Improving Bankruptcy and Insolvency Laws Proposals Paper – submission to Treasury from Herbert Smith Freehills

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ANZ Tower 161 Castlereagh Street Sydney NSW 2000 Australia
GPO Box 4227 Sydney NSW 2001 Australia

T +61 2 9225 5000 **F** +61 2 9322 4000
herbertsmithfreehills.com DX 361 Sydney

Submission from Herbert Smith Freehills

1 Introduction

This submission has been prepared by Herbert Smith Freehills in response to the Australian Government's proposals paper released on 29 April 2016 in relation to 'Improving bankruptcy and insolvency laws' (the **Proposals Paper**).

Set out below in this submission are responses to the specific queries raised in the Proposals Paper, as well as additional comments on the proposals and further recommendations in relation to matters not included in the Proposals Paper.

Our submission and the observations herein are based on our extensive experience acting on a large number of significant corporate restructuring, distressed debt and formal insolvency transactions in Australia and in other jurisdictions around the world. Herbert Smith Freehills is a top tier international law firm with a market-leading restructuring, turnaround and insolvency practice both nationally and globally. In Australia, our national team has advised on a number of the significant corporate restructuring transactions and complex insolvencies in the last 10 years, including:

- Advising TPG on the restructuring and recapitalisation of the Alinta Energy Group;
- Advising Centro Properties Group on its restructuring;
- Advising the senior lending syndicate on the fully consensual restructuring and recapitalisation of the I-MED Network group;
- Advising Goldman Sachs, as holder of mezzanine bonds, on the restructuring of Nine Entertainment Group;
- Advising the administrators and liquidators of the Retail Adventures Group in relation to its administration and subsequent liquidation;
- Advising Seven Group Holdings in respect of its acquisition of debt interests in Nexus Group and the subsequent "DOCA takeover" of the Nexus Group;
- Advising the receivers of SubZero Group Limited;
- Advising Liberty Metals & Mining LLC in relation to the administration of, and deed of company arrangement for, Cockatoo Coal Limited; and
- Advising Arrium Limited in relation to its proposed restructuring and recapitalisation and advising the initial administrators to Arrium Limited in relation to the administration of the Arrium group.

A number of members of our restructuring, turnaround and insolvency team in Australia have also practised in other jurisdictions, including the United Kingdom (**UK**) and the United States or America (**USA** or **US**), and have accordingly had significant experience with the restructuring and insolvency systems in those jurisdictions.

2 Proposal 2 – Safe harbour

As a general comment, we welcome the Government's initiative to introduce legislation to reform Australia's strict insolvent trading regime. We consider that the reform is important to allow greater flexibility to restructure businesses and thereby rescue viable businesses and achieve better outcomes for all stakeholders.

Whilst we make comments on each of the models proposed below, we note at the outset that we support Model B, with modifications, over Model A. In our view, Model B provides greater flexibility for directors to take the appropriate steps when restructuring a company. We also consider the regime set out in Model A to be too narrow and prescriptive, and without regard to the different circumstances and contexts in which companies operate.

We have responded to each of the questions in the Proposals Paper below. Our specific recommendations are also set out below.

2.1 General comments

Australia's insolvent trading laws

Directors of Australian companies have a duty to prevent insolvent trading pursuant to section 588G of the Corporations Act 2001 (Cth) (**Corporations Act**).

Insolvent trading is said to occur if a company incurs a debt whilst it is insolvent (that is, it is unable to pay its debts as and when they fall due). Should a company subsequently enter into liquidation, a director may be personally liable for debts incurred when the company was insolvent, unless the Court relieves the director from civil liability or the director can establish one of the statutory defences set out in section 588G of the Corporations Act. A director can also be criminally liable for insolvent trading if the director's failure to prevent the company incurring the debt was dishonest.

The justification for insolvent trading laws is largely focussed on creditor protection, and is designed to encourage directors to prevent the company continuing to trade if they suspect its insolvency, so as to reduce the potential loss suffered by creditors through incurring additional credit when it may not be fully repaid.

Striking the right balance

Australia's insolvent trading laws are considered to be some of the strictest in the world, particularly compared to the regimes in other finance and business jurisdictions:

(a) in the USA there is no personal liability for directors in connection with any conceptual equivalent to insolvent trading;

(b) the UK's Insolvency Act 1986 (UK) c. 45 (**UK Insolvency Act**) provides for 'wrongful trading', where a director may be liable to make a contribution to the company's assets if the company has gone into insolvent liquidation and the director knew or ought to have known that there was no reasonable prospect that the company would avoid going into insolvent liquidation. Given directors are only at risk for losses incurred once there is no longer a reasonable prospect of avoiding insolvent liquidation, in practice this provides significant space for directors to pursue restructurings while the company is insolvent;

(c) Hong Kong does not currently have any insolvent trading provisions, although directors may be liable for 'fraudulent trading' which requires dishonest conduct on the part of directors (albeit there are proposals to introduce a stricter regime including insolvent trading provisions along with a new corporate rescue regime); and

(d) a director of a company incorporated in Singapore may be liable under the wrongful trading regime if the director knowingly or recklessly causes the company to incur debts when there is no reasonable ground of expectation of the company being able to repay those debts. In Singapore, wrongful trading is an offence; it is only upon conviction of the offence that the director may be ordered to compensate creditors who have suffered a loss as a result of being unable to recover the debt in question.

The strict regime in Australia acts as an incentive to companies to only trade whilst solvent. This provides a degree of protection to creditors who might otherwise have extended credit to the company. However, by effectively requiring directors to appoint an external administrator, this can also prevent directors from taking sensible steps to attempt to achieve a better outcome for shareholders, existing creditors and other stakeholders through a corporate restructuring. It has therefore been asked whether Australia's insolvent trading laws are a cure that is worse than the disease.[1]

Further, it has been suggested that:

(a) the threat of insolvent trading claims, combined with uncertainty over the precise moment when the company is insolvent, means that often companies enter voluntary administration, sometimes prematurely;[2]

(b) formal appointments such as that of a voluntary administrator can result in a destruction of, or diminution in, the value of a company;[3] and

(c) due to a fear of liability, directors are disinclined to take what may be reasonable commercial risks to restructure a company or undertake a work-out plan. A vast majority of directors agree that the risk of personal liability has caused them to take an overly cautious approach to business decision making.[4]

In addition, we note that in 2013 Singapore undertook a major review of its insolvency laws which included a consideration of whether to adopt Australia's insolvent trading regime. As part of that review, the Singapore Ministry of Law's Insolvency Law Review Committee stated:[5]

> *"The Committee is of the view that the Australian provisions on insolvent trading should not be adopted. The Australian provisions are considered to be some of the strictest provisions amongst the major jurisdictions, in the sense that they effectively prohibit trading once there are "reasonable grounds for suspecting" that a company is insolvent. The Committee is of the view that they are not appropriate for Singapore. A wide notional cessation of trading even prior to the commencement of insolvency proceedings may further endanger a financially-troubled company's ability to trade through a period of crisis, and thus worsen the company's financial difficulties. It does not strike the best balance between the interest in protecting creditors against the reckless or unreasonable incurring of debts by an insolvent company, and the interest in allowing the directors of a distressed company a fair opportunity to take reasonable steps to avoid the company's financial ruin. There should be more latitude afforded to a director to continue to trade in the reasonable expectation that, although the*

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[1] Jason Harris, 'Director liability for insolvent trading: Is the cure worse than the disease?' (2009) 23(3) Australian Journal of Corporate Law 266.

[2] Business Set-up, Transfer and Closure Productivity Commission Inquiry Report, 378.

[3] Joint Submission made by the Law Council of Australia, Insolvent Practitioners Association of Australia (now Australian Restructuring Insolvency and Turnaround Association) and the Turnaround Management Association of Australia dated 2 March 2010 in relation to the Australian Government's Insolvent Trading Safe Harbour Options Paper.

[4] Australian Institute of Company Directors, Director Sentiment Index: Research Findings Second Half 2015 (2015).

[5] Insolvency Law Review Committee, Final Report (Singapore, 2013), 204-5.

company is insolvent, it is most likely to be able to trade out of its present difficulties.

The Committee further notes that the Australian position must be understood in a broader legislative context. For example, the Australian taxation regime imposes personal liability on company directors if the company's tax remains unpaid, and provides for the issuance of a notice by the Commissioner of Taxation which requires the directors to adopt one of four options within 14 days: (a) paying the tax owed, (b) compromising the tax owed, (c) placing the company into liquidation, or (d) opting for voluntary administration. It has therefore been noted that the Australian Commissioner of Taxation often serves as a de facto regulator of insolvency laws. The Australian approach (including its strict insolvency trading provisions) is not suitable in the Singapore context in that it tips the balance too much in favour of an early invocation of insolvency processes. The entry into formal insolvency procedures often has severe consequences on the company, and may in itself bring about the untimely end of the company. Further, the above legislative framework does not appear to provide sufficient avenues for informal workouts outside of formal insolvency procedures."

We share these concerns. Whilst sometimes necessary, formal insolvency processes can destroy, or cause significant value destruction to, businesses. It is inappropriate to impose personal liability risk on directors who are taking reasonable steps to restructure the company to get the best outcome they can for stakeholders. We therefore believe that Australia's insolvent trading laws need to be reformed to reduce the unreasonable burden of liability on directors and allow more opportunities, in appropriate cases, for viable businesses to be rescued and restructured, thereby delivering better outcomes for all stakeholders.

We believe that it is preferable to have a regime with reasonable flexibility rather than a safe harbour concept that is too narrow or prescriptive. Corporate restructurings vary significantly from case to case. It is important that any regime encourages directors to achieve the best outcome for the relevant stakeholders that is practically achievable in the circumstances.

We therefore believe that further, broader, reform of the insolvent trading laws should be considered, having regard to international experience and best practice. However, we believe that Model B is a positive step in this direction.

Model A

2.2 Response to Query 2.2

Query: 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.

