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Dear Sirs

Insolvency Law Reform – Submission of Henry Davis York

Henry Davis York has one of Australia's leading insolvency and restructuring practices. We express our views below on the matters set out in the Proposal Paper issued in April 2016.

Ipso facto clauses – general observations

HDY is generally supportive of the submission of ARITA on this issue, and we offer the following additional observations.

The underlying policy rationale for a prohibition on ipso facto clauses that operate upon the occurrence of an 'insolvency event' is to preserve value by in effect shifting the commercial power to the (external administrator of the) distressed entity that has entered a formal insolvency regime.[1] Under current law, that commercial power resides with the non-defaulting counterparty. This shift represents a clear policy choice. In its limited and targeted way, it shifts the balance away from the contractual rights of the counterparty, to favour the stakeholders of the distressed entity – creditors, employees and community.

From a value preservation perspective, it is important that the distressed entity have the ability to determine whether the consideration it would receive under an existing contract containing an ipso facto clause is worth the cost of continued performance.[2] This should

[1] ie receivership, administration, deed of company arrangement, liquidation, provisional liquidation or has filed an application for a scheme of arrangement.

[2] HDY does not consider there is any need for a more limited application of the ipso facto prohibition. However, if there is significant concern with the present proposal, consideration could be given to imposing a time limit on the prohibition eg, 4 weeks after the commencement of the formal insolvency regime, which is capable of extension by order of the court in complex cases. During this time, the insolvency practitioner can determine which contracts are essential to the company, and assesses the company's position and ability to honour the company's side of the contract. If, after those 4 weeks the insolvency practitioner concludes that a contract is not essential to the company, the prohibition on termination will no longer apply and the non-debtor counterparty will have the option to terminate the contract.

significantly improve the prospects of a distressed entity preserving enterprise value and therefore augment the assets available to finance a restructure or pay creditors.[3] In our experience, the current law allows non-defaulting contractual counterparties to 'renegotiate' the bargain to the detriment of the distressed entity, and in some cases, of which One.Tel is an example, to cause major detriment to the value of the distressed enterprise by terminating the contract even though there is no payment default or any other breach of contract.

HDY considers that an effective ipso facto prohibition:

- Must not impinge upon secured creditors' existing powers of enforcement, in particular under Part 5.3A Division 7, Subdivision B of the Corporations Act.
- Must be consistent with and complement any safe harbour reform. Non-defaulting counterparties should not be allowed to use one reform to undermine or avoid the intent of the other e.g., a non-defaulting counterparty should not be allowed to avoid the operation of the ipso facto prohibition by redrafting event of default provisions to include the appointment of a restructuring advisor, at least where the event is sought to be relied upon to enable contract termination after the appointment of an external administrator. This could result in the non-defaulting counterparty effectively circumventing the present proposal for ipso facto reform.
- Would not require public disclosure.

Ipso facto prohibition would nonetheless be a substantial interference with the private contractual right to form legally binding contracts. Care must therefore be taken to ensure that any interference with this right is limited, and that appropriate safeguards are implemented to ensure that the reform does not unduly burden non-defaulting contractual counterparties. Our thoughts in these respects are set out below.

Query 3.2.a - Are there additional circumstances where reliance on an ipso facto clause should be prohibited?

By 'additional circumstances' we understand that observations are sought regarding whether consideration should be given to prohibiting the termination or variation of a contract for reasons other than the commencement of a 'formal insolvency' as presently proposed on page 18 of the Proposals Paper.

Other specific instances where consideration should be given to prohibiting ipso facto clauses that terminate, vary or otherwise amend a contract, include if the distressed debtor, whilst under external administration, seeks to:

(a) assign the benefit of the contract;

(b) create a 'security interest' as that term is defined in s12 Personal Property Securities Act 2009, by way of raising debt finance.

Query 3.2.b - Should the legislation re ipso facto have retrospective operation?

HDY has nothing further to add to the submission of ARITA on this query.

3 This is consistent with the objectives of Part 5.3A: *see* s 435A

Query 3.2.b - Are there any other circumstances to which a moratorium on the operation of ipso facto clauses should be extended?

This query requires consideration of whether the concept of an 'insolvency event', is appropriate to ensure successful implementation of the desired underlying policy objective regarding the proposed reform.

