AUSTRALIAN BANKERS' ASSOCIATION INC.
Strong banks – strong Australia

Level 3, 56 Pitt Street
Sydney NSW 2000
Australia
+61 2 8298 0417
@austbankers
bankers.asn.au

07 June 2016

Mr James Mason
Manager
Corporations and Schemes Unit
Financial Systems Division
The Treasury
Langton Crescent
Parkes ACT 2600
Email to: insolvency@treasury.gov.au

Dear Mr Mason,

National Innovation and Science Agenda – improving bankruptcy and insolvency laws

The Australian Bankers' Association (ABA) is the peak national body representing banks which are authorised by the Australian Prudential Regulation Authority (APRA) to carry on banking business in Australia and to use the word "bank".

Membership of the ABA comprises 25 banks. Members include the four major banks, former regional banks which now operate nationally, foreign owned banks which operate as Australian banks and two mutual banks.[1]

1. Summary of key recommendations

The following key recommendations are outlined in more detail in this submission:

- Instead of a general reduction in the default bankruptcy period from three years to one year, consider:
  - An early release mechanism for business-related bankrupts under certain circumstances; or
  - Confine the reduction to one year to first time, business-related bankruptcies, involving debts below a sensible amount. The trustee would have a right to extend the bankruptcy period where reasonable.
- There should be no reduction in the retention period for personal insolvency information in credit reports.
- In respect of a safe harbour defence, the ABA supports Model B in preference to Model A, as long as the onus of proving elements of the defence rests with the directors.
- The ABA requests Treasury convenes a representative working group of interested parties, including banks, to examine both Models A and B in more detail.
- There should be a specific prohibition on the disclosure of the appointment of a restructuring adviser under continuous disclosure rules, to improve the prospects of the company avoiding insolvent liquidation.

[1] ABA members see http://www.bankers.asn.au/About-Us/Members

- The ABA supports the development of guidelines as to qualifications and experience directors should take into account when appointing a restructuring adviser, but not specific rules.
- Due to a high likelihood of unforseen implications for business and markets, the broad proposed reach of the ipso facto changes compared to other jurisdictions, and the uncertainty that would be created by them in their current form, the ABA requests Treasury also consult with a representative working group of key interested parties including banks on these changes.
- There are a range of agreements, the scope of which requires further consideration and consultation, that should be excluded from the proposed changes to ipso facto clauses, given the potential detrimental impact on such arrangements may outweigh the benefits of the changes.
- The ABA is opposed to the proposal that a prohibition on ipso facto clauses should be extended to variations of the terms of a contract and to the exercising of existing rights under a contract to accelerate payments or to require further security for a credit facility, given this substantially increases the risk for counterparties.
- The ABA supports the right for a counterparty to apply to a Court if it is not entitled to terminate or amend a contract after an insolvency event has occurred and will suffer hardship or other detriment.
- The release of an Issues Paper following the current consultation may be helpful in exploring some of the issues raised by industry in this and other submissions.

Additional, more detailed recommendations are provided below.

2. Introductory remarks

2.1 The banking industry

The banking industry makes a significant contribution to facilitating business investment and activity, and promoting Australia's economic growth and prosperity. Australia's banks provide a range of financial services to businesses, both large and small.

Banks are required to make prudentially responsible lending decisions. The occurrence of non-performance with loan repayments is low, given the substantial number of business loans in Australia.

Banks make substantial efforts to work with business and agribusiness customers when they experience financial difficulties to restore the loan to a satisfactory position.

For these reasons the ABA is supportive of the government's efforts to ensure that the regulatory environment complements and contributes to banks' efforts to rehabilitate a failing business where this is feasible and consistent with interests of the business' creditors.

2.2 Policy discussion

We understand that the policy consideration underpinning the proposals is to encourage innovation and entrepreneurship for the Australian economy to transition to a 'new economy'. Banks, better than most, understand the importance of this transition and the need to encourage growth in innovative industries and the digital economy; however, they are also cautious about the way the transition is managed. At a policy level, the ABA is concerned that some of the proposed reforms do not strike the right balance between fostering innovation and protecting creditors. The risk of not getting the balance right is that the effects of insolvency must be borne more broadly across the economy, making the costs of doing business more expensive for everyone.

The ABA believes that development of an entrepreneurial culture would be better focused on constructive measures for avoiding bankruptcy such as better preparation and training for business proprietors, especially new start-ups. Banks have played a role in the preventative aspects of bankruptcy through working out financial difficulties with their financially troubled small business customers and their guarantors, including under the Code of Banking Practice's pre-contractual disclosures for guarantors.

3. Reducing the default bankruptcy period

The ABA has reservations concerning the government's proposal to reduce the default period of bankruptcy from three years to one year. It is acknowledged that certain obligations of a bankrupt would continue beyond the one year bankruptcy period, such as income contributions and providing assistance to the bankrupt's trustee.

We understand the government's intent behind this reform is to remove a potential barrier to innovation and business start-ups so as to encourage entrepreneurial behaviour and reduce the stigma associated with bankruptcy. The Proposals Paper suggests this outcome is related to those bankrupts who had been engaged in entrepreneurial activity prior to their bankruptcy. But the Proposals Paper does not suggest that the one year period only applies for such bankruptcies.

