THE DOOR TO REORGANISATION: STRATEGIC BEHAVIOUR OR ABUSE OF VOLUNTARY ADMINISTRATION?

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[Not all companies should be allowed to reorganise under voluntary administration; reorganisations change individual rights drastically. Currently, eligible companies must be insolvent or likely to become insolvent. Recent proposals to reform this insolvency requirement do not ensure that reorganisation creates the highest economic value from the company’s resources. Policymakers must understand this underlying policy and its trade-offs to prevent ‘abuses’ but permit ‘strategic behaviour’ consistent with desirable policy. Alternatives like the United States ‘Chapter 11 good faith test’ and the little-known ‘voluntary administration good faith test’ are too uncertain. Instead, this article advocates for directors to value the business upfront before they conclude that reorganisation extracts the most value from the company’s resources. This proposed additional ‘value maximising test’ would remedy the inadequacy of the current eligibility requirement.]

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I INTRODUCTION

The debtor severs all its ties, including those with its creditors, shareholders, employees, suppliers, customers and the community. The participants of a reorganisation negotiate a new set of ties. The debtor emerges from reorganisation leaner and meaner. Those who have something to contribute can stay. Those who were a burden are cast off. Reorganisation reallocates resources of society. It assesses each participant’s relationship and redefines it. Given reorganisation’s formidable power, the door to reorganisation should only open for a debtor who satisfies certain criteria. The door should never open too widely. Nor should it close too sharply. It has to safeguard the reorganisation system against abuses and yet, at the same time, encourage at-risk debtors to enter.

Reorganisation is closely associated with a financially distressed corporate debtor’s attempts to reorder its affairs and fight for survival. Reorganisations can involve a restructuring of the corporation’s business operations, undertakings or investment activities, as well as its financial or capital structure.

Before a corporate debtor enters voluntary administration — the formal legal procedure for reorganisations set out in Part 5.3A of the Corporations Act 2001 (Cth) (‘Corporations Act’) — it must meet certain requirements. The current threshold criterion is that the company is, in the opinion of the directors, insolvent or is likely to become insolvent.1

In July 2004, the Joint Committee on Corporations and Financial Services recommended lowering this threshold ‘insolvency test’ to allow a debtor who merely ‘may become insolvent’ to enter voluntary administration.2 Controversy ensued with some warning of potential abuse.3

1 Corporations Act s 436A. Alternative paths to enter voluntary administration include appointment of an administrator by a liquidator or provisional liquidator: Corporations Act s 436B; or appointment of an administrator by a person who has a charge over the whole, or substantially the whole, of the company’s property: Corporations Act s 436C. These alternatives are beyond the scope of this article.


3 See, eg, Tracy Lee and Marcus Priest, ‘Claims Insolvency Test Open to Abuse’, The Australian Financial Review (Sydney), 3 July 2004, 7.
The Corporations and Markets Advisory Committee (‘CAMAC’), a governmental committee, considered a different threshold requirement along the lines of the ‘good faith test’ found in the reorganisation system in Chapter 11 of the United States Bankruptcy Code (‘Chapter 11’). In addition to insolvency, this Chapter 11 good faith test examines various factors such as a debtor’s subjective motives and ability to reorganise. Yet the committee eventually abandoned the idea of adopting this test.

Amidst this discussion, but unknown to many, the Australian courts have been more willing to experiment with an embedded good faith test to control access to the voluntary administration system. This ‘voluntary administration good faith test’ focuses more narrowly on the directors’ purpose in reorganising.

The policymakers are yet to resolve the dilemma.

This discussion about the threshold requirement to enter voluntary administration is part of a wider uncharted policy debate on permissible ‘strategic behaviour’ and impermissible ‘abuse’ of reorganisation. Policymakers are hesitant to characterise many corporate reorganisations as blatant abuses of voluntary administration despite the public outrage that the debtors may have caused. The reluctance in changing the threshold requirement of voluntary administration shows a fear of causing more undefined abuses. Contentious as this strategic behaviour versus abuse debate may be, it merely reflects the underlying tension among the competing policies of reorganisation. Policymakers cannot define abuse without first making some hard choices and resolving these competing policies.

This article seeks to make two contributions. First, it provides policymakers with a framework to differentiate an abuse of the reorganisation system from permissible strategic behaviour and singles out, as examples, certain uses of reorganisation as being the most undisputed abuses of the system.

As a starting position in the policy debate, the fundamental justification of reorganisation is an economic one. By keeping the company’s assets and resources together in continued operation, reorganisation preserves and maximises the debtor’s economic value as a going concern. Good policy demands that a debtor only reorganise if it is worth more as a result. This article identifies this rationale as the ‘value maximisation’ policy of reorganisation. It follows that a ‘non-value maximising’ use — reorganising the debtor without aiming for a more efficient or higher-valued use of scarce resources — is one of the most undisputed abuses of reorganisation.


6 See below Part III(D)(1).


8 See below Part III(D)(2).
Value maximisation, however, comes at a cost. In keeping the debtor’s assets together, reorganisation necessarily affects individual claims against these assets in various ways. Trade-offs are inevitable. This impact on individual rights often provokes claims that a debtor or its directors are abusing the reorganisation system. On the other hand, it may only be part of a debtor’s legitimate strategic attempt to make the best economic use of its resources. To determine whether value maximising uses are permissible uses of voluntary administration, policymakers need to further balance the competing interests of individuals and value maximisation.

Second, this article seeks to give the policy debate a practical focus by critiquing the law surrounding the threshold requirements to enter voluntary administration. It asks whether the current voluntary administration threshold insolvency test or the alternative good faith test adequately differentiate permissible strategic behaviour from impermissible abuse of reorganisation. It concludes that the tests could be improved in order to ensure that debtors who enter administration are worth more after reorganisation than if liquidated immediately.

Rather, as a foremost measure to prevent the most undisputed abuse, a better voluntary administration threshold test would require an up-front valuation of how much a company would be worth if reorganised. A debtor may enter administration only if its business has greater value with reorganisation rather than without. This article advocates that the debtor’s directors should assess the company’s reorganisation value before they appoint an administrator and refers to this requirement as the ‘value maximising test’.

This article has five parts. Part II constructs a theoretical framework that maps the policy tension between permissible strategic behaviour and impermissible abuse of reorganisation. It seeks to demonstrate that the most obvious abuses occur when reorganisation does not achieve the highest valuation for a debtor’s resources. Determination of other impermissible abuses of reorganisation requires further balancing of conflicting interests. Part III lays out the law surrounding the operation of the threshold requirement to enter voluntary administration. The argument is advanced that Australia’s voluntary administration has two contrasting threshold tests: the widely-recognised insolvency test and an embedded voluntary administration good faith test. This Part also comparatively scrutinises the Chapter 11 good faith test. Using the theoretical framework that Part II constructs, Part IV critiques the insolvency test and the voluntary administration good faith test, proposing that the threshold requirements include a new value maximising test. This new test is in addition to the principal insolvency test that requires the directors to find that the company is insolvent or likely to become insolvent. This test further requires the directors to value the company before they appoint an administrator and conclude that reorganisation will achieve the highest value for the company’s resources. Part V concludes that a clear understanding of the value maximising policy enables differentiation between the most blatant abuses and permissible strategic behaviour. A more sophisticated understanding of the distributive effects of the

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9 See below Part II(B), (C), (D).
value maximising policy brings the difficult trade-offs into sharp focus and highlights questions that policymakers cannot avoid.

II STRATEGIC BEHAVIOUR OR ABUSE: A THEORETICAL FRAMEWORK FOR THE DEBATE

A threshold requirement for a debtor to enter reorganisation protects the system against abuse. But what is an abuse of reorganisation? Existing Australian and American literature on corporate reorganisation leaves a noteworthy gap. The following develops a framework that maps the unrecognised policy tension between simple strategic behaviour and blatant abuse of reorganisation. In doing so, this Part briefly explains the functions of reorganisation. It then dispels the belief that so-called strategic behaviour is incompatible with reorganisation policies. Lastly, it defines the underlying policies of reorganisation and the abuses that contravene them.

A The Functions of Reorganisation

So, what functions does reorganisation serve? The formal legal systems for corporate reorganisation evolved from bankruptcy and insolvency laws. The most uncontroversial justification of bankruptcy law is to solve the problems that arise when a debtor fails to pay its debts. Outside of bankruptcy, a creditor has a legal right to collect its debt against a debtor’s assets when the debtor defaults. When a debtor defaults on multiple debts, creditors will scramble towards the debtor’s assets. Creditors fear being the last in line and left with nothing if they let other creditors raid the debtor’s coffers first. The unruly debt collections of creditors destroy the value of the debtor’s business as a going concern. The debtor faces collapse. This is known as the ‘collective action’ or ‘common pool’ problem. Bankruptcy law presumes that diverse claimants who have claims against the debtor — both creditors and shareholders — are better off if they act as a group. Bankruptcy forces the

10 While coming from an Australian perspective, this article draws heavily upon American literature and uses terms interchangeably because the underlying principles and policies are similar. ‘Corporate reorganisation’ occurs within specific formal legal processes, procedures, regimes or systems that form part of bankruptcy and insolvency laws. ‘Insolvency law’ refers to Australia’s formal legal system that deals with the corporate debtor’s insolvency under ch 5 of the Corporations Act, including the voluntary administration procedure under Corporations Act pt 5.3A. ‘Bankruptcy’ refers to the formal legal procedure that deals with corporations in financial difficulties in the United States, including the reorganisation regime under Chapter 11. This article uses ‘bankruptcy law’ interchangeably with ‘insolvency law’. Bankruptcy as referring to individual insolencies in Australia and the United States is beyond the scope of this article. Principles and comments relating to Chapter 11 are applicable to voluntary administration unless specifically qualified.


13 Jackson, above n 12, 10–11.

14 See generally Ibid 10–19.
The ability of reorganisations to change or redistribute the rights of claimants is unsettling. The critical question is: when should access to reorganisation and its redistributive power be allowed? Or conversely, when might access to reorganisation and its redistributive power be an abuse? The role of the threshold requirement for reorganisation is to make this rough distinction at the earliest possible stage.

