Australian Private Equity &
Venture Capital Association Limited

27 May 2016

The Manager, Corporations and Schemes Unit
Financial System Division
The Treasury
Langton Crescent
PARKES, ACT 2600

Dear Sir/Madam,

Thank you for the opportunity to put forward a submission in relation to the proposals outlined in the *Improving bankruptcy and insolvency laws* paper released in April 2016 (Paper).

The Australian Private Equity & Venture Capital Association (AVCAL) is a national association which represents the private equity and venture capital industries. AVCAL's members comprise most of the active private equity and venture capital firms in Australia, who together manage over A$28 billion on behalf of Australian and offshore superannuation and pension funds, sovereign wealth funds and family offices.

Private equity (PE) and venture capital (VC) firms provide capital for early stage companies, later stage expansion capital, and capital for management buyouts of established companies. These businesses help contribute more than 4% per annum to Australia's national output and support, both directly and indirectly, over 500,000 jobs.[1] In the financial year ending 30 June 2015 alone, PE and VC funds invested $3.3bn into Australia.

## 1. Background – relevance of private equity and venture capital to the proposed reforms

We strongly support the Government's renewed focus on reinvigorating the Australian economy via the implementation of reforms outlined in the National Innovation & Science Agenda (NISA). We believe that private equity and venture capital funds can play an essential role in this transition. Much of the capital invested by these PE and VC funds is in smaller, high growth Australian companies, with a particular focus on commercialisation of research & development, and innovating and expanding established businesses. PE and VC fund managers have both the capital and expertise necessary to drive this growth.

As part of their model, some PE firms undertake investments into financially distressed companies in an attempt to turnaround those businesses. Ultimately the aim of such investments is to return companies to profitability, with attendant benefits for employees, investors, creditors, and of course the broader economy. As a result, we have a particular interest in the safe harbour (see part 2 below), and ipso facto clause (see part 3 below) proposals outlined in the Paper.

In summary, we support Government efforts to improve the balance between encouraging entrepreneurship and protecting creditors. In particular, the current operation of insolvency-related ipso facto clauses regularly have the effect of eroding the commercial value of companies to the detriment of employees, investors and creditors. Accordingly, AVCAL believes that reform of this area would improve the ability of firms to make investments that would give distressed companies the best opportunity to avoid insolvency and continue to trade (or be sold) as a going concern.

## 2. Safe harbour provisions

AVCAL supports legislative measures being introduced which serve to provide directors with protection from insolvent trading liability where the company has appointed a professional restructuring adviser (proposed Safe

[1] Deloitte Access Economics, *The Economic Contribution of Private Equity in Australia*, 2013

Harbor Model A). We agree with the Paper that the current law can operate to encourage companies to enter voluntary administration, rather than risk breaching the insolvent trading provisions. This can have the effect of deterring investors and professional directors from becoming involved with a start-up, or indeed a struggling company in need of restructuring, despite the fact that the company may have long term viability if provided with the right capital and professional stewardship.

We support the adoption of Safe Harbor Model A as it appears to strike a principled balance between protecting creditors and providing businesses with the opportunity to turn-around their fortunes by requiring that a restructuring adviser: 1) be provided with adequate financial records maintained by the company; and 2) is and remains of the opinion that the company can avoid insolvent liquidation and is likely to be able to be returned to solvency, as a precondition for the company's directors being able to access the safe harbor protections.

As a policy integrity measure, AVCAL supports the proposed requirement that the relevant restructuring adviser be an accredited member of an organisation approved by the Minister. This would prevent service providers who lack the necessary skills from acting as the gatekeeper for directors wishing to avail themselves of the safe harbor framework. In many cases, the relevant advice will need to be sought from a professional with significant commercial expertise.

In particular, it is important that the relevant restructuring adviser possess specialised skills and experience in company restructures, as opposed merely to legal or insolvency practice, noting that the intended aim of the safe harbour is to essentially provide the company with the "breathing space" necessary to guide a company back to profitability. It is also appropriate that the restructuring adviser be carved out of the expanded "shadow director" provisions of the Corporations Act 2001, noting that they are acting in a professional capacity, in the best interests of the company, and with an obligation to report any discovered misconduct to the corporate regulator, ASIC.

As a probity safeguard, we suggest that the restructuring adviser should not be a person who has acted as the company's auditor prior to their proposed appointment. This would help ensure that there is no misalignment of interests or perceived lack of independence. Further, we agree that the restructuring adviser should be unable to be appointed in any subsequent insolvency (without the leave of the court).

We believe that Safe Harbor Model B is a less attractive policy option given it lacks the certainty to directors provided by Safe Harbor Model A's strong protection where a restructuring adviser has been appointed. Further, Safe Harbor Model B suggest a broader list of potentially relevant factors that a court may consider in determining whether directors took reasonable steps to maintain or return a company to solvency. It is simpler and more efficient that directors appoint a restructuring adviser, in accordance with Safe Harbor Model A.