The requirement to appoint a restructuring adviser

While in many circumstances appointing some form of restructuring adviser will be a step directors take in the interests of pursuing a restructure, we do not think that the insolvent trading safe harbour should require the formal appointment of a restructuring adviser. This may be overly prescriptive and inflexible as an element to an insolvent trading defence, particularly having regard to the different context and circumstances in which companies operate. We are not aware of any other comparable jurisdiction that has adopted a requirement of this sort.

Restructuring advice

Whilst we acknowledge that there is merit in encouraging financially distressed companies to seek advice from suitably qualified specialists, we question whether the prescriptive regime of requiring a formal appointment of a designated 'restructuring adviser' is the best method of providing an insolvent trading safe harbour.

Restructurings and turnarounds are best begun early, before financial distress has become too acute and while the company has more options. A company exploring restructuring and turnaround options at this stage may need a broad range of financial, operational, strategic and legal advice that will very much depend on its circumstances. As the process continues the mix of advisers and the emphasis of their work may be adjusted to reflect the changing condition of the company and the stage of the process.

Appointment of a specific 'restructuring adviser' may have unhelpful side effects on the restructuring and turnaround process. If creditors or other market participants perceive that a formal 'restructuring adviser' has been appointed for the specific objective of establishing a safe harbour, this may lead to a loss of confidence in the company (given the implication that the directors are potentially concerned about insolvent trading). We agree with the comments of the Law Council of Australia that it would be desirable for companies to continue to be able to appoint advisers who can act in a number of capacities (not just restructuring advice), particularly given that restructuring is best commenced early when a broad set of skills is required to comprehensively respond to a company's financial challenges.

Is the restructuring adviser an officeholder or an adviser?

The Proposals Paper refers to the restructuring adviser having powers and duties (and that these must be exercised in good faith and in the best interests of the company). This suggests that the restructuring adviser role may go beyond simply advising the company and involve the adviser holding some form of office. The precise nature of the role needs clarification and consideration.

There is some tension between the concept of an adviser and that of an officeholder. For example, would the restructuring adviser be required to provide advice to the company consistent with the objective of returning the company to solvency, or would the scope of the role of the restructuring adviser be set by the company? Do the directors remain ultimately responsible for decision making in respect of the restructuring despite the opinion of the restructuring adviser? If so, what would the position of the restructuring adviser be where the directors subsequently choose not to adopt (or otherwise depart from) the recommendations of the restructuring adviser?

Directors taking appropriate steps

Model A does not provide any protection for a director who takes reasonable steps to ensure the business enterprise survives if a restructuring adviser is not appointed. Such a director may be acting honestly, prudently and in the best interests of the company and its creditors, and may have taken all of the steps that a restructuring adviser would have recommended. Indeed, the director may have the appropriate experience and skills to handle a restructuring without the appointment of a third party restructuring adviser. Consideration should be given to whether it is appropriate to extend the benefit of the defence to circumstances where the actions taken by the directors are appropriate, even if a restructuring adviser was not appointed.

General comments

We acknowledge that Model A is not in the form of draft legislation, and is drafted in general terms. However, if Model A was adopted, we suggest that any draft legislation or the Explanatory Memorandum ought to address the following:

(a) what is meant by the term 'reasonable director', and in particular, whether a subjective and objective test (or one or the other) is applied when determining what is meant by reasonable. A subjective and objective test would be consistent with the approach to other defences available under the Corporations Act (see for the section 588H(3)). However, it may be more appropriate in the case of the Model A insolvent trading provision to limit this to a subjective test only, as the restructuring adviser is presumably appointed to provide the company with objective guidance;

(b) whether there will be legislative or regulatory guidance on what is meant by 'reasonable period of time' and 'reasonable steps'. In our view these should not be dictated by legislation, but some guidance may be given in the Explanatory Memorandum to the Bill. We would expect that these would be flexible concepts that would depend on the circumstances of the individual company, what is necessary to return the company to solvency, how long this would require in practice, whether the restructuring adviser recommends these steps and whether the restructuring adviser believes that there are reasonable prospects of success within the relevant timeframe;

(c) whether it is intended for the defence to operate where the company is already insolvent. We submit that it should apply regardless of whether the appointment is made when the company is solvent or later transpires to have been insolvent at the relevant time. The temporary inability of a company to pay all of its debts when they fall due does not necessarily mean that a solvent restructuring is not achievable. As was recognised by the Productivity Commission's Inquiry Report, the precise point of insolvency is often difficult to identify; and

(d) the Proposals Paper refers to the restructuring adviser having both powers and duties (which must be exercised in good faith and in the best interests of the company). However, these powers and duties are not specified in the Proposal. We suggest that in the period prior to formal insolvency the formal powers and duties should remain with the board of directors, and the role of the restructuring adviser should be restricted to an adviser rather than an officeholder. Accordingly, we do not propose that the legislation should prescribe any powers or duties for the restructuring adviser (instead the legislation should merely prescribe the requirements to be satisfied for the defence to be applicable).

Recommendation 2.1*: Model B, with modifications, provides for a more appropriate safe harbour for directors than Model A.*

Recommendation 2.2*: If Model A is adopted, the following matters should be clarified:*

- *that a designated 'restructuring adviser' need not be appointed, but the appointment of any adviser capable of providing restructuring advice be sufficient;*
- *that the role of the restructuring adviser is as an adviser, not an officeholder, and therefore has no statutory powers or duties;*
- *that guidance be provided in respect of the terms 'reasonable director', 'reasonable period of time' and 'reasonable steps'; and*
- *that the defence should apply even if it later transpires that the company was insolvent at the time of appointment.*

2.3 Response to Query 2.2.1a

Query: The Government seeks views from the public on what qualifications and experience the 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.

As noted above, we do not think the safe harbour should require appointment of a restructuring adviser.

However, if appointment of a restructuring adviser is nevertheless required, we suggest that the directors should determine who is an appropriately qualified and experienced restructuring adviser, after having regard to the nature and unique circumstances of the business.

We would generally expect that a restructuring adviser should have significant experience in restructuring or turnaround and be capable of understanding the operational, financial and legal aspects relevant to the business. There are a range of qualifications that a suitable restructuring adviser may have, including corporate restructuring, management, business, finance or legal qualifications. However, the precise mix of skills, qualifications and experience that are appropriate will depend on the circumstances of the relevant company – it is not a 'one size fits all' situation. We therefore believe it is important to ensure that directors and other relevant stakeholders have the flexibility to appoint restructuring advisers that are appropriate to their circumstances.

We do not consider it necessary at this stage for those factors to be set out in regulations or in regulatory guidance by the Australian Securities and Investments Commission. Whilst we acknowledge that regulatory guidance may assist some directors unfamiliar with restructuring or the notion of appointing a restructuring adviser, there are industry bodies (for example the Turnaround Management Association and Australian Restructuring, Insolvency and Turnaround Association), as well as advisers, such as legal practitioners, who can provide assistance and education about these matters.

> ***Recommendation 2.3****: If Model A were adopted, it should be a matter for the directors to appoint an appropriately qualified and experienced restructuring adviser having regard to the nature and circumstances of the business.*
>
> ***Recommendation 2.4****: The factors that directors should take into account when appointing a restructuring adviser should not be set out in regulations or in a regulatory guide.*

2.4 Response to Query 2.2.1b

Query: The Government seeks views from the public on which organisations, if any, should be approved to provide accreditation to restructuring advisers in such approval is incorporated in the measure.

We strongly support the active involvement of professional bodies that provide accreditation to the insolvency and restructuring community. Such bodies provide an important educational role, promote the benefits of early intervention and appropriate advice, and help to set standards for quality and conduct in the industry.

However, we consider that membership of any such organisation is insufficient to establish that a restructuring adviser is suited to an individual appointment. For example, a member of the Law Society may have little or no experience in respect of restructuring or insolvency, and may be unable to form a view on the financial position of the company. It may be important that a restructuring adviser have skills or experience in respect of a particular industry or certain financial arrangements that are key to successfully restructuring the business.

Furthermore, we submit that requiring membership of particular organisations is overly prescriptive and does not recognise that there are non-members that may be suitable for the restructuring adviser role. For example, in group corporate reorganisations, a restructuring may be led by foreign advisers who are highly experienced and qualified, but who are not members of any of the Australian professional bodies. Within Australia there are also a number of highly qualified and experienced restructuring and turnaround advisers who are not members of any of the formal bodies but who provide appropriate advice that is critical in rescuing a significant number of Australian companies and businesses.

We are therefore of the view that it is not helpful to require that a restructuring adviser be accredited by particular organisations.

> ***Recommendation 2.5****: If Model A were adopted, we do not think that a restructuring adviser should be required to be accredited by specified organisations.*

2.5 Response to Query 2.2.1c

Query: Is this an appropriate method of determining viability?

Viability

We suggest it is important to have clarity as to the concept of 'viability' and to the broader objective being promoted by the safe harbour regime.

As is apparent in the Productivity Commission Inquiry Report on Business Set-Up, Transfer and Closure (the **Report**), the concept of viability is complex and there can often be a different meaning attributed to it by different organisations.

We note that the Proposals Paper refers to both the viability of the company and the viability of the business, and it is important to distinguish these concepts.

Viability of the business

In restructuring, the most fundamental question is whether the business (or a substantial part of it) is viable on a going concern basis. Whether a business can continue as a going concern will depend on a number of aspects, such as whether the business has sufficient resources and the likely future cash flow of the business. Ultimately, however, it requires consideration as to whether the business itself is, or can be, feasibly restructured to become (including by reductions in its existing debt burden), profitable. From an economic perspective, if the business cannot operate profitably then it would be better to simply sell the assets to allow them to be put to more efficient use.