Commentators have been uneasy about debtors reorganising and thereby redistributing individual claims and changing the rules of the game for the claimants and other participants. Labels to describe this behaviour vary and include: ‘opportunism’,18 ‘commercial (im)morality’,19 ‘business strategy’,20 ‘rent seeking behaviour’,21 ‘strategic behaviour’,22 ‘strategic manipulation’,23 ‘strategic manoeuvring’,24 ‘strategic insolvency’,25 ‘strategic bankruptcy’,26

15 Ibid.
16 Ibid.
17 Warren, above n 11, 785–9.
23 Jackson and Scott, above n 21, 199.
24 Ibid 201.
From the list, abuse is clearest in its normative disapproval. Abuse is defined as ‘wrong or improper use, misuse’. The other labels are vague, not just in semantics, but also in the behaviour described. In this article, ‘non-abuses’ come under the banner of strategic behaviour, referring to uses of reorganisation that affect individual rights and offend some moral norms, but which are nevertheless consistent with the policy of reorganisation. This is contrasted with abuse, which retains its ‘improper use’ definition in this article.

The existing literature leaves a gap: an uncharted tension between strategic behaviour and abuse of reorganisation. Many do not realise that this so-called strategic behaviour may be consistent with desirable reorganisation policy. Hence, strategic behaviour could remain an allowed incidence of reorganisation and is distinct from the undesirable abuse.

Take for example ‘forum shopping’. Douglas G Baird and Thomas H Jackson contend that bankruptcy should not change pre-bankruptcy rights because this change causes ‘forum shopping’ or the choosing between bankruptcy and non-bankruptcy forums for different sets of rights. To them, forum shopping is undesirable. Baird and Jackson’s criticism, however, prompted Lynn M LoPucki and William C Whitford to state that:

> we are unconvinced that forum shopping, as Baird and Jackson define the term, is a bad thing. If chapter 11 can resolve the financial difficulties of a reorganizing company in a way that yields more societal wealth than resolutions that would be reached outside bankruptcy, then the choice to file bankruptcy seems to us a good thing, and encouragement of it is no vice.

Criticisms of the purported costs of strategic behaviour are also unconvincing. For example, Jackson and Robert E Scott are critical of the costs of enforcing the rules regulating access to the system, the screening costs to differentiate desirable and undesirable uses, and the uncertainty costs of ‘wasteful or excessive

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30 Transcript of Proceedings, Patrick Stevedores Operations No 2 Pty Ltd v Maritime Union of Australia (High Court of Australia, Julian Burnside, 28 April 1998).
33 Baird, ‘Loss Distribution’, above n 29, 824–8; Jackson, above n 12, 20–1. In another context, see Lynn M LoPucki, Courting Failure: How Competition for Big Cases Is Corrupting the Bankruptcy Courts (2005) 27, where the author uses ‘forum shopping’ to mean a party to litigation choosing among bankruptcy courts.
precautionary behaviour.’36 Barry E Adler also disapproves of strategic behaviour because of the allegedly protracted negotiation and litigation, delay and inherent uncertainty associated with it.37 However, the uncertainty surrounding strategic behaviour arguably arises because the rules of reorganisation are unclear. Jackson and Scott recognise that ad hoc rules cause uncertainty.38 As they concede, a fixed, across-the-board rule would lessen the uncertainty.39 According to this view, strategic behaviour need not be uncertain.

Previous literature often describes strategic behaviour as involving deliberate, active and voluntary decision-making by the debtor or its directors.40 However, decision-making has many shades and, by itself, does not make strategic behaviour undesirable. The debtor or its directors may make a conscious decision to reorganise and the decision may still be consistent with desirable reorganisation policy. As Donald R Korobkin puts it:

‘Strategic bankruptcy’ criticism of Chapter 11 … often blurs a critical distinction. That managers use Chapter 11 as a ‘financial tool’ in their corporate planning — as they would any other important law — is not by itself grounds for complaint. Presumably, Chapter 11 exists to be used, and one would want corporate managers to be rational planners, using all available opportunities to benefit their various constituencies. Nonetheless, what is troubling about strategic bankruptcies is the possibility that managers may use Chapter 11 in ways that are fundamentally unfair, or otherwise unwarranted. We thus need to distinguish between ‘desirable’ and ‘undesirable’ strategic bankruptcies.41

This begs the question: what are the undesirable or impermissible abuses of reorganisation?

C The Policies of Reorganisation

Identifying an abuse of reorganisation involves highly normative judgement of whether an action contradicts desirable policies. There needs to be ‘some normative standard that determines what constitutes a proper and an improper use of bankruptcy law.’42 A threshold requirement for reorganisation could keep behaviour inconsistent with desirable policies out of the system.

38 Jackson and Scott, above n 21, 198–9.
40 ‘[A] company with financial problems not themselves sufficiently immediate or serious to trigger bankruptcy is more likely today to choose to file in Chapter 11 in order to solve some major legal problem’: Warren and Westbrook, above n 28, 786–8. Strategic bankruptcy filing results from strategic decision-making rather than being passive responses to market forces: see, eg, Delaney, above n 26, 59; Spender, ‘Scenes from a Wharf’, above n 19, 65. ‘Strategic insolvency is one that is viewed as the best option after a review of all available options’ and involves some deliberate conduct or deliberate recourse to insolvency law: Noakes, above n 25, 92–3.
42 Ibid.
Value Maximising Policy

The underlying so-called value maximisation policy provides the primary justification of reorganisation — reorganisation produces a more efficient and hence higher-valued use of resources. Creating a collective decision, reorganisation would preserve and maximise the going concern value of the debtor or its business. Reorganisation is justified if the debtor or its assets are worth more economically if reorganised than if not. The assumption is that a higher-valued use of the debtor’s resources indirectly benefits the participants of reorganisation as a whole, be it the shareholders, creditors, employees, suppliers or the community. This value maximisation policy draws from both a narrow ‘asset maximising’ approach and a wide ‘rehabilitation’ approach.

The narrow asset maximising approach aims to create the largest pool of money to pay the creditors and shareholders. The two most notable law and economics theorists of bankruptcy law, Baird and Jackson, are the leading proponents of this approach. The most economically efficient use, or the highest realisable value of a debtor’s assets, would presumably maximise this pool of money. Hence, a debtor should only continue in business if its intrinsic economic value is greater than the value realisable by immediately selling its business and assets. Otherwise, selling or liquidating its assets is preferable, so as to allow these assets to flow to other higher-valued uses in society.

Economic efficiency is a justifiable aim. However, better return for claimants, as Baird and Jackson see it, is not always an accurate measure of economic efficiency. Business failures produce external costs such as the loss of jobs, and have adverse effects on suppliers and the welfare of the wider community. The highest return for claimants may not be the best outcome for the society’s overall economic wealth. For example, the claimants may want to liquidate the debtor immediately and get their money back. Conversely, the debtor, if it survives, may supply goods and services to the community that are far more valuable.

The wide approach to reorganisation — debtor rehabilitation — addresses the limitation of Baird and Jackson’s asset maximising view. Rehabilitation emphasises that a debtor’s survival is in itself valuable to society. Elizabeth Warren argues that reorganisation serves wider public interests by deliberately creating a chance for a debtor to survive. Some see rehabilitation as a ‘value-based’ or ‘norm-based’ goal separate from economic efficiency. However, rehabilitation is also a wider economic ‘societal wealth maximization’ policy that recognises

43 The term ‘value maximisation’ is adapted from the ‘wealth maximization principle’ in LoPucki and Whitford, ‘Corporate Governance’, above n 35, 752.
44 Delaney, above n 26, 43.
46 Delaney, above n 26, 42–3.
47 Altman, above n 20, 6.
48 Ibid.
49 See LoPucki and Whitford, ‘Corporate Governance’, above n 35, 752.
50 Ibid.
the external costs of business failures. Rehabilitation weighs the benefits to society of a debtor’s survival against the costs of its failure.

The asset maximising and rehabilitation approaches share a common focus on the intrinsic economic value of the company, its assets and resources. Both approaches demand that reorganisation produce the most efficient or highest-valued economic outcome in terms of the use of resources.

This policy of value maximisation is distinct from a ‘distribution’ question of who gets what. How resources are used is separate from who has claims to them. Crucial to this distinction is the well-established division between the investing and financing decisions of firms. An illustration is helpful — making the pie larger is the investment or ‘value maximising’ question, whilst dividing and sharing the pie is the financing or ‘distribution’ question. This distinction also occurs in practice. For instance, the administration of the airline Ansett Australia in 2002 initially scheduled two separate sessions of creditors’ meetings where creditors were supposed to vote on Ansett’s fate: the first on the investment plan of selling Ansett’s business and the second on the distribution plan of sharing the sale proceeds.

2 Distribution Policy

To maximise the value of a business through a collective decision, reorganisation necessarily suspends, changes or redistributes individual claims to a company’s resources. For example, a debtor may lease its essential manufacturing equipment from a lessor who has a right to repossess the equipment if the debtor defaults on its lease payments. The debtor defaults but tries to reorganise. The equipment may be worthless elsewhere and is only valuable as the debtor currently uses it. The debtor’s basically sound business may be worth more reorganised than liquidated immediately. The lessor’s rights to repossess the equipment may have to be suspended, substituted or even extinguished in reorganisation so that the debtor can continue using the equipment. As this example shows, while the two are distinct, value maximisation is no less a question of redistribution of individual claims.

Distribution is a policy question dependent on competing and conflicting norms. At its heart, distribution involves two overlapping tasks of balancing...
competing interests: determining how losses shall be distributed among diverse claimants;\textsuperscript{61} and deciding to what extent the rights of individual claimants should be changed to protect the debtor’s business as a going concern.\textsuperscript{62} Hence, Warren disagrees with Jackson and Baird’s contention that the sole aim of bankruptcy law is economic efficiency.\textsuperscript{63} She contends that ‘with an inadequate pie to divide … [d]istribution … is the center of the bankruptcy scheme.’\textsuperscript{64} Illustrating a distributional policy, Warren observes that policymakers intend to protect vulnerable parties who have an interest in a business’s continued existence, like employees, customers, suppliers and the local community.\textsuperscript{65}

Reorganisation necessarily changes and redistributes individual claims. This change and redistribution of individual claims is at first glance normatively acceptable because reorganisation creates more value for all to share. Nevertheless, how reorganisation divides this value requires policymakers to further balance competing interests.

