Governance Institute of Australia

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To Treasury

Improving bankruptcy and insolvency laws
Proposals paper

Governance Institute of Australia (Governance Institute) is the only independent professional association with a sole focus on whole-of-organisation governance. Our education, support and networking opportunities for directors, company secretaries, governance professionals and risk managers are unrivalled.

Our members have primary responsibility to develop and implement governance frameworks in public listed, unlisted and private companies, as well as in the not-for-profit (NFP) and public sectors. As such, they provide advice to directors on a range of matters. They are involved in corporate administration and compliance with the Corporations Act (the Act) and we have drawn on their expertise in this submission.

We welcome the opportunity to comment on the proposals paper.

1 Reducing the default bankruptcy period

Governance Institute is of the view that it is important to differentiate between business bankruptcies and consumer bankruptcies when discussing any reduction in the default bankruptcy period in order to encourage innovation and entrepreneurship.

We note that the Productivity Commission's *Report on Business Set-up, Transfer and Closure*[1], which recommended a reduced default bankruptcy period, explicitly refers to business bankruptcies. However, our understanding is that the vast majority of bankruptcies are consumer bankruptcies, resulting from consumers incurring unsustainable levels of debt (for example, on credit cards).

We would not be in support of reducing the default bankruptcy period for consumer bankrupts, which could encourage consumers to fall further into debt.

However, we do support encouraging entrepreneurship by reducing the default bankruptcy period for business bankruptcies (and therefore the period in which a person is disqualified from managing a company), which would allow access by those establishing businesses to credit more quickly than is currently possible.

[1] Productivity Commission, *Final Report —Business Set-up, Transfer and Closure*, 2015

Our support is subject to the business bankrupt still being required to pay off debts, although we query how this is to work in practice. Under the current income contribution scheme, the leverage for securing a percentage of income to pay off debts is underpinned by the constraints of bankruptcy. Once the bankrupt is discharged, we question how the income contribution is to be secured, given that the person is no longer disqualified from managing a business and not subject to constraint.

A possible mechanism for securing a percentage of income to pay off debts is that the bankruptcy be suspended as long as the debt repayments continue, with the resumption of bankruptcy being the lever to ensure continuation of debt payments. ASIC could have in place a mechanism similar to an enforceable undertaking which applies for five years, which would return the person to bankruptcy if they fail to meet their repayment obligations.

Governance Institute recommends that the reduced default bankruptcy period be confined to business bankruptcies but not apply to consumer bankruptcies.

2 Safe harbour

Concerns with s 588G

Governance Institute notes that the insolvency regime in Australia, in relation to the personal liability of directors, is far more onerous than any similar legal regime operating in other jurisdictions. Since s 588G was introduced in the 1960s, there has been a fundamental change in the role and responsibilities of the regulator and an exponential increase in disclosure obligations and the personal liability attaching to directors. As a result, creditors are now protected by a variety of measures, and the original need for s 588G no longer exists. The moral hazard risk can be managed through other liability provisions, such as voidable transactions, directors' duties under Pt 2D.1 and the increasing importance of civil penalty provisions as well as the personal liability for disclosure contraventions in relation to misleading and deceptive conduct and (for directors of disclosing entities) continuous disclosure. This is in addition to the myriad of regulatory penalties available for compliance failures relating to reporting and notifications.

While Governance Institute is of the view that the original need underpinning s 588G no longer exists, we recognise that it continues to provide a very powerful incentive for directors not to allow a company to trade while insolvent, and for individuals not to use companies to incur and avoid their debts.

We understand that the policy objective of the current proposals paper is not to interrogate the efficacy or otherwise of s 588G but to introduce a safe harbour for directors from the insolvency provisions of the Act.