The ABA believes that a reduction in the default period of bankruptcy to one year for all bankruptcies would be a disproportionate measure for the government to achieve its objective. This is due to the relatively few business related bankruptcies compared with non-business related bankruptcies (e.g. where 'personal lifestyle choices' of individuals have led to their bankruptcy). A discussion of personal insolvency statistics supporting this finding is provided below.

Reducing the default period may see an increase in personal bankruptcies generally, not just for business-related reasons. We understand the number of personal bankruptcies in the U.K. and New Zealand have significantly increased since their periods of bankruptcy were reduced in recent years.

In addition, the ABA believes there is a risk in a 'one size fits all' approach, even for business related bankruptcies. In this regard, there are instances where:

a) The quantum of debt owed by the bankrupt is very significant. We query if it is appropriate, in a policy sense (even if it is a relatively rare scenario), for a person who has become bankrupt owing creditors, say, $100,000,000 (and/or where there is evidence of potential fraud) to be able to be 'back in business' after only one year of becoming bankrupt.

b) The bankrupt is using the mechanism of bankruptcy on multiple occasions to avoid payment to creditors. The risk of this occurring increases where the period of bankruptcy is only one year.

3.1 Personal insolvency statistics

Personal insolvency statistics for the period 2013-2014 provided by the Australian Financial Security Authority (AFSA) show that 19% of debtors (or 5,857 debtors) entered personal insolvency because of business related reasons.

In 2013-14, the most common causes of debtors entering business related personal insolvencies were:

- Economic conditions (2,378 debtors)
- Other business reasons (1,347 debtors)
- Personal reasons including ill health (446 debtors), and
- Lack of capital (398 debtors).[2]

[2] https://www.afsa.gov.au/resources/statistics/socio-economic-statistics/causes-1/causes-business-related

As these statistics show, most personal insolvencies are not business related. In the period 2013-2014 *non-business* related personal insolvencies were 24,438 compared with 5,857 *business* related personal insolvencies. Of these, 14,595 were personal insolvencies and 4,759 were bankruptcies.

The most common occupations of debtors who entered a business related personal insolvency in 2013–14 were:

- ***Construction trades workers:*** 669 debtors with economic conditions the most common cause of insolvency.
- ***Road and rail drivers:*** 353 debtors with economic conditions the most common cause of insolvency.
- ***Hospitality, retail and services managers***: 289 debtors with economic conditions the most common cause of insolvency.
- ***Other technicians and trades workers:*** 282 debtors with economic conditions are the most common cause of insolvency. These occupations include: hairdressers, printing trades workers, textile, clothing and footwear and wood trades workers.

It is noteworthy that of a total of 5,857 business related personal insolvencies in 2013-2014, just 17% were administered under debt agreements under Part IX and a further 2% under personal insolvency agreements under Part X.

More recent AFSA bankruptcy statistics for the March 2016 quarter show there were only 964 business related bankruptcies compared with non-business related bankruptcies (3,277) in this period.[3]

3.2 Other issues

There is also a significant risk with a one year bankruptcy period, particularly for business related bankruptcies, because a trustee may not have sufficient time to investigate the circumstances of the debtor. In the administration of a business related bankruptcy or where there is added complexity or lack of a bankrupt's cooperation, one year is unlikely to be sufficient time for a competent trustee to conduct the necessary work.

This would include identifying any antecedent transactions or restructuring of the debtor's assets to determine whether any uncommercial or other questionable dealings had taken place by the debtor to avoid or lessen the consequences of the bankruptcy for the debtor.

These investigations are an important protection for the business community if the debtor is to be released prematurely from bankruptcy to resume a business career which could expose future creditors of the debtor to risk of loss. For example, AFSA's statistics show that prior to bankruptcy a debtor may have engaged in excessive drawings on the business and failed to account for taxation, failed to keep proper books of account, engaged in gambling or speculation, displayed a lack of business ability including a failure to assess the potential of the business, had a lack of initial working capital to support the business (in 2013–2014, a total of 1,458 bankruptcies) and for other business reasons (a further 1,347 bankruptcies).

Further, as noted above, the ABA understands that the experience in the U.K. and New Zealand after the bankruptcy period was reduced from three years to one year saw an exponential increase in bankruptcies that later fuelled increases in other personal insolvency arrangements other than bankruptcy.

If this experience were to be repeated in Australia this would, among other things, also present a substantial increase in the number of bankruptcies to be overseen by AFSA with consequential resourcing and costs implications.

[3] https://www.afsa.gov.au/resources/statistics/provisional-business-and-non-business-personal-insolvency-statistics/quarterly-statistics/quarterly-statistics

3.3 Alternative options

The ABA suggests two alternative options that could achieve the government's objective in preference to a general reduction in the bankruptcy period from three years to one year:

1) For the law to provide an early release mechanism for those business related bankrupts who have clearly demonstrated sound business acumen and responsibility and who have been unsuccessful in their business ventures due to circumstances beyond their control, for example due to adverse economic conditions, illness or family disruption or who just were unsuccessful in their entrepreneurial business ventures conducted in good faith; or

2) Confine the one year period of bankruptcy to first time business related bankruptcies involving total debts below a sensible dollar amount, coupled with the right for the trustee to extend the bankruptcy period for additional periods of up to eight years where the trustee reasonably considers it appropriate to do so. This could be due to the complexity of the bankrupt's affairs, lack of cooperation by the bankrupt or where the trustee's investigations indicate the bankrupt has engaged in fraudulent activity or is utilising the mechanism of bankruptcy to defraud or avoid payment to creditors. A right for the bankrupt to seek to contest the extension in the Court could be included as part of such a package, provided there is an indemnity from whatever source for the trustee's costs of responding to that application.