D Abuse

Only where there is a universally agreed feature of abuse can the threshold to reorganisation assist in filtering out abuse. Abuses occur on two levels. At a fundamental level, the justification for changing individual rights when the debtor reorganises is that reorganisation maximises the economic value of the debtor’s resources.\textsuperscript{66} Accordingly, where reorganisation does not create better return overall or rehabilitate the debtor, abuse of reorganisation occurs, because the justification for changing or redistributing individual rights is absent. Put metaphorically, it is an abuse if the debtor reorganises only to carve the pie up differently without enlarging or preserving the pie. As Judge Smith in \textit{Re Integrated Telecom Express Inc} stated:

\begin{quotation}
A [Chapter 11 bankruptcy] petition must do more than merely invoke some distributional mechanism in the Bankruptcy Code. It must seek to create or preserve some value that would otherwise be lost — not merely distributed to a different stakeholder — outside of bankruptcy.\textsuperscript{67}
\end{quotation}

\textsuperscript{61} Ibid 777, 785.
\textsuperscript{62} See ibid 787–9.
\textsuperscript{63} Ibid 800–4.
\textsuperscript{64} Ibid 785.
\textsuperscript{65} Ibid 787–8. For a discussion on the distributional policies in the context of Australia’s voluntary administration, see below Part III(A). Other distributional policies or norms include the ‘absolute priority’ rule in Chapter 11, where senior claimant classes are paid in full before junior claimant classes, and ‘temporal equality’, where claimants in the same class are treated equally irrespective of when their claims arise: see, eg, \textit{Bankruptcy Code}, 11 USC § 1129(b) (2000); LoPucki and Whitford, ‘Corporate Governance’, above n 35, 682. See also Mark J Roe, ‘Bankruptcy and Mass Tort’ (1984) 84 \textit{Columbia Law Review} 846, 850–5.
\textsuperscript{66} See above Part II(C).
\textsuperscript{67} 384 F 3d 108, 129 (3\textsuperscript{rd} Cir, 2004).
Baird also disapproves of debtors exploiting a rule in Chapter 11 that allows debtors to reject their collective bargaining agreements with the unions:\textsuperscript{68}

One cannot think that a firm should be able to repudiate a collective bargaining agreement in bankruptcy … and then be surprised if a firm chooses to use bankruptcy to repudiate a collective bargaining agreement \textit{and for no other reason}}.\textsuperscript{69}

Beyond these fundamental non-value maximising abuses, other abuses of reorganisation are not as easy to define. Strategic behaviour causes uneasiness but is not incontrovertibly an abuse, because an adverse impact on individual rights may simply be inevitable if a more efficient use of resources is to be achieved. When value maximisation and a change of individual rights both exist, the question of whether strategic reorganisation should be allowed depends on how one balances normatively conflicting interests. Clashes of norms are often unresolved. The following examples illustrate this proposition.

1 \textbf{Delay Creditors}

Voluntary administration suspends individual creditors’ collection rights against the debtor with a moratorium on enforcement processes.\textsuperscript{70} Debtors may use voluntary administration as a stalling tactic or a ‘debt holiday’.\textsuperscript{71} It is an abuse if a debtor enters reorganisation ‘hoping merely to stave off the evil day when the creditors take control of his property.’\textsuperscript{72}

2 \textbf{Litigation Tactic}

Voluntary administration gives a litigant a tactical advantage by staying winding-up applications\textsuperscript{73} and other proceedings against the company or its property.\textsuperscript{74} In \textit{Blacktown City Council v Macarthur Telecommunications Pty Ltd}, a company countered an action for negligent advice by entering administration.\textsuperscript{75} The company was dormant and had stopped its business for two years.\textsuperscript{76} The court found an abuse because there was no purpose of ‘rehabilitating the

\textsuperscript{68} See \textit{Bankruptcy Code}, 11 USC § 1113 (2000). There is no equivalent rule in Australia’s voluntary administration but the comment is applicable to any change or redistribution of individual rights.


\textsuperscript{70} During the moratorium a person cannot enforce a charge on the company’s property: \textit{Corporations Act} s 440B; an owner or lessor cannot recover property used by the company: \textit{Corporations Act} s 440C; and no enforcement process in relation to the property of the company can begin or proceed: \textit{Corporations Act} s 440F.

\textsuperscript{71} Explanatory Memorandum, Corporate Law Reform Bill 1992 (Chi) 95; Rose and Law, above n 31, 21; \textit{CAMAC Report}, above n 7, 21.


\textsuperscript{74} \textit{Corporations Act} s 440D.

\textsuperscript{75} (2003) 47 ACSR 391, 392 (Barrett J).

\textsuperscript{76} Ibid 396 (Barrett J).
company as a commercial concern’, whilst improved returns to claimants were ‘purely speculative.’

3 Directors’ Escape Valve

The legislature has provided incentives for directors to use voluntary administration because they lose legal control of the company when an administrator is appointed. This includes a defence for insolvent trading, a stay on enforcement of personal guarantees against a director and avoidance of personal liability for unpaid tax. Some perceive these incentives as a ‘soft-landing’ for directors of troubled companies. Policymakers have favoured the policy of encouraging reorganisations over the competing desire to hold directors accountable.

Unintended incentives may also drive directors to pursue self-preservation tactics. For instance, directors escape investigation in liquidation by appointing an administrator. Also, where voluntary administration follows a winding-up application against the debtor, the statutorily-defined ‘relation-back day’ shifts from the earlier date on which the winding-up application was filed to the later date on which administration began. Older transactions would fall outside the voidable transactions relation-back period when the debtor eventually liquidates. Abuses are inevitable if these unintended incentives do not serve the purpose of encouraging an efficient use of resources.

4 Control of the Company

An administrator can ‘wrest control’ from a person controlling the company. Further, reorganisation reorders a company’s capital structure, resulting in a change of company control. In *Kirwan v Cresvale Far East Ltd (in liq)*, it was found that a share issue was not improper even if the director’s dominant purpose was to gain company control, because the company needed fresh capital to survive. However, no-one except the director to whom the shares were issued would provide the funds. This rehabilitative aim outweighed the

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77 Ibid 397 (Barrett J).
78 *Corporations Act* ss 436A, 437A, 437C.
79 *Corporations Act* s 588H(6)(a).
80 *Corporations Act* s 440J; Explanatory Memorandum, Corporate Law Reform Bill 1992 (Cth) 108.
81 *Income Tax Assessment Act* 1936 (Cth) pt VI div 9, ss 222AOB, 222AOBA, 222AOBA, 222AOC, 222AOD, 222AOE, 222AOJ, 222APB.
82 Rose and Law, above n 31, 21; Roulledge, above n 18, 132.
83 Australian Securities Commission, above n 73, 28; Rose and Law, above n 31, 21.
84 *Corporations Act* ss 9, 513A(b), 513C.
85 *Corporations Act* pt 5.7B. In one case, the director used this irregularity as a self-preservation tactic as he personally benefited from these voidable transactions: see *St Leonards Property Pty Ltd v Ambridge Investments Pty Ltd* (2004) 210 ALR 265.
86 *Corporations Act* s 437A; see also *Aloridge Pty Ltd v Christianos* (1994) 13 ACSR 99, 102 (Burchett J).
87 (2002) 44 ACSR 21, 92 (Young CJ in Eq).
88 Ibid.
89 Ibid 52 (Giles JA).
5 Employees

While a successful rehabilitation often benefits the employees, reorganisation may also change their rights. Chapter 11 allows a debtor to reject collective bargaining agreements with unions. Continental Airlines Corporation had this in mind when it filed for bankruptcy in 1983. More recently, United Airlines used Chapter 11 strategically against its competitors. It lowered its costs by terminating employee pension plans and cutting wages and benefits.

The United States airlines’ strategic behaviour is at least arguably consistent with intended policy. United States law-makers balanced rehabilitation against a change in employee rights — ‘a political battle was fought’. However, one could question whether this balance is economically sound. Chapter 11 may give inefficient airlines “unfair artificial competitive advantages” over their rivals, leaving unhealthy excessive competition in the industry.

Voluntary administration does not have an equivalent to the Chapter 11 rule that allows rejection of collective bargaining agreements. Nevertheless, the 1998 waterfront dispute between the Patrick Group and the Maritime Union of Australia provides a contrasting case.

Four insolvent employer companies in the Patrick Group entered voluntary administration so that the administrator could dismiss the unionised workforce. Normally, employers cannot dismiss an employee simply because the employee is a union member. More disconcerting was how the employer companies became insolvent: a prior group restructuring had left the employer companies

92 Re Continental Airlines Corporation, 38 BR 67, 70–2 (Bankruptcy Judge Wheless Jr) (Bankr SD Tex, 1984).
94 Ibid.
96 Re Royal Composing Room Inc, 848 F 2d 345, 354 (Feinberg CJ) (2nd Cir, 1988).
98 See Patrick Stevedores Operations No 2 Pty Ltd v Maritime Union of Australia (1998) 195 CLR 1 (‘Patrick Stevedores’).
100 Workplace Relations Act 1996 (Cth) s 659(2)(b).
with only labour supply agreements; another Patrick Group company subsequently terminated these agreements.101

Despite these facts, the High Court implicitly accepted the validity of the voluntary administration.102 It further refused to limit the administrator’s discretion to determine whether the insolvent employer companies should continue trading.103 Peta Spender contends that voluntary administration did not rehabilitate the employer companies nor did it provide a better return for the claimants.104 On this basis, voluntary administration was abused; its sole aim was to change the employees’ rights without maximising the value of the company and its resources.105

*Patrick Stevedores* demonstrates a gap in the existing voluntary administration threshold insolvency requirement.106 Generally though, there is little evidence that debtors use voluntary administration to the detriment of employees. An Australian survey of strategic insolvency found that only 0.45 cases per insolvency practitioner involved ‘bad, reckless or immoral behaviour’ with ‘deliberate transactions designed to avoid obligations to employees.’107

6 Future Claimants

The Chapter 11 bankruptcy filing of the American asbestos company Johns-Manville Corporation (‘Johns-Manville’) raised complex issues regarding future claimants of un-manifested mass tort injuries caused by the corporation’s pre-bankruptcy actions.108

Future claimants face two problems when reorganisation freezes all claims against the debtor.109 First, future claims are estimated and discounted to a present value. The future is inherently risky as the actual claim may exceed the estimated claim.110 Second, future claimants do not yet know that they exist and are not at the negotiation table to protect their interests against other participants during reorganisation.111 Johns-Manville especially invoked ire because it seemed financially strong — the public perceived its Chapter 11 petition as an attempt to evade responsibility to asbestos victims.112

102 Ibid 34–41 (Brennan CJ, McHugh, Gummow, Kirby and Hayne JJ).
103 Ibid 38–9 (Brennan CJ, McHugh, Gummow, Kirby and Hayne JJ). See *Corporations Act* s 437A.
104 Spender, ‘Scenes from a Wharf’, above n 19, 66.
105 The root of the problem may not be with voluntary administration itself, but rather with limited liability and corporate groups in general where different companies own the businesses, assets and liabilities of a commercial enterprise: see ibid 46–8; Noakes, above n 25, 92.
106 See below Part IV(A)(2).
107 Noakes, above n 25, 97.
109 In the Australian voluntary administration context, a deed of company arrangement binds all creditors of the company, so far as it concerns claims arising on or before the day specified in the deed: *Corporations Act* s 444D(1).
110 See Roe, above n 65, 850.
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Rehabilitation conflicts with the rights of future claimants. Johns-Manville’s strategic behaviour of early filing may have achieved rehabilitation by preventing ‘the debtor firm’s operational collapse.’ On the other hand, Spender observes that collectivisation of claims ‘will almost inevitably lead to under-compensation of tort creditors.’ In addition, different claimants’ interests conflict — between contract creditors and tort claimants, between shareholders and tort claimants, and even between current and future tort claimants.

