27 May 2016

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

Dear Sir/Madam

Re: Improving Bankruptcy and Insolvency Laws Proposals Paper (April 2016)

This submission is made in reply to the Proposals Paper referenced above. It addresses all of the queries raised under Section 2 in relation to the law on insolvent trading.

Yours faithfully

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General Remarks

The duty to avoid insolvent trading, as noted by a leading commentator,[1] is the most controversial of the duties imposed upon company directors in Australia. The Government's Innovation Statement,[2] together with the credit crunch of the global financial crisis, has exposed the inflexible operation of the insolvent trading laws under Part 5.7B of the *Corporations Act 2001* (Cth) - widely regarded as one of the most stringent in the world.[3] As part of the deterrence regime, directors (de facto or shadow) under commercial pressure may incur civil or criminal liability, or on 'pain of personal liability'[4] pay compensation to the creditors if they permit their company to trade whilst insolvent.

Not everyone, it appears, is fully convinced of the need for this law reform. The possibility has been raised that the risk of personal liability for directors are 'exaggerated and overstated' [5] due to the small number of insolvent trading cases. Nor, in the first instance, is everyone convinced for the need to have insolvent trading laws.[6]

Some countries have a variation of insolvent trading laws on their statutes, designed to capture fraudulent or wrongful trading,[7] but with the United States and Canada being significant exceptions - it has no such laws.[8]

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[1] I Ramsay, 'An Overview of the Insolvent Trading Debate' in Ramsay (ed) *Company Directors' Liability for Insolvent Trading*, Centre for Corporate law and Securities Regulation (CCH Australia, 2000), 1.

[2] *See* National Innovation & Science Agenda, *Insolvency Law Reform*, http://www.innovation.gov.au/page/insolvency-laws-reform (last visited 20 May 2016).

[3] The Hon Wayne Martin, Chief Justice of Western Australia, 'Official Opening Address' (Speech delivered at Insolvency Practitioners' Association of Australia 16th National Conference, Perth, 28 May 2009). For comparative study of insolvent trading regimes in other countries, see J Harris, 'Director Liability for Insolvent Trading: Is the Cure Worse than the Disease?' (2009) 23 *Australian Journal of Corporate Law* 266.

[4] *Woodgate v Davis* [2002] NSWSC 616 at [36]; (2002) 42 ACSR 286.

[5] See House Debates speech of Terri Butler, Second Reading of Insolvency Law Reform Bill 2015, drawing upon enforcement data cited in the Productivity Commission, *Business Set-Up, Transfer and Closure* Final Report No 75 (30 September 2015, Canberra) [http://www.openaustralia.org.au/debate/?id=2016-02-09.119.1]. It should be noted that were at least 6 insolvent trading cases in the last 13 months from April 2015.

[6] See discussion in I Ramsay, n 1.

[7] See, for example, s 214 of UK Insolvency Act (1986) which prohibits wrongful trading. For recent application, see *Ralls Builders Limited (in liquidation)* [2016] EWHC 243 (Ch).

[8] See D Oesterle, 'Corporate Directors' Personal Liability for "Insolvent Trading" in Australia, "Reckless Trading" in New Zealand and "Wrongful Trading" in England: A Recipe for Timid Directors, Hamstrung Controlling Shareholders and Skittish Lenders' in Ramsay (ed) *Company Directors' Liability for Insolvent Trading*, Centre for Corporate law and Securities Regulation (CCH Australia, 2000), 19. Oesterle argues that

The operation of the insolvent trading law raises the difficult, but pragmatic, question of whether to trade or not to trade.[9] The problem is exacerbated by the fact that, often, there is no clear dividing line between solvency and insolvency from the perspective of the directors of a trading company which is in financial difficulties, as recognised by the court.[10] The question of a company's solvency 'frequently is not black and white,[11] and can give rise to differing interpretations by directors - particularly in the early stages of small businesses and start-ups where views may legitimately differ on whether a particular business opportunity will succeed.

For better or for worse, the Proposals Paper (April 2016) does not contemplate the removal of the insolvent trading laws from the statute book. Against the backdrop of these relevant policy considerations, the following responses are offered to the issues outlined in Part 2 of the proposal paper.