Proposal 1.1

The Government proposes to retain the trustee's ability to object to discharge and to extend the period of bankruptcy to up to eight years.

Query 1.1

The Government seeks views from the public on whether the criteria for lodging an objection and the standard of evidence to support an objection should be changed to facilitate a trustee's ability to object to discharge.

ABA Response:

Proposal 1.1 is supported, but only if one of the alternative options above is adopted. The trustee in bankruptcy should be able to extend the period of bankruptcy where the trustee reasonably considers it appropriate for the reasons we have outlined above or for other reasons. The onus would rest on the bankrupt to establish that the trustee's objection was unreasonable.

Additional grounds of objection to the bankrupt's discharge should also be included in s149D if the bankrupt was a director or officer of an insolvent company or was involved in the management of two or more insolvent companies or had breached the duties of a director or officer under the Corporations Act or taxation legislation.

Further, if as proposed, the default period of bankruptcy is to be reduced to one year there will be a resulting reduction in time available to the trustee to inquire into the affairs of the bankrupt; that is two thirds less than the time currently available to the trustee. A correlative increase should be applied to the standard of proof required of the bankrupt to satisfy the Inspector-General that the bankrupt's objection to the trustee's notice of objection to discharge under s.49N (1) should be upheld. The proof should be of a sufficiently high standard leaving no reasonable doubt that the bankrupt ought to be discharged.

Proposal 1.2.1

The Government proposes to change the Bankruptcy Act to ensure the obligations on a bankrupt to assist in the administration of their bankruptcy remain even after they have been discharged to allow for the proper administration of bankruptcy.

Query 1.2.1a

The Government seeks views from the public on which particular obligations on a bankrupt should continue even after a bankrupt is discharged.

ABA Response:

The ABA agrees with the principle of Proposal 1.2.1. Any new obligations that should continue after discharge intertwine with the question of the circumstances in which the trustee can have the bankruptcy extended as discussed above. To the extent that framework applies and the trustee does not see a need to extend the bankruptcy, the existing scope of the Bankruptcy Act focused on assisting in the realisation and distribution of vested property is probably sufficient.

If, on the other hand, it is intended make it more difficult for the bankruptcy period to be extended (e.g. requiring the trustee to apply to the Court to do so) then a natural consequence is a need for greater powers to ensure that, for example, the bankrupt is obliged to continue to cooperate fulsomely in respect of matters relating to their bankrupt estate even though the bankruptcy period has ended.

Query 1.2.1b

The Government seeks views from the public on what incentives and mechanisms should be in place to ensure compliance with obligations after discharge.

ABA Response:

The ABA suggests incentives and mechanisms on a scale of conduct.

The Act should provide for non- compliance with these continuing obligations to be an offence as if the failure to comply had occurred during the bankruptcy period.

Further, if under the current regime non-compliance with these obligations would result in an extension to the bankruptcy, and under the new regime, non-compliance after the one year bankruptcy period but within the income contribution period, this should result in a comparable extension of the income contribution period for up to eight years.

In addition, a bankrupt who is automatically discharged after one year and does not comply with their post-bankruptcy obligations should be ineligible to act as a director or be engaged in the management or effective control of a company.

Proposal 1.3.1a

The Government proposes to reduce credit restrictions under the Bankruptcy Act to one year, subject to any extension for misconduct.

ABA Response:

The ABA supports this proposal, but misconduct should be extended to misconduct by the bankrupt occurring after the commencement of the bankruptcy involving a credit facility, for example under s.154(1) of the National Credit Code (making a false or misleading representation in relation to a matter that is material to entry into a credit contract or a related transaction).

Proposal 1.3.1b

The Government proposes to retain the permanent record of bankruptcy in the National Personal Insolvency Index.

Query 1.3.1b

The Government seeks views from the public on whether it is appropriate to reduce the retention period for personal insolvency information in credit reports.

ABA Response:

It would not be appropriate to reduce the retention period for personal insolvency information in credit reports. In the ABA's view, there is no logical correlation between the period of an individual's bankruptcy and the need for retention of this information on a credit file. It is the fact of the bankruptcy and not the period of bankruptcy that is most important to a potential credit provider. There is no policy reason for the credit provider to be less informed.

Further, this would mean that credit providers may be required to run separate National Personal Insolvency Index searches on every credit application rather than access this information from a credit bureau's credit report.

4. Safe harbour - insolvent trading

The ABA is generally supportive of the government's objective to reduce the incidence of directors appointing a voluntary administrator to their business. This could be due to a concern that the company may continue to trade whilst insolvent (or may become insolvent by continuing to trade) in circumstances where the directors believe, in good faith and on rational grounds, that the ultimate outcome for creditors would be beneficial if the business continued to trade. The current position under the law is considered to be a disincentive for directors continuing to trade with a potentially viable business but which may become insolvent by continuing to trade.

The Proposals Paper is innovative in putting forward two possible models each having its own potential benefits, however the ABA considers that there are key compliance elements which should be considered in any safe harbour defence:

- A safe harbour should be a defence for directors to a claim of insolvent trading; not a regime in itself.

- A safe harbour defence to insolvent trading should not constitute or operate simply because the directors' have appointed a restructuring adviser (RA). First, any RA must be suitable; this does not necessarily mean that a RA must be an insolvency practitioner but the directors must be held accountable if the person is unsuitable for the task at hand (and the RA should not accept instructions to act in the first place unless they have appropriate expertise).

