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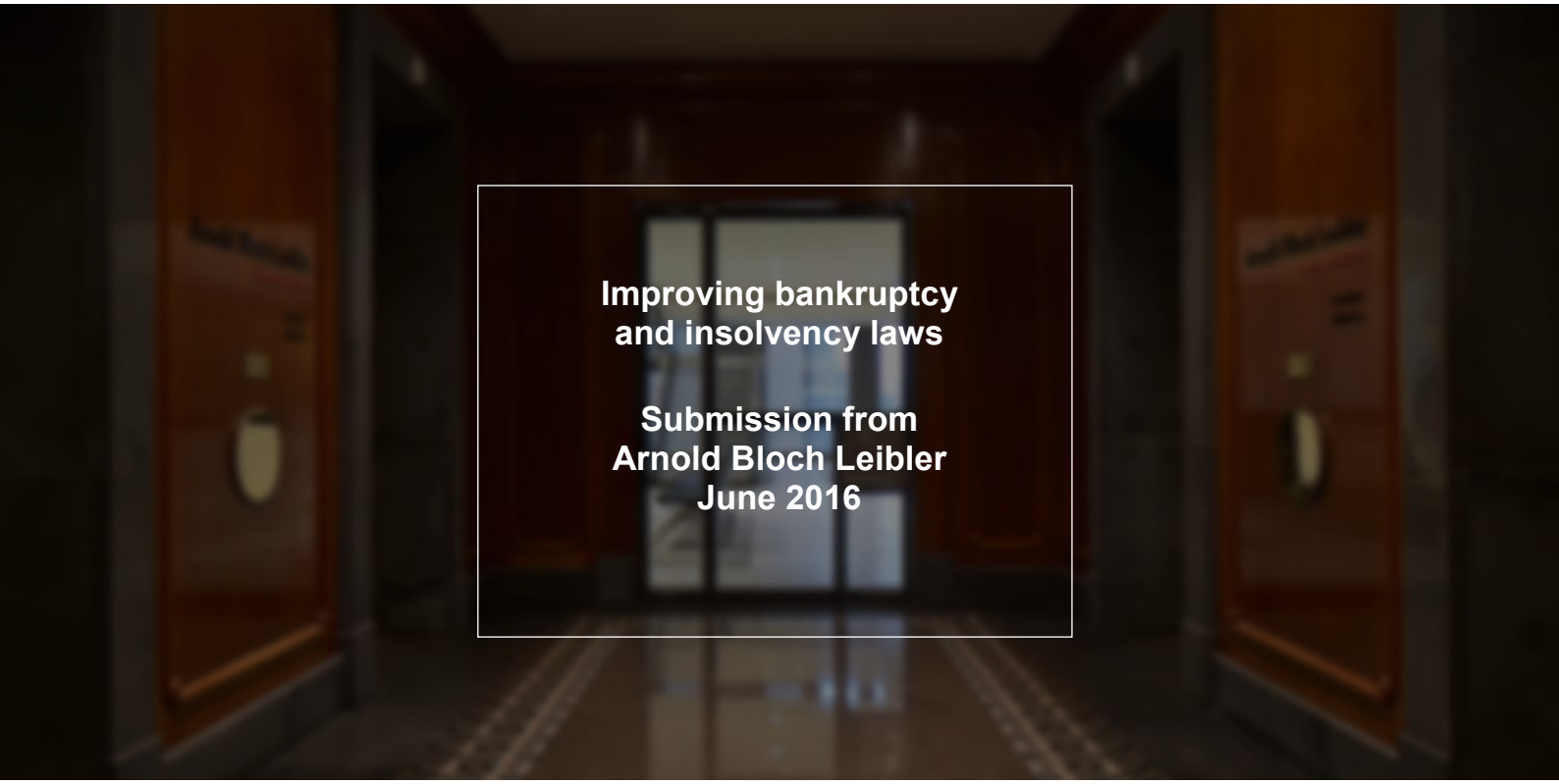

Improving bankruptcy and insolvency laws

Submission from
Arnold Bloch Leibler
June 2016

1 Introduction

1.1 This submission has been prepared by Arnold Bloch Leibler in response to the Australian Government's request for feedback on its proposals paper entitled 'Improving bankruptcy and insolvency laws' (**Proposals Paper**).