For many, whilst reorganisation had rehabilitated the firm, it failed to resolve the distribution issues. The reorganisation system itself may be incapable of dealing with future claimants. Reforms of the reorganisation system or special measures outside the system may be necessary to address the problem of under-compensated future claimants.

These issues are highly pertinent for Australian policymakers. The Australian asbestos company that later moved to the Netherlands, James Hardie Industries NV, initially proposed a statutory compensation board to compensate its asbestos claimants. Under public pressure, James Hardie eventually entered into a ‘Heads of Agreement’ with the Australian Council of Trade Unions, Unions New South Wales, asbestos support groups and the New South Wales Government on 21 December 2004, leading to a legally-binding ‘Principal Agreement’ to establish a ‘Special Purpose Fund’ for asbestos claimants. James Hardie agreed to contribute 35 per cent of its annual free cash flow to this Special Purpose Fund for at least the next 40 years. The ‘Final Funding Agreement’ (as the Principal Agreement is now called) was signed on 1 December 2005, conditional on James Hardie being satisfied with the tax treatment of the

113 See Re Johns-Manville Corporation, 36 BR 743, 746 (Bankruptcy Judge Lifland) (Bankr SD NY, 1984). See also his Honour’s comment that ‘[t]he liquidation of this substantial corporation would be economically inefficient in not only leaving many asbestos claimants uncompensated, but also in eliminating needed jobs and the productivity emanating from an ongoing concern.’ at 746.
114 Roe, above n 65, 856.
116 See Roe, above n 65, 910–12.
118 See Douglas G Baird and Thomas H Jackson, Cases, Problems, and Materials on Bankruptcy (1985) 146 (emphasis in original):

The unasserted tort claimants will want to be included as ‘claimants’ in the bankruptcy process, as long as they do not know who they are. Once they know who they are — and become ‘present’ claimants — they will have an incentive to keep other unasserted claimants out, because that means more assets for those who know who they are …
119 See Roe, above n 65, 862–4.
120 Ibid 864–92. To address the issue of an inherently risky future, the author suggests handing over the company’s common stock to a trustee who administers the pool of common stock for the benefit of future mass tort creditors. Other ways to alleviate, though probably not eliminate, the future claimants’ lack of negotiation leverage include appointing a representative for future claimants during negotiation: see, eg, Re Johns-Manville Corporation, 36 BR 743 (Bankr SD NY, 1984).
123 Ibid.
proposed Special Purpose Fund payments. However, its implementation is in doubt as James Hardie and the Australian Taxation Office continue to negotiate the question of its tax treatment.124

Interestingly, the Special Commission of Inquiry into the Medical Research and Compensation Foundation (the asbestos victims’ fund that James Hardie left in Australia before moving to the Netherlands) considered the possibility that a Chapter 11 procedure could be used to deal with the problem of un-manifested future tort liabilities. The Special Commission also suggested that voluntary administration could address the problem of un-manifested future tort liability through an exercise of the court’s discretion under Corporations Act s 447A, an appointment of a legal representative for future claimants and a requirement on the administrator to consider the interests of future claimants.125 Whether these suggestions are workable is yet to be seen. In a later unrelated report, CAMAC specifically noted the suggestions of the Special Commission but did not consider the matter further.126

As part of the reform of compensation for tort victims, but outside of the voluntary administration system, the New South Wales Government completed a Review of Legal and Administrative Costs in Dust Diseases Compensation Claims127 and introduced the Dust Diseases Tribunal Amendment (Claims Resolution) Act 2005 (NSW) effective from 1 July 2005 to implement the review’s proposed new claims resolution process at the Dust Diseases Tribunal.128

These recent events highlight the critical need for policymakers to balance the competing interests in reorganisations and to make policy judgements.

E Consolidaing the Theoretical Framework

A value maximising question — asset maximisation or rehabilitation — is distinct from a distribution question. Changing or redistributing individual claims is acceptable because a larger pie means that there is more to share. Hence, the most undisputed abuse of reorganisation occurs when reorganisation does not try to extract more value from a better or more efficient use of the

126 CAMAC Report, above n 7, 10.
debtor’s resources, as all that is left is reorganisation’s instantaneous effect on individual rights.

Reorganisation is, however, not just about maximising the economic value of resources. A point comes when a potentially larger pie might not justify an inequitable sharing of the pie. Then, differentiation of impermissible abuse from permissible strategic behaviour requires a resolution of competing interests to achieve a normatively acceptable balance.

The theoretical framework established in this article provides a coherent structure for the policy debate on strategic behaviour and abuses of reorganisation. It suggests how an impermissible abuse can be distinguished from permissible strategic behaviour. Promoting the fundamental economic efficiency rationale of reorganisation inescapably involves balancing competing interests. Policymakers need to make some hard distribution decisions. The following Parts apply this theoretical framework to critique the ability of the voluntary administration threshold requirements to separate impermissible abuses of reorganisation from permissible strategic behaviour.

III  THE THRESHOLDS

A critique of the threshold requirements for a debtor to enter voluntary administration begins with an understanding of the existing law. The following outlines the intended policies of voluntary administration legislation in Australia. It then lays out the law relating to the current voluntary administration threshold insolvency test. Policymakers recently proposed reforms relating to this insolvency test and considered the Chapter 11 good faith test. This Part draws attention to voluntary administration’s own embedded threshold good faith test.

A  The Intended Policies of Voluntary Administration

The voluntary administration procedure in Part 5.3A of the Corporations Act is the product of the Law Reform Commission’s General Insolvency Inquiry, headed by Commissioner Ron Harmer.129 Voluntary administration starts when the company’s directors appoint an administrator.130 A moratorium on creditors’ collection processes operates during administration while the participants negotiate a resolution.131 Voluntary administration could end if at the second creditors’ meeting the creditors accept a deed of company arrangement which binds the reorganised company, its creditors and shareholders.132 Alternatively, the company could liquidate.133

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130 Corporations Act ss 435C(1)(a), 436A.
131 Corporations Act pt 5.3A div 6.
132 See Corporations Act pt 5.3A. The deed of company arrangement also binds the deed administrator: Corporations Act s 444G(c).
133 Corporations Act s 439C(b). The company may also return to its pre-administration state: Corporations Act s 439C(c). However, this will be a rare occasion.
Consistent with the underlying value maximising justification of reorganisation, the legislature intended that voluntary administration achieves a more efficient economic outcome. The first provision governing voluntary administration, Corporations Act s 435A, declares:

The object of this Part is to provide for the business, property and affairs of an insolvent company to be administered in a way that:

(a) maximises the chances of the company, or as much as possible of its business, continuing in existence; or
(b) if it is not possible for the company or its business to continue in existence — results in a better return for the company’s creditors and members than would result from an immediate winding up of the company.

The primary object — to maximise the chances of a company or its business continuing in existence — is the same as the wider value maximising rehabilitation policy. The Harmer Report suggested that voluntary administration focuses on ‘the possibility of saving a business … and preserving employment prospects’. The secondary object — to provide better return for the creditors and shareholders as a group — reflects the narrower asset maximising policy.

While little is said on which of the two legislative objects (rehabilitation or asset maximisation) should prevail in a given case, both objects reflect an investment goal to achieve the best collective use of the company’s resources, rather than a distributive mandate on who has claims to those resources. Unfortunately, the threshold requirements to enter voluntary administration fail to clearly identify either of these value maximising objects.

On the distribution issue, the legislature also neglected to say how the participants of administration might share the pie. The distribution in liquidation is one of the prescribed terms of a deed of company arrangement, but it is not mandatory. Negotiations during voluntary administration produce unpredictable redistribution patterns.

The legislature simply left to the courts the task of balancing competing interests when redistributions are challenged. Courts have recognised that using voluntary administration solely to change individual rights without maximising the value of the business is an abuse. Where a change of rights and value maximisation are both present, the courts employ various standards to balance competing interests.

134 Lightman, above n 22, 64.
135 Corporations Act s 435A(a); Explanatory Memorandum, Corporate Law Reform Bill 1992 (Cth) 93.
137 Corporations Act s 435A(b).
138 See below Part IV(A), (B).
139 see below Part IV(A), (B).
139 Corporations Act ss 444A, 471C, 555, 556, 563A, 563C; Corporations Regulations 2001 (Cth) reg 5.3A.06, sch 8A cl 4. The order of priorities in liquidation is roughly: secured creditors who remain outside of the liquidation process, administrative priorities for costs of administering the liquidation, public interest priorities for employees, unsecured creditors, subordinated creditors and shareholders.
140 See, eg, Corporations Act ss 445D, 447A.
141 See, eg, Blacktown City Council v Macarthur Telecommunications Pty Ltd (2003) 47 ACSR 391.
For example, a beneficial deed of company arrangement that maximises return for the group justifies discrimination among the creditors to some extent.\(^{142}\) However, there is a baseline measure of fairness that even greater economic benefit cannot violate; courts may terminate a deed if it is ‘oppressive or unfairly prejudicial to, or unfairly discriminatory against, one or more such creditors’.\(^ {143}\) One court suggested that this baseline may be assessed against what a creditor would receive in liquidation.\(^ {144}\)

There are other provisions which balance competing interests and prevent an impermissible abuse of voluntary administration.\(^ {145}\) The threshold requirement to enter voluntary administration could perform this function at the earliest point before a debtor appoints an administrator.

### B Insolvency Test

There are two main elements to the current mandatory threshold insolvency test to enter voluntary administration: the state of insolvency and the directors’ opinion as to the likelihood of insolvency.