  Secondly, any solution must require the directors and the RA to act in good faith and in a timely fashion and ensure that if, at any time (and after continuing consideration), a view is formed that is not in the interests of the general body of creditors to continue to operate the company, then an administrator should be appointed immediately.

- The execution of the defence must be conducted in confidence to ensure its prospects of success are not detrimentally affected by disclosure to creditors, the market or the regulator.

4.1 Safe harbour Model A

Proposal 2.2

It would be a defence to s588G if, at the time when the debt was incurred, a reasonable director would have an expectation, based on advice provided by an appropriately experienced, qualified and informed RA, 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 directors appoint a RA 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. The RA adviser would be accountable to the directors to exercise their powers and discharge their duties in good faith in the best interests of the company and to inform ASIC of any misconduct they identify. The directors would be accountable for the overall outcome.

Query 2.2

Subject to the further information on the proposal set out in the sections below, the Government seeks views from the public on whether this proposal provides an appropriate safe harbour for directors.

ABA Response:

The ABA's core concern with this proposal is the limited requirements imposed on the directors to be independently satisfied as to the ongoing viability of the insolvent entity once they have appointed a RA.

Further concerns are:

a) The lack of any suggestion that the process must be completed within any particular timeframe or with any degree of urgency recognising that during this period creditors may be providing goods and services to the company, unaware of the appointment of a RA, and potentially suffer loss;

b) the need for further clarity on the specific consequences for the directors if they appoint an inadequate RA, even if they do so in good faith; and

c) the risks associated with the heavy reliance on the RA and the RA's advice recognising that the RA may not have detailed background on the problems associated with the business prior to the RA's appointment which could be critical to the prospects of creditors receiving a better outcome.

However, the ABA supports a requirement that the onus of establishing this defence rests on the directors to prove.

Finally, the ABA believes there should be a specific prohibition on the disclosure of the appointment of a RA under continuous disclosure rules.

4.1.1 The restructuring adviser

The proposed qualifications and experience of the RA focus' on insolvency practitioners and contemplate a form of licensing or accreditation for RAs as approved by the Minister.

The ABA does not support this limitation on the appointment of a RA where the circumstances of the company may dictate advice in addition to or other than advice provided by an insolvency practitioner.

Query 2.2.1a

The Government seeks views from the public on what qualifications and experience directors should take into account when appointing a restructuring adviser and whether those factors should be set out in regulatory guidance by the Australian Securities and Investments Commission, or in the regulations.

ABA Response:

For the largest restructurings there might be a team of advisers rather than an individual RA. The ABA believes it will be difficult to determine a set of qualifications that are suitable for all distressed businesses. Much depends on the nature of the business and the particular issues that confront it which in turn will inform the nature of the expertise expeditiously required to determine its ongoing viability. For example, if the business is heavily focused on the information technology sector, the RA must have (or have access to) expertise in that sector. Hence any suggested qualifications to assess the experience and capabilities of the RA or RA team should be generic, such as experience, capability, knowledge, qualifications, standing and so on.

The qualifications and experience of a RA should be prescribed as guidance for directors.

It is unclear whether the RA must be an external contractor. It would be undesirable for directors not to be able to satisfy achieving safe harbour simply because the person who would otherwise meet the criteria was engaged in an executive capacity rather than as a consultant.

In this regard limiting the experience and qualifications of a RA to those currently held by insolvency practitioners would not be appropriate in our view. More is potentially required.

Query 2.2.1b

The Government seeks views from the public on which organisations, if any, should be approved to provide accreditation to restructuring advisers if such approval is incorporated in the measure.

ABA Response:

The ABA questions this approach as this could limit the organisations that can accredit restructuring advisers and could result in the appointment of RA's who do not have the expertise required for the particular businesses.

The Proposals Paper proposes a test for viability based on the company's ability to avoid insolvent liquidation and to be returned to solvency within a reasonable time.

Query 2.2.1c

Is this an appropriate method of determining viability?

ABA Response:

The ABA agrees that one of the roles of any RA (in conjunction with the directors) would be to form an early opinion as to whether the company is "viable" and then devise and implement a plan to ensure continuing viability.

However, it is queried whether a "return to solvency within a reasonable period of time" is necessarily the best formulation for "viability'. The key issue, in circumstances where a company is insolvent, is comfort that by continuing to operate it will achieve the best outcome for the general body of creditors compared with immediate administration or insolvent liquidation. We think this should be reflected in any statutory test.

Query 2.2.1d

What factors should the restructuring adviser take into account in determining viability? Should these be set out in regulation, or left to the discretion of the adviser?

ABA Response:

There should be a non-exclusive list of generic, non-prescriptive factors included in the regulations to which directors of the company may have regard in appointing a RA such as the nature of the business, its ownership structure and sources of working capital, its market competitiveness, the expertise of its personnel and capacity to operate in a highly regulated industry.

Query 2.2.1e

The Government seeks views from the public on whether these are appropriate protections and obligations for the restructuring adviser, and what other protections and obligations the law should provide for.

ABA Response:

The ABA submits that it is the directors who appoint the RA and who are seeking to avail themselves of the defence, not the company. The directors owe duties to the company and to operate the company under the advice of the RA. The RA is not running the company; only advising the directors on how to run the company and hence the primary duties should continue to reside with the directors who should remain accountable for the outcome.