Notwithstanding our support for Safe Harbor Model A, we support the view of the Turnaround Management Association (TMA), that further enhancements to the model should be considered. Firstly, we support the safe harbor being made available to companies prior to directors believing that the company may be insolvent. By allowing companies to access the safe harbor at an earlier point in time - what is known by turnaround professionals as the "twilight zone of insolvency" - the chances of the company avoiding insolvency are maximised (with attendant benefits to employees, shareholders and creditors). This would reflect the reality that often management, directors, and a company's advisers, may be unsure of the company's insolvency until after the fact.

Appointing a restructuring adviser to devise an appropriate turnaround plan (thereby accessing the safe harbor), would be preferable to the current reality in which directors typically take the more conservative option of appointing an external administrator so as to avoid insolvent trading risks and potential personal liability. Indeed the very act of appointing an external administrator may be devastating to the value and longevity of the company, including due to the operation of ipso facto clauses (discussed further below).

Secondly, while Safe Harbor Model A contemplates that directors would have protections from the insolvent trading provisions of the Corporations Act 2001, in practice it would be beneficial (if perhaps beyond the Paper's scope) if those protections were extended to the more general directors' duties (sections 180-183, Corporations Act). Otherwise directors may, if the safe harbor was limited to insolvent trading, still be inclined to put a company into voluntary administration rather than face personal liability for a breach of the general directors' duties.

In our view, there is protection afforded to a company and its shareholders from improper director behaviour where the ability to access the safe harbor is contingent on the appointment of a restructuring adviser who is obliged to report any misconduct to ASIC.

Further, in practice, such a change would represent, essentially, a bolstering of the current business judgment rule contained in section 180(2), Corporations Act. The change would provide much needed certainty for directors, as currently the ambiguity of the business judgement rule lends itself to directors conservatively opting for voluntary administration (or risk personal liability).

We recommend that any changes should not remove liability for employee entitlements (section 596AB), or unreasonable director related transactions (section 588FDA). Furthermore, we recommend that the safe harbor operate on a prospective basis only, meaning that liability would remain for breaches of insolvent trading or directors' duties obligations prior to the appointment of a restructuring adviser.

**3. Ipso facto clauses**

AVCAL welcomes the proposed reforms to the operation of ipso facto clauses, recognising that such contractual terms often have the effect of eroding an enterprise's value, and can contribute to the company being unable to continue as a going concern.

As noted above, some private equity firms carry out investments in struggling companies with a view to turning them around, and restoring profitability. In practice, although ipso facto clauses may reduce the price a potential buyer may pay for a business, it is more likely to deter the investment from proceeding. The ability of a company's suppliers, customers and partners to terminate a contract due to an insolvency-related ipso facto clause, means that the company loses much of its attraction from a potential buyer's perspective.

Accordingly, potentially worthwhile investments, which would have allowed a company to continue operating, are often passed by.

We agree that reform in this area should not be limited to termination rights, but also the right to vary the terms of a contract, as these can have a significant impact on the value of a business. As recognised in the Paper, the legislative provision will need to be carefully drafted so as to include an adequate anti-avoidance mechanism. Further consideration will need to be given to the treatment of "termination for convenience" clauses so as to ensure they are not used to undermine the proposed ipso facto reforms.

We support the proposal in the Paper that the legislative intervention not prevent terminations for breaches such as non-payment or non-performance, nor require the extension of further credit to a company, as this would unduly restrict the ability of parties to contract on commercial terms, and may increase the exposure of creditors. Regarding the proposed definition of an insolvency event, we suggest that it be expanded to include liquidations given the liquidator will be attempting to carry on the business of the company with a view to its sale (section 477(1)(a), Corporations Act).

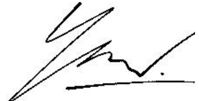
Furthermore, we recommend that the moratorium on the operation of ipso facto clauses should also be extended to circumstances where a company has appointed a restructuring adviser and is operating in the new, proposed safe harbor environment. This is important to ensure that the ability of the company to return to profitability during the safe harbor is not compromised by contractual terms allowing counter-parties to terminate where the company is operating in the safe harbor (which we expect would be a market response to the introduction of the proposed regime).

**4. Next steps**

Finally, we would like reiterate the importance of the proposed safe harbor and ipso facto reforms to the broader National Science & Innovation Agenda. Sometimes companies that find themselves in financial distress may have products or services that would be of significant market value, but become insolvent or enter voluntary administration before that potential can be realised. The above reforms will help go some way to addressing these issues, allowing directors of companies additional breathing space to set about turning around an enterprise and putting it on a solid financial footing.

We would like to thank you for considering this submission, and look forward to continuing our engagement with you on these, and broader innovation-related issues. If you have any queries in relation to this submission, please contact Christian Gergis, Head of Policy & Research, on 02 8243 7010 or alternatively myself on 02 8243 7000.

Yours sincerely



Yasser El-Ansary
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