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Improving Bankruptcy and Insolvency Laws

Ferrier Hodgson is supportive of the innovation agenda and the periodic review of insolvency laws. We are generally supportive of the initiatives outlined in the Government's Proposals Paper, although in order for the reforms to deliver the intended objectives, we believe there are a number of practical issues which need to be addressed. It is our view that there needs to remain an appropriate balance between incentivising a risk-taking culture and protecting the interests of creditors.

Background

Ferrier Hodgson is one of Asia-Pacific's leading provider of restructuring and business advisory services. For the past 40 years, we have developed a reputation of solving complex problems with commercial solutions that deliver value and results to all levels of stakeholders.

Our key services lines are:

- Restructuring, turnaround and insolvency
- Advisory
- Forensic accounting
- Forensic IT
- Management consulting
- Transaction advisory

As a group, Ferrier Hodgson represents leadership, excellence, and integrity in everything we do. We are grateful for the opportunity to provide feedback on the Government's Proposals Paper on improving bankruptcy and insolvency laws as part of the National Science and Innovation Agenda reforms.

Ferrier Hodgson is an affiliation of independent partnerships/entities
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1 Reducing the default bankruptcy period

Reducing the default bankruptcy period from three years to one year may go some way to improving the culture of entrepreneurship and innovation. Freeing debtors to resume control of business ventures and access credit after 12 months while aligning other restrictions to the period of bankruptcy should stimulate economic activity and go some way toward reducing the stigma associated with bankruptcy. We also support the proposed requirement for income contributions applying for a three year period as this will serve to minimise the impact on creditors at the time of bankruptcy.

1.1 Misconduct

Query	FH Comment
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.*	We are satisfied with the current objection to discharge criteria and standard for evidence and therefore do not recommend any change. We accept that trustees will need to have undertaken an effective investigation program in the first year of bankruptcy to ensure that an objection is lodged in appropriate circumstances.

1.2 Ongoing obligations for bankrupts

1.2.1 Requirement to assist trustee

In order to achieve the objectives of the Proposals Paper, we believe that the bankrupt should to the greatest extent possible, be freed of obligations associated with the bankruptcy following discharge. In addition to the requirements of s152 remaining in place, there are a number of basic requirements which the trustee would reasonably require post discharge including contact details for the discharged bankrupt, details regarding income and any information regarding assets not previously disclosed.

Query	FH Comment
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.*	s152 should be expanded to specifically include requirements associated with: a) continuing income contributions post discharge, including details of the bankrupt's income from time to time and a requirement to provide an annual statement of income b) changes to the debtors address c) any assets not previously disclosed
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.*	Incentive: Post discharge, the bankrupt retains the benefit of after-acquired assets which under the proposed reforms would occur after 12 months rather than 3 years. The bankrupt's ability to retain such benefit should be subject to continued compliance with obligations after discharge. Mechanism: We suggest that a failure to comply with obligations post discharge constitutes grounds for reversing the discharge / reinstating the previous bankruptcy with the effect that any after-acquired assets form part of the bankrupt estate.

1.2.2 Income contributions

We support the proposal for income contributions to continue for a three year period (i.e. two years after discharge) as we believe that this achieves a suitable balance between encouraging entrepreneurship and protecting creditors.

1.3 Restrictions

As stated above, the bankrupt should as much as possible be freed from restrictions following discharge from bankruptcy.

1.3.1 Access to credit

Query	FH Comment
Query 1.3.1 *The Government seeks views from the public on whether it is appropriate to reduce the retention period for personal insolvency information in credit reports*	We believe that the proposals in 1.3.1a and 1.3.1b will assist former bankrupts in accessing credit while still permitting credit providers with the ability to confirm previous bankruptcy status.

1.3.2 Overseas travel

Query	FH Comment
1.3.2 *The Government proposes to reduce the overseas travel restrictions to one year, subject to any extension for misconduct*	We believe that the proposal to reduce overseas travel restrictions to one year (subject to any extension for misconduct) are appropriate and necessary in order to achieve the aims of the reforms. There is however a risk of former bankrupts absconding overseas in order to avoid income contributions and other obligations post discharge.

1.3.3

Query	FH Comment
1.3.3 *The Government proposes to consult with relevant industry and licensing associations with a view to aligning restrictions with the reduced period of bankruptcy, where appropriate*	We support the government's suggestion to consult with relevant industry and licensing associations. Industry and licensing associations should however be free to impose restrictions to membership at their discretion.

2 Safe harbour

2.1 Background

As a firm, Ferrier Hodgson supports any mechanisms which would assist companies in turning around or restructuring their business to avoid insolvency. A critical component of this is the early acknowledgement of financial difficulty and the engagement of a suitably qualified restructuring adviser to assist the company in achieving an informal workout where possible.