Governance Institute agrees with the view that attaching personal liability to the insolvency provisions can generate inappropriate incentives and outcomes. Surveys undertaken by the Australian Institute of Company Directors (AICD) and The Treasury[2] have evinced a strong response from directors that they are concerned about the level of personal liability attached to the role. Furthermore, the survey results suggest that the current insolvency laws mean that directors of companies in financial distress tend to call in administrators — or their lenders call in receivers — prematurely, rather than seeking to work out their difficulties. While any threat of personal liability will influence behaviour, what makes insolvent trading liability so destructive to good faith corporate decision-making is that establishing insolvency as an accounting exercise is inherently difficult and uncertain. Furthermore, the potential scope of personal liability extends to all unsecured debts following the point of insolvency. If the directors are unable to affirmatively establish solvency each day then they run the risk of exposing themselves to all debts being incurred, regardless of whether they are acting in good faith or not. During times of financial health this risk may be negligible, but during times of financial distress there is a real

[2] http://archive.treasury.gov.au/content/Company_Directors_Survey/17_0.html

risk to directors of losing all of their personal assets, even where unbeknownst to the director at the time, the company turns out to be insolvent and a reasonable person could have suspected insolvency. Restructuring efforts can be delicate balancing exercises that can fail or succeed on a variety of commercial factors. The extensive risk of almost strict liability discourages directors from participating in restructuring and encourages them to resign from the company at a time when their expertise and guidance are needed most.

While there is insufficient evidence to prove that this suggestion is fact, nonetheless Governance Institute accepts that the risk of personal liability for insolvent trading affects director behaviour. As one respondent to The Treasury survey noted: 'I don't feel as if my actions will put me at ultimate risk but I may lose five years of my life proving it'. In relation to director behaviour if the company is in financial distress, we are of the view that the risk of personal liability leads directors to call in external administrators prematurely in circumstances where a work-out managed by the directors and the company might ultimately lead to a better outcome for shareholders, creditors and employees.

When perception drives behaviour, the unintended consequence of the current law is that directors' focus on their own interests rather than those of the company, and Governance Institute is of the view that it is not desirable that the corporations law should have this effect.

Support for a safe harbour

Governance Institute is therefore on the public record as noting that the Act should be amended to include provision for a 'safe harbour' to allow companies and their directors to explore restructuring options, in good faith and acting reasonably, without liability for insolvent trading. We are of the view that providing the opportunity for directors acting in good faith to seek and rely on professional advice in relation to a work-out will generate better outcomes for all stakeholders, including creditors who are more likely to be paid as the business is returned to viability.

Our views on the two models proposed for a safe harbour are set out below.

2.2: Safe harbour Model A — a defence

Governance Institute does not support Model A.

In effect, Model A creates another business judgment rule. This reflects models put forward by a number of industry groups and discussed by the Productivity Commission in its 2015 report *Business set-up, transfer and closure.* We are concerned that the proposed defence has too many elements to establish and is too complicated to provide directors with sufficient certainty and confidence that their good faith restructuring efforts will not give rise to insolvent trading liability if the restructuring fails. We are also of the view that the suggested limitations in the proposals paper could lead to only a small number of virtually solvent companies being able to use the defence, which defeats the very concept of a safe harbour.

Moreover, the defence still provides the possibility of a director being sued by an insolvency practitioner, which in turn can lead to further opportunistic litigation particularly when insolvency practitioners will have the power to assign personal rights of action following the introduction of the *Insolvency Law Reform Act 2016* in early 2017.[3]

Q 2.2.1a: The restructuring adviser

Governance Institute is of the view that either Model A or Model B should be predicated on directors seeking the professional advice of a registered restructuring adviser.

However, we are also of the view that regulatory oversight of those providing restructuring advice is required. Currently there are some parties offering pre-insolvency advice whose advice is geared to the avoidance of legal obligations and the creation of phoenix companies,

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[3] See *Insolvency Law Reform Act 2016* (Cth) Sch 2, s 100-5.

rather than assisting companies to turn the business around and directors to meet their obligations.

Governance Institute recommends that the Australian Securities & Investments Commission (ASIC) should maintain a register of restructuring advisers, which would include their qualifications, education and whether they are subject to professional codes of conduct.

We also recommend that ASIC issue regulatory guidance on the qualifications and experience that directors should take into account when appointing a restructuring adviser.

Q 2.2.1b: Accredited organisations

Governance Institute supports the recommendation in the proposals paper that restructuring advisors must be current members of recognised professional associations that have appropriate disciplinary and professional conduct rules including a robust code of ethics.