Response to Query 2.2

This submission supports the introduction of a statutory defence (safe harbour) for insolvent trading. Such a defence is likely to promote restructuring decisions outside of formal administration, reducing the director's fear of personal liability. The role of the restructuring adviser, as gatekeeper, is a central feature of this defence. It is appropriate to expect the restructuring adviser to exercise their powers and discharge their duties in good faith (with honesty) in the best interests of the company and to act as whistle-blower by informing ASIC of any misconduct they identify. The latter obligation is consistent with what the current law expects of administrators, receivers and liquidators.

The proposal paper notes that the restructuring adviser's duty to act in the best interests of the company is, indeed, to be owed to the company. In light of the discussion below, it is desirable to offer statutory guidance to indicate what is meant by this duty.

The legal test for the duty to 'act in good faith and in the best interests of the company', albeit in the context of directors fiduciary duties, has been identified to be 'one of the most problematic in company law.'[12] This is because it begs relevant questions – who are the

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the Australian insolvent trading law is "excessively protective of creditors and inherently impracticable" at 20.

[9] See further, A Hargovan, 'Director's Liability for Insolvent Trading, Statutory Forgiveness and Law Reform' (2010) 18 *Insolvency Law Journal* 96.

[10] *Hall v Poolman* [2007] NSWSC 1330; (2007) 65 ACSR 123.

[11] See joint submission of Law Council of Australia, Insolvency Practitioners Association of Australia and Turnaround Management Association of Australia (2 March 2010) to Treasury Discussion paper (January 2010), *Insolvent Trading: A Safe Harbour for Reorganisation Attempts Outside of External Administration* [www.treasury.gov.au]

[12] See D Prentice, 'Creditor's Interests and Director's Duties' (1990) 10 *Oxford Journal of Legal Studies* 265, 275. Similarly, other commentators have noted that the content of this duty has not been settled satisfactorily in

stakeholders of the company? Does this duty permit the inclusion of specific classes of stakeholders or the broader community?[13] The learned authors Austin and Ramsay, *'Ford, Austin and Ramsay's Principles of Corporations Law'* (16th ed, 2015, LexisNexis) at p 455 answer this question by noting:

> *Although there may be no direct legal obligation in company law on directors to take other interests into account, it does not follow that directors cannot chose to do so. The management of a co may be justifiably concerned to ensure that the company is a good corporate citizen ...*
>
> *decided cases [show] management may implement a policy of enlightened self-interest ... but may not be generous with company resources when there is no prospect of commercial advantage …*

Similarly, as noted by Emeritus Professor Paul Redmond,[14] this consensus is unconfirmed since it does not rest on explicit legislative direction or authoritative judicial decision. What sense then are a restructuring adviser, and a director of an insolvent company subject to fiduciary duties, to make from this legal uncertainty?

Moreover, when a company is in financial distress and directors' duties to consider creditors intrude, it creates a 'challenging framework'[15] within which decisions must be made to comport with the overarching duty to act in the company best interests.

The reason for the challenge is that judicial authorities in Australia,[16] until the dubious legal propositions by the majority judgement in *Westpac Banking Corporation v The Bell Group Ltd (in liq) (No 3)*,[17] have not gone much beyond simply articulating a need to consider creditor interests when the company is insolvent to nearly insolvent.[18]

The recent Appellate Court decision in the *Bell* case exemplifies the legal uncertainties on this topic which arose upon the directors' exploration of corporate rescue plans in the context of looming insolvency. It appears directors now have an elevated duty at general law to ensure

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Australia. See further, S Marshall and I Ramsay, 'Stakeholders and Directors' Duties: Law, Theory and Evidence' (2012) 35 *University of New South Wales Law Journal* 291.

[14] P Redmond 'Directors' Duties and Corporate Social Responsiveness' (2012) 35 *University of New South Wales Law Journal* 317 at 324.

[15] C Mallon and S Waisman (ed), The Law and Practice of Restructuring in the United Kingdom and United States (Oxford University Press, 2011) 27.