Achieving a better outcome for stakeholders

However, viability of the business may not necessarily involve the continuation of the company itself (especially in a corporate group context). Accordingly, the ability to return the company to solvency may not always be the correct measure of a successful restructuring. Instead, it may be more appropriate to consider the treatment of the company's stakeholders, and whether a restructuring of the business is feasible and offers creditors a better outcome than promptly entering into voluntary administration or liquidation. This does not necessarily require the preservation (or solvency) of the company itself (although returning a company to solvency would normally achieve this).

Clearly however, the restructured business, to be feasible, will only be able to operate viably going forwards if the relevant company or companies operating that business are solvent.

Where insolvent liquidation is unavoidable

Whilst a solvent restructuring of a company (or an entire corporate group) will usually be the best outcome, this will frequently not be achievable. In such a circumstance the law would ideally still allow the relevant stakeholders to pursue and achieve the best outcome reasonably practicable in the circumstances. This may mean pursuing a restructuring that utilises formal insolvency of one or more companies as an implementation tool. It may also mean planning and preparing for a formal insolvency of the company or group in a manner that achieves the best outcome for creditors in the circumstances. Achieving either of these things requires time, as directors and their professional advisers plan and organise for the relevant restructuring transactions and insolvency processes.

Australia's existing insolvent trading regime does not, however, provide directors with any clear basis upon which to take the time to prepare for such outcome, as insolvent trading liability potentially arises as soon as it is clear the company cannot pay all of its debts as and when they fall due (thereby frequently necessitating immediate insolvency appointments). In addition, directors have the risk of exposure under the broader directors' duties regime if actions they take in good faith shortly before an administrator appointment transpire not to benefit the company in the circumstances.

Ideally, any safe harbour regime that is introduced would allow directors to continue trading in circumstances where, despite a company being unable to pay its debts or an insolvency appointment appearing inevitable, time can reasonably be taken to help prepare for the formal insolvency (potentially including a restructuring through an insolvency process) such that is implemented in a manner that achieves a better outcome for stakeholders than an immediate appointment. However, this would only be feasible if directors were protected, not only from insolvent trading liability but from any potential exposure under other directors' duties for taking those steps in good faith.

An appropriate test

The factors described above clearly give rise to some complexity and subtlety, particularly when dealing with larger restructurings. Crafting an appropriate legal regime to balance these factors whilst giving directors sufficient certainty to make business decisions in a stressful environment without fear of liability is not easy. We are of the view that it would be preferable to include clear protections for directors in respect of both the insolvent trading regime and the broader directors' duties regime.

Part of the solution could be to adopt a modified version of the UK's 'wrongful trading' provision. We discuss this further in our response to Model B below.

> ***Recommendation 2.6****: We think that the concept of 'viability' gives rise to significant complexity, and is not necessarily a helpful gauge for determining whether a restructuring is desirable or successful, or whether a company should continue trading. Our recommendations for an appropriate test are set out in our response to Model B below.*

2.6 Response to Query 2.2.1d

Query: 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?

> ***Recommendation 2.7****: In our view, these are not matters that ought be set out in regulation, but rather should be left to the discretion of the adviser. The circumstances in which companies operate are such that it will be difficult, and prohibitive, for there to be indicia of viability.*

2.7 Response to Query 2.2.1e

Query: 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 provider for.

As noted above, we believe it will be important to have clarity as to whether, and the extent that, the restructuring adviser is intended to operate as an officeholder with decision making (or other) powers or merely as an adviser. This will determine the extent to which these protections and obligations are sufficient or necessary.

However, we do not support the requirement that the restructuring adviser be required to inform ASIC of any misconduct they identify. This seems to misconstrue the role of the restructuring adviser, who is not an external administrator, and is not investigating the affairs of the company, and ought not be required to inquire into such conduct when undertaking a restructure.

Recommendation 2.8*: If Model A is adopted the legislation should be clear that the restructuring adviser acts as an adviser only, not as a broader officeholder. In particular this would mean:*

- *the restructuring adviser would not have any statutory powers or duties;*
- *the restructuring adviser would not have any obligations to report misconduct to ASIC; and*
- *there would be no need to exempt the restructuring adviser from liability as a shadow director (as an adviser should not be acting in this capacity).*

2.8 Response to Query 2.2.2a

Query: Do you agree with this approach?

We consider it important that there be clarity as to what impact, if any, a safe harbour has on other voidable transactions such as an unfair preference.

For example, a payment received by a creditor within 6 months prior to the appointment of a voluntary administrator, at a time when the company was insolvent, or became insolvent as a result of the transaction, may be characterised as an unfair preference subject to claw-back by a liquidator. The risk that a creditor dealing with a company during the safe harbour period (when the company may be insolvent) may be forced to return payments it received during this period if the restructuring ultimately fails has not been dealt with in the Proposals Paper.

Recommendation 2.9*: If Model A is adopted the legislation should clarify what impact, if any, the safe harbour has on all voidable transactions.*

2.9 Response to Query 2.2.2b

Query: Do you agree with our approach to disclosure?

We agree that the Government ought not require companies to disclose whether they are operating in safe harbour as this will be counterproductive to achieving a successful restructure. In our view, there should be no requirement to lodge a form with ASIC disclosing the appointment of a restructuring adviser.

We note that as to continuous disclosure requirements, it will need to be clear in any legislation that the mere appointment of a restructuring adviser does not alone require disclosure to the market (though we appreciate that this may differ on a case by case basis).

Recommendation 2.10*: If Model A is adopted:*

- *there should be no requirement to disclose the appointment of the restructuring adviser (with ASIC or otherwise); and*
- *care should be taken in the drafting to ensure that to the extent possible appointment of a restructuring adviser does not give rise to a disclosable event under ASX continuous disclosure requirements.*

2.10 Response to Query 2.2.3

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

We submit that the Court is the most appropriate body to determine whether a person is ineligible to rely on safe harbour in any insolvent trading claim made, however, we consider it critical that the legislation and any regulations prescribe in what circumstances safe harbour may not be available.

We note that guidance is required on what would be a ‘significant’ failure to pay employee entitlements and taxes.

Temporal context will also need to be given to when there has been significant failure to pay employee entitlement and taxes. For example, if there had been a significant payment failure at or some time prior to the time of appointment of an external administrator, but those payments were subsequently made out of the company’s property, would safe harbour still continue to apply?

Recommendation 2.11*: The court, and not ASIC, should determine when a person is not able to rely on safe harbour. The legislation and any regulations should prescribe when safe harbour may not be available.*

Model B

2.11 Response to Query 2.3

Query: The Government seeks your feedback on the merits and drawbacks of this model of safe harbour

As noted above, we submit that Model B is the preferable model.

It provides directors who are acting in the best interests of the company and its creditors as a whole with flexibility in the reasonable steps taken to maintain or return the company to solvency. We also think it is preferable for the safe harbour to operate as a ‘carve out’, rather than a defence.

Issues with formulation of Model B

However, we have concerns about the following:

(a) it requires the directors to seek to return the company to solvency within a reasonable period of time. This may not be achievable (and in any event it is unclear how long a period is ‘reasonable’), but we note that there may still be some circumstances where it is worthwhile continuing to pursue a restructuring that results in the continuation of a viable business and a better outcome for

creditors than an immediate formal insolvency, albeit this would require consideration of appropriate additional protections for directors in respect of their broader directors' duties;

(b) whilst the directors may be of the view that continuing to trade and pursue a restructuring is in the best interests of the company, it may be difficult for directors to form that view in respect of every individual debt being incurred during that period. Rather it should be sufficient for the directors to form that view with respect to a course of trading; and

(c) incurring a new debt is likely to materially increase the risk for that particular creditor. We therefore presume the creditor in respect of whom the debt is incurred is not to be included in any analysis of the increased risk of material loss to creditors under limb (c) (i.e. presumably this only relates to *existing* creditors, and taken as a whole rather than individually). Furthermore, if this is the case, it is unclear whether limbs (b) and (c) are essentially covering similar ground, or whether there are intended to protect against different things. Once a company is insolvent there may well already be a risk of serious loss to creditors – how should a director approach the question as to whether incurring any particular debt materially increases that risk, given that the test is framed objectively but the risk assessment is inherently subjective?

Alternative formulation of Model B

Given the difficulties with this formulation, we suggest it may be more appropriate to consider adopting a formulation similar to the 'wrongful trading' provision set out in section 214 of the UK Insolvency Act.

Section 214 provides that the court, on the application of the liquidator, may declare that that person is to be liable to make such contribution to the company's assets that the court thinks proper if:

- the company has gone into insolvent liquidation;
- at some time before the commencement of the winding up of the company, that person knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation; and
- that person was a director of the company at that time.

It further provides that the court shall not make a contribution declaration if the court is satisfied that the person took every step with a view to minimising the potential loss to the company's creditors as (assuming the person to have known that there was no reasonable prospect that the company would avoid going into insolvent liquidation) the person ought to have taken.

An advantage of adopting a provision based on the UK equivalent is that there is a much greater degree of certainty as to how this provision will work in practice. As mentioned above, the UK provision has in practice allowed directors a greater degree of flexibility to pursue restructurings that are in the interests of stakeholders as directors are not required to achieve cash flow solvency within any particular period of time.

In light of the UK experience (and consistent with the suggestions of commentators) we suggest that the requirement that a person take "every step" with a view to minimising potential loss to creditors is too difficult to establish in practice. Instead we would suggest that directors merely be required to take "reasonable steps". Consideration should also be given to whether the onus should be on the liquidator to demonstrate that the director did not take such reasonable steps.

***Recommendation 2.12**: Model B, with modifications, should be adopted.*

In particular we suggest:

- *modifying Model B to reflect the concerns set out in paragraphs (a) – (c) above; and*
- *considering whether to adopt a (modified) version of the UK's wrongful trading provision as a manner of addressing these issues.*

3 Proposal 3 – *Ipso facto* clauses

There have been many calls for reform of this area of Australia's insolvency laws and we support this aspect of the Proposal. There is, however, a significant amount of detail to be considered and debated before any reform is ultimately implemented. In the time available to review and respond to the Proposal it has not been possible to identify every aspect of a proposed *ipso facto* reform, but we have highlighted a number of key points in the following sections.