Early recognition of distress is an objective of the current Voluntary Administration regime and the stringent requirements of s588G were intended to focus directors on the solvency of the business at an early stage. The introduction of any safe harbour for directors impacts upon this mechanism and should therefore be entertained with some caution.

We recognise however that the point at which a company becomes insolvent is not always clear and we acknowledge the difficulties directors face in attempting to achieve a restructuring of a company under the spectre of personal liability for insolvent trading. We would support any provisions which provide a window for directors to achieve a restructuring which would benefit all stakeholders.

Given the fundamental role that the insolvent trading regime plays in relation to Voluntary Administration we are of the view that Model A which operates as an additional defence to insolvent trading, is preferable to Model B which dilutes the effectiveness of s588G. We believe diluting the insolvent trading provisions as proposed in Model B would not cause directors to identify and act upon financial distress at an early stage. On the contrary, we believe that in many cases it would have the impact of delaying recognition of distress, reducing the prospects for a successful restructure and resulting in a lesser return for creditors in an eventual liquidation.

2.2 Safe harbour model A

Query	FH Comment
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.*	We believe that Model A may provide an appropriate model to provide directors with a safe harbour in which to pursue a restructuring / turnaround of the business. Model A seeks to maximise the prospects of a company achieving a restructure, however, this must be weighed up against the risks to parties which continue to trade with that company, unaware that it is operating in safe harbour. The two primary concerns in this regard are: a) The protection of new creditors incurred during the period of safe harbour; and b) Restricting the duration of any period in which the company trades whilst insolvent under safe harbour.

Our two primary concerns, and a number of other practical issues are discussed below:

Issue	FH Comment
The protection of new creditors incurred during the period of safe harbour	The parties most at risk from a company continuing to trade during a safe harbour period are the new creditors incurred while the restructuring is being attempted. If the company is trading whilst insolvent under safe harbour, these new debts are, by definition, at risk. These creditors are not being informed of the company's financial difficulty and, unless they are already creditors, have nothing to gain from the restructuring. Imposing risk of loss on these new creditors for the sake of other creditors and the company may cause injustice. The risk to new creditors may be an unavoidable element of the safe harbour concept however, several options for the protection of new creditors are worthy of consideration: a) Requiring the payment of new creditors in full as a pre-condition to the safe harbour defence; b) Providing new creditor claims incurred during the safe harbour period with a priority in any subsequent liquidation over claims of unsecured creditors existing at the time the safe harbour commences; c) Limiting the period during which the company can operate under safe harbour in order to minimise any damage to new creditors.
Restricting the duration of any period in which the company trades whilst insolvent under safe harbour	It is unclear under the proposals how long a company may operate under safe harbour. In our view, because of the disproportionate risk to post safe harbour creditors, the *"reasonable period of time"* to return the company to solvency should be kept as short as possible. We do not believe that safe harbour should provide medium to long term protection from s.588G. i.e. it should not be the case that a company be permitted to operate in safe harbour for say 5 years while it undertakes a turnaround project. We would suggest setting a maximum time limit be set for a company to operate in safe harbour (say 6 or 12 months) extendable only with permission of ASIC or the Court. Any requirement for Court involvement would need to take account of commercial sensitivity and privacy considerations.
A failed restructuring under safe harbour may well result in a lower return to creditors than an insolvency administration now.	It is quite likely that in practice, a company's financial position under safe harbour may deteriorate further before it gets better. In such cases, a failed restructuring may well provide a lower return to creditors than a traditional administration at the point of insolvency/commencement of safe harbour.

	The continual assessment by the restructuring adviser of both the company's viability and the prospects of returning it to solvency within a reasonable time is therefore of high importance.
What constitutes a reasonable period for a restructuring adviser to form a view on the viability of the business?	The period of time for the restructuring adviser to deliver his or her opinion on the viability of the business would need to be kept short. From a practical perspective this will depend upon the complexity of the business operation and the nature of the information provided by the directors. To reinforce the restructuring adviser's gatekeeping role and to minimise potential for abuse, it may be worth considering a two stage approach, requiring the restructuring adviser to: a) provide a preliminary assessment of viability in short order after his or her appointment; followed by b) a final report to be issued within a set time period after that. An extension mechanism may be required for large companies or corporate groups.
When does the period of safe harbour commence? Does safe harbour apply for the period between engagement and the restructuring adviser delivering an opinion?	In our view, safe harbour would need to commence from the date of the appointment of the restructuring adviser. The safe harbour defence would need to be available to the directors for the period in which the restructuring adviser took to produce his or her advice (regardless of the nature of that advice).