The policy objectives of ipso facto reform

In the United States, one of the few jurisdictions that has comprehensive ipso facto protection for distressed debtor entities, the prohibition on the termination, amendment or variation of an executory contract only applies during a formal restructuring process e.g., Chapter 11 of the Bankruptcy Code. It does not apply during informal 'work out' scenarios. The underlying policy rationale for ipso facto protection is broadly the same as the policy objective set out above. We consider that ipso facto protection should similarly only apply to formal insolvency processes in Australia.

Importantly in the United States, the non-debtor counterparty is only prohibited from terminating, amending or varying the pre-bankruptcy petition contract. There is no statutory compulsion to continue to perform the contract - during the Chapter 11 bankruptcy, the debtor entity has no better contractual rights than it had pre-bankruptcy.

The question of whether the non-debtor counterparty is required to continue to perform the contract is determined by the pre-bankruptcy petition rights and obligations of the parties recorded in the executory contract. If that is not determinative, the respective commercial bargaining power of the parties will govern the issue during the term of the bankruptcy. Critically, the non-debtor counterparty's continued performance (whether brought about through a pre-bankruptcy petition obligation or post-bankruptcy petition negotiation) is usually protected by being considered to be an administrative expense of the bankruptcy. All such expenses must be paid in full (or otherwise agreed) before a plan of restructuring can be confirmed by the Bankruptcy Court.

The administrative expense status of the continued performance is an important safeguard. It ensures that the non-debtor counterparty is not at risk of continuing to perform, without recovering the pre-bankruptcy agreed consideration. It is in our opinion important to ensure the reform here has the equivalent safeguards.

Receivership, scheme of arrangement, administration and deed of company arrangement

The Proposals Paper correctly identifies that the ipso facto prohibition should apply during receivership, scheme of arrangement, administration and deed of company arrangement. The need to ensure that the consideration payable to the non-debtor contractual counterparty will be paid in full is a concept that is already recognised in receiverships (s419) and administration (ss 443A and 443B, 556(1)(c))[4].

We consider that it is crucial that the protection should also apply during a deed of company arrangement. The protection should only cease once the company has completed its restructure and often this is implemented via a deed of company arrangement. The policy objectives outlined above concerning a prohibition on ipso facto clauses are the same with respect to schemes of arrangement and deeds of company arrangement. If the

[4] It is accepted that s419, s443A and s443B many need to be amended to clarify the precise nature of the pre or post appointment liability being incurred by the insolvency practitioner.

prohibition does not apply during a deed of company arrangement, there is a risk that the policy objective could be undermined by a non-debtor counterparty waiting to terminate the contract once the distressed debtor transitions from administration to the deed of company arrangement. Part 5.3A already contains protections that are consistent with this objective: *see* s444C and s444E.

We accept that a scheme of arrangement requires court approval and any disgruntled non-debtor counterparty could register its objection with the court. However, under the existing law - *see* s445D and s447A - and under the Proposal Paper's draft appeals process, such a counterparty would have a similar avenue for court review with regard to a deed of company arrangement.

Appointment of a restructuring advisor

The successful implementation of safe harbour reform and ipso facto protection should be regarded as interdependent. Coordinated policy implementation is critical. Non-debtor contractual counterparties should not be able to use one measure as a means of defeating the other. It is imperative that market practice does not shift

The Proposals Paper does not currently include the appointment of a restructuring advisor under Safe Harbour Model A as an insolvency event. Without the incorporation of such a definition, it is foreseeable that a non-debtor counterparty may amend the definition of event of default in a contract to bring forward the "insolvency event" to the appointment of the restructuring advisor. Such an event would likely give rise to a right to terminate the contract and in many respects defeat the policy objective associated with Safe Harbour Model A.

While it is accepted that ipso facto reform should in no way affect the existing rights of a secured party to enforce its security, in particular under Part 5.3A Division 7, Subdivision B of the Corporations Act, in the limited circumstances set out below, we consider that the safe harbour and ipso facto reforms should work together to prevent either or both being frustrated to the point of futility by unsecured non-debtor counterparties.

As set out above, any ipso facto reform is a significant infringement on the private right to contract and the associated right to assess and respond to the credit worthiness of an existing contractual counterparty. Non-debtor counterparties should in general be entitled to appropriately protect themselves against the risk of financial non-performance by a distressed entity. A balance between the competing policies must be struck, and we support the position that the protection should only be available to a company under external administration.

It is submitted that if an unsecured non-debtor counterparty learns of the appointment of a restructuring advisor, and this is an event of default enabling termination/variation, the counterparty should be allowed to take such action as it chooses, including terminating a contract. However, the balance should change when the company enters external administration. Importantly here, an unsecured non-debtor counterparty should be prohibited from retrospectively relying on the appointment of a restructuring advisor as a termination event, once a formal insolvency regime has commenced or in the case of a scheme of arrangement, an application has been filed with the court. To allow an unsecured non-debtor counterparty to do so at this point would substantially undermine the objective of the proposed Safe Harbour.