1. **Insolvency**

   ‘A person is solvent if, and only if, the person is able to pay all the person’s debts, as and when they become due and payable.’\(^ {146}\) Conversely, ‘a person who is not solvent is insolvent’.\(^ {147}\) Insolvency in Australia is generally a cash flow concept.\(^ {148}\) However, insolvency encompasses balance sheet items of asset and liability.\(^ {149}\) The legal definition of insolvency does not correspond with a

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\(^{143}\) Corporations Act s 445D(1)(f). In determining what is fair, ‘the court may have to balance competing interests’: Colin Anderson and David Morrison, *Crutchfield’s Corporate Voluntary Administration* (3rd ed, 2003) 225.

\(^{144}\) Lam Soon Australia Pty Ltd v Molit (No 55) Pty Ltd (admin apptd) (1996) 70 FCR 34, 48 (von Doussa, O’Loughlin and Lehane JJ). The ‘best interests of creditor test’ under Chapter 11 requires that the reorganisation plan provides each dissenting claimant with at least as much as what each would receive if the debtor is liquidated: *Bankruptcy Code*, 11 USC § 1129(a)(7) (2000).


\(^{146}\) *Corporations Act* s 95A(1).

\(^{147}\) *Corporations Act* s 95A(2).


company’s retrospective accounting cash flow — looking at financial statements is not enough.

Insolvency is a question of fact determined from the company’s financial position taken as a whole. It is ‘to be decided as a matter of commercial reality in the light of all the circumstances … viewed as it would be by someone operating in a practical business environment.’ A leading treatise explains: ‘The basic question is whether the company’s business is viable.’ Insolvency is not the same as a temporary lack of liquidity. The High Court described insolvency as an ‘endemic shortage of working capital’.

The courts examine the company’s debt or liability as well as resources or assets. From the debt or liability side, the courts consider factors like the company’s debts currently due, its debts that become due within the near future, and its prospective and contingent debts. From the resources or assets side, factors include the company’s present and expected cash resources, resources available to meet its liabilities as they fall due, other non-cash resources realisable by sale or secured borrowing, and the time when such resources are realisable.

Insolvency is not a mere question of finance. The debtor’s ability to borrow without security from external sources shows the debtor’s strong financial standing and solvency. Courts may take into account the financial support available to the debtor, its terms of credit, and the possibility that its creditors may not always insist on payment strictly in accordance with their terms of trade. Indications of an express or implied agreement extending the time of payment, conduct amounting to an estoppel, a well-established and recognised course of conduct in the industry, a course of dealing amounting to a long-standing arrangement, or a clear understanding in the absence of such dealing could persuade the courts to look beyond the terms of the contract. Insolvency is more a description of the debtor–creditor relationship than numbers. The focus is on the debtor’s and the creditor’s behaviour.

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150 Purcell, above n 148, 197.
152 Sandell v Porter (1966) 115 CLR 666, 670 (Barwick CJ).
155 Sandell v Porter (1966) 115 CLR 666, 670 (Barwick CJ).
156 Hymix Concrete Pty Ltd v Garrity (1977) 13 ALR 321, 328 (Jacobs J).
157 Austin and Ramsay, above n 154, 950.
158 Corporations Act s 459D.
159 Austin and Ramsay, above n 154, 950.
161 Austin and Ramsay, above n 154, 951.
164 Ibid.
165 Re Newark Pty Ltd (in liq) [1993] 1 Qd R 409, 414 (Thomas J).
166 Re Kerisbeck Pty Ltd (1992) 10 ACLC 619, 622 (Harper J); Austin and Ramsay, above n 154, 950.
The Door to Reorganisation

2 Directors’ Opinion of Insolvency

In order to invoke the voluntary administration procedure, the director, or more commonly, the directors, must reach an opinion that the company is insolvent or likely to become insolvent. In Kazar v Duus, Merkel J held that the director’s opinion of the company’s insolvency must be genuine and bona fide.\(^{167}\) Although the directors’ subjective intentions are relevant, his Honour held that the court must examine the directors’ opinion objectively.\(^{168}\)

In Crimmins v Glenview Home Units Pty Ltd (in liq), Palmer J elaborated that the directors’ genuine and bona fide opinion of insolvency consists of subjective and objective elements.\(^{169}\) The subjective element requires directors to actually hold the opinion.\(^{170}\) The objective element involves asking whether a ‘competent director in the position of the director concerned could reasonably have formed the opinion on the facts known to that director.’\(^{171}\) An opinion must not be ‘fanciful’; it requires that ‘[a liability] will probably be incurred or that there is a real, not remote, chance of it being incurred, rather than that it is merely possible that it will be incurred’.\(^{172}\) Nevertheless, Palmer J gave directors much latitude:

> The scope for forming an opinion of likely insolvency is very broad … For example, a director may legitimately form the view that insolvency is likely ten years hence because … the company’s business is already dwindling at such a rate that continuing liabilities will inevitably outstrip the company’s ability to pay. Such a view … may well justify the director in immediately invoking the aid of [voluntary administration].\(^{173}\)

Weinberg J in Downey v Crawford agreed that the question is whether the directors ‘genuinely believed, on reasonable grounds, that the company was insolvent or likely to become so in the future’.\(^{174}\) Reasonable grounds are referable to the objective standard of ‘a director of ordinary competence’.\(^{175}\) The reasonableness of the directors’ belief depends on factors like whether the directors took adequate steps to satisfy themselves that the statutory requirement of insolvency or likely insolvency is met.\(^{176}\) Policy discussions are informed by how directors approach the insolvency test.

\(^{167}\) (1998) 88 FCR 218, 231 (‘Kazar’).
\(^{168}\) Ibid 232.
\(^{169}\) [2001] NSWSC 699 (Unreported, Palmer J, 17 August 2001) [50].
\(^{170}\) Ibid.
\(^{171}\) Ibid.
\(^{172}\) Ibid [52].
\(^{173}\) Ibid [51].
\(^{175}\) Ibid, citing Metropolitan Fire Systems Pty Ltd v Miller (1997) 23 ACSR 699, 703 (Einfeld J).

C Reformsing the Insolvency Test

Policymakers have agonised over the level of insolvency required to enter voluntary administration. A high threshold supposedly prevents abuse. On the other hand, a low threshold purportedly provides an incentive for early initiation of voluntary administration.

The current threshold insolvency test requires the company to be at least ‘likely to become insolvent at some future time’. The Harmer Report suggested that a ‘reasonable prospect of insolvency’ is sufficient. In July 2004, the Joint Committee on Corporations and Financial Services recommended that it be sufficient that the company ‘may become insolvent’. In October 2004, CAMAC determined that these alternative levels of insolvency were too open-ended and favoured the current level.

Early initiation of voluntary administration is why policymakers are interested in the stringency of the voluntary administration insolvency threshold. CAMAC claimed, ‘[t]he earlier a company responds to its financial difficulties, the better may be its prospects of successful rehabilitation.’ The Harmer Report also advocated early positive action to deal with insolvency. The legislature concurred: ‘It is an important theme of the proposed new Part 5.3A … that directors are to be encouraged … to take the earliest possible action to tackle solvency difficulties.’ The Joint Committee on Corporations and Financial Services noted that voluntary administration ‘encourage[s] directors to give early consideration to the company’s financial difficulty.’ Its proposal to moderate the insolvency test was to ‘ensure that the [voluntary administration] procedure provides sufficient incentives to companies to initiate the procedure.’ It wanted to ‘alleviate perceptions that [voluntary administration] is only available to insolvent companies.’

During the debate, CAMAC searched for an alternative threshold test for reorganisation. It considered a threshold test similar to the good faith test in the Chapter 11 reorganisation system but concluded that such a test would increase

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177 CAMAC Discussion Paper, above n 5, 2.
178 Ibid.
179 Corporations Act s 436A.
180 Harmer Report, above n 129, 30.
181 Joint Committee on Corporations and Financial Services, above n 2, 84:
182 CAMAC Report, above n 7, 24.
183 CAMAC Discussion Paper, above n 5, 1 (emphasis omitted).
184 Harmer Report, above n 129, 29.
185 Explanatory Memorandum, Corporate Law Reform Bill 1992 (Cth) 110.
186 Joint Committee on Corporations and Financial Services, above n 2, 83.
187 Ibid 84.
188 Ibid.
litigation and court supervision. However, Australian policymakers need not look far for an alternative threshold test.

D Good Faith Test

The good faith test is most notable as a threshold requirement in the Chapter 11 reorganisation system. Yet to date, no-one has pointed out that Australia’s voluntary administration has an embedded threshold good faith test. The following examination starts with the Chapter 11 good faith test and concludes with the voluntary administration good faith test.

1 Chapter 11 Good Faith Test

In the United States, a debtor may voluntarily file a petition with a bankruptcy court to commence a Chapter 11 reorganisation bankruptcy case. Insolvency, whether balance sheet or cash flow, is not a formal requirement of a voluntary Chapter 11 petition. In its place, courts have implied a good faith prerequisite to filing a Chapter 11 petition. A lack of good faith in filing is cause for dismissing the petition. The debtor’s ‘intent to abuse the judicial process or the overall purpose of the bankruptcy reorganization provisions’ indicates a lack of good faith. Courts examine the Chapter 11 petition’s good faith on a case-by-case basis, evaluating ‘the facts and circumstances germane to each particular case’, including ‘the debtor’s financial condition, motives, and the local financial realities.’ In Re Johns-Manville Corporation, it was acknowledged that ‘the concept of good faith is an elastic one which can be read into the statute on a limited ad hoc basis.’ Standards vary. For example, one case required both ‘objective futility of any possible reorganization and the subjective

189 CAMAC Report, above n 7, 21, 25. See also CAMAC Discussion Paper, above n 5, 2 (emphasis omitted) which specifies some of the prerequisites for initiating the procedure:

1.6 These prerequisites should not unduly inhibit companies from undertaking remedial action, though they should not provide a means for companies merely to delay or defeat particular creditors’ rights, rather than to undertake a genuine and realistic restructuring to deal with their financial difficulties.

1.7 Some possibilities include:

• a financial stress test: for instance, actual or likely insolvency
• a purposive test: for instance, a requirement that any procedure be initiated in good faith.

190 Bankruptcy Code, 11 USC § 301 (2000).
191 Re Johns-Manville Corporation, 36 BR 727, 732 (Bankruptcy Judge Lifland) (Bankr SD NY, 1984).
192 Re Marsch, 36 F 3d 825, 828 (Kozinski, Trott and Williams JJ) (9th Cir, 1994).
193 Ibid. The bankruptcy court has the discretion to dismiss a case for ‘cause’. Bankruptcy Code, 11 USC § 1112(b) (2000).
196 Ibid.
197 36 BR 727, 737 (Lifland J) (emphasis omitted) (Bankr SD NY, 1984).
bad faith of the petitioner’. Another stated three requirements: the debtor’s honest intention, some real need and real ability to reorganise.