[16] *Walker v Wimborne* (1976) 137 CLR 1; *Kinsela v Russell Kinsela Pty Ltd (in liq)* (1986) 4 NSWLR 722; *Spies v R* (2000) 201 CLR 603. For discussion of these seminal cases, see A Hargovan, 'Directors' Duties to Creditors in Australia after Spies v The Queen – Is the Development of an Independent Fiduciary Duty Dead or Alive?' (2003) 21 *Company and Securities Law Journal* 390; 'Geneva finance and the "duty" of directors to creditors: imperfect obligation and critique' (2004) 12 *Insolvency Law Journal* 134.

[17] (2012) 89 ACSR 1; [2012] WASCA 157 (hereinafter *Bell*). For critical analysis, see A *Hargovan* and J *Harris*, '*For Whom the Bell Tolls*: Directors' Duties to Creditors after Bell' (2013) 35(2) *Sydney Law Review* 433.

[18] Save for confirmation by the High Court in *Spies v R* (2000) 201 CLR 603 that directors do not owe an independent duty to creditors capable of enforcement by the creditors in their own right.

that creditor interests are properly protected during commercial decisions taken prior to insolvency to ensure a pari passu outcome,[19] as opposed to having their interests merely considered as one of a number of stakeholder groups.

Consequently, it is now unclear as to whether directors must go beyond consideration of creditors' interests and ensure that creditors are protected in conformity with the pari passu principle.

Given the fact that the law is riddled with uncertainties, in the manner discussed above, it is appropriate to have a guiding statement on how the various interests are to be weighted, prioritised or reconciled. Like a beacon on the hill, it is submitted that a set of guidelines will be helpful to assist the restructuring adviser, and the director, to discharge this important duty.

It is worthwhile to consider something akin to the contents of s 172 of the UK Companies Act 2006 (reproduced below).[20] Such statutory content was considered for inclusion into the Corporations Act 2001 (Cth), to offer guidance on this duty, but was twice rejected[21] for reasons that are not entirely convincing. It is submitted that the CAMAC and PJC (2006) decisions on this key issue deserves to be revisited.

The safe harbour proposal presents an even stronger case to clarify the position of all stakeholders impacted by corporate insolvency. Without such practical guidance, directors and restructuring advisers will continue to operate in the twilight zone of legal uncertainty.

Response to Query 2.2.1a

Restructuring advisers, indeed, can play a crucial gatekeeping role in a safe harbour and it is fair to say that this will be the natural expectation of all the relevant stakeholders. Gatekeepers have a key role to play in promoting corporate responsibility, to detect and report corporate

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[19] (2012) 89 ACSR 1, 335; [2012] WASCA 157, [2031] (Drummond AJA).

[20] **Section 172 Duty to promote the success of the company (UK Companies Act 2006)**
(1)A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters) to—
(a)the likely consequences of any decision in the long term,
(b)the interests of the company's employees,
(c)the need to foster the company's business relationships with suppliers, customers and others,
(d)the impact of the company's operations on the community and the environment,
(e)the desirability of the company maintaining a reputation for high standards of business conduct, and
(f)the need to act fairly as between members of the company.

[21] CAMAC, *The Social Responsibility of Corporations Report* (December 2006) http://www.camac.gov.au/camac/camac.nsf/byheadline/pdffinal+reports+2006/$file/csr_report.pdf.
Parliamentary Joint Committee on Corporations and Financial Services (PJC), *Corporate Responsibility: Managing Risk and Creating Value* (June 2006) https://www.aph.gov.au/binaries/senate/committee/corporations_ctte/completed_inquiries/2004-07/corporate_responsibility/report/report.pdf

misconduct and are heavily relied upon for effective corporate governance. In the wake of a series of corporate governance disasters in the US and Australia (Enron, WorldCom, One Tel and HIH), members of 'gatekeeping' professionals playing a watchdog role did not bark on their watch – an epic demonstration of gatekeeping failure due the compromise in the values and standards of these professional members who failed to spot and prevent misconduct.