Accordingly, the ABA would question a notion that the RA also should owe duties to the creditors in this scenario as a further protection (of the nature described in para 2.2 of the Proposals Paper).

It follows that the ABA does not see any need to "water down" the RA's duty to the directors or prescribe any specific defences for the RA.

4.1.2 Other features of safe harbour

In 2.2.2 of the Proposals Paper, in specifying that the safe harbour would operate as a defence to insolvent trading under s.588G, there are several consequential proposals preserving existing rights and obligations.

Query 2.2.2a

Do you agree with this approach?

ABA Response:

The ABA agrees that the directors should continue to be bound by the duties and obligations imposed on them under the law and claims as described in 2.2.2 of the Proposals Paper.

Query 2.2.2b

Do you agree with our approach to disclosure?

ABA Response:

The ABA disagrees with this approach because as discussed at the March 2016 roundtable there appeared to be overall support from interested parties for confidentiality to be preserved in a restructuring endeavour to improve the prospects of the company avoiding insolvent liquidation. Further, and as mentioned above in Query 2.2, the ABA believes there should be a specific prohibition on the disclosure of the appointment of a RA under continuous disclosure rules.

4.1.3 Where safe harbour is not available

Query 2.2.3

The Government seeks views from the public on in what other circumstances should the safe harbour defence not be available.

ABA response

The ABA refers to its previous comments above.

Further, the safe harbour would be raised as a defence in a later claim of insolvent trading. Therefore, the ability of ASIC or the Court to determine the ineligibility of a director to rely on the defence should be based on events occurring before or while in safe harbour but not to later events.

4.2 Safe harbour Model B

The ABA prefers the simplicity of Model B over Model A, provided it is clear that the onus of proving the matters outlined in Model B rests with the directors.

Proposal 2.3

Section 588 does not apply:

a) If the debt was incurred as part of reasonable steps to maintain or return the company to solvency within a reasonable period of time; and

b) The person held the honest and reasonable belief that incurring the debt was in the best interests of the company and its creditors as a whole, and

c) Incurring the debt does not materially increase the risk of serious loss to creditors.

Query 2.3

The Government seeks your feedback on the merits and drawbacks of this model of safe harbour.

ABA Response:

The ABA broadly supports this approach provided the onus of establishing the defence rests with the directors. It has merit in avoiding the complications associated with Model A as stated above.

There should be a list of factors, including whether the appointment of a RA was necessary and, if so, the suitability of that appointment, which a Court may take into account in determining whether a person had satisfied the exemption from the application of the section.

The ABA does not support the notion that taking reasonable steps should include early engagement with shareholders, creditors (including employees) and other stakeholders. As mentioned above this would compromise the prospects of a successful outcome for the company.

The coverage of Model B in the Proposals Paper is limited compared with Model A. There are complementary features in both models.

Finally, the ABA is unclear what is intended by "serious loss to creditors". More broadly we believe further consideration needs to be given to which creditors are relevant for the purposes of the defence. Are they the existing creditors whose return would be potentially diluted upon the incurring of further debt? Or new creditors to whom the debt relates and who may not realise they are providing services on the basis unaware they may not be fully paid or at all? Or both?

Any defence should ensure that at all times the directors were satisfied, in good faith and on rational grounds, that by incurring any further debts, this would likely result in the prospect of a better outcome for all creditors compared with proceeding to administration or insolvent liquidation.

The ABA requests Treasury convene a representative working group of interested parties (including banks) to examine both models in more detail.

5. Ipso facto clauses

5.1 Introduction

Of the three insolvency reforms in the Proposals Paper, the proposal to prohibit ipso facto clauses which allow termination of contracts due solely to an insolvency event is by far the most difficult from both a technical, legal and practical perspective. The risk of inadvertently creating unforeseen implications for business are high, judging by experience with such provisions in the U.S. and U.K.

However, the ABA is generally supportive of the proposal to restrict or limit the impact of ipso facto clauses in certain contracts, particularly where a company is seeking to restructure in an endeavour to avoid administration or insolvent liquidation.

The ABA has a specific concern in the banking context with the proposal that a prohibition on ipso facto clauses should be extended to variations of the terms of a contract and to the exercise of existing rights under a contract to accelerate payments or to require further security for a credit facility. Application of the prohibition to termination and variation of contracts and to rights of acceleration would substantially increase the risks for counterparties, especially banks and other credit providers, to protect their legitimate interests.

5.1.1 Prudential considerations

Australian Prudential Standard 220 (**APS 220**) on credit quality requires banks to have:

10. A robust system for the prompt identification of sources of credit risk and an accurate and complete measurement of such risk is at the heart of any good credit risk management system. The system must provide for a consistent approach to measurement of credit risk, including when questions arise as to the value of facilities and collateral held and as to the ultimate collectability of an ADI's credit exposures to entities.

If the proposed ipso facto prohibition is to be applied to the terms of a credit, or other financial accommodation facility where the bank has performed its contractual obligation to provide financial accommodation under the contract, the likely result will be for credit providers to bring forward any enforcement activity by utilising triggers which have effect as soon as there is any suggestion that the debtor company may experience a future insolvency event. This would defeat the purpose of the proposed reforms to insolvent trading restructuring.