The standards generally fall into three groups: first, present need to file; second, valid reorganisation purpose; and third, improper motive. The ‘present need to file’ standard suggests that the debtor needs to show some measure of insolvency, imminent illiquidity or similar financial distress. The ‘valid reorganisation purpose’ standard requires that the debtor files the Chapter 11 petition to preserve and maximise its going concern value for the benefit of creditors. Courts will also objectively examine the debtor’s ability to effect a reorganisation.

The ‘improper motive’ standard examines the debtor’s nefarious reasons for filing. In essence, this standard relates to whether the debtor seeks to change and redistribute rights. An improper motive, in this sense, includes gaining a tactical litigation advantage.

2 Voluntary Administration Good Faith Test

Australian observers have asserted that the voluntary administration threshold requirement only involves a financial insolvency test and not a purposive good faith test.

The voluntary administration good faith test has two characterisations. First, Merkel J in Kazar described the power to appoint an administrator as a statutory power. As such, his Honour found that it must be exercised for the purpose for which it was conferred. Noting the objects of rehabilitation and better return for claimants as intended by the legislature, Merkel J said that:

the exercise of the power to appoint an administrator … must be in furtherance of the object of Pt 5.3A as set out in s 435A. Thus, if the power to appoint an administrator is exercised for a purpose unrelated to that object but for an ulterior or extraneous purpose, then it will be invalidly exercised.

199 Re North Redington Beach Associates Ltd, 91 BR 166, 169 (Chief Bankruptcy Judge Paskay) (Bankr MD Fla, 1988).
203 See generally Hesse, above n 201, 14.
204 See, eg, Re Stel Carbon Corporation, 200 F 3d 154, 167–70 (Scirica, McKee and Brodman JJ) (3rd Cir, 1999).
205 See, eg, CAMAC Discussion Paper, above n 5, 2. CAMAC Report, above n 7, 21. Colin Anderson notes that courts may review an appointment of an administrator based on the general ground of an abuse of position as a fiduciary but does not link it to the Chapter 11 threshold good faith test nor discusses the matter further: see Colin Anderson, ‘Commencement of the Part 5.3A Procedure: Some Considerations from an Economics and Law Perspective’ (2001) 9 Insolvency Law Journal 4, 6.
207 Ibid.
208 Ibid.
Second, in *Cadwallader v Bajco Pty Ltd*, Austin J, the trial judge, described the directors’ power to appoint an administrator as a ‘fiduciary power’ in their fiduciary capacity. An improper exercise of a fiduciary power by the directors is a ‘breach of duty owed to the company rather than to any individual shareholder or interested person’. However, his Honour did not elaborate on the scope of the fiduciary duty or whether it matches the statutory power as described by the objects of voluntary administration intended by the legislature. Part IV of this article shows that characterising the power to appoint an administrator as a fiduciary power may not ensure that reorganisation achieves the highest valuation for the debtor or its business.

Focusing instead on a factual enquiry into the actual purpose of an exercise of the power to appoint an administrator, *Kazar* and *Cadwallader Trial* indicate that familiar principles apply. On appeal, the court in *Cadwallader v Bajco Pty Ltd* affirmed that the courts are entitled to look at the situation objectively to ascertain the purpose of an exercise of power. Although statements about the motives or subjective intentions of individual directors are relevant, the courts examine the character and operation of the exercise of power by looking at the facts and circumstances surrounding it. Where there is more than one purpose, the exercise of power will be invalid if an improper purpose is substantial. Whether the improper purpose is substantial depends on whether, but for the improper purpose, the directors would have passed the impugned resolution.

In *Kazar*, the governing committee of an incorporated Aboriginal council invoked voluntary administration to avoid the appointment of another administrator under the *Aboriginal Council and Associations Act 1976* (Cth). Merkel J also found that the committee initiated voluntary administration to perpetuate its control and concluded that it was an improper ulterior purpose.

Control of the company was also a pivotal factor in *Cadwallader Appeal*. The courts demonstrated neatly how the insolvency test and the voluntary administration good faith test intertwine. The New South Wales Court of Appeal agreed with Austin J that the company was in fact solvent and was likely to...
remain solvent. By inference, the directors were aware of this fact. Hence, the directors did not hold the opinion that the company was insolvent. The further inference was that the directors exercised the power to initiate administration for the purpose of preserving their positions. Therefore, the directors used the power for an improper purpose and failed to act in good faith.

The threshold insolvency test and good faith test are functionally different. The insolvency test focuses on the debtor’s prevailing financial state, while the Chapter 11 and voluntary administration good faith tests allow courts to scrutinise the debtor’s or its directors’ use of reorganisation. The good faith judicial enquiry is more encompassing than a bare insolvency test. By putting a judicial gloss over the current voluntary administration threshold insolvency test, Australian courts suggest that the insolvency test is inadequate. Yet, the voluntary administration good faith test is far from perfect. Part IV shows the ways in which both tests fail to require that debtors enter administration only if this option maximises the value of their businesses.

IV A Better Threshold

The following dissects the two voluntary administration threshold tests within the theoretical framework constructed in Part II. It challenges the effectiveness of the insolvency test and the good faith test in distinguishing an impermissible abuse from permissible strategic behaviour before a debtor appoints an administrator. The insolvency test does not prevent the most obvious abuse because it fails to ensure that a debtor actually uses reorganisation to increase the company’s value. The voluntary administration good faith test considers more factors and allows scrutiny of the directors’ purposes. Yet, the good faith test creates uncertainty when courts balance the competing interests of claimants affected by the reorganisation. A better value maximising threshold test for voluntary administration would require the directors to make a valuation to find that reorganising the company creates more value than other possibilities. Such a threshold would prevent clear abuses and, at the same time, promote beneficial strategic behaviour by focusing on the value maximising policies of reorganisation.

A Assessing the Insolvency Test

The current voluntary administration threshold insolvency test draws a line between two situations: a lack of insolvency and the presence of insolvency.


223 Ibid [126] (Heydon JA).

224 Ibid.

225 Ibid [119]–[120], [269] (Heydon JA).
Lack of Insolvency

When a debtor commits multiple defaults, a collective action problem threatens its value as a going concern because individual creditors scramble to grab the debtor’s assets, jeopardising its existence. Voluntary administration preserves and maximises the debtor’s value for the benefit of the claimants as a group by overriding individual collection rights and forcing the claimants to reach a single resolution.

A minimum level of insolvency, which evidences a debtor’s need to reorganise, is essential to justify reorganisation. Insolvency, as legally defined in the current voluntary administration threshold requirement, approximates the existence of a collective action problem. It signifies ‘a chronic lack of liquidity which forces the creditors of the company to seek recovery of their debts’. It is not a pure financial cash flow enquiry but rather an assessment of the debtor–creditor relationship and their behaviour. Factors indicating insolvency such as inaccessibility to funds and destruction of supplier–customer relationships have detrimental effects on a debtor’s operations and resources.

Hence, an insolvent debtor has a critical need to preserve or increase the company’s value, consistent with desirable reorganisation policy. An American bankruptcy court said: ‘if a petitioner has no need to rehabilitate or reorganize, its petition cannot serve the rehabilitative purpose for which Chapter 11 was designed.’

Given that insolvency is necessary, the next logical question concerns the level of insolvency (actual or anticipated) necessary for a debtor to enter voluntary administration. Calls for reform range from the strict to the lenient: ‘genuine insolvency’; ‘reasonable prospect of insolvency’; to ‘may become insolvent’. Reformers are concerned about abuses yet keen on encouraging early initiation and a successful rehabilitation. Depending on the definition and level of insolvency one wants, minds may reasonably differ as to a debtor’s eligibility to reorganise. Take for example, Johns-Manville, which filed a Chapter 11 petition while its underlying business was perceived to be strong. Spender contends that Johns-Manville was clearly not insolvent. In contrast, Jackson speculates that Johns-Manville may well have faced a collective action problem and was a candidate for reorganisation, even though it could have met its debts as they fell due. Using financial models to assess the distress’

226 See above Part II(A), (C).
227 See Jackson, above n 12, 197–201.
228 James O’Donovan, ‘Corporate Insolvency: Policies, Perspectives and Reform’ (1990) 3 Corporate and Business Law Journal 1, 1 (citations omitted).
229 See Roe, above n 65, 856–62.
230 Re SGL Carbon Corporation, 200 F 3d 154, 166 (Scirica, McKee and Brotman JJ) (3rd Cir, 1999).
231 Spender, ‘Blue Asbestos and Golden Eggs’, above n 22, 244.
233 Joint Committee on Corporations and Financial Services, above n 2, 84.
234 CAMAC Discussion Paper, above n 5, 2.
236 Jackson, above n 12, 200.
Presently, the directors’ opinion of insolvency must merely be genuine, bona fide and based on reasonable grounds referable to the objective standard of ‘a director of ordinary competence’. The insolvency test does not require actual insolvency and is not much of a legal impediment in its current form.

The current lenient insolvency threshold has some merit. Insofar as it increases the chances of a successful rehabilitation, reorganising early prior to actual insolvency is desirable strategic behaviour in line with the rehabilitation policy. The fear that early reorganisation might cause undesirable redistribution of individual rights is unwarranted. Regardless of when a debtor reorganises, or how solvent or insolvent the debtor is, if other parts of the reorganisation system are the cause of undesirable distribution, then it is likely to remain. A debtor’s insolvency does not make undesirable distribution any more favourable. Criticising a Chapter 11 rule that allows debtors to reject collective bargaining agreements, Jackson comments: ‘if it is perceived to be an incorrect use of bankruptcy when done baldly, it should not be a correct use of bankruptcy when combined with insolvency’. Preventing early access comes at the expense of beneficial value maximising reorganisations without necessarily solving the problems of a fundamentally flawed system.

A more stringent requirement on directors to reach an opinion that the company is actually insolvent before appointing an administrator does not sit easily with the directors’ duties to prevent insolvent trading.