Further, there is no sound underlying policy consideration associated with allowing an unsecured non-debtor counterparty to take any action upon such an appointment because:

(a) the time would have passed for the unsecured non-debtor counterparty to take any meaningful action to mitigate the risk associated with the financial position of the distressed debtor; and

(b) as set out above, an administrator and a receiver already have broad statutory liability for the debts incurred during the course of the administration or receivership – this provides the protection to the counterparty (and mirrors the analogous position in the US) that balances its loss of contractual entitlement.

Query 3.2.1 - Comment on anti-avoidance mechanism.

HDY is supportive of the submission of ARITA on this question. See also our observations at paragraphs 3.5 to 3.10 above.

Query 3.2.2 What contracts or classes of contracts should be specifically excluded from the operation of the provision?

HDY has nothing further to add to the submission of ARITA on this query.

Query 3.2.3 - Is the proposed appeal mechanism necessary and appropriate?

HDY is supportive of the submission of ARITA on this query.

In addition, the contract should be terminable with the consent of the insolvency practitioner.

Safe Harbour – General observations

The government's recently stated aim to create more of a rescue culture in Australia, promoting a platform for innovation, provides an opportunity to reflect on how our current insolvency laws allow or inhibit such an environment to exist. The proposal paper notes that Australia's current insolvent trading laws have long been identified as a driver behind companies entering voluntary administration, even when they may in fact be viable businesses. The first step in moving more toward a rescue culture ought to be to reflect on whether the current laws are apt to serve that purpose.

The Safe Harbour models proposed are commendable attempts to lessen or "work around" the impacts of the current insolvent trading laws. However, it is worth considering whether the strict insolvent trading laws still represent an appropriate policy choice. It has been noted[5] that no other major economy in the world has insolvent trading laws as stringent as Australia's. Has Australia made the right choice in having and keeping these insolvent trading laws (with the rest of the world getting this issue wrong)?

It is already well established in Australia that when a company enters the zone of insolvency, which is itself a very complex issue,[6] a director's duties are in effect "owed" to

5 The Joint Submissions in Relation to Insolvent Trading Safe Harbour Option Paper submitted by Law Council of Australia, IPAA (now ARITA) and TMAA dated 2 March 2010.

6 Ibid.

the creditors of the company. The director's duties already encompass duties to exercise an appropriate degree of due care and diligence, to act in good faith and incorporate a business judgment rule. Reflecting on the relatively few successful insolvent trading cases, it would be proper to consider whether such a regime, which inhibits genuine restructuring attempts, is really required at all, let alone when the intention is to create an environment to foster a rescue culture.

It is submitted that both proposed safe harbour models have merits, and HDY is very supportive of the introduction of an appropriate safe harbour, but the proposals could be perceived as mere Band-Aids applied to stem the flow of blood, rather than the surgery that would cure the ailment. It may be that more minor amendments could be made to the existing director duties or business judgment rule to spell out the requirements for directors in the zone of insolvency (along similar lines to the requirements of Proposal A), and that would allow Australia's insolvent trading laws to be repealed and in this sense, effect a harmonisation of our laws with those of our trading partners.

Such an approach is supported by what statistics exist in this area. Report 456 *Insolvency statistics: External administrators' reports* (July 2014 to June 2015) (**Report 456**) surveyed the 8,354 reports that ASIC received from external administrators during the 2014–15 financial year, finding that of the companies the subject of the reports:

- 85% had assets of $100,000 or less;
- 79% had less than 20 employees; and
- 43% had liabilities of $250,000 (or less).

Report 456 found that of the companies in the above group, 97% of creditors received between 0–11 cents in the dollar.

Of the 4,285 reports received after 8 December 2014, 2,447 (or 57.1%) external administrators alleged insolvent trading had likely occurred.

The following general conclusions emerge from the above, which inform discussion about rescue culture generally and the safe harbour proposals in particular:

- The great majority of insolvency administrations involve SMEs;
- The frequency of insolvent trading amongst SMEs may be high; and
- The risk to directors of SMEs of an insolvent trading action is, in reality, very low.

In relation to the last point, the small quantum of claims and the absence of funds available to pursue them are practical obstacles. The historically low instances of insolvent trading actions bear out these matters.