In summary:

(a) In our view, the operation of the *ipso facto* prohibition should vary depending on the circumstances of the relevant company (that is, whether it is in administration, in receivership, has proposed a creditors' scheme of arrangement, has proposed a deed of company arrangement, or (potentially) is operating in 'safe harbour');

(b) The legislation should be crafted in a manner that is as clear as possible. We do not think a general anti-avoidance principle will be sufficiently clear;

(c) Exceptions to the *ipso facto* prohibition are necessary and should be tailored to the circumstances. It would be desirable to have some flexibility around the identification and development of the categories of exception;

(d) Balancing creditor protections should be carefully considered in each case (for example, ensuring that counterparties who continue to deal with or extend credit to a company that is subject to an insolvency event are not unfairly prejudiced).

We have responded to each of the questions set out in the Proposal below. Our general observations in connection with this aspect of the proposed reform are set out in section 3.7. Our specific recommendations are set out below following our more general comments in each section.

Terminology

We should also note that when describing the *ipso facto* rule, the Proposal referred to the 'termination' or 'modification' of a contract as a result of an insolvency event. This terminology is not entirely clear. We have assumed what is meant by a 'modification' is any change to the rights, obligations or current contractual position of the parties under a contract that is triggered by that insolvency event (rather than, for example, a contractual amendment). For example, we assumed that the phrase 'modification' was intended to include (among other things) the following types of contractual provisions:

- 'events of default' arising upon an insolvency event under finance contracts (allowing acceleration or enforcement by the lender);
- asset transfers or sales occurring (or a counterparty being entitled to call for such a transfer or sale) upon an insolvency event;

- the cessation or grant of any licence or lease of property, or the shortening or extending of any such lease or licence, (or a counterparty being entitled to call for any such thing) upon an insolvency event;
- payments arising, becoming due, changing or ceasing (or a counterparty obtaining rights to do any such thing) upon an insolvency event;
- conditions precedent under sale, finance or service contracts becoming satisfied, or failing to be satisfied, upon an insolvency event.

These concepts will require clarification in any legislation.

3.1 Response to Query 3.2a

Query: 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.

As set out in more detail in section 3.7 below, we think the operation of the proposed *ipso facto* prohibition should vary depending on the company's circumstances. For example, if a company has proposed a creditors' scheme of arrangement, we do think the prohibition should prohibit the acceleration of debt solely because of the scheme proposal. However, it may not be appropriate to prohibit acceleration of debt in all circumstances where the company has appointed an administrator.

Please see section 3.7 for our suggestions, and some issues for further consideration, as to how the *ipso facto* prohibition might operate in different contexts.

> ***Recommendation 3.1****: Different rules should apply to different insolvency scenarios. Specific details are set out in section 3.7 below.*
>
> ***Recommendation 3.2****: Clarification should be provided as to the meaning of 'void'. Does the prohibition intend to make ipso facto clauses void ab initio, or rather will such ipso facto clauses be generally unenforceable or unenforceable in specific circumstances (we recommend this last approach, in line with our comments below)?*

3.2 Response to Query 3.2b

Query: Should any legislation introduced which makes ipso facto clauses void have retrospective operation?

As a general observation, in order for any reform to have the desired effect in the near to intermediate term, it would be desirable for it to take effect for any 'insolvency events' occurring after the enactment of the reform. In that case, the rule would generally operate retrospectively to contracts that had been entered into prior to the reform taking effect (but not in respect of insolvency events that have already occurred). The alternative, to only apply the *ipso facto* rule to contracts entered into after the date of the enactment would lead to a disparity of rights of contractors in an insolvency, depending upon when their contract was entered into (and uncertainty around the treatment of contracts that are amended or novated after the enactment date).

Having the legislation operate retrospectively in this way may, however, cause prejudice to counterparties that have contracted on the basis of the existing regime.

If the amendments are given sufficient lead time (e.g. a transitional period), this should allow stakeholders to review and consider the impact of the reforms on existing and new contracts. In such an instance, the practical circumstances where hardship relief may be sought may be limited to contracts entered into prior to the commencement date of the

amendments (although this will still potentially include a large number of contracts). Following the commencement date, counterparties of new contracts should be aware of their rights and should contractually and commercially manage the operation of the amendments like any other law. In addition, further thought should be given to whether there are specific types of contracts or rights that should not be subject to any retrospective operation of the rule so that the counterparty's termination or modification rights are effectively 'grandfathered'.

> ***Recommendation 3.3****: We think it would be difficult to introduce the legislation without retrospective operation (i.e. application to pre-existing contracts). However, further consideration should be given to: (i) whether specific types or classes of contracts should be 'grandfathered'; and (ii) giving stakeholders reasonable lead time to understand and prepare for the amendments eg by delaying the operative commencement of the amending legislation.*

3.3 Response to Query 3.2.b

Query: Are there any other circumstances to which a moratorium on the operation of ipso facto clauses should also be extended?

> ***Recommendation 3.4****: If a new safe harbour for insolvent trading is enacted, depending on the model finally adopted, consideration should be given to extending the operation of the ipso facto prohibition to support the safe harbour. This is discussed in more detail in section 3.7 below.*

3.4 Response to Query 3.2.1

Query: Does this constitute an adequate anti-avoidance mechanism?

We are concerned that the scope of the proposed anti-avoidance principle is not sufficiently clear. For example, if a company appointed an administrator, would a term of a contract permitting termination following the factual insolvency of the company (that is, general inability to pay debts) or a 'material adverse change' to its financial position fall within the prohibition? Companies in administration are in almost every case insolvent or near insolvent so the *ipso facto* rule would probably have little substantive effect if these types of termination events remained permissible in the administration context. If a company has proposed a creditors' scheme of arrangement and has obtained an order under s 411(16) of the Corporations Act imposing a moratorium on creditor action in support of the scheme, would a term of a contract permitting termination of the contract if the company becomes subject to a moratorium fall within the prohibition?

Given that the *ipso facto* prohibition will apply in circumstances where time and resources are limited and the stakes are high, we suggest that the prohibition (and any anti-avoidance principle incorporated in the reforms) be crafted so as to ensure that its operation is as clear as possible.

In our view, this means that the specific operation of the *ipso facto* rule should vary depending on which type of 'insolvency event' has occurred, rather than one rule (and supporting anti-avoidance regime) applying generally to companies in a range of restructuring and insolvency scenarios as is currently contemplated by the Proposal.

It also needs to be recognised, however, that an *ipso facto* rule will not be a silver bullet. The circumstances of company insolvencies vary significantly from case to case. Companies entering formal insolvency processes will generally be suffering from significant financial distress and therefore may already be in breach of many of their contracts (or become in breach once payments are not made when due within the formal insolvency process). It will not be possible to draft an *ipso facto* rule that covers all contract terminations that might be considered undesirable in the context of any given

insolvency without instituting a rule that is very broad and/or uncertain in scope. We believe it is preferable to adopt an *ipso facto* rule that is modest in ambition but clear in effect.

Our suggestions on how an *ipso facto* prohibition might apply to companies in various Australian insolvency-related scenarios are set out below in section 3.7.

> ***Recommendation 3.5****: We do not think that there should be a general anti-avoidance provision as this will introduce significant uncertainty. Rather, the proposed amendments, should be clearly drafted to describe the precise operation and scope of the ipso facto prohibition as it applies to each insolvency event.*

3.5 Response to Query 3.2.2

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

We have set out below certain classes of contract or contractual obligations that the Government should consider excluding from the legislation. Realistically, given the different nature and objectives of each insolvency regime, it is likely that different carve outs should apply to each separate insolvency event. For instance, while we suggest that creditors holding security over all or substantially all of a company's assets should be exempted from the *ipso facto* prohibition upon the appointment of a voluntary administrator, this may not be appropriate in the context of a scheme of arrangement. In the latter situation, the scheme process provides an alternate course of action for creditors which should not be undermined by the *ipso facto* prohibition.

Identifying and defining appropriate exceptions is likely to be an iterative process. Accordingly, it may be appropriate to set these out in a set of rules or regulations supporting the legislation that can be amended more easily, to ensure the regime is sufficiently flexible.

Classes of contract or contractual obligations that we suggest the Government consider excluding from the legislation include:

(a) Contracts or contractual obligations to provide further financial accommodation to a company after the company enters administration or receivership or proposes a scheme of arrangement. Creditors should not be unable to cease funding an affected company where there is a risk of non-recovery of the additional funds.

(b) Derivatives such as swaps, and other financial contracts and netting arrangements protected under the *Payment Systems and Netting Act 1998 (Cth)* (or foreign equivalents) where uncertainty in the ability to enforce the contract would represent a material risk to the operation of financial markets. The Government has already indicated it would consider excluding these specific contracts from the proposed regime. This exemption should apply to a company that enters administration or proposes a scheme of arrangement.

(c) By extension, other financial instruments such as repurchase agreements, forward contracts, commodity contracts and securities contracts may also be excluded. Such contracts are covered in the financial market exclusions to the provisions of the US Bankruptcy Code that render *ipso facto* clauses ineffective. Similarly in the US, the objective behind these financial market exclusions is to mitigate systemic risk and contagion. This exemption should apply to a company that enters administration or proposes a scheme of arrangement.

(d) Contracts providing for enforcement rights of creditors holding security over all or substantially all of a company's assets. Such creditors are permitted under

existing law to enforce their security (including by appointing a receiver to the company) following the appointment of an administrator to the company: see Corporations Act s 441A. This is a fundamental secured creditor protection under the existing insolvency framework and we assume the Government did not intend to modify it via the proposed *ipso facto* reforms.

(e) Lease contracts in respect of aircraft objects in aviation transactions. These are already governed by the *International Interests in Mobile Equipment (Cape Town Convention) Act 2013 (Cth)* and the *Protocol on Matters Specific to Aircraft Equipment*. Australia has adopted 'Alternative A' which provides clear remedies to affected parties following an insolvency event and such remedies intersect with the powers of administrators under section 443B of the Corporations Act to elect to exercise rights in relation to the aircraft object.