To prevent, or minimise, such history repeating, it is essential for the restructuring adviser to be a fit and proper person, appropriately experienced and qualified. At minimum, he or she should have at least 3 years of relevant experience, similar to the threshold requirement to becoming a member of ARITA, and should have academic qualifications similar to those of a professionally qualified accountant or lawyer. To underscore the importance of these criteria, it should be included in the regulations, analogous to the way in which the professional requirements to be a registered liquidator are referenced in s 1282 of the *Corporations Act 2001* (Cth).

Response to Query 2.2.1b

ARITA meets all of the essential criteria (disciplinary framework, educational framework and ethical standards) and appears to be well positioned to discharge the responsibilities expected from an accredited organisation from which restructuring advisers are appointed. To become an ARITA professional member, members need to undertake an academically robust and challenging Advanced Certification course which is delivered in partnership with the University of Technology Sydney (UTS) – led by insolvent expert Associate Professor Jason Harris and his team in which an interest is declared.

Moreover, all professional members of ARITA are expected to complete 40 hours of continual professional development. ARITA regularly provides a series of training courses dealing with topical professional standards issues to ensure that practitioners and their staff understand their obligations and can implement them into practice. The courses are delivered in innovative ways, including the new electronic classroom to ensure members have access to high quality, professional, education courses.

Response to Query 2.2.1c

Viability is taken to mean the ability to survive. If so, it is then essential for a company to have the ability to pay its outstanding debts and meet ongoing commitments. Thus, it is submitted that the avoidance of insolvent liquidation would be an appropriate method of determining viability.

Coupling this with the requirement of returning the company 'to solvency within a reasonable period of time' may result in this approach being a double-edged sword.

The benefit of such an additional requirement is that it is likely to deter a prolonged period for restructuring, particularly in instances that may not have not entirely meritorious in the first place. On the other hand, this additional time-based requirement may add undue pressure on what is already a difficult financial situation – it may exacerbate an adverse outcome for all stakeholders.

Response to Query 2.2.1d

It is submitted that the factors the restructuring adviser should take into account in determining viability be left to the discretion of the adviser. This submission recognises that companies come in all 'shapes and sizes' and that any regulation will have difficulty in capturing the scale of corporate diversity and complexity. A 'one size fit all' approach is inappropriate here.

Response to Query 2.2.1e

The proposed exclusion of the restructuring adviser from the expanded statutory definition of director (de factor or shadow) is a positive step worthy of reinforcement.

The current statutory definition of director in s 9 provides a carve out for situations where a director acts on advice given by a person in the proper performance of functions attaching to the person's professional capacity, or the person's business relationship with the company. Arguably, restructuring advisers acting in a professional capacity are currently excluded from the current statutory definition of director.

That said, it is important to remember judicial warnings that labels or descriptions given to persons instructing the company to act according to their wishes are not intended to be prescriptive.[22] In such circumstances, courts have repeatedly expressed caution on becoming fixated with, and blinded by, labels given to persons.[23] It is important to note that courts are free to come to their own conclusion after a critical assessment of the way in which the company is managed.[24]

In light of the approach advocated by judicial authorities, the proposed carve out is not superfluous - it has real work to do to ensure that restructuring advisors are not treated as directors, owing the full range of directors' duties - both fiduciary and statutory under the Corporations Act.

In order to dispel doubt and to promote reliance upon the safe harbour defence, the proposed carve out which expressly excludes restructuring advisers is desirable. Without such an express

[22] See *ASIC v Murdaca* (2008) 68 ACSR 66 at [11]; *Grimaldi v Chameleon Mining NL (No 2)* (2012) 200 FCR 296.
[23] Ibid.
[24] Ibid.

carve out, potential exists for the goals of the safe harbour defence to be impeded due to lingering concerns over the restructuring adviser's potential liability for insolvent trading.

It is submitted that an express carve out, such as the version contained in the proposal, will squarely address potential obstacles to securing appointments and will add to the efficacy of the safe harbour defence. It is relevant to note, albeit in a different context, that the expanded definition of director has caused concern among creditor financial institutions and professional advisers during corporate insolvency- as illustrated in several litigated cases.[25]

Response to Query 2.2.2a

The circumstances described in 2.2.2, pertaining to the exclusion of the operation of the safe harbour defence, are appropriate.