The above statistics provide important context. The observations of the productivity commission (referred to in the Proposals Paper) that the threat of insolvent trading laws and uncertainty about the fact of insolvency are a driver behind entry into external administration <u>for viable companies</u> ought be viewed in the above context. That is not to suggest the absence of merit in safe harbour provisions, rather to acknowledge that the provisions will generally impact a small proportion of companies, and the challenges that this reality presents to the generation of a rescue culture.

The two alternative proposals advanced in the Proposals Paper ought also be viewed in the light of the characteristics of the companies likely to engage them.

We offer the following specific comments regarding the specific proposals set out in the discussion paper.

Query 2.2 - Safe Harbour Model A - Subject to the further information on the proposal set out in the sections below, the Government seeks views from the public on whether their proposal provides an appropriate safe harbour for directors.

We are generally supportive of ARITA's submissions, albeit we see more merit in aspects of Model B, as we explain in the next section.

We agree with ARITA's submission that a return to solvency may not be the appropriate test or aim, as there are other options in a restructuring as ARITA notes, for example, a whole or partial sale of the business or business units, even though the original company remains insolvent. The restructuring advisers' advice may be to effect an orderly liquidation. We agree broadly with the ARITA draft submissions that the test should be that the director took reasonable steps to minimise significant risk of loss to the creditors as a whole.

We agree with ARITA's submission that the directors should be under an obligation to consider the interests of creditors as a whole.

We agree with ARITA's submissions that director's duties should be heightened rather than relaxed in any safe harbour - we contend that this reflects existing director duty law.

There are, however, drawbacks with the way the proposal is currently described.

For example, as a defence that requires the appointment of a Restructuring Adviser (RA) it may be inherently inequitable to the directors of SMEs including micro companies[7] (ie liabilities <$250,000). SMEs in distress will not always be able to afford the services of a RA (whose costs will likely reflect the level of education, qualification and regulation that we would recommend be required) - the defence as currently proposed would be unavailable to them. However, this is more a criticism of the existing insolvent trading laws, and not of this proposal, which at least improves the law by promoting a rescue culture for larger companies.

The restructuring adviser

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.

We agree with ARITA's submissions to the effect that there should be a high level of education covering ethics, independence and financial restructuring at a minimum. There must be regulatory oversight over the "restructuring adviser industry" to maintain high standards, with the power to exclude practitioners who fail to meet those high standards.

[7] See footnote 10.

Query 2.2.1c - Is this an appropriate method of determining viability?

We agree with ARITA's submissions.

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?

We agree with ARITA's submissions.

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.

We agree with ARITA's submissions.

Query 2.2.2a - Do you agree with this approach?

We agree with ARITA's submissions.

Query 2.2.2b - Do you agree with our approach to disclosure?

We agree with ARITA's submissions.

Query 2.2.3 - The Government seeks views from the public on in what other circumstances should the safe harbour defence not be available.

We agree with ARITA's submissions.

Query 2.3 - Safe Harbour Model B - The Government seeks your feedback on the merits and drawbacks of this model of safe harbour.

This is described in the *Proposals Paper* as "a carve out, rather than a defence"; thus placing the burden of proof on a liquidator bringing a claim to show that a director had breached this provision. This raises a very important issue of legal principle (i.e. onus of proof) and one equally important issue of policy (i.e. how best to promote a restructuring culture).

The *Proposals Paper* also notes that "this model is not formally predicated on the appointment of a restructuring adviser", but assumes that that will be a factor considered in determining whether the director has taken "reasonable steps". "Early engagement with shareholders, creditors (including employees) and other stakeholders" would be another factor considered with respect to the taking of "reasonable steps", the indicia of which would be set out in the Explanatory Memorandum which accompanies the legislation.

The Model B Proposal goes further along a spectrum of protecting directors than does the Model A Proposal and offers greater assistance to a director genuinely seeking to rescue the company from collapse. For this reason, and subject to refinement, it ought to be preferred to Model A to foster a restructuring culture and protect those directors that are properly and diligently seeking to avoid value destruction from a formal appointment.

This submission also suggests ways in which Model B might be altered to more effectively achieve the policy objectives.

The Onus of Proof

One of the main arguments against a carve-out as a form of safe harbour is that by shifting the onus of proof from the director to a liquidator (or ASIC), the proposal renders the insolvent trading laws unreasonably difficult to prove. (We note this point is made by ARITA in its submission.) We do not agree with this perspective.