(f) Contracts entered into by special purpose vehicles (**SPVs**) in structured transactions by sophisticated parties who have contractually pre-determined the post-insolvency distributions of the SPV. This is particularly common in structured finance or project finance transactions and in such a scenario, the policy objective behind the proposed prohibition may not be as compelling as the affected counterparties are limited in number and have contractually determined their insolvency risk with the SPV. Such SPVs are typically not trading businesses and their contracts generally constitute an agreed framework entered into by all relevant parties ('flip clauses' commonly utilised in rated securitisation and structured financings to subordinate payments to swap counterparties upon certain events, including insolvency, are one example of the contractual rights that might fall within this exception).

Recommendation 3.6*: Any exemptions to the ipso facto prohibition should be detailed in rules and regulations rather than the primary legislation to provide flexibility in making any necessary amendments.*

Recommendation 3.7*: The contracts and/or contractual obligations to be exempted from the ipso facto prohibition should include the contracts and/or contractual obligations described in paragraphs 3.5(a) to (f) above.*

3.6 Response to Query 3.2.3

Query: Do you consider this safeguard necessary and appropriate? If not, what mechanism, if any, would be appropriate?

Yes – in our view it would be appropriate to include a provision that affected counterparties may apply to the court to vary contract terms, or vary the operation of the *ipso facto* legislation, if they have suffered hardship.

Balancing counterparty rights and principles of freedom of contract against the policy objective of facilitating business rescue is one of the critical aspects of this reform proposal. We do think it is important to ensure that affected counterparties have an avenue of redress in the event that they are unfairly prejudiced by the operation of the legislation.

Further thought will need to be given to the parameters of any available relief on 'hardship' grounds, however, as any counterparty that has an *ipso facto* clause in its contract will necessarily suffer some hardship by the operation of the proposed reform.

Recommendation 3.8*: A hardship safeguard is a necessary and appropriate mechanism. The parameters of what should constitute 'hardship' should be considered further.*

3.7 Other comment in relation to Proposal 3

The operation of the *ipso facto* prohibition should vary depending on the company's circumstances

Our suggestions on how an *ipso facto* prohibition might apply to companies in various Australian insolvency-related scenarios are set out below. As noted above, we think there is a significant amount of detail to be considered and debated before any reform is ultimately implemented, and in our view it is appropriate to consider the detailed operation of the rule separately in the context of each relevant insolvency regime (administration, receivership, scheme of arrangement, deed of company arrangement, and potentially safe harbour).

It also needs to be recognised, however, that an *ipso facto* rule will not be a silver bullet. The circumstances of company insolvencies vary significantly from case to case. It will not be possible to draft an *ipso facto* rule that covers all undesirable contract terminations without a rule that is very broad and/or uncertain in scope.

Companies in administration

The primary purpose of the administration regime is to facilitate the rehabilitation of distressed companies and enable them to continue trading.[6] It can be very difficult to achieve this in circumstances where the company's key suppliers and contractors are free to terminate their contracts with the company solely on the basis of the appointment of an administrator, including where the company is otherwise continuing to perform. There is widespread support in the restructuring community for the introduction of an *ipso facto* rule that would prevent this from happening (subject to appropriate safeguards and exceptions).

The Proposal would prevent counterparties from terminating or amending contracts solely based on the appointment of an administrator. As noted above, in order to ensure the reform has the intended effect, it will need to go further than this – for example, companies in administration are in almost every case factually insolvent and generally suffering from obvious financial deterioration so counterparties should also be prevented from terminating or amending contracts on the basis of these types of defaults as well.

An appropriate regime for companies in administration might be one that prevented the termination or modification of contracts following the appointment of an administrator solely because of *either*: (i) the appointment of an administrator in respect of the company and the operation of Part 5.3A of the Corporations Act in respect of the company (this would include, for example, the moratorium on creditor actions that applies to a company in administration); or (ii) the insolvency or financial condition of the company at any time before or during the company's administration (with termination or modification still permitted for other events such as non-payment of the relevant contractor).

Restrictions on the exercise of contractual rights can be more easily justified where a company is in administration (compared with, for example, a company that is undertaking a scheme of arrangement) because there is a regime in place to provide protection to creditors that continue trading with the company in administration - for example, an administrator is personally liable for certain debts incurred by the administrator following his or her appointment under s 443A of the Corporations Act. It may however be necessary to consider extending this protection in connection with the proposed *ipso facto* rule (indeed, it may be appropriate to consider the introduction of an 'administration expenses' regime as exists in UK administration and US Chapter 11 cases, rather than simply relying on the personal liability of the administrator).

[6] *Corporations Act 2001* (Cth) s 435A(a).

Further questions that arise where a company is in administration include:

- Whether counterparties should also be prevented from terminating or modifying contracts due to the appointment of a receiver or controller to the company or its property. This question is further addressed below.
- Whether the scope of any ipso facto prohibition should prevent the acceleration of debt owed by that company. For example this could impact the ability of lenders to call under guarantees against other unaffected obligors until there was a payment or other default not subject to the ipso facto rule. This is an issue that will be of significant concern to the banking and finance industry.
- We assume that the Government did not intend to alter the current regime allowing a creditor with security over all or substantially all of a company's assets to accelerate and enforce that security by way of appointment of a receiver following the appointment of an administrator to the relevant company.

Recommendation 3.9: *Consideration should be given as to whether acceleration of debt should be prohibited in all circumstances where the company has appointed an administrator (for example, how this will affect guarantees).*

Recommendation 3.10*: For companies in administration, termination or modification of contracts should be prevented following the appointment of an administrator solely because of either: (i) the appointment of an administrator in respect of the company and the operation of Part 5.3A of the Corporations Act in respect of the company; or (ii) the insolvency or financial condition of the company at any time before or during the company's administration (with termination or modification still permitted for other events such as non-payment of the relevant contractor).*

Recommendation 3.11*: Consideration should be given to the introduction of an 'administration expenses' regime as exists in UK administration and US Chapter 11 cases, rather than simply relying on the personal liability of the administrator.*

Recommendation 3.12*: Further consideration should be given to the operation of the ipso facto prohibition in the context of a company in administration, including the items referred in bullet points 1 to 3 above.*

Companies that have proposed a scheme of arrangement

A creditors' scheme of arrangement is a flexible restructuring tool that can be used to restructure one or more classes of a distressed company's debt and other liabilities without the widespread (negative) effects of placing the company into formal insolvency proceedings. Their effectiveness would be enhanced if (as proposed by the Government) the risk of creditors and other counterparties terminating or amending their contracts with the scheme company solely because it has formulated, or proposed, a scheme was eliminated, and we support the Proposal in this respect. In our view it would also be appropriate in the scheme context to prohibit the acceleration of debt solely due to the proposal of the creditors' scheme.

The proposal refers to schemes of arrangement 'for the purpose of avoiding administration or insolvent liquidation'. This purposive element may be difficult to apply in practice, so it may be clearer to simply cover all creditors' schemes.[7]

In the scheme context, it should not be necessary to extend the *ipso facto* prohibition by, for example, prohibiting contract terminations or modifications due to the scheme company's factual insolvency or financial condition. Given their subjective nature, counterparties are generally reluctant to rely on these types of termination events where

[7] It may also be appropriate to cover members' schemes where they are proposed in connection with a creditors' scheme.

a company remains outside of a formal insolvency process in any event (unless tied to objective considerations such as financial covenants). Moreover, unlike the case of companies in administration, schemes generally will not affect all types of creditors and there are no additional economic protections available to parties that continue trading with a distressed company that has proposed a scheme.

There will also be circumstances where a separate moratorium on creditor enforcement action is appropriate where a company has proposed a scheme. This is discussed in more detail in section 4 below. Further consideration should be given as to whether the *ipso facto* legislation should prevent contract termination or modification on the basis of the imposition of a moratorium on creditor action against a company, where that moratorium has been put in place in connection with a creditors' scheme.

> ***Recommendation 3.13****: It would be appropriate in the scheme context to prohibit the termination or modification of a contract solely due to the proposal of the creditors' scheme (i.e. no purposive element should be required). It should also not be necessary to extend the ipso facto prohibition by, for example, prohibiting contract terminations or modifications due to the scheme company's factual insolvency or financial condition.*

> ***Recommendation 3.14****: Further consideration should be given as to whether the ipso facto legislation should prevent contract termination or modification on the basis of the imposition of a moratorium on creditor action against a company, where that moratorium has been put in place in connection with a creditors' scheme. We believe this would be appropriate.*

Companies in receivership or subject to security enforcement

The Proposal would prevent counterparties from terminating or amending contracts solely based on the appointment of a receiver or controller to a company or its property. Receivership, a remedy available to secured creditors, is primarily focused on allowing a secured creditor to realise assets in a manner that delivers the best return to the secured creditor. Whilst that may often be achieved through a going concern sale, receivership is technically not a regime that is designed to facilitate corporate rescues for the benefit of all creditors. We therefore do not think that the *ipso facto* rule should apply to receiverships (in isolation). This is consistent with the existing regime: the broad moratorium arising in an administration is a related concept and this does not apply to receiverships.

However, in practice, it is common for companies in receivership to be subject to a parallel administration (either because the directors appoint an administrator following the receiver's appointment, or because a secured creditor holding all assets security chooses to appoint a receiver 'over the top' of an administrator following the administrator's appointment). Typically in this scenario the receiver will take primary control of the company for the benefit of the secured creditor and the administrator will take a 'back seat'. In this case the receiver effectively obtains the benefit of the administration moratorium and it may therefore also be consistent in these cases for the same *ipso facto* prohibitions to apply as would be the case for any company in administration in order to best facilitate value preservation (coupled with appropriate protections for counterparties that continue dealing with the company in receivership).