1.2 Our response addresses the following two of the measures highlighted in the Proposals Paper:

(a) the introduction of a 'safe harbour' for directors from personal liability for insolvent trading if they appoint a restructuring adviser to develop a turnaround plan for the company; and

(b) making 'ipso facto' clauses unenforceable if a company is undertaking a restructure.

1.3 As a general observation we welcome the proposed reforms as a significant improvement to the current insolvency and restructuring legislative framework. ABL has advocated for these reforms for some time, including through our submissions to the Productivity Commission regarding the 'Business Set-up, Transfer and Closure' inquiry and draft report. Those submissions are attached as an annexure to this submission.

1.4 This submission is also borne out of our experience in larger corporate solvent and insolvent reconstructions over the last 20 years including Brashs 1994+, Ansett 2001+, Newmont Yandal 2003+, Alinta 2010-2011, Centro 2007+, Timbercorp 2010+, Gunns 2012 +, Nine Entertainment 2012-2013, One.Tel 2014 and Arrium current, as well as others not in the public domain.

2 The Safe Harbour Defence - Model A

2.1 The Safe Harbour Model A proposed provides a defence to an alleged breach of the insolvent trading prohibition under section 588G of the *Corporations Act 2001* (Cth) (**Corporations Act**) if:

> *a reasonable director would have an expectation, based on advice provided by an appropriately experienced, qualified and informed restructuring adviser, that the company can be returned to solvency within a reasonable period of time, and the director is taking reasonable steps to ensure it does so.*
>
> *The defence would apply where the company appoints a restructuring adviser who:*
>
> *a) is provided with appropriate books and records within a reasonable period of their appointment to enable them to form a view as to the viability of the business; and*
>
> *b) is and remains of the opinion that the company can avoid insolvent liquidation and is likely to be able to be returned to solvency within a reasonable period of time.*

Query 2.2 ***Does this proposal provide an appropriate safe harbour for directors?***

2.2 We support the implementation of a safe harbour defence broadly in the form of Model A. However, we think the defence will be more effective if further refined.

2.3 In our submission, we think the proposed defence should be amended to:

(a) include a purposive element, such that it only applies where a director is acting:

(i) is acting in good faith;

(ii) is acting for the purpose of achieving a:

(A) a better return to creditors than they could achieve in a liquidation;

(B) restructure of the company; or

(C) informal workout with the company's creditors;

(iii) has considered the interests of the company's creditors as a whole;

(b) apply immediately on appointment of the restructuring adviser (rather than on receipt of advice from the restructuring adviser);

(c) require restructuring advisers to provide a written report on the company's viability and a recommendation as to whether it would be in the interests of the company to pursue a strategy which results in a better return for creditors than a liquidation (whether that be a formal restructure or informal workout with creditors) or proceed into a formal insolvency procedure;

(d) only continue to apply where, after giving their initial report and recommendation, the restructuring adviser remains informed of the steps being taken by the company to return it to solvency (where the adviser has recommended a restructuring strategy);

(e) cease to operate in circumstances where the restructuring adviser has informed the company that s/he is no longer of the opinion the company can be returned to solvency within a reasonable period of time (the adviser must also be obligated to inform the company of any such change of opinion); and

(f) the restructuring adviser should be independent from the company and unrelated to its directors.

2.4 **The safe harbour defence should include a purposive element:** In order to avoid the possibility of directors appointing a restructuring adviser in order to obtain protection, without having any real intention of pursuing a restructure, the defence should only operate where a director is acting is acting in good faith;

(i) is acting for the purpose of achieving a:

(A) a better return to creditors than they could achieve in a liquidation;

(B) restructure of the company; or

(C) informal workout with the company's creditors;

(ii) has considered the interests of the company's creditors as a whole;

2.5 **The safe harbour defence should apply immediately on appointment of a restructuring adviser:** As currently drafted, the defence only applies once the restructuring adviser has provided advice to the effect that the company can be returned to solvency within a reasonable period of time. There is no protection for directors in the period between appointment of a restructuring adviser and the provision of their advice. Any exposure to directors is likely to undermine the purpose of the defence, which is to encourage directors to pursue informal workouts before invoking formal appointments. In complex situations, such as large distressed corporate groups, the provision of advice and a recommendation to the company may take some time. If the defence only applies on receipt of advice, restructuring advisers are likely to be pressured to provide advice more quickly than would otherwise be desirable in order to develop a successful turnaround strategy.