2.2.1 The restructuring adviser

Query	FH Comment
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.*	The restructuring adviser would have a critical role in the success of the Model A proposal. The restructuring adviser should be an individual that is appropriately qualified and have sufficient experience to: • assess and determine whether the company is solvent at the time of their appointment; • determine whether the company is commercially viable; • assess the commercial prospects for the company's turnaround or restructuring and determine the timeframe within which this can reasonably and practically be achieved;

	• Properly assess and evaluate the impact upon stakeholders to the business from the alternative options available (including formal insolvency proceedings). In order to fulfil the role, the restructuring adviser must also be an independent professional with appropriate regulatory and ethical oversight. We believe that restructuring advisers need to have: • in depth experience in restructuring and turnaround cases; • sound commercial judgement and skill; • capability to conduct complex financial analysis and valuation assessments; • experience in assessing the impact on various stakeholders' rights in formal vs. informal restructure scenarios; • a good understanding of the insolvency provisions of the Corporations Act and associated practice; • Appropriate professional qualifications. Given the above, it is our considered view that the restructuring adviser position be restricted to Registered Liquidators. We strongly believe that the mere fact that a person is registered as a member of a turnaround association or body should not be sufficient qualification for persons to undertake this important role. It is expected that the restructuring adviser will from time to time require appropriate legal and specialist accounting advice and that the restructuring adviser would engage with these parties on an as needs basis. An effective regulatory framework is already in place governing the admission and supervision of Registered Liquidators. Requiring restructuring advisers to be Registered Liquidators would therefore obviate the need to establish a new regulatory framework.
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.*	There is an established system and criteria for the registration of liquidators which is supervised by ASIC. Requiring restructuring advisers to be Registered Liquidators would obviate the need to establish a new accreditation process / body.
Query 2.2.1c	In broad terms the Government's proposed test of "viability" appears appropriate. It may however be beneficial to add further clarity as to

Is this an appropriate method for determining viability?	the methods by which a company may be "returned to solvency", details of which are provided in our response to 2.2.1d.
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?*	In our view, the restructuring advisor in forming his or her opinion on viability should comment upon whether the company can achieve a return to solvency via: i) The commercial turnaround of the business which results in creditors being paid in full; or ii) A consensual informal restructuring which sees creditor rights adjusted / creditors accepting less than full repayment; or iii) The implementation of a formal restructuring under a Scheme of Arrangement or Voluntary Administration / Deed of Company Arrangement. The additional detail will provide greater structure around the restructuring adviser's opinion and assist in determining what can be achieved within a reasonable period of time. We believe that these broad categories should be formally incorporated within the test of viability.
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.*	In general the obligations and protections of the restructuring adviser appear to be appropriate, subject to the following: i) While under safe harbour, the company is operating whilst insolvent or within the zone of insolvency. The restructuring adviser should therefore have some regard to the interest of the creditors of the company. While working to facilitate the restructuring of the company's affairs, the restructuring adviser and the directors should have a responsibility to ensure creditors are not materially adversely impacted and that the risks to which creditors are exposed are commensurate with the potential benefit of the restructuring. ii) we believe that the protections for the restructuring adviser with respect to civil liability should not apply where: a) where the restructuring adviser is not appropriately qualified; or b) in a case of gross negligence or wilful misconduct.

2.2.2 Other features of safe harbour

Query	FH Comment
Query 2.2.2a *Do you agree with this approach?*	We consider that there is a practical issue in relation to the proposed carve-out of the safe harbour defence for employee entitlements accrued during the safe harbour period. In any trading enterprise, employee entitlements will continue to accrue and can only be paid when an employee takes leave, resigns or is terminated. Employee entitlements will accrue in almost all trading businesses. Depending on the business, these may be substantial. To exclude these from the safe harbour defence would mean that directors only ever benefit from a partial safe harbour and were always exposed to potential personal liability. Employee entitlements accruing during the safe harbour period would rank alongside all other entitlements in a liquidation. The provision as proposed would, in effect, require directors to ensure that all employee entitlements (including those previously accrued) could be paid in full whenever safe harbour is invoked. In light of the exclusions relating to employee claims and tax deductions in 2.2.3 of the Proposals Paper, it is not necessary to impose liability on directors for accruing employee entitlements during the safe harbour period. We agree with the proposed approach that any safe harbour period is excluded for the purpose of calculating the relation back period. (i.e. the period of safe harbour is added to the statutory relation back period)
Query 2.2.2b *Do you agree with our approach to disclosure.*	We agree with the suggested approach that there should be no specific requirement for directors to disclose that they are operating in safe harbour as this would be counter-productive to the aims of the reforms. There are however, dangers of injustice to new suppliers, by the company incurring new debts while in safe harbour and without the suppliers being informed of the company's ability to pay. Please see our comments in respect of 2.2 above in relation to the protection of new creditors incurred during the safe harbour period. We also note that the continuous disclosure requirements for publicly listed companies are likely to require disclosure of the appointment of a restructuring adviser, which may alert stakeholders to the fact that the company is operating in safe harbour, and therefore in financial difficulty. We do not think such requirements should be altered.