By way of illustration, it is unclear whether this risk could include an inadvertent overriding of rights under security law (for example, restricting creditors' rights to access cash pledged as security, presenting a bond held as collateral). For project finance, documentation is negotiated with sophisticated wholesale borrowers who benefit from independent legal and financial advice. The contractual certainty allows lenders to provide high leverage if a contract can explicitly terminate following insolvency then the financier will either:

a) Seek contractual rights to cure and continue contractual obligations in place of borrower, or

b) Adjust its lending decision to exclude or discount the benefit of this contract.

Introducing uncertainty will make it more difficult to finance highly structured transactions.

As the ABA has stated, the risk of inadvertently creating unforeseen implications and substantial uncertainty is high. The risks extend far wider than to contracts for credit and financial accommodation to financial services contracts generally. This has been made evident in the submissions of the Australian Securitisation Forum[4] and King and Wood Mallesons[5] with which the ABA agrees.

Further, the proposal could increase moral hazard. As mentioned above, banks negotiate additional protections with borrowers who benefit from material revenue or cost contracts with third parties to enable lenders to assume these contracts will remain in place following insolvency. Such protections include multi party agreements (between the third party, bank and borrower) to enable the continuation of key contracts during and post any restructure, administration or receiver process. If these provisions are introduced, then borrowers may increasingly push for a weakening of financing terms (such as multi party agreements and asset level security) and push lenders to rely on ipso facto. For specific sectors such as project finance this may actually weaken the credit standards of banks' loans.

4 http://www.securitisation.com.au/Submissions/2016/ASF%2020160527%20Submission%20to%20Treasury%20-%20Insolvency%20law%20proposals.pdf

5 http://www.kwm.com/~/media/SjBerwin/Files/Knowledge/Insights/au/2016/06/02/kwm-response-australian-government-insolvency-laws-ipso-facto-reform.ashx?la=en

5.2 Comparison with other jurisdictions and an international perspective

The proposed ipso facto prohibition would put Australia out of step with other comparable jurisdictions in terms of the expansive reach of the proposed reform. In particular, the proposed reforms go much further than the ipso facto restrictions in either the U.K. or the U.S.

In the U.K. ipso facto restrictions were introduced last year and only apply to the provision of essential services. This is already the law in Australia as a result of s.600F of the Corporations Act. Although U.K. legislators had the option to introduce a broader ipso facto rule, it appears that they did not consider that it was necessary to go beyond the moderate restrictions that were introduced.[6]

While the U.S. has a broader ipso facto rule than in the U.K. it remains more moderate than the proposal advanced in Australia and seeks to balance the interests of competing stakeholders. The prohibition on ipso facto clauses only applies to executory contracts or unexpired leases. An executory contract is regarded as a contract where both parties have further performance obligations under their contract. Non-executory contracts are not subject to the ipso facto restriction. The US Bankruptcy Code contains exceptions to the ipso facto prohibition, in particular, s.365.

There are many international participants providing secured asset financing in the Australian market.

Taking security over the asset being financed reduces the risks for creditors, facilitates the extension of credit, and reduces the borrowing costs for debtors. This depends on the predictability of the enforceability of the security, being able to act quickly to repossess the asset, and thereby protect the value. A bank's own experience is that a moratorium or stay on enforcement makes it more difficult for it to approve transactions in those jurisdictions (e.g. U.S. and Spain). And that some investors choose not to operate in jurisdictions where there is a moratorium in place. For example, US$40billion of aircraft have been financed through the Japanese aviation leasing market between 2001 and 2014. Major airlines in Europe and Asia, including Qantas, finance significant portions of their fleet through the Japanese aviation leasing market as it offers competitive pricing. However, Japanese investors are reluctant to offer lease financing to carriers in the U.S. due to the Chapter 11 provisions, with no transactions being completed for North American airlines in that period. The ABA has sought clarification on whether the ipso facto clauses would be declared void or if there would be a moratorium on their operation. We have not seen a jurisdiction where insolvency provisions would be void.

The proposal may not be consistent with Australia's obligations under the Cape Town Convention. The Cape Town Convention is an international treaty designed to protect and enhance commercial ownership rights and security interests in aircraft with the objective of facilitating aircraft financing.

Australia has acceded to the *Convention on International Interests in Mobile Equipment 2001* (Cape Town Convention) and its related *Protocol on Matters Specific to Aircraft Equipment* (Aircraft Protocol) (together the Convention). Australia's accession to the Convention took effect on 1 September 2015.

Under the Convention, upon the occurrence of an insolvency related event the insolvency administrator or debtor (as the case may be) must give possession of the aircraft to the creditor in no later than 60 calendar days. The insolvency administrator or debtor may retain possession of the aircraft where, within the relevant time period following the insolvency event, it has cured all defaults (other than the default constituted by the commencement of insolvency proceedings) and has agreed to perform all future obligations under the agreement. If an administrator does this, the administrator becomes primarily liable for rent and other costs relating to an aircraft during the course of the administration.

[6] "Ipso facto" clauses; A law Reform Challenge (2016) 27 JBLFP 72
Kleinhaus and Zuckerman: Enforceability of *ipso facto* clauses in Financing Agreements: *American Airlines* and Beyond. Norton Journal of Bankruptcy Law and Practice Vol 23 No 2 (2014) p. 193

5.3 Application of the ipso facto model

Proposal 3.2

The Government proposes that any term of a contract or agreement which terminates or amends any contract or agreement (or any term of any 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.

Query 3.2a

Are there other specific instances where the operation of ipso facto clauses should be void? For example by prohibiting the acceleration of payments or the imposition of new arrangements for payment, or a requirement to provide additional security for credit.