Response to Query 2.2.2b

A do nothing approach to disclosure, as currently advocated in the proposals paper, is not recommended. The timely disclosure of market sensitive information, as recognised by the Court,[26] is essential to maintaining and increasing the confidence of investors and to improve the accountability of company management. There is a real risk it will add to the already fertile ground of class action litigation largely founded on breach of continuous disclosure law. It is important to consider the introduction of a specific carve out from the current list under ASX LR 3.1A.

Response to Query 2.2.3

The list of exclusions in the proposal paper appears to be appropriate. It is unclear, however, for the need to qualify the failure to pay employee claims and entitlements by the need for it to be 'significant'

The approach adopted in the proposal paper raises the pertinent question whether directors should be given latitude, in the first place, for failure to pay employee claims and entitlements. The current formulation, it is submitted, runs the risk of moral hazard – it appears to undermine a key responsibility of directors and signals the wrong message that is ok not to pay employee claims and entitlements so long as the outstanding amount reached is not significant.

Response to Query 2.3

Model B, at first blush, appears to be a more flexible and attractive proposal that Model A from a costs perspective and creditor engagement perspective.

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[25] *Emanuel Management Pty Ltd v Foster's Brewing Group Ltd* (2003) 178 FLR 1; *Buzzle Operations Pty Ltd (in liq) v Apple Computer Australia Pty Ltd* (2011) 277 ALR 189. See further, Anil Hargovan, 'Throwing Light on Shadow Directors - Court of Appeal in Buzzle v Apple' (2011) 10 *Insolvency Law Bulletin* 173.
[26] *James Hardie Industries NV v ASIC* [2010] NSWCA 332; (2010) 81 ACSR 1.

In contrast to Model A, it seeks to encourage greater creditor engagement with the insolvent company to work out a recovery solution. It also appears to offer the benefits of simplicity. This, however, may not necessary be the case as the carve out is predicated on the director taking 'reasonable steps' and returning the company to solvency within a 'reasonable time'. These key threshold requirements are not defined and this flexibility may also represent its weakness through lack of guidance. However, it is encouraging to note that indicia of both ‘reasonable steps’ and ‘reasonable time’ are intended to be included in the Explanatory Memorandum accompanying the legislation.[27]

Model B also appears to be a deceptively simpler and cheaper process due to the absence of any express reference for the director to appoint a restructuring adviser. Such an appointment, however, is nonetheless contemplated and, consequently, may engender a reasonable expectation by the court. The Proposals Paper flags that the appointment of an appropriately qualified and experienced restructuring adviser will help inform whether the director has satisfied the first limb of the carve out, set out above. Should this become a regular expectation in practice, Model B has potential to present false economy and flexibility.

The second limb of the carve out in Model B, requiring a director to have a 'honest and reasonable belief', uses language that is appropriate and familiar in corporations law. The term 'honesty' is used in many sections of the Corporations Act (such as ss1317S and 1318) and has been subject to judicial interpretation on many occasions, with its commonly held meaning ascribed to as conduct that is:[28]

> without moral turpitude in the sense that it is without deceit or conscious impropriety, without intent to gain improper benefit or advantage and without carelessness or imprudence at a level that negates the performance of the duty in question.

Model B contemplates the safe harbour as a carve out, rather than a defence. Thus, the Proposal Paper suggests that the burden of proof would lie on the liquidator to establish the director had breached any one of the three limbs of this proposal.[29] Presumably, the burden of proof would also lie on ASIC as the corporate regulator - the Proposals Paper is silent on this key issue.

From a law enforcement and deterrence perspective, the proposal to place the burden of proof on the liquidator (and ASIC) is questionable, as it may dilute the focus of the insolvent trading law. Arguably, it would be more effective to get the director to bear the burden of proof and show that they have complied with all three limbs of the carve out under Model B.

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[27] Australian Government, *Improving bankruptcy and insolvency laws* Proposals Paper (April 2016) at 16.
[28] *ASIC v MacDonald (No 12*) (2009) 73 ACSR 638.
[29] Australian Government, *Improving bankruptcy and insolvency laws* Proposals Paper (April 2016) at 15.