2 Presence of Insolvency

The recent reform debate relating to the height of the voluntary administration threshold insolvency test missed a more critical deficiency of the insolvency test — it does not ensure that a debtor enters voluntary administration only when reorganisation creates the most value from the company or its business. This most obvious form of abuse may involve insolvent companies. This observation does not preclude an insolvent company (including a hopelessly insolvent one) from legitimately using voluntary administration as an easy and cost-effective path to an eventual winding-up, if this route preserves or maximises value. However, insolvency merely indicates that the debtor has a problem which reorganisation can potentially solve. If reorganisation could not solve the problem through preserving and maximising the value of the company, it is an

237 Altman, above n 20, 90. Altman defines ‘corporate financial distress’ as covering four technical terms: ‘failure’, ‘insolvency’, ‘default’ and ‘bankruptcy’. Financial problems include ‘failure’ which focuses on the economic profitability of the business, ‘illiquidity’ and ‘balance sheet insolvency’. These financial problems may or may not lead to legal consequences of ‘default’, ‘bankruptcy’ or other formal bankruptcy or insolvency procedures: at 3–6.


240 Jackson, above n 12, 195 (emphasis in original), referring to Bankruptcy Code, 11 USC § 1113 (2000).

abuse to enter voluntary administration because individual rights will be affected instantaneously (for example, by the moratorium on creditors’ collection processes) without any justifications.

The voluntary administration threshold insolvency test distracts the courts from the real enquiry into whether a debtor’s behaviour is compatible with the value maximising policy of voluntary administration. Courts had used insolvency to justify administration. In Rodgers v Radly, Warren J refused to end an administration because the company was insolvent.242 This was despite the ‘apparent ingenuineness [sic] of the fact of the debts being allowed to lie for a period of two years and then suddenly being activated for the purposes of demonstrating insolvency’.243 Similarly, in Patrick Stevedores, the High Court assumed that voluntary administration was valid because the employer companies were ‘insolvent’ even though rehabilitation or a better return for claimants arguably did not occur.244

Insolvency as a precondition is, moreover, not entirely out of the debtor’s control if it really wants to induce insolvency. Michael Bradley and Michael Rosenzweig argue that insolvency is an endogenous decision and ‘firms can choose to become “insolvent” by not maintaining a sufficient balance of [liquid] assets.’245 Patrick Stevedores also suggests that an upstream company can trigger a company’s insolvency in a corporate group.246

Finding insolvency or a need to preserve or maximise the company’s value does not prevent an abuse of the reorganisation system. The more pertinent enquiry for policymakers is whether the debtor or its business is worth more in reorganisation. The debtor’s financial state before entry into voluntary administration is relevant to whether its use of the system is permissible. However, the enquiry cannot stop there.

B Assessing the Good Faith Test

The hitherto indistinct voluntary administration threshold good faith test asks better questions than the bare threshold insolvency test because it focuses on the purposes of the debtor’s directors in using voluntary administration. However, the courts’ attempts to balance competing interests obscure the reorganisation policy of finding the most efficient or highest-valued use of the debtor’s resources. While the discussion below is specific to Australia’s voluntary administration good faith test, the Chapter 11 experience is valuable.

1 In Whose Interests?

The courts held that the officers and directors in Kazar and the Cadwallader litigation exercised their power to appoint an administrator for the improper

243 Ibid 92 (Warren J).
246 Spender, ‘Scenes from a Wharf’, above n 19, 64–5. See above Part II(D)(5).
purpose of preserving their positions and control of the company. The courts in
Kazar and Cadwallader litigation implicitly found that examining the directors’
purpose could better control the use of reorganisation than examining the
debtor’s solvency. However, both matters left much unsaid.

Austin J in Cadwallader Trial characterised the power as a director’s ‘fiduci-
ary power’. The core of the director’s fiduciary duty is to act in good faith in
the interests of the company. The courts extended this duty to the ‘company as
a whole’ to refer to the shareholders as a general body. When the company is
solvent, the interests of the creditors cannot intrude upon the interests of the
company as a whole. When insolvency approaches, the creditors could
potentially displace the shareholders, and the directors need to take the interests
of the creditors into consideration. However, directors do not owe an inde-
pendent duty to creditors.

Classifying the directors’ power to appoint an administrator as a fiduciary
power is deficient in two ways. First, it is primarily focused on shareholders and,
to a lesser extent, creditors. Directors do not owe a wider duty to the employees
or the public unless it is in the interest of the company to take account of their
interests. Compare this narrow fiduciary duty with the wide rehabilitation
policy — the latter considers the economic costs of the debtor’s collapse on the
employees, suppliers, customers and the wider community.

Second, the directors’ duty to act in good faith in the interests of the ‘company
as a whole’ does not say what directors should do when there is a conflict of
interests between the majority and the minority within the same class of claim-
ants, or between different classes of claimants. The directors may face this
conflict between the creditors and shareholders when appointing an administra-
tor. Shareholders may resist administration because they could be excluded
from the process. Creditors may be the only ones who gain from voluntary
administration’s preservation of company assets. Truly grappling with the

248 Percival v Wright [1902] 2 Ch 421, 425 (Swinfen Eady J).
249 Ngurlt Ltd v McCann (1953) 90 CLR 425, 438 (Williams ACJ, Fullagar and Kitto JJ); Green-
halgh v Arderne Cinemas Ltd [1951] Ch 286, 291 (Evershed MR).
251 Ibid; Walker v Wimborne (1976) 137 CLR 1, 6–7 (Mason J).
252 Spies v The Queen (2000) 201 CLR 603, 636–7 (Gaudron, McHugh, Gummow and Hayne JJ).
253 Parke v Daily News Ltd [1962] Ch 927, 963 (Plowman J); Hutson v West Cork Railway Co
(1883) 23 Ch D 654, 671–3 (Bowen LJ).
254 For an example of conflict between majority and minority shareholders in the context of altering
the company’s constitution, see Gambotto v W C P Ltd (1995) 182 CLR 432, 443–4 (Mason CJ,
Brennan, Deane and Dawson JJ), 452 (McHugh J).
255 For a discussion of the conflict between ordinary and preference shareholders, see Mills v Mills
(1938) 60 CLR 150, 164 (Latham CJ).
256 See also in the context of Chapter 11, LoPucki and Whitford, ‘Corporate Governance’,
above n 35, 786–10.
257 See, eg, Brash Holdings Ltd v Shafir (1994) 14 ACSR 192, 196 (Beach J).
258 See Keach, above n 200, for an example of the converse situation where shareholders benefit to
the creditors’ detriment in the context of Chapter 11.
difficulty of distributing losses among claimants, ‘courts have struggled to strike a balance’.  

The court’s characterisation of the power to appoint an administrator as a fiduciary power in *Cadwallader Trial*, affirmed on appeal, inadequately emphasises reorganisation’s value maximising policy at a time when the preservation of company resources may be critical. The orthodox view that the duty is owed to the company as a ‘corporate entity’ or a ‘personified fund or estate upon which both members and creditors may have claims’ somewhat alleviates the second deficiency. Instead of balancing competing interests and mediating among claimants, this view refocuses the directors’ task on preserving the company’s assets. Nevertheless, this view does not oblige directors to take heed of the wider community’s economic wealth in considering what is the highest-valued use of the company’s resources. In comparison, *Kazar*’s characterisation of the power to appoint an administrator as a statutory power is preferable; the legislature’s intended objects of voluntary administration — rehabilitation or a better return for claimants — provide some guidance in achieving a value maximising end.

The courts have yet to recognise this divergence between a fiduciary power and statutory power. This ambiguity regarding whose interest the directors should have regard to when appointing an administrator is only half the problem.

2 *Mixed Purposes*

After determining the scope and nature of the power, courts need to examine the actual purpose for which the power was exercised. Jackson argues that a Chapter 11 good faith enquiry cannot respond adequately to ‘mixed motive’ cases. By this Jackson refers to cases where a value maximising use and a selfish goal of changing rights are both present. Jackson’s critique echoes the difficulty that Part II highlights: when value maximisation and redistribution of rights are both present, whether reorganisation is permissible depends on how one balances competing interests. Uncertainty arises when this balancing task is left to the courts in a threshold good faith enquiry.

In relation to the Chapter 11 good faith test, Michael J Venditto comments that courts have been inconsistent in their approach to define bad faith — some have

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261 *Corporations Act* s 435A.

262 For a distinction between common law and equitable origins, see Austin and Ramsay, above n 154, 357.

263 For a distinction between the duty to act in good faith and a duty to act for proper purposes, see Sarah Worthington, ‘Directors’ Duties, Creditors’ Rights and Shareholder Intervention’ (1991) 18 Melbourne University Law Review 121, 123–4.


265 Jackson, above n 12, 196.
taken an objective approach, some subjective, and some both. Some scrutinise the objective circumstances to determine the debtor’s need to reorganise and the feasibility of reorganisation. Others find subjective intentions or motives of bad faith sufficient to dismiss a bankruptcy petition. Jackson argues that a good faith enquiry is fact-specific and costly. The uncertainty of ad hoc outcomes creates costs.

Although there is no case on point, Australian courts have more guidance. The voluntary administration good faith test taps into familiar principles regarding the directors’ exercise of power for proper purpose. The test is narrower in focus than the Chapter 11 good faith test. The factual enquiry ‘is not about the effect of the exercise of the power; it is about the directors’ purpose in using the power.’ The directors’ actions are invalid if their subjective motives or intentions are found to be substantial purposes that the law considers impermissible.

The voluntary administration good faith test empowers the courts to examine a wide range of factors: the character and operation of an exercise of power to appoint an administrator, and the facts and circumstances surrounding such an exercise. Courts will presumably balance the directors’ value maximising purpose against their ulterior motive when determining whether the latter is a substantial purpose or a ‘significantly contributing cause’. While there may be more principles that guide Australian courts than American bankruptcy courts, the result is no more predictable.

The voluntary administration good faith test is still in its infancy. Its scope of enquiry is wider than the insolvency test. Implicit in the judicial statements suggesting the presence of such a test is that the courts have found the insolvency test inadequate to filter impermissible abuses of voluntary administration. However, there is a danger in applying this test: that the courts will be too preoccupied with ascertaining the directors’ purpose rather than assessing the economic value that reorganisation might add to the company. It is doubtful whether the voluntary administration good faith test will prevent the most undisputed abuses of reorganisation that do not maximise the value of the company. The courts’ ad hoc balancing of competing interests at the doorstep

267 See, eg, Re Johns-Manville Corporation, 36 BR 727 (Bankr SD NY, 1984); Re Continental Airlines Corporation, 38 BR 67 (Bankr SD Tex, 1984).
268 See, eg, Carolin Corporation v Miller, 886 F 2d 693, 694 (Phillips J) (4th Cir, 1989) and above n 202 and accompanying text.
269 See, eg, Re Phoenix Piccadilly Ltd, 849 F 2d 1393, 1395 (Roney CJ) (11th Cir, 1988).
270 Jackson, above n 12, 196.
271 Jackson and Scott, above n 21, 198–9.
272 Austin and Ramsay, above n 154, 363.
causes much uncertainty. This uncertainty may deter the debtor and its directors from entering voluntary administration as permissible strategic behaviour.