2.6 **Requirement for restructuring advisers to provide a preliminary written report and opinion within 28 days:** The current draft is unclear as to what constitutes advice from a restructuring adviser and what form that advice needs to take. In order to avoid uncertainty and to maximise the likelihood of the appointment of the restructuring adviser should be required to prepare a preliminary written report setting out an opinion as to:

(a) the company's viability and financial circumstances; and

(b) whether it would be in the interests of the company to pursue a strategy which would result in a better outcome to creditors than what they would receive in a formal liquidation (whether that be in the form of a formal restructure of informal workout with creditors) or proceed into a formal insolvency procedure.

If the report recommends a restructuring strategy be pursued, the proposed strategy should be articulated within the report. Strict compliance with the strategy articulated by a restructuring adviser should not be a pre-requisite to the operation of the safe harbour defence.

2.7 **The safe harbour defence should only apply where restructuring advisers remain informed of the steps being taken by the company to return it to solvency:** By incorporating the need for an opinion from a qualified, independent restructuring adviser, the defence balances the interests of creditors with the need to better facilitate corporate rehabilitation. However, in order for that objective to be achieved, it is necessary for that opinion to remain current and informed throughout the process. This is particularly the case where directors are taking reasonable steps to return the company to solvency, but ultimately adopt a different or amended strategy to that recommended by the restructuring adviser.

2.8 **The safe harbour defence should cease to apply where the restructuring adviser is no longer of the opinion that the company is capable of returning to solvency within a reasonable period:** The restructuring adviser's opinion as to viability is a critical element of the safe harbour defence and an functions as a protection of the interests of creditors. Where that opinion is no longer held, the defence should cease to apply. It follows that restructuring advisers should have an obligation to advise the company, and its directors, if their opinion as to the company's viability changes. This information should be conveyed to the company, and its directors, within a reasonable time.

2.9 **The restructuring adviser should be independent:** Restructuring advisers should be independent from the company. That is, they ought not to have been a director or employee of the company within the last five years and should not be related to any of its directors.

Query 2.2.1a ***What qualifications and experience should directors take into account when appointing a restructuring adviser and should those factors be set out in regulatory guidelines or in regulations?***

2.10 In our submission, restructuring advisers should be accredited by an independent body. However, accreditation alone is not sufficient. Directors should still be required to consider whether the particular adviser has the expertise required to deal with their particular company.

Query 2.2.1b ***Which organisations, if any, should be approved to provide accreditation to restructuring advisers if such approval is incorporated in the measure?***

2.11 Accreditation should be managed by an independent statutory body [such as the Australian Securities and Investment Commission]. In our submission, the role of industry bodies should remain focused on education rather than formal accreditation of its members.

2.12 Restructuring advisers should be required to have the similar minimum qualifications as those required for liquidators under section 1282 of the Act, as well as a minimum experience requirement. Whilst we accept that restructuring requires a skill set different to that required for conducting pure liquidations, restructuring advisers should still have

the relevant accounting and commercial law skills and understanding of the 'Plan B' options.

Query 2.2.1c ***Is the proposed test for determining whether a company is 'viable' appropriate?***

2.13 The test requiring companies to be capable of returning to solvency within a 'reasonable time' is generally appropriate. What is reasonable will be informed by the particular company's circumstances and whether the restructuring adviser continues to hold the opinion that the company is capable of returning to solvency.

2.14 The purpose of the defence is to give directors the protection required to encourage attempts at restructuring so as to avoid the loss of going concern value which inevitably occurs when formal insolvency procedures are invoked.

Query 2.2.1d ***What factors should the restructuring adviser take into account in determining viability and should those factors be set out in regulations or left to the discretion of the adviser?***

2.15 The factors which ought properly be considered in determining viability are vast and will vary in every instance. Relevant factors include current and forecast cash flows, business value, market conditions, legal and commercial risks, attitude of financiers and other contractual counter-parties, need for further capital injections, the capability of existing management and their attitude towards proposed change and the legal and commercial structure of the business.