> ***Recommendation 3.15****: The ipso facto rule should not apply to receiverships (in isolation), as receivership is a secured creditor enforcement regime rather than a general insolvency or restructuring process. This is also consistent with the administration moratorium not being made available to receivership. However, unless broader reform is proposed, if a company enters administration, the ipso facto rule should apply to the subsequent appointment of a receiver (for as long as the administration continues).*

A company that has entered into a deed of company arrangement

A deed of company arrangement, or 'DOCA' – essentially a restructuring plan between a company in administration and its creditors – is the means by which a company can successfully restructure and exit administration. It would make sense (as contemplated by the Proposal) for the *ipso facto* prohibition to prevent the termination or modification of contracts or the acceleration of debts solely by reason of a company entering into a DOCA. No other *ipso facto* protections should be required in this context (for example, prohibiting contract termination based on a company's financial position) as, following its exit from administration, a restructured company should be solvent and operating on a stable financial footing.[8]

> ***Recommendation 3.16****: The ipso facto prohibition should prevent the termination or modification of contracts solely by reason of a company entering into a DOCA*

A company operating under an insolvent trading 'safe harbour'?

Depending on the form of any insolvent trading safe harbour ultimately enacted, it may be necessary to consider whether any ipso facto protection is desirable for companies operating within the safe harbour. For example, if 'Model A' (which has a trigger by the appointment of a restructuring adviser) is adopted, it may facilitate the operation of the safe harbour if counterparties are prohibited from terminating or modifying contracts with a company, or accelerating debts owed by the company, for the sole reason that the company or its directors have appointed such an adviser. It may not however be appropriate for the ipso facto rule to prevent a counterparty from terminating or modifying its contract for other reasons where a company is operating in safe harbour – for example, the factual insolvency of the company or a material adverse change in its financial condition. Many of the same considerations as are set out above in respect of schemes of arrangement, including lack of balancing creditor protections, would apply in this context.

> ***Recommendation 3.17****: Further consideration is required for the operation of the ipso facto rule for an affected company operating in the insolvent trading 'safe harbour'.*

Other issues

Other issues that we suggest should be considered in more detail in connection with the proposed *ipso facto* reform include the following:

(a) Whether qualifying *ipso facto* clauses be void as proposed, or simply unenforceable in specific circumstances and/or for a specified period of time. As noted above, this raises a broader query as to how the proposed amendments will be structured. It may be that each prescribed insolvency event should provide for its own regime as to the treatment of *ipso facto* clauses (and related exemptions) rather than a 'one size fits all' approach.

(b) What additional creditor protections may be necessary to balance the limitations in the ability of creditors to contractually manage debtor insolvency risk. This is a critical question as it will be important to balance the encroachment on counterparty's contractual rights with appropriate protections in circumstances where the counterparty continues dealing with or extending credit to a company that is subject to an insolvency event.

(c) Depending on the scope of the *ipso facto* legislation, it may be necessary to consider how cross default and cross acceleration clauses should be treated (for example, clauses that allow Counterparty A to terminate a contract with, or

[8] Unless the company has entered into a 'holding DOCA'.

accelerate debt owed by, a company because that company has failed to pay a debt owed to Counterparty B or debt owed by that company to Counterparty B has been accelerated). It may not be justifiable to restrict Counterparty A's contractual rights in this scenario, because to do so would give Counterparty B an advantage.

(d) Whether additional rules are required for the insolvency of corporate groups. For example:

If Company A is in administration but Company B is not in administration, could the creditors of Company B terminate their contracts with Company B on the basis that Company A is in administration?

Company A and Company B are both in administration. Can a counterparty to Company A terminate or modify its contract with Company A because Company B has also entered administration (even if it can't terminate or modify for Company A entering administration)? If the rule was to be expanded in this manner would the two companies need to be related entities? If so what degree of connection would be required? What if one of the companies is a foreign company in a foreign process?

(e) Treatment of multilateral contracts. Consideration should be given to contracts involving three or more parties. We presume the intention is that in such situations the *ipso facto* rule should apply to terminations or modifications to contractual rights and obligations between the insolvent party and one or more of the other parties. However, we also assume that two or more solvent parties should remain free to terminate or modify contractual rights and obligations between themselves by reference to any insolvency event of the insolvent party. We think this principle should clarified in the drafting.

Recommendation 3.18*: The proposed reforms will need to consider, as set out in greater detail in paragraphs (a) to (e) above:*

- *Whether qualifying ipso facto clauses be void as proposed, or simply unenforceable in specific circumstances and/or for a specified period of time*
- *Treatment of cross default and cross acceleration clauses*
- *What additional creditor protections may be necessary to balance the limitations in the ability of creditors to contractually manage debtor insolvency risk*
- *Whether additional rules are required for the insolvency of corporate groups*
- *Treatment of multilateral contracts, so as to ensure there is clarity that solvent parties may agree to contractual terminations or modifications between themselves that take effect by reference to insolvency events of another party.*

4 Further reform recommendations

4.1 Schemes of arrangement

Introduction

A very important aspect of the insolvency law reform process - reforms to the creditors' scheme of arrangement regime contained in Part 5.1 of the Corporations Act – was not included in the Proposal.

This is particularly significant given the creditors' scheme of arrangement regime was introduced in the late 1800s and has not been materially amended since, leaving it failing to meet modern day restructuring needs in a number of respects. Modification to the regime is crucial to increase Australia's reputation as a regional hub for large corporate restructures. It should come as no surprise to anyone that laws that were enacted in the late 1800s no longer adequately serve the needs of Australian businesses today.

An effective tool for restructuring large corporate groups, creditors' schemes of arrangement have recently been successfully used in a number of high profile restructures, including Alinta, Centro, Nine Entertainment and Atlas Iron. Creditors' schemes have significant advantages over the alternative of deeds of company arrangement (or DOCAs). Most notably, when creditors' schemes are used, the distressed company is not exposed to the stigma of entering an administration process, thus avoiding significant potential value destruction.

Creditors' schemes would be used more often if the inadequacies in the current law were addressed.

Essential reforms to the Australian regime

To enhance the Australian creditors' schemes of arrangement framework, seven essential reforms are urgently needed. These complement the reform proposals contained in the Proposal and we hope to see them added to the agenda in the near future. These reforms are summarised below under the heading 'Australian Reforms'. The urgent need for these reforms has become apparent to us in our dealings with actual and potential creditors' schemes of arrangement.

Singapore reform process

Before turning to the proposed reforms to the Australian creditors' scheme of arrangement regime, we note that, after preparing an earlier draft of these submissions, copies of two Singapore insolvency law reform papers came to our attention. Those papers are:

- *Report of the Insolvency Law Review Committee*, Final Report, 2013 (**Singapore 2013 Report**); and
- *Report of the Committee to Strengthen Singapore as an International Centre for Debt Restructuring*, 20 April 2016 (**Singapore 2016 Report**).[9]

These (extremely thoughtful) papers, which reflect the input of committees of luminaries (comprising insolvency practitioners, academics and other stakeholders), contain various recommendations for reforms to the Singapore creditors' scheme of arrangement regime. Many of the reforms highlighted below in section titled 'Australian Reforms' are also

[9] Singapore's insolvency law reform process commenced in November 2010 when the Ministry of Law decided that, as part of its ongoing review of insolvency laws, it would appoint a committee to review the existing bankruptcy and corporate insolvency regimes (Report of the Insolvency Law Review Committee, Final Report, 2013, at 1).

proposed in the Singapore reform papers. The Singapore scheme of arrangement regime is substantially the same as the Australian regime.

We have reproduced a number of passages from the Singapore 2013 Report and the Singapore 2016 Report below as they are equally apposite to the Australian creditors' scheme of arrangement regime.

Australian reforms

Broader, more flexible, moratorium powers

First, it is essential that the courts are given broader powers to create moratoriums on creditor enforcement action during the formation of a scheme of arrangement.

In its Report, the Productivity Commission recommended (Recommendation 14.6) that the Corporations Act be amended to achieve that result. As a safeguard, the Productivity Commission proposed that the courts also be given the power to lift all or part of a moratorium if its application would lead to unjust outcomes. Unfortunately, this very important reform proposal was not included on the Government's current agenda.

Currently, s411(16) of the Corporations Act enables a company to apply to the court to restrain further proceedings against it where a restructuring has been proposed. While this is intended to provide the company with breathing space to implement a restructure, as indicated below, a number of deficiencies limit its effectiveness in practice.

Accordingly, the following amendments to the Corporations Act are required.

(a) Timing for moratorium

The Corporations Act should be amended to give the court the discretion to grant a moratorium by making a restraining order from the early stages of the formulation of a creditors' scheme. The current language of s411(16) which requires the scheme of arrangement to have been "proposed" presently limits this ability. The limited case law to date has said that a scheme will have been proposed if the draft scheme documentation has been submitted to ASIC as part of its statutory review process.[10] In order to be effective, it must be possible for moratoriums to be put in place much earlier than this. The court should be given a broad discretion to decide on the timing of the commencement, and on the duration, of the moratorium after taking into account all the relevant circumstances.

This was also recognised as an issue in the Singapore 2013 Report, where the Insolvency Law Review Committee (**ILRC**) noted, in respect of s210(10) of the Singapore Companies Act (which is in essentially the same terms as s411(16) of the Corporations Act), that:

> "*[T]he statutory moratorium under section 210(10) of the Companies Act can currently only be invoked if a scheme "has been proposed between the company and its creditors or any class of such creditors". The Committee is of the view that this requirement that a scheme must have been "proposed" before a moratorium can be granted may in some instances be counterproductive: in some cases, the moratorium is needed precisely because the company needs time to work out a scheme to propose to its creditors. The Committee therefore recommends that the court should have the power to grant a statutory moratorium where there is an intention to propose a scheme of arrangement, subject to such terms as the court sees fit to impose. For example, in cases where a scheme has not yet been proposed, the court may only be willing to grant*

[10] See, for example, *Playcorp Pty Ltd v Venture Stores (Retailers) Pty Ltd* (1992) 7 ACSR 193 at 195.