ABA Response:

The ABA sees merit in the notion that certain valuable commercial contracts that are held by a distressed company may not be terminated simply because an insolvency event as described in the Proposals Paper occurs.

The ABA is aware of a number of instances where significant value in a business has been lost "unfairly" because of clauses that allow a counterparty to use the mere occurrence of an insolvency event to terminate a contract the counterparty would prefer to exit for other entirely separate commercial reasons.

However:

a) Noting the question of the "potential need for a prohibition on the acceleration of payments or the imposition of new arrangements for payment, or a requirement to provide additional security for credit", the ABA is unclear what precisely is intended in the Proposals Paper on these aspects.

   In particular, the ABA is unclear on whether it is intended to alter the current position where if an administrator is appointed to a company and a bank holds an "all asset security", the bank may, without more, accelerate its loan repayments and enforce its security by appointing a receiver (see s.441A of the Corporations Act).

   If such an alteration is intended, the ABA is strongly opposed to that course of action as this would significantly alter the current relative positions of secured and unsecured creditors in an insolvency situation.

b) The ABA understands, despite the Proposals Paper stating that an ipso facto clause would be "void," the ipso facto prohibition would not change the existing position where the occurrence of an insolvency event constituting an event of default under a loan agreement means a bank is no longer required to continuing to fund the customer under that agreement. This is crucial to any support by the ABA.

c) It is unclear what is intended in respect of a bank seeking to rely on a contractual right to accelerate loan repayments under an event of default through the occurrence of the insolvency event. This is arguably not a right to terminate a contract – rather a right to demand immediate repayment of the entire debt earlier than originally agreed because an event has occurred. The ABA starts with the proposition that the right of acceleration under a credit contract where an insolvency event occurs should be preserved.

d) It is also unclear what is meant where the Proposals Paper states that clauses which "amend" the contract upon an insolvency event would be void.

Is it intended to extend this to clauses that prescribe a consequence that arises upon an insolvency event? Taking debt capital market transactions as an example, the ABA would not support a regime whereby clauses such as the following (that are triggered upon an insolvency event) are rendered ineffective (since that would have significant adverse consequences for those markets):

i) Noteholder put options

ii) Step up margins

iii) Debt to equity conversion rights

iv) Fast pay/amortisation mechanisms that arise upon an insolvency event

v) Additional security rights clauses

vi) Change of service or custody provider

Further to the above and our comments with respect to 3.2.2 Exclusions in the Proposals Paper, the ABA believes a range of agreements (the scope of which requires further consideration and consultation) should be excluded from the proposed prohibition on ipso facto clauses. These classes of agreement should include:

- General debt financing, covering general financing structures (e.g. debt financings, structured asset leasing facilities, debt capital markets)
- Commodity contract transactions entered into under both ISDA and bespoke master agreements such as repos, forwards and options over commodities such as bullion, base metals, energy products and grain
- Derivatives
- Securitisation and covered bonds transactions
- Margin lending
- Exchange Traded Options
- Contracts for difference
- Agreements for the sale and purchase of commodities and bullion where settlement of the purchase price and/or the relevant commodity or bullion is not immediate.

In addition to the foregoing, the ABA does not support this proposal in its current form because:

a) It would apply beyond a simple termination of the contract to executory and non-executory contracts and to bank facilities of the kind described above; and

b) By declaring the ipso facto clause void rather than unenforceable; it would create uncertainty including that by rendering the clause void this may affect the enforceability of the other provisions of the contract.

Query 3.2b

Should any legislation introduced which makes ipso facto clauses void have retrospective operation?

ABA Response:

By retrospective operation, it is assumed this would apply to such clauses in contracts existing at the commencement of the legislation as may be appropriate to preserve value in a distressed business.

The ABA sees merit in this proposal as applied to general commercial contracts but this is subject to the ABA achieving an acceptable exclusion of all classes of banking services and banking related contracts from the prohibition i.e. those contracts for the provision of financial accommodation and those other contracts referred to above in the ABA's response to Query 3.2a.

Query 3.2.b

Are there any other circumstances to which a moratorium on the operation of ipso facto clauses should also be extended?

ABA Response:

The ABA understands that the proposal is for ipso facto clauses to be declared void. *Query 3.2b* refers to a "moratorium" on the operation of ipso facto clauses. Further clarification is sought.

If the confidentiality of directors taking reasonable steps to try and restore the company and avoid its insolvent liquidation is preserved under either Model A or Model B, other circumstances than those listed should be unnecessary to identify. Otherwise, the second bullet point in the list should make it clear that a "scheme of arrangement" may include the proposed safe harbour steps taken by directors to preserve the company.

5.4 Anti-avoidance

The Proposals Paper proposes an anti-avoidance mechanism to make any provision in a contract that has the effect of providing for, or permitting anything in substance that is contrary to the voiding of an ipso facto clause would be of not force or effect. It is proposed that this mechanism would not extend beyond ipso facto clauses.

Query 3.2.1

Does this constitute an adequate anti-avoidance mechanism?

ABA Response:

Subject to our earlier comments not supporting the extension of the proposed ipso facto prohibition to:

a) Contractual terms which may be used to vary the terms of a contract, and

b) The inclusion of contracts for the provision of financial accommodation (whether executory or otherwise), the ABA is supportive of a carefully drafted anti-voidance provision.