2.16 In our submission, the relevant factors to be considered in a particular instance ought to be left to the discretion of the adviser.

Query 2.2.1e ***Are the proposed protections for restructuring advisers appropriate and what other protections and obligations should the law provide for?***

2.17 The proposed protections for restructuring advisers are adequate.

2.18 In our submission, any obligation on restructuring advisers to report misconduct to ASIC should be limited to serious misconduct, rather than any breach of the Corporations Act. It should also be made clear that this obligation does not give rise to a positive duty on restructuring advisers to conduct an investigation into the company's historical affairs. The role of a restructuring adviser should be primarily focused on the company's current position and future opportunities.

2.19 As noted above, restructuring advisers should have a positive obligation to advise the company, and its directors, if their opinion as to the viability of the company changes.

Query 2.2.2a ***Comments on proposed approach regarding scope of safe harbour***

2.20 We agree the safe harbour should not prevent a director from being personally liable for outstanding employee entitlements in a subsequent winding up and that it should be disregarded for the purpose of calculating the relevant periods for voidable transactions.

Query 2.2.2b ***Is the proposed approach to disclosure appropriate?***

2.21 We agree that confidentiality can be critical to a successful restructure and that there should be no obligation to formally advise ASIC or any other regulatory body of the appointment of a restructuring adviser to a company.

2.22 In our opinion, it is appropriate to include a specific carve-out for disclosure of the appointment of a restructuring adviser for company's subject to continuous disclosure obligations. Absent a formal carve-out, it is difficult to see how directors of listed,

reporting entities could ever comfortably conclude that the appointment of a restructuring adviser to the company would not have a material impact on its share price. The carve-out should be limited to the appointment. Any circumstances which have given rise to the need to appoint a restructuring adviser should remain subject to disclosure obligations so that the market remains informed of the position of the company.

Query 2.2.3 ***In what other circumstances should the safe harbour defence not be available?***

2.23 The proposal to disallow reliance on the defence in circumstances where a director has previously breached their directors' duties and the breach resulted in creditors suffering loss due to the company having insufficient property to meet their claims should be limited to breaches of directors' duties which involve an element of dishonesty such that they fall within section 184 of the Corporations Act.

2.24 Directors who have breached directors' duties would already be liable to compensate the company for any loss suffered as a result (assuming those breaches are prosecuted) and provided they are acting for the purpose of rehabilitating the company they should be able to rely on the safe harbour defence. This recognises that the existence of the defence benefits creditors as well as directors, as a successful informal restructure will generally result in a better outcome for creditors than a formal appointment.

3 The Safe Harbour Defence - Model B

General feedback on the merits and drawbacks of this model

3.1 In our submission, whilst this model goes some way to addressing the issues arising under the current insolvent trading regime, it does not do enough to sufficiently protect directors and has the potential to overly complicate the operation of section 588G.

3.2 The key benefit of Model B is that it purports to operate as a carve out of section 588G, rather than a defence which necessarily shifts the burden of proof to the director. Accordingly, in practice, we understand the proposal to mean that it in addition to the current requirements under section 588G, a liquidator or ASIC would now also be required to prove one of the following three factors:

(a) that the debt was incurred other than as part of reasonable steps to maintain or return the company to solvency within a reasonable period of time; or

(b) the director did not hold an honest and reasonable belief that incurring the debt was in the best interests of the company; or

(c) the debt materially increased the risk of serious loss to creditors.

3.3 In our submission, this provision will be very difficult to apply as a matter of practicality for the following reasons:

(a) directors are unlikely to hold subjective opinions in relation to each and every single debt incurred by a company; and

(b) the first two limbs effectively require a liquidator to prove a negative.

3.4 Further, the general comments in the proposal to the effect that:

(a) the formal appointment of an appropriately qualified and experienced restructuring adviser; and

(b) early engagement with shareholders, creditors and other shareholders,

are factors which would considered by a court in determining whether the debt was incurred as part of reasonable steps to maintain or return the company to solvency within

a reasonable time, suggest that these provisions will, as a practical reality, result in an evidentiary burden being placed on the director.