While we accept that insolvent trading cases are difficult to prove, as a matter of principle we consider it should always be for the plaintiff – the party alleging that a wrong has occurred - to establish by evidence that the alleged wrong has in fact been committed. Insolvent trading liability should be no different, and the additional aspects of the safe harbour proposal should be seen as integral elements of the wrongful conduct.

Moreover, ASIC and liquidators have unique investigative powers at their disposal to obtain the relevant evidence, such as through public examinations.

The difficulty with proving insolvent trading cases may be evident from the small number of cases pursued. There has been an average of 2 civil cases that proceed to judgment per year between 1993, when the prohibition was enacted in its present form, and 2010.[8] While the reasons for these figures may be many and varied, at least one inference is that insolvent trading claims under the existing legislation are simply too hard for liquidators to pursue on a commercially viable basis.

However, it is significant to note that the effect and purpose of the insolvent trading prohibition, as distinct from other voidable transactions, is to prevent debts from snowballing and to act as a deterrence mechanism. In doing so, we note that recovery of money for creditors under the section is already rare and in the broader sense a less desirable outcome for creditors than a successful rescue. For this reason, directors acting honestly with that goal in mind ought to be protected.

The Terms of the Model B Proposal

The terms of the Model B Proposal allow for greater flexibility, particularly when dealing with small to medium sized businesses which may not be in a position to afford the services of an experienced and well qualified RA, but which may be able to show that advice had been sought from a source that might objectively be considered to have had suitable business and/or industry experience and expertise and that they conscientiously acted on the advice they received.

Model B best advances the policy of promoting innovation and a rescue culture. Provided the terms of the legislation are satisfied, no contravention is committed. This contrasts with Model A where a director attempting to bring herself within the safe harbour faces the legal reality that the contravention has occurred (with draconian consequences – personal liability for debts and possible imprisonment) unless the defence can be established. This is more than a subtle issue of onus. It is the difference between a director being able to identify and observe her legal obligations, and one who is in contravention of the law unless a defence is made out. The former position reflects the appropriate policy choice where a rescue culture is sought to be encouraged.

In our opinion, Model B in its current form needs improvement and refinement.

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[8] Anna MacFarlane, 'Safe harbour reforms - should insolvent trading provisions be reformed?' (2010) 18 *Insolvency Law Journal* 138 at 145.

With the objective of deterring reckless conduct in mind and the issues with prosecution highlighted above, Model B could minimise the related uncertainty and risks of the proposed reform by adding clearer and detailed legislative guidance as to what a Court (and a therefore a director) should take into account when assessing whether conduct constitutes "reasonable steps". We note our submission accords with the ARITA Submission in this respect.

A level of uncertainty will be undesirable for both:

1. a director, trying to understand what must be done to act in the best interest of the company and its stakeholders while making decisions that may have significant ramifications for his or her personal liabilities; and

2. a liquidator who, having regard to his or her duty to efficiently deploy the limited assets that may remain in an insolvent company for the benefit of its creditors, will be reluctant to embark on difficult litigation.

We therefore submit that the requirements necessary to obtain the benefit of a safe harbour framework and to achieve the goals of such a framework should be set out in the legislation, including (in the absence of special circumstances – which could include cost for a micro company) the requirement to retain a restructuring adviser with appropriate qualifications and experience, which we have addressed in our submissions on the Model A Proposal. We consider any proposal to leave these matters for an Explanatory Memorandum or to be left wholly to the discretion of a Court (to be decided in all the circumstances of the case) to be unsatisfactory. For example, we submit the section should also include a provision along the following lines[9]:

In determining what constitutes "reasonable steps" in accordance with paragraph (a), the Court is to consider:

the retention of an independent and qualified Restructuring Advisor (a defined term explained above];

any steps taken in accordance with a plan or guidance provided by the Restructuring Advisor; and

if the company is a "micro company",[10] then reasonable steps in accordance with a detailed and considered business plan (not necessarily proposed by an external provider) that demonstrates how solvency will be returned to the company within a reasonable period,[11]

as factors which would suggest that the steps taken were reasonable, unless the circumstances otherwise suggest that the above steps were not undertaken honestly and for the benefit of creditors and members.

9 This is not an attempt to draft the legislative provision. It is an indication of the matters that should be addressed in such a provision.

10 "Micro company" is a term adopted from ARITA in *Discussion Paper: A Platform for Recovery 2014* at 9. It is defined to be a company with liabilities not exceeding $250,000.

11 But see our comments regarding query 2.2 where we suggest a wider definition of what outcome may be appropriate.

Yours faithfully
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