C A New Value Maximising Test

A better reorganisation entry requirement answers the challenge that the two current voluntary administration threshold tests fail to adequately address. The insolvency test ensures that voluntary administration is used in response to a need to preserve and maximise the debtor’s value. Yet, it lets the most obvious non-value maximising abuses of voluntary administration slip through the door. While the voluntary administration good faith test potentially requires reorganisation to be the more economically efficient outcome, ad hoc judicial balancing of interests does not express this goal clearly.

The following proposal addresses the gaps in the two voluntary administration threshold tests. In addition to the existing legislative requirements, companies would have to pass a new value maximising test to enter voluntary administration. Under the current threshold requirement, to appoint an administrator, the directors must find that the company is insolvent or is likely to become insolvent. This new value maximising test requires the directors to further find that voluntary administration achieves the highest valuation of the company and its business. In other words, the test requires the directors to undertake a valuation of the company as reorganised. In addition to an opinion that the company is insolvent, directors must also hold an opinion that the company will be more valuable in voluntary administration than other possibilities. Modifying the current legislative insolvency requirement in s 436A, this value maximising test might appear as follows:

(1) A company may appoint an administrator if the board has resolved that:
   (a) in the opinion of the directors voting for the resolution:
      (i) the company is insolvent, or is likely to become insolvent, at some future time; and
      (ii) administration will, or is likely to, achieve a higher valuation for the company, its resources or business (including through maximising the chances of the company continuing in existence or, if it is not possible for the company to continue in existence, through resulting in a better return for the company’s creditors and members than would result from an immediate winding-up of the company); and
   (b) an administrator of the company should be appointed.

By compelling an up-front valuation of the business, this value maximising test allows companies to use voluntary administration only if its use is consistent with the underlying value maximising policy of reorganisation, implicit in the legislative objects of voluntary administration in s 435A. As between the primary rehabilitation and the secondary asset maximisation objects in the legislation, this value maximising test further sharpens the focus on the object that creates more economic efficiency in a particular case.
1 The Elements

The new value maximising test is significant for several reasons. First, the value maximising test defines the most obviously impermissible abuse of voluntary administration. If reorganisation does not maximise the value of the business for the benefit of society or the claimants as a group, what is left of voluntary administration is its function of changing and redistributing individual rights. Hence, there is an abuse of voluntary administration. This test fills the void in the bare insolvency test; merely finding insolvency or a need to preserve company value is insufficient.

Second, it encourages strategic behaviour consistent with the underlying policy of voluntary administration. It requires the directors to determine early in the process whether voluntary administration could save the company or extract more economic value from its assets than immediate liquidation. Resources will not be wasted if it is clear that reorganisation would not add value to the company. Early determination of the company’s reorganised value is possible. This test encourages a more efficient use of resources, benefiting the claimants or the wider society. Instead of merely identifying the prevailing problem of insolvency, the test requires the directors to be more forward-looking and make reorganisation the solution.

Third, the test emphasises to directors that the fundamental justification for reorganisation to change and redistribute individual rights is because reorganisation rehabilitates or maximises the economic value of the company. It sends a clear message to the debtor’s directors that voluntary administration is for the benefit of all the claimants and society. It reminds the directors that, wherever their loyalties may lie, the issue of saving a company and preserving the value of its resources is distinct from the question of distribution to individual claimants. It avoids the ambiguity of the voluntary administration good faith test relating to whose interest the directors should consider when appointing an administrator (although further empirical research is required to determine whether a threshold value maximising test causes the debtor and its directors to initiate voluntary administration only when it maximises the company’s value).276

Fourth, the test avoids the ad hoc judicial balancing of interests in the current threshold good faith enquiries. This avoidance is deliberate for several reasons. Examination of the voluntary administration good faith test shows that judicial balancing of interests is extremely uncertain and produces inconsistent distributive outcomes. It obscures the value maximising goal of reorganisation. This value maximising test provides more certainty to a debtor before entering

276 For example, LoPucki and Whitford proposed a determination of the company’s reorganisation value early in a Chapter 11 bankruptcy case to pre-emptively exclude junior claimants from the bargaining process: see Lynn M LoPucki and William C Whitford, ‘Bargaining over Equity’s Share in the Bankruptcy Reorganization of Large, Publicly Held Companies’ (1990) 139 University of Pennsylvania Law Review 125, 186.

277 See above Part IV(B)(1); LoPucki and Whitford, 'Corporate Governance', above n 35, 780–7, 799. There is also a related issue as to whether there should be institutional enforcement of the new threshold requirement, for example by independent judicial scrutiny or peer review panel: see, eg, Spender, ‘Blue Asbestos and Golden Eggs’, above n 22, 250; Joint Committee on Corporations and Financial Services, above n 2, 82–3. Cf Colin Anderson, above n 205, 5, 17; CAMAC Report, above n 7, 18–19, 21, 25.
 voluntary administration and encourages early action. It also gives courts more guidance when applying the threshold requirements. In addition, the emphasis on competing interests distracts everyone from the urgent task of rehabilitating the debtor and preserving its value, and it is unproductive when company resources may be dissipating. Practitioners have recently criticised the use of voluntary administration as a precursor to liquidation, rather than a rescue procedure. At an early stage of the process, the balance should arguably tilt in favour of preserving the company’s ongoing business so that there is a larger pie to share.

Finally, much of the pie-sharing arrangements result from the participants’ negotiations during voluntary administration, as the legislature has consistently avoided prescribing how claimants might share the pie. The ultimate redistribution in each case is often unpredictable. An early balancing exercise prematurely precludes opportunities to rehabilitate or provide a better return for the claimants and other participants based on some anticipated detriment which may not even occur.

The voluntary administration threshold requirement must be seen in the context of the entire voluntary administration system. Voluntary administration has other safeguards to balance competing interests; the threshold requirement need not perform this task. A more fundamental solution may be to change the rules within voluntary administration that cause undesirable effects. Preventing debtors from reorganising because an imperfect system produces undesirable changes of rights is merely “treating the symptom, not the cause”.

Finally, the value maximising test is more objective relative to the purposive voluntary administration good faith test. Mirroring the current threshold insolvency test, this value maximising test focuses on the reasonableness of the directors’ opinion. Directors are most likely to know about the condition of the company. James Routledge contends that “the door to an attempt to rehabilitate should only be open when there are sufficient grounds to anticipate a successful outcome.” This test accepts that it may be difficult to determine at the outset the company’s possible reorganised value. Hence, it does not require an actual valuation but merely that the directors’ opinion is reasonable. As an illustration of how this may work in practice, expert valuation reports could be used to support the directors’ opinion. Further, the price that a third party is willing to pay for the reorganised business, for example by injecting funds to pay out existing creditors and shareholders, could form a basis for the valuation of the reorganised company.

278 Joint Committee on Corporations and Financial Services, above n 2, 81–2.
279 See above Part III(A).
280 See, eg, Corporations Act ss 445D, 447A.
281 Writing in a different context, Daniel J Tyukody Jr argues that the bankruptcy system should maintain parity with non-bankruptcy systems in order to prevent abuses: see Daniel J Tyukody Jr, ‘Good Faith Inquiries under the Bankruptcy Code: Treating the Symptom, Not the Cause’ (1985) 52 University of Chicago Law Review 795.
282 Colin Anderson, above n 205, 16. See above nn 238–9 and accompanying text.
283 Routledge, above n 18, 128.
The new value maximising test refocuses attention on the fundamental value maximising policy of reorganisation not to waste scarce resources. It does what the courts have been trying to do: plug the gap in the insolvency test as a threshold requirement to voluntary administration. Yet, it also provides the clarity and certainty that the voluntary administration good faith test lacks. It is the first step towards ensuring that the claimants and the community as a whole benefit from a higher societal economic wealth. On this solid basis, policymakers can understand the trade-offs and make further and better distributive choices.

V Conclusion

Reorganisation changes the rights of its participants and ensures that the claimants as a group reach a decision on the debtor’s future. Its power shapes the behaviour of its participants. Nevertheless, it is vulnerable to abuse.

The debate on strategic behaviour and abuse of reorganisation follows a logical framework. Definition of strategic behaviour and abuse is possible only when the underlying policy of reorganisation is clear. The fundamental rationale of reorganisation is that changes in individual rights are acceptable because the claimants and the community as a whole benefit from preserving and maximising the economic value of the company and its resources. Hence, the most apparent abuse of reorganisation occurs when a debtor invokes reorganisation solely to change rights but does not seek to maximise the value of the company for the benefit of its claimants or society. Strategic behaviour causes public wariness but escapes the unequivocal branding of ‘abuse’ because of disagreement about competing norms. Balancing conflicting interests is necessary in deciding whether this strategic behaviour remains legally acceptable.

Within this framework, the existing voluntary administration threshold requirements try to differentiate impermissible abuses of reorganisation from permissible strategic behaviour. The principal insolvency test identifies a need to preserve the debtor’s value but does not prevent non-value maximising abuses of voluntary administration. The discovery of Australia’s own voluntary administration good faith test proves that the bare insolvency test is inadequate. However, there will be uncertainty when courts begin to balance competing interests. Both tests obscure the underlying value maximising policy of voluntary administration, underplaying the significance of the fundamental rationale of reorganisation. This article proposes a new threshold test to voluntary administration. This new value maximising test is in addition to the principal insolvency test. It refocuses the enquiry on the underlying policy of voluntary administration. Under this proposal, the value maximising test requires the directors to find that entering voluntary administration would create more value from the company’s resources.

A debate on strategic behaviour and abuse of voluntary administration is misguided if it overlooks the fundamental rehabilitation and asset maximising rationales of reorganisation. Only by understanding these rationales can society properly evaluate the changes in individual rights and decide whether the price that individuals pay for the greater good is justified. Furthermore, identifying
this value maximising rationale of reorganisation is merely the first step. The next step is to balance this goal against other norms that society wants to protect and make the necessary trade-offs. Moving beyond the threshold requirement, policymakers need to ensure a desirable balance within the voluntary administration system. The theoretical framework makes this task clear.

Wrangling on the doorsteps to reorganisation does not achieve anything. It is only by looking behind the door that the wide-reaching outcomes of reorganisation become clear. Reorganisation redefines the debtor’s relationship with the participants of reorganisation. It determines who stays and who goes. The door to reorganisation is both an entrance and an exit.