Q 2.2.1c: Determining viability

Our understanding is that the policy objective behind the proposal to introduce a safe harbour is to provide a moratorium in which directors can turn the business around. In turn, this would see a better return for creditors and the ongoing productive use of assets, rather than a 'fire sale' of assets. On this basis, we agree that the role of the restructuring adviser would be to form an opinion as to whether the company is 'viable'.

However, while we agree that the test of viability should be the avoidance of insolvent liquidation, we do not agree that a 'return to solvency' is the appropriate method for determining viability, given the strict test for solvency currently contained in the Act. In many successful restructurings of corporate groups there will be particular companies that will be wound up when their business assets are sold, which represents a rescue of the viable business through sale to a new owner.

Governance Institute recommends that the term 'return to viability' is a more appropriate term to use than 'return to solvency'.

Q 2.2.1.d: Determining viability

We do not recommend an overly prescriptive approach and favour allowing the registered restructuring adviser, as an experienced and qualified professional, to be able to properly assess business viability during a restructuring effort. However, with the focus of company directors on restructuring efforts to avoid insolvent liquidation, reference could be made to the wrongful trading provision in the United Kingdom which imposes liability where directors 'knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation'. We recommend that this formulation inform the scope of the viability requirement.

Q 2.2.2a: Other features of a safe harbour

Governance Institute agrees that Model A should operate only as a defence to the insolvent trading provisions and that directors should remain subject to all other obligations that the law provides. However, conduct that comes within the safe harbour should also obtain protection from directors' duties that are triggered on insolvency, particularly the requirement to act in the best interests of the company under s 181 which has been interpreted by the courts as requiring consideration of creditor interests.[4] If the safe harbour does not include protection against an action for breach of directors' duties based on a failure to consider creditor interests by pursuing restructuring in good faith then its efficacy will be greatly reduced.

Q 2.2.2b: Approach to disclosure

Governance Institute considers that any reforms to directors' personal liability for insolvent trading should not be made at the expense of innocent creditors, employees, customers and

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[4] See for example *Westpac Banking Corp v The Bell Group Ltd* (in liq) [No 3] [2012] WASCA 157.

suppliers who deal with a company in good faith on the assumption that the company is solvent. Any reform of the law that is applied to directors' duties in regard to insolvent trading should not be at the expense of creditor protection.

In previous submissions on this issue, we have stated that we support the concept of an informed market and believe that providing information to existing and potential creditors should be a foundation stone of any approach to the insolvent trading laws.

This position was based on our concern that creditors would be uninformed of the financial position of the company, which exposes creditors to ongoing trading with the company without knowledge that it is insolvent. However, we have considered the proposal that directors not be required to disclose whether they are operating in a safe harbour (with no relaxation of a company's continuous disclosure obligations) and support this approach, given that:

- confidentiality currently applies to restructuring and work-out situations — creditors are not informed and so there would be no change to the current situation
- many creditors who are trade suppliers should be secured under the *Personal Properties Securities Act 2009* (Cth) — if creditors have not protected their interests they will lose their goods regardless of whether a safe harbour for directors from the insolvency provisions in the Act are introduced
- the proposals paper sets out a neutral position, in that it is the decision of the directors of public listed companies as to whether they need to disclose to the market under the continuous disclosure laws that the company is in a work-out. It is arguable that such a work-out falls within the disclosure carve-out in the listing rules, in that the potential insolvency of the company is insufficiently definite and the terms of any work-out may still be subject to negotiation or part of an incomplete proposal and a reasonable person would not expect them to be disclosed given that such a disclosure could cause customers and suppliers to stop dealing with the company at a time when directors are undertaking a business rescue.

We note that unlisted disclosing entities may be required to disclose the financial position of the company on the ASIC register and the company's website.

The proposed moratorium would not prevent secured creditors taking action to enforce their security or unsecured creditors commencing proceedings to recover amounts owed to them.

Q 2.2.3: Where a safe harbour is not available

Governance Institute is of the view that it is a matter for the court to determine if the defence does not apply, and does not support the legislation specifying the types of persons to whom the defence does not apply. For example, we note that there is already a criminal provision attached to persons disqualified from managing a company. This does not need duplicating in any defence to s 588G.

Governance Institute also does not support ASIC determining after the fact that either the defence does not apply or the type of person to whom it does not apply.