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> *a short moratorium (e.g. 14 days or a month), on the basis that the court will consider granting a longer moratorium once a scheme has been proposed.*"[11]

In addition, the Committee to Strengthen Singapore as an International Centre for Debt Restructuring (**SSICD Committee**) recommended in the Singapore 2016 Report that the procedure for obtaining an interim moratorium should be streamlined by providing that the moratorium arises automatically upon the filing of an application for a moratorium under s210(10) of the Singapore Companies Act. The SSICD Committee recommended a number of safeguards against abuse of this provision including that basic information be provided with the application, including evidence of support for the moratorium from creditors of sufficient importance to the restructuring of the debtor.[12]

We also note that the English courts have indicated that they are prepared to take a pragmatic and flexible approach to moratoriums in the context of English creditors' schemes of arrangement.[13]

(b) Level of protection afforded by the moratorium

The Corporations Act should also be amended to give the court discretion to not only restrain "further proceedings" but impose a moratorium on any enforcement action generally by creditors subject to the proposed scheme. The service of a notice of acceleration or demand for payment under a finance document is an example of such enforcement action. The service of a notice of acceleration or demand can cause just as much damage as the commencement of recovery proceedings themselves. If the relevant company does not, at the time the notice is served, have the financial wherewithal to pay the amount that is the subject of the notice, it will be considered unable to pay its debts as they fall due. This will frequently cause the directors of that company to immediately place the company into voluntary administration. In addition, if the company might be able to make a full or partial payment at the expense of other creditors, the lack of a broad moratorium that can be imposed quickly can encourage hold out or "greenmail" creditors to make such demands quickly before the scheme can be implemented or the existing moratorium imposed.

A similar issue was identified by the ILRC who were concerned that the moratorium provisions in a scheme of arrangement were weak[14] and in that regard recommended in the Singapore 2013 Report that:

> "*[T]he court should be given discretionary powers to alter the scope of the moratorium to be granted to the company. This would allow the court to tailor the scope of the moratorium in each case according to its circumstances. Further, in any instances of abuse, aggrieved creditors would be entitled to apply to the court for relief. Ultimately, this would provide flexibility and accountability in the interests of all parties.*"[15]

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[11] *Report of the Insolvency Law Review Committee*, Final Report, 2013 at Chapter 7, 142-143 [22].

[12] *Report of the Committee to* Strengthen *Singapore as an International Centre for Debt Restructuring*, 20 April 2016 at 10 - 11 [3.8]–[3.9].

[13] See, for example, Sea *Assets Ltd v PT Garuda Indonesia (No 2)* [2001] WL 1251844 and *Bluecrest Mercantile Bv v Vietnam Shipbuilding Industry Group* [2013] EWHC 1146.

[14] *Report of the Insolvency Law Review Committee*, Final Report, 2013 at Chapter 7, 140-141 [16].

[15] *Report of the Insolvency Law Review Committee*, Final Report, 2013 at Chapter 7, 142 [21].

(c) Extension of moratorium to entities related to the company

In addition, the court should have the discretion to impose the moratorium on the relevant creditors of not only the company that is the subject of the proposed creditors' scheme of arrangement, but also other members of its corporate group, including foreign companies (at least to the extent that the proposed creditors' scheme would be capable of effecting a release of claims against such other group entities). This would recognise the reality of multiple obligors and complex cross-guarantee arrangements in large corporate groups.

Again, a similar issue was identified by the SSICD Committee who made the following recommendation in the Singapore 2016 Report:

> "*In the circumstances, the Committee is of the view that moratoriums in […] schemes of arrangement should have the flexibility of being extended to the related entities of a debtor. However, to safeguard against abuse and as the need to protect related entities from creditor action will vary from case to case, an extension of the moratorium to a debtor's related entities should be granted if it is shown that the related entity and/or entities is/are relevant to the restructuring and their inclusion in the moratorium would contribute to its success.*"[16]

We agree with these comments.

Ability to deal with foreign companies (including foreign subsidiaries) under an Australian scheme of arrangement

Second, there are a number of scenarios in which it may be appropriate to deal with a foreign company under or in connection with an Australian creditors' scheme of arrangement. Unfortunately, the Australian creditors' scheme regime does not currently facilitate this – and this can lead to difficulties and inefficiencies in seeking to implement a restructure. By way of example:

- a large Australian corporate group will often have foreign subsidiaries which cannot currently be the subject of an Australian creditors' scheme of arrangement; and
- irrespective of whether a foreign company is part of a large Australian corporate group, a foreign body corporate may have entered into a financing agreement which is governed by an Australian law.

Unfortunately, the Corporations Act only allows for a "Part 5.1 body" to be the subject of an Australian creditors' scheme. A Part 5.1 body is defined to include (as well as a company that was incorporated in Australia) a foreign company or an Australian body which is registered under Part 5B.2 of the Corporations Act.

To address these issues, Part 5.1 of the Corporations Act should provide that a court has jurisdiction in respect of not only a Part 5.1 body (as is currently the case), but also a foreign company that, although it is not registered under Division 2 of Part 5B.2, has:

- an Australian centre of main interests (or "COMI");
- an Australian bank account (with funds in it) or other assets in Australia;
- debt obligations that are governed by an Australian law; or
- submitted to the jurisdiction of Australian courts for dispute resolution purposes.

[16] *Report of the Committee to Strengthen Singapore as an International Centre for Debt Restructuring*, 20 April 2016 at 12 [3.15]–[3.16].

The list of factors that will entitle an Australian court to assume jurisdiction should be non-exclusive. The Act should make similar provision in relation to a registrable Australian body which is not registered under Division 1 of Part 5B.2.

There are sophisticated rules of private international law which can address the issues relating to the enforceability of the effect of the Australian creditors' scheme in the foreign jurisdiction.

The SSICD Committee also addressed issues in relation to foreign debtors who wish to restructure in Singapore under a Singapore creditors' scheme of arrangement and made the following recommendation in the Singapore 2016 Report:

> *"In order to introduce greater clarity for foreign corporate debtors that want to restructure in Singapore, further guidance should be provided on the factors which the courts will take into account to determine if they have jurisdiction over foreign corporate debtors. This could be accomplished by promulgating rules which clearly set out a list of factors which may be taken into account. To preserve flexibility, the list should not be exhaustive. The Singapore court may still determine that its jurisdiction has been invoked even if a foreign corporate debtor does not satisfy any of the factors on the list"*[17]

Ability to cram down on shareholders and creditors

(a) Shareholders and creditors with no real economic interest

Third, scheme participants should be able to "cram down" on shareholders and subordinated debt holders by giving the court a discretionary power to extinguish their rights if the court is satisfied that, in light of the level of indebtedness of the distressed company, such holders no longer have any "real economic interest" (being the test adopted in the case law by the courts)[18] in that company. From a policy perspective, it is not appropriate that persons with worthless assets be able to use those assets for ransom (or greenmail) value to impede a restructure which would otherwise save a distressed company from the alternative of liquidation.

The ability to "cram down" on shareholders already exists in the context of DOCAs, with s444GA of the Corporations Act permitting an administrator, with the order of a court, to transfer shares in a company (without consent of the shareholder). There is no reason not to extend this power to the courts in creditors' schemes. As shown in the Mirabela and Nexus Energy DOCAs, there would be sufficient protection for shareholders as a court will take into account their interests in considering whether to exercise its discretion.[19]

Similarly, in the context of creditors' schemes, the courts have already indicated that, if they are satisfied that subordinated debt holders or shareholders have no real economic interest in the scheme company, they are not entitled to have a vote on the outcome of a creditors' scheme.[20]

Unfortunately, however, the inability to extinguish the rights of such persons has meant that, although worthless, the rights have had to remain in place, thus

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[17] *Report of the Committee to Strengthen Singapore as an International Centre for Debt Restructuring*, 20 April 2016 at 9-10 [3.4]–[3.6].

[18] See, for example, *Re Bluebrook Ltd* [2009] EWHC 2114 at [24]-[25].

[19] See, for example, *Re Mirabela Nickel Ltd (subject to deed of company arrangement)* [2014] NSWSC 836; *Re Nexus Energy Ltd (subject to deed of company arrangement)* [2014] NSWSC 1910.

[20] See the discussion in T Damian and A Rich, *Schemes, Takeovers and Himalayan Peaks*, Third Edition, The University of Sydney, 2013, at 136-141 [4.3.7(d)] and 517-520 [9.11.1], and, in particular, the cases that the authors cite.

necessitating complex restructuring (e.g. via the transfer of assets out of the group and into a new group).

(b) Dissenting class of creditors

In addition to being able to "cram down" on shareholders and creditors with no real economic interest (as discussed above), scheme participants should also, in certain circumstances and subject to appropriate safeguards against unfair prejudice, be able to "cram down" on a dissenting class of creditors so that the scheme of arrangement is approved and will bind such class of dissenting creditors notwithstanding that they have not approved the scheme. Again, the policy basis for this proposal is that it is not appropriate for a class of creditors to veto or threaten to veto a creditors' scheme (where the only real alternative to the creditors' scheme is liquidation) under which scheme the relevant class of creditors will receive a better economic outcome than under a liquidation.

The ILRC also considered such "cram down" provisions in the context of the Singapore scheme of arrangement regime and recommended the enacting of such provisions similar to those found in the US Bankruptcy Code that will allow a scheme of arrangement to be approved notwithstanding that a class of creditors has not approved the scheme (subject to appropriate safeguards to ensure that the dissenting class of creditors are not prejudiced).[21] Some arguments considered by the ILRC in favour of introducing such provisions include:

"(1) A minority of creditors in a dissenting class should not be able to veto a scheme merely because they are in a separate class, provided that they are treated fairly under the proposed scheme. Otherwise, a single dissenting class may hold the entire scheme ransom to the prejudice of the vast majority of creditors who support the scheme.