If, contrary to our recommendations, contracts for the provision of banking services are not excluded, it would be important to ensure that any anti-avoidance mechanism makes it clear that certain contractual terms providing for the occurrence of certain events as agreed between the parties are not treated as ipso facto clauses. Examples include conditions precedent to the performance of an obligation or terms requiring compliance with financial covenants in financial accommodation

contracts so they are treated as breaches for non-performance including terms for acceleration of repayment obligations or which allow for increased margin or collateral to be required.

A further aspect of the proposal is unclear, particularly if it relates to clauses that "amend" a contract upon an insolvency event arising. Is it proposed that clauses which give additional rights to a financier upon an insolvency event arising are said to, in substance, "amend" a contract and are therefore of no force and effect?

Greater clarity is needed on the scope of what is intended.

5.5 Exclusions

The Proposals Paper acknowledges that termination and enforcement rights of counterparties under certain types of financial services and markets contracts should be preserved.

The ABA is concerned to ensure that the primary legislation should carve out these "prescribed financial services contracts" and that a regulation making power is available to deal with any unforeseen classes of contracts.

Query 3.2.2

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

ABA Response:

The matter of exclusion is of fundamental concern to the ABA and its members.

There must be clear and acceptable exclusions for the range of clauses identified in the Proposals Paper as warranting exclusion and those further classes of other contracts which the ABA has identified in this submission, particularly in financing contracts.

Commentators and the submissions of the Australian Securitisation Forum and King and Wood Mallesons (and others) have identified a wide range of contracts that ought to be excluded including, for example, contracts which are part of securitisation programs where a right of recourse is essential.

In addition, as the Proposals Paper notes, there are "Flip clauses" which have also been identified by some commentators and industry associations as a right that should be excluded from the ipso facto rule.

As already contended, the ABA submits that contracts for the provision of financial accommodation (in a broad sense) should be specifically excluded.

There may also be a range of agreements which ADIs (or other financial institutions which are important to the functioning of Australian financial markets) enter into (for example custody or clearing agreements, or agreements for the provision of services to the ADI) which, if the ipso facto proposal were to apply to them, may lead to increased risk to ADIs. Such additional risks may have numerous impacts, for example, on the stability of these key participants in the financial markets, structuring agreements to enable earlier termination, or increased costs to consumers of financial services. These impacts may undermine the aim of fostering innovation.

In addition, if certain types of terms (such as increased margin or collateral, and Flip clauses) used in structured financing and the capital markets are affected by these proposals, a potential effect is to increase the funding costs of Australian corporates as these terms are typically among key considerations for finance providers when determining the price of the funding they are willing to provide, particularly in relation to smaller corporates. This may possibly affect access by such corporates to capital.

It is axiomatic that the insolvency of a debtor (including the debtor's entry into a form of insolvency administration) must be an event of default in virtually all contracts for financial accommodation. Consequences of this default include the right of the bank to accelerate repayments and enforce security subject to any existing limitations, for example under s440B of the Corporations Act (subject to s.441A).

A bank may be prepared to waive or not seek to rely on a payment default or a breach of financial covenants because it is able to rely on the debtor's insolvency or its entry into an insolvency administration as a discrete breach.

If this is not possible under the legislation, the bank would be unlikely to waive these specific breaches with the resulting impact being directly on the assessment by the debtors' auditors and directors of the solvency of the debtor.

Further, if a secured lender's right of enforcement is to be restricted under the legislation following the appointment by the debtor company of a voluntary administrator which otherwise would have triggered this right, this would provide the directors with the incentive to appoint the voluntary administrator earlier to prevent a lender taking enforcement action based on another existing breach.

In a similar way, as stated above, a secured lender may act earlier to enforce its rights in anticipation that the company may appoint a voluntary administrator.

In both these scenarios, the resulting outcome of the proposed reforms, which are designed to facilitate restructuring, could destabilise the company and defeat the objectives of the reforms.

It would be an extraordinary outcome from this consultation process on the Proposals Paper if the right of a secured creditor to enforce its security under s.441A of the Corporations Act could be undermined on the basis of a clause in a financing contract being declared void under the proposed legislation.

5.6 Appeal

The Proposals Paper proposes that an affected counterparty may apply to the Court to vary contractual terms if they can show they have suffered hardship.

Query 3.2.3

Do you consider this safeguard necessary and appropriate? If not, what mechanism, if any, would be appropriate?

ABA Response:

A general right, presumably a statutory right, for a counterparty to apply to the Court where it is not entitled to terminate or amend a contract after an insolvency event has occurred and will suffer hardship or other detriment from that outcome would be appropriate. This is particularly important to the extent that the legislation will apply to existing contracts signed prior to the new regime applying.

Questions of standing to apply and how "hardship" is to be defined will need to be resolved.

In conclusion, the ABA appreciates the consultative processes which Treasury and the Attorney-General's Department have undertaken so far. We look forward to ongoing consultation and involvement as the proposals for reform take further shape.

Our suggestion is for a representative working group of key interested parties to be established, which we believe would assist in identifying further issues that will require attention, addressing current concerns and refining the more detailed aspects of the reforms. This would be extremely valuable in dealing with the classes of contracts that ought to be excluded from the ipso facto model and how best this might be achieved.

If the Government were to release an issues paper following the current consultation this would help to advance the process.

Yours sincerely

Ian Gilbert
Director Banking Services Regulation
03 9852 7976
Ian.Gilbert@bankers.asn.au