Governance Institute recommends that the court should determine if the defence does or does not apply.

Governance Institute also recommends that clarity as to how the safe harbour should operate could be dealt with in the explanatory memorandum to legislation, where it could be stated that the types of persons set out in the proposals paper are already covered under other provisions which a court would take into account when determining if the defence does not apply.

2.3 Safe harbour Model B — a carve-out

Governance Institute strongly supports Model B as the preferred model over Model A.

We note that Model B is closer to the United States business judgment presumption against liability. The carve-out has more flexibility and provides for the focus on the management of a turnaround.

Governance Institute recommends that:

- Model B be introduced as the safe harbour for directors within which they may attempt to return the company to profitability
- a carve-out from s 588G be predicated on the appointment of a restructuring adviser
- all three limbs be amended to change 'the debt incurred' to 'debts incurred' to ensure that the focus is on debts as a whole, rather than focus on a 'debt by debt' analysis. It would be impracticable to require the directors to satisfy themselves that each and every debt incurred is essential for the restructuring effort. Such a requirement would serve to further distract the board and management into undertaking a forensic analysis of every potential debt while they should be focused on managing the restructuring effort
- the first limb should replace 'return the company to solvency' with 'return to business viability' for the reasons explained above
- the final limb of Proposal 2.3 (Model B) should read 'creditors as a whole' — this is consistent with the second limb in this proposal and also the explanatory text
- the duty to consider the interests of creditors be consistent with directors' duties under s 181 of the Act — the carve-out needs to be consistent with the broader framework of liability.

Governance Institute also recommends that regulatory guidance be issued clarifying the following terms:

- reasonable steps
- reasonable period of time
- materially increase the risk of serious loss to creditors — directors will need confidence that they can take steps to return the company to profitability and not be paralysed by uncertainty as to what constitutes the risk of serious loss to creditors.

This would be consistent with how guidance is issued in relation to reckless trading laws in other jurisdictions.

We also suggest that it is worth considering if a statutory definition of 'debt' or 'debt incurred' should be included in the Corporations Act.

Q 2.3: Merits and drawbacks of proposal

This model provides directors with the confidence that if they act within the scope of the carve-out they are unlikely to be successfully sued for insolvent trading, compared with the introduction of Model A that would require directors to establish the defence after being successfully sued for insolvent trading. We acknowledge that Model B may be seen to be more 'pro-director' by making it harder to sue for insolvent trading, but we believe that this is justifiable if the government wishes to shift the focus of corporate boards from protecting themselves against personal liability to concentrating on good faith efforts to attempt to save viable businesses.

While adding a safe harbour defence would be an improvement on the current law, similar to our comments on Model A, the Governance Institute is concerned that the safe harbour still leaves directors open to opportunistic litigation from liquidators and creditors, or even an assignee if the liquidator decides to sell the right to sue under the new powers to be conferred by the *Insolvency Law Reform Act 2016*.

3 Ipso facto clauses

Most commercial contracts that a company enters into contain a clause that can be triggered in the event of insolvency.

Given that the policy objective set out in the proposals paper is to provide a moratorium for directors in which to return the company to profitability, Governance Institute supports the proposal to make ipso facto clauses unenforceable if a company is undertaking a restructure.

Our support is based on the following:

- If the company is failing to trade out of financial distress, and cannot make payments or otherwise comply with the performance obligations under the contract, it can be sued for breach of contract.
- If the company is technically insolvent but it is making payments and complying with the contract, the contract cannot be terminated simply because of the fact of insolvency or the appointment of an external administrator.
- Under the ordinary terms of contracts, if the company is not complying, the contract can still be terminated.

Conclusion

Governance Institute supports the concept of a 'safe harbour' on the basis that, if a director has 'done the right thing' while seeking to return the company to solvency, they will be protected. Governance Institute believes that it is appropriate that a safe harbour apply in cases of insolvent trading, so long as in these cases the carve-out from s 588G does not put creditor protection at risk.

We note that there is considered risk and foolhardy risk, and that any reduction in personal legal liabilities should not suggest that directors could feel the need to be less diligent than they should be.

We look forward to the release of an exposure draft of legislation for public consultation.

Yours sincerely

Steve Burrell
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