(2) Where the dissenting creditors get at least as much under the rescue plan as they would in liquidation, and are not being otherwise discriminated against, they cannot complain that the scheme is unreasonably imposed on them. Often, much of the dissention arises from creditors who merely wish to improve their bargaining position in order to obtain a greater share of the dividends.

(3) At present, there are cases where parties have spent much time and costs over the classification of creditors. Providing for a cram-down mechanism may help to avoid excessive emphasis on the classification exercise."[22]

The ILRC recommended that, to better protect the rights of all creditors and to allow the court to check against abuse of cram-down provisions and unreasonable comparative valuations, the court should require a high threshold of proof that the dissenting class is not going to be prejudiced by the cram down.[23]

By way of further example of the types of safeguards against unfair prejudice in these circumstances, under the US Bankruptcy Code the following

[21] See *Report of the Insolvency Law Review Committee*, Final Report, 2013 at Chapter 7, 154-156 [46]-[53].

[22] *Report of the Insolvency Law Review Committee*, Final Report, 2013 at Chapter 7, 155 [49].

[23] *Report of the Insolvency Law Review Committee*, Final Report, 2013 at Chapter 7, 156 [53].

requirements (among others) must be met before a plan of reorganisation can be confirmed over the objection of a class or classes of creditors[24]:

- the plan must be "fair and equitable". The US Bankruptcy Code contains detailed requirements that must be met in order for a plan to be fair and equitable, depending on whether the relevant claims are secured or unsecured;
- the plan must not discriminate unfairly. To satisfy this requirement in Chapter 11 cases, the debtor must demonstrate that the plan provides for a greater distribution than would be received in a liquidation. In the creditors' scheme context, a liquidation comparison would of course only be appropriate in circumstances where it was established that liquidation was the only real alternative to the proposed creditors' scheme; and
- at least one class of "non-insider"[25] impaired creditors must vote in favour of the plan. To have an accepting impaired class, one class of creditors must not receive a full distribution (and therefore be "impaired"), and vote in favour of the plan; and
- the plan must be feasible (that is, not likely to be followed by another bankruptcy case if the plan is confirmed).

Removal of Listing Rule restrictions on issuing new shares

Fourth, ASX Listing Rules 7.1 and 7.1A should be amended to incorporate an exemption for issues of securities over the 15% limit in the case of creditors' schemes because shareholders are already adequately protected through the court approval process.

Indeed, in deciding whether or not to approve the creditors' scheme, the courts have already indicated that they will consider the economic interests of shareholders.[26] For example, in the creditors' scheme in *Re Opes Prime Stockbroking Ltd (No 1)*[27], Finkelstein J made the following remarks in relation to the position of shareholders:

> *"What is proposed is the transfer of assets and liabilities of several companies to another without an issue of new shares. Such an arrangement may affect members if their financial stake in the transferring company is diminished. In that event their consent would be required. Here, however, the members have no interest in what is proposed because these companies are in the process of being wound up and their assets are insufficient to satisfy its creditors in full: Re Tea Corporation Ltd [1904] 1 Ch 12. Hence it is permissible to pool the assets and liabilities of the Opes group into OPGL without a meeting of members."*[28]

Furthermore, it is anomalous that the ASX is content to dispense with the requirement for shareholder approval in Listing Rule 11 which applies where a listed entity (through its administrator) is disposing of its main undertaking, yet there is no corresponding dispensation for new share issuances.[29]

We note that this reform proposal will require ASX involvement, as it involves an amendment to the ASX Listing Rules, rather than to the Corporations Act. However, there

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[24] 11 USC § 1129.

[25] "Insiders" are related parties of the debtor (the US Bankruptcy Code contains a detailed definition of "insider").

[26] See the discussion in T Damian and A Rich, *Schemes, Takeovers and Himalayan Peaks*, Third Edition, The University of Sydney, 2013, at 136-141 [4.3.7(d)] and 517-520 [9.11.1].

[27] (2009) 73 ACSR 385.

[28] (2009) 73 ACSR 385 at 405 [76].

[29] See ASX Guidance Note 12, Significant Changes to Activities, 30 September 2014, at 27 [4.6].

is no need to impose any form of discretionary or judgmental decision making, or investigative process, on the ASX. The court process will provide the necessary safeguards for shareholders.

Addressing the deficiencies of the head count approval requirement

Fifth, reform is needed to the address the anachronistic requirement that, in addition to requiring a 75% vote by value, a creditors' scheme must also be approved by a majority in number of the creditors in the class present and voting at the meeting, either in person or by proxy (this limb of the agreement threshold is referred to as "the head count test"). The proposed reforms are set out below.

- (Abolition of the head count test) The head count test should be abolished. It is inappropriate that creditors with a small economic exposure should be able to veto a creditors' scheme which is supported by creditors holding the overwhelming majority by value of the debt. In this regard, it is noteworthy that, the Government's Corporations and Markets Advisory Committee (which was considering reforms to the members' scheme of arrangement regime) has also recommended the abolition of the head count test.[30]
- (Ability to dispense with the head count test) Sub-subparagraph 411(4)(a)(ii)(A) of the Corporations Act permits the court to dispense with the head count test in the case of shareholders' schemes of arrangement. An alternative (albeit less optimal) reform proposal to the abolition of the head count test (described above), this discretion should be extended to creditors' schemes of arrangement because issues, such as debt splitting to manipulate the results of the head count test, are equally repugnant from a policy perspective.[31]

Giving the court additional powers in relation to classes

Sixth, the court needs to be given additional powers in relation to classes.

Creditors must be marshalled into classes for the purposes of voting on a creditors' scheme. The time-honoured test for identifying a class for scheme of arrangement purposes is that articulated by Bowen LJ in *Sovereign Life Assurance Company v Dodd*[32]:

> *"It seems plain that we must give such a meaning to the term "class" as will prevent the section being so worked as to result in confiscation and injustice, and that it must be confined to those persons whose rights are not so dissimilar as to make it impossible for them to consult together with a view to their common interest."*[33]

The class test can be notoriously difficult to apply in practice.

The composition of classes is of fundamental importance in every scheme and a matter in respect of which particular care must be given. This is because the failure to properly constitute a class will deprive a court of jurisdiction to approve the scheme, and will leave the court with no choice but to decline to approve the scheme, even if the scheme would still have been approved by creditors had the classes been composed correctly.

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[30] Corporations and Markets Advisory Committee, "Members' schemes of arrangement", Report, December 2009, at 92-94.

[31] Parliament's express policy objective in giving the Court the discretion to disregard the head count test in the case of shareholders' schemes of arrangement was to neutralise the effect of "share splitting" – that is, the practice of shareholders transferring small parcels of shares to a large number of other persons with the intention of increasing the number of votes that they may cast for the purposes of the head count test (see, for example, Explanatory Memorandum to the *Corporations Amendment (Insolvency) Bill* 2007 (Cth), at 57 [4.179] and 57 [4.181]).

[32] [1892] 2 QB 573.

[33] [1892] 2 QB 573 at 583.

In other words, if the classes are incorrectly constituted, even if this has had no effect on the outcome of the vote, the whole scheme must fail, resulting in a considerable waste of time and expense and, worse still, possibly consigning the scheme company to the fate of insolvency. This possibility has been a matter of continuing frustration for the courts, as witnessed in the following passage:

> *"Under [the scheme of arrangement provisions], the court will have no jurisdiction to sanction the scheme if the classes have been incorrectly constituted. It is perhaps unfortunate that this is the case and there is much to commend an approach which enables the court to sanction a scheme in an appropriate case, where the classes have been incorrectly constituted in a way which would not have affected the outcome of the meetings."*[34]

To address this issue, the Corporations Act should be amended to give the court the following powers:

- (*Binding class determinations*) the court should be given the discretion to make a binding determination on the composition of classes at the first court hearing; and
- (*Curative power*) the court should be given specific discretion to approve a scheme even if the classes have been wrongly constituted.[35]

The ILRC similarly recognised the benefit of having issues, such as classification of creditors, resolved as early as possible and before steps are taken by the company on the basis of a disputed position as opposed to having them ruled upon at the sanction hearing. In that regard, the ILRC recommended that there should be a statutory right given to the company, its creditors and scheme managers to apply to the Court for directions on the appropriate classification of creditors for the purpose of voting on the scheme.[36]

Publication of explanatory statements

Seventh, and finally, to provide a more transparent and efficient regime, there should be a requirement that the explanatory statements that are required to be prepared (and sent to the relevant class or classes of creditors) in connection with creditors' schemes be lodged with ASIC so that they are publicly available, as is the case with explanatory statements for members' schemes (and sent to the relevant class or classes of creditors).[37] This is particularly the case given that those affected by a creditors' scheme may not be limited to the class (or classes) of creditors that are the subject of the creditors' scheme.

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[34] *Re Telewest Communications plc* [2004] BCC 342 at 348 [14].

[35] In December 2009, the Corporations and Markets Advisory Committee (which was considering reforms to the members' scheme of arrangement regime) concluded that, whilst it did not agree with the first of these two reform proposals, it did agree with the second of these two reform proposals (see Corporations and Markets Advisory Committee, "Members' schemes of arrangement", Report, December 2009, at 91 [5.4.1]).

[36] See Report *of the Insolvency Law Review Committee*, Final Report, 2013 at Chapter 7, 148-149 [33]-[35].

[37] See s412(6) of the Corporations Act. We have deliberately used the word "lodge" rather than "register" because, once a court has authorised or approved an explanatory statement for publication, there is no need for another ASIC review of the explanatory statement (noting that ASIC has a statutory 14 day period to review a draft explanatory statement before it goes to the court).

5 Concluding remarks

If you have any queries in respect of the content of this submission, please contact:

Paul Apáthy
Partner, Finance
paul.apathy@hsf.com
+61-2-9225 5097

Andrew Rich
Partner, Corporate
andrew.rich@hsf.com
+61-2-9225 5707

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