resolving the dispute regarding the compulsory acquisition. However, the court held that the primary motivating factor was obtaining almost complete ownership by diluting the minority shareholdings.

The DOCA did not return the company to solvency as it still owed considerable amounts to related party creditors. The DOCA fund was unnecessary as the company always had sufficient cash reserves to meet unrelated creditor claims.

Furthermore, Baron Corp stated it had 'lost patience' with the 'shennanigans' over the compulsory acquisition as the reason it was calling in the loan. The court also rejected the argument that the enforcement of the loan was simply Baron Corp enforcing its legal rights, finding that this was an 'necessary step' in the plan by Mr Bart to dilute the minority shareholders.

This was based in large part by the steps that Mr Bart took prior to enforcement (i.e. meeting with an insolvency practitioner to discuss the options, formulating a plan, discussing it with the other director and advising the other director that the firm of administrators who advised Mr Bart could be appointed and if this did occur a DOCA involving a debt for equity swap may be supported by Baron Corp).

The court held that if the dominant purpose of the administration was to dilute the minority shareholdings this would be an abuse of Pt 5.3A because it did not meet the goals set out in s 435A.¹⁴ The court said:

¹⁴ At [204].

This is not a case in which Mr Bart intended to utilise Pt 5.3A of the Corporations Act to achieve a result contemplated by the legislation, while also having an ulterior purpose outside the scope of the legislation. His intention and purpose was to utilise Pt 5.3A to achieve an object not contemplated by the legislation and thus outside its scope.¹⁵

The court also held that Mr Bart had continued to act as an officer of the company despite his resignation from the board. Mr Bart:

- Recommended that the remaining director appoint an administrator and suggested who the administrators should be (the firm that had previously advised him)
- Was involved in drafting the DOCA (the other director of New Bounty was not) which included answering queries on the draft DOCA from the administrators
- Instructed the solicitors who acted for both New Bounty and Baron Corp
- Procured creditor votes in favour of the DOCA.

The court therefore held that although Mr Bart did not appoint the administrator (as he was not a director at the time), his involvement in the process justified attributing his improper purpose for the administration to the company.¹⁶

Use of s 447A orders

The court then considered whether the share issue by the administrator could be set aside by using s 447A orders. There is authority for the use of s 447A orders to vary or terminate a DOCA,¹⁷ but Winpar sought to vary the DOCA by rescinding the share issue while

keeping the DOCA fund in place. This cut at the heart of the DOCA which was to produce the debt for equity swap. Specifically, Winpar has sought orders under s 447A that would:

- Empower the court to set aside clauses in the DOCA
- Change the wording of s 437A so that the administrators could not issue shares
- Change the operation of Pt 5.3A to allow the court to require the share transferee to retransfer the shares back to New Bounty
- Require the company to rescind the share issue, cancel the shares and rectify the register of members.

The court noted that the High Court in *Australasian Memory Pty Ltd v Brien* (2000) 200 CLR 270 had found that s 447A orders could be made once the company's administration had ended (in that case resulting in a creditors' voluntary liquidation) as long as the orders only take effect from the date that they are made.

His Honour was prepared to accept that s 447A orders could be made to effect a DOCA that had terminated, not for the purpose of validating actions taken under the former deed but to vary the former deed, however 'such circumstances are likely to be rare'.¹⁸ The court held that the orders sought could not be given because they sought to give the court a power that it did not have under Pt 5.3A and therefore were not orders about 'how Pt 5.3A is to operate'.¹⁹

The court held that the proposed orders would be inconsistent with s 445H which provides that the termination of a DOCA does not affect anything that has been done under the DOCA. In this case the shares were issued and the DOCA terminated. At

the time the shares were issued the administrator had the power to do so, and the share issue was not invalid.

The court rejected the application to use s 447A to retrospectively invalidate the share issue. Section 447A orders are not retrospective and can't be used to invalidate actions taken under a DOCA that were valid at the time.²⁰

The court also rejected the proposed order that s 447A could change the operation of Pt 5.3A so as to give the court the power to order the share transferee to retransfer the shares back to New Bounty, as such an order was not about 'how Pt 5.3A is to operate' it would be to give Pt 5.3A a power that was not otherwise available.

The court also decided that even if s 447A did allow the proposed orders, Winpar had waited too long to make its application to challenge the DOCA and now that both the share issue and the operation of the DOCA were complete it was a relevant consideration in exercising discretion. Furthermore, varying the DOCA by rescinding the share issue would be likely to leave the company without the continued support of Mr Bart's companies and hence insolvent.

Other relief?

Winpar also sought orders under s 1324 of the Corporations Act (the statutory injunction provision) that would prevent any person from relying upon the clauses in the DOCA that it sought to have deleted. These orders were based on allegations that Mr Bart had breached his directors' duties and that there had been impermissible financial assistance to allow the purchase of the shares (a breach of s 260A).

¹⁵ At [206]. ¹⁶ At [113]. ¹⁷ See *Re GIGA Investments Pty Ltd* (1995) 17 ACSR 547; *Erol v Cavus* [2012] QSC 371. ¹⁸ At [224]. ¹⁹ At [225]. ²⁰ At [227]-[230].

The court held that as Mr Bart had not been joined as a party to the case it was inappropriate to rule on whether he had breached his directors' duties. Furthermore, the orders against Baron particularly where it had not be established by Winpar that Baron was 'involved' in any alleged contravention by Mr Bart while he acted as an officer of New Bounty. The court also rejected that the administrator's issue of shares involved financial assistance so that no breach of s 260A was established.

VALUABLE LESSONS

The result of the New Bounty case is that an administration commenced for an improper purpose, which constituted an abuse of Pt 5.3A and resulted in 1.5 billion shares being issued in order to squeeze out minority shareholders, did not produce any adverse results for the director or company involved. There was no suggestion by the applicant or by the court's reasons that the administrators acted improperly.

However, there are valuable lessons to learn from this case for future distressed M&A transactions.

Firstly, the administration needs to satisfy the statutory purposes in s 435A. In this case the administration and DOCA didn't assist the company to return to solvency and didn't provide any better return for creditors than liquidation. Following on from the Bell litigation, it is important that there be prospects of a plan for the company to return to solvency or to improve returns to creditors.

In this case the conversion rate for the debt to equity swap could only be explained as an attempt to comprehensively dilute the minority holdings. Of course an order under s 444GA could have been sought, but that would have required positive evidence of no unfair prejudice which may have been difficult to prove given the compulsory acquisition proceedings on foot.

Secondly, the potential conflicts of interests do not appear to have been managed well in this case. The

controller of the company attempted to formally distance himself from the transaction but took an active role in formulating the DOCA and responding to queries from advisors. He appeared on multiple sides of the transaction at the same time. It goes without saying that insolvency practitioners need to always be mindful of in what capacity a person is acting.

Thirdly, when applying for orders under s 447A it is important that they are squarely focused on modifying a provision in Pt 5.3A, not trying to create powers that are not otherwise there.

Lastly, it is important to make an application to challenge a DOCA as soon as possible. Leaving the challenge until after the DOCA has completed and has been terminated may dramatically limit the relief available. ▲

Editor's note: Jason Harris leads the University of Technology Sydney team that develops and delivers the ARITA Advanced Certification course.



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