2.2.3 Where safe harbour is not available

Query	FH Comment
Query 2.2.3 *The Government seeks views form the public on in what circumstances should the safe harbour defence not be available.*	In addition to the circumstances identified, we believe safe harbour should also not be available where: i) false and misleading information has been provided to the restructuring adviser; ii) information is not provided to the restructuring adviser within a reasonable time period (to be specified); and iii) where the restructuring adviser selected does not carry the requisite qualifications

2.3 Safe harbour model B

Query	FH Comment
Query 2.3 *The Government seeks your feedback on the merits and drawbacks of this model of safe harbour.*	As outlined above we believe diluting the insolvent trading provisions as proposed in Model B would not cause directors to identify and act upon financial distress at an early stage. On the contrary, we believe that in many cases it would have the impact of delaying recognition of distress, reducing the prospects for a successful restructure and resulting in a lesser return for creditors in an eventual liquidation. In addition, the softening of the insolvent trading provisions proposed in Model B is likely to result in a reduction in the use and effectiveness of the Voluntary Administration provisions of the Corporations Act, and, to the extent that informal restructuring is unsuccessful, an increase in companies proceeding directly to liquidation.

3 Ipso facto clauses

3.1 Background

We believe that one of the greatest inhibitors of successful restructuring under Voluntary Administration is the existence and impact of ipso facto clauses and we support the proposals to curtail their effect during formal restructurings.

Curtailing the enforcement of ipso facto clauses does however impact on the freedom to contract and it may disproportionately effect certain creditors. A lesser, but we feel still effective model, would be to restrict creditors and suppliers ability to take action with respect to ipso facto clauses only during the Voluntary Administration period, in the same way that lessors and landlords are currently restrained. This is because the Voluntary Administration

is for a limited period of time, it is conducted by an independent, professional person and is specifically aimed at the rapid development and execution of a restructuring plan.

3.2 The ipso facto model

Query	FH Comment
Query 3.2.a *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?*	We believe that Proposal 3.2 should extend to other instances, such as the acceleration of payments or the imposition of new arrangements for payment or a requirement to provide additional security for credit. In this expanded form, it may be fairer to creditors if the ipso facto clause protection was to operate during a period Voluntary Administration only. See comments above.
Query 3.2b *Should any legislation introduced which makes ipso facto clauses void have retrospective operation?*	Our view is that any legislation should be applied retrospectively such that ipso facto clauses contained in contracts entered into prior to the introduction of the new laws are considered void in the event of an insolvency which occurs post the introduction of the new laws.
Query 3.2c *Are there any circumstances to which a moratorium on the operation of ipso facto clauses should also be extended?*	If the expanded ipso facto model is adopted, we believe this should also be applied to incorporate provisional liquidation on the basis that the business continues on a "business as usual" basis. There should however be a restriction such that the ipso facto clauses are only void against a managing controller, where the appointee controls the whole or substantially the whole of the company's assets, and not in cases where a controller is appointed over specific assets of the Company.

3.2.1 Anti-avoidance

Query	FH Comment
Query 3.2.1 *Does this constitute an adequate anti-avoidance mechanism?*	We support the proposed approach to anti-avoidance and believe that it represents an adequate mechanism.

3.2.2 Exclusions

Query	FH Comment
Query 3.2.2 *What contracts or classes of contracts should be specifically excluded from the operation of the provision?*	We recognise and support the need to specifically exclude certain "prescribed financial contracts" from the operation of the ipso facto proposal, including swaps, hedges, derivatives, etc.

3.2.3 Appeal

Query	FH Comment
Query 3.2.3 *Do you consider this safeguard necessary and appropriate? If not, what mechanism if any, would be appropriate?*	We agree that affected parties should have a power to apply to the court to appeal against the operation of the ipso facto restriction.

Thank you for considering our submission. We would be happy to participate further in any consultation period. If you have any questions please contact Jim Sarantinos, a Partner based in our Sydney office, on 02 9286 9818.

Yours faithfully
Ferrier Hodgson

Steve Sherman
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