3.5 A retrospective review of the steps taken by a company to maintain or return it to solvency will always be undertaken with the benefit of hindsight and with knowledge of all the reasons as to why the steps to maintain or return the company to solvency within a reasonable period were ultimately unsuccessful. Accordingly, we think the ability to rely on advice from an external restructuring adviser as contemplated in Model A constitutes better protection for directors.

4 Ipso Facto Clauses

The Government proposes that any term of a contract or agreement which terminates or amends any contract or agreement (or any term of a contract or agreement), by reason only that an 'insolvency event' has occurred would be void.

Any provision in an agreement that has the effect of providing for, or permitting, anything that in substance is contrary to the above provision would be of no force or effect.

General comments

4.1 The Productivity Commission Report recommended that the Corporations Act be amended to render clauses which enable termination of contracts solely due to an insolvency event unenforceable if the company is in voluntary administration or in the process of proposing a scheme of arrangement.

4.2 The Proposal Paper provides that an 'insolvency event' would include:

(a) an administrator having been appointed in respect of the company;

(b) the company undertaking a scheme of arrangement for the purpose of avoiding administration or insolvent liquidation;

(c) a receiver or controller being appointed;

(d) the company entering into a deed of company arrangement.

4.3 Given that the legislation will not operate in the context of liquidations, we think it would be sensible to change the reference to 'insolvency event' to 'restructuring event' in order to avoid confusion.

4.4 In our submission, there is no basis for private appointments of receivers or controllers to be granted the same protection as circumstances where a company is taking steps to effect a restructure.

4.5 The concept of contractual terms which purport to '**amend** any contract or agreement' is somewhat nebulous. It is unclear whether this prevents the operation of existing contractual terms being operative on an insolvency event. For example, it is unclear whether clauses enabling a party to require cash on delivery for the supply of goods or which impose higher prices in the event its counterparty commences a restructuring process are intended to be caught by the current drafting.

4.6 In our view, any contractual terms which purport to significantly alter any key commercial terms of the agreement on the basis of a 'restructuring event' should also be unenforceable.

Are there specific instances where the operation of ipso facto clauses should be void?

4.7 Ipso facto clauses should only be deemed unenforceable to the extent they purport to operate on the occurrence of a 'restructuring event'.

4.8 The legislation should not result in the relevant contractual provision, or part thereof, being void ab initio, as this would render them incapable of operation in the event of a subsequent liquidation.

Should any legislation introduced have retrospective operation?

4.9 We do not support retrospective operation of any legislation impacting the enforceability of ipso facto clauses. Many commercial parties will have negotiated the terms of their relationships on the basis that they are able to mitigate their counter-party risk through the operation of ipso facto clauses. The government should be extremely cautious in interfering with subsisting commercial relationships given that commercial certainty is closely aligned with consumer confidence, market efficiencies and economic development.

Are there other circumstances to which a moratorium on ipso facto clauses should be extended?

4.10 The definition of 'restructuring event' should be expanded to include the appointment of a restructuring adviser.

Is the proposed anti-avoidance mechanism adequate?

4.11 The proposed 'in substance' test is an appropriate anti-avoidance mechanism.

What contracts or classes of contracts should be specifically excluded from the operation of the provision?

4.12 We agree that certain class of financial contracts such as close-out netting contracts, swaps and derivatives need to be excluded from the operation of the ipso facto prohibition.

4.13 In our submission, ipso facto clauses in finance agreements which would otherwise require the provision of funding (new or existing) during the restructuring period should not be enforceable where the only 'restructuring event' is the appointment of a restructuring adviser, as this would discourage the appointment of restructuring advisers and undermine the attempt to encourage informal and early restructurings and workouts. However, they should otherwise be enforceable where the company goes into administration or propose a scheme of arrangement.

4.14 Lenders' ability to terminate facility agreements where the borrower is facing financial difficulty is a fundamental means by which lenders manage their risk. Any change to enforcement rights would drastically impact the utility of security and would result in potentially huge uplifts in lending costs, which are generally priced based on the underlying risks associated with the loan.

Is the hardship appeal safeguard necessary and appropriate and, if not, what mechanism, if any, would be appropriate?

4.15 We think it is appropriate to include a mechanism for counterparties to obtain relief where they can establish hardship.

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