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To The Manager
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Dear Sir

Improving bankruptcy and insolvency laws – Submissions in response to Proposals Paper by the Treasury

We refer to the Improving bankruptcy and insolvency laws – Proposals Paper (**Proposals Paper**) released on 29 April 2016, and the request for submissions on the recommendations made under the Proposals Paper.

We welcome the opportunity to make submissions on the Proposals Paper. We consider that the queries raised in the Proposals Paper raise important issues for the future of bankruptcy and insolvency regimes.

A. Safe Harbour

One submission addresses the proposal of a Safe Harbour and relates to the following recommendations from the Proposals Paper:

- Proposal 2.2 – Safe Harbour Model A; and
- Proposal 2.3 – Safe Harbour Model B.

In particular, our submission considers the appropriateness of Safe Harbour Model A (Query 2.2) and Safe Harbour Model B (Query 2.3) and states that whilst both approaches have respective advantages, neither completely addresses the weaknesses of the current regime. Most importantly, we consider that the proposed Safe Harbour models are unlikely to encourage start-up activity or facilitate innovation for the reasons set out in our submission at [4.2 and 4.4].

To support this conclusion, we have included in our submission a detailed analysis of the history and rationale of the current insolvent trading regime, and also a comparison of the approach in international jurisdictions to demonstrate why we support the foundation of the Proposals Paper's premise that reform is necessary.

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We consider that the objectives set in the Proposals Paper, namely "*to strike a better balance between encouraging entrepreneurship and protecting creditors*", would be best achieved by way of some relatively minor amendments to the insolvent trading prohibition which we discuss in our submission at [5.3]. We consider that the proposed minor amendments as set out in our submission would also provide better protection to creditors and to directors during the "twilight zone".

B. Ipso Facto

Our submission on the Ipso Facto reform proposals endorses a number of the proposals. It makes suggestions in relation to others, including that:

- the "broad brush" approach of making the Ipso Facto reform of general application and the identification of specific exclusions is problematic;
- the extent of the exclusions that would be required to avoid unintended consequences in many key markets beyond the scope of the current consultation process (with the complexities involved in defining the exception for financial contracts being an important example); and
- in terms of applicable procedures, we strongly endorse the extension of Ipso Facto reform to companies attempting to restructure by scheme of arrangement and support its application during the administration procedure (the proposed future initiatives in relation to receivership and deed of company arrangement require further consultation in our view).

C. Bankruptcy

Our submission on the Bankruptcy reform proposals focuses on what we consider to be the principal issue of reducing the bankruptcy period.

Whilst we are supportive of the concept of encouraging entrepreneurship, in our submission we speak to what we perceive to be the not inconsiderable downsides of reducing the present bankruptcy period.

Yours Faithfully

King & Wood Mallesons.

King & Wood Mallesons

A. Innovation in the boardroom - How safe is the Harbour?

1 The Proposals Paper

The release of the *Improving bankruptcy and insolvency laws – Proposals Paper* (**Proposals Paper**) by the Commonwealth Government on 29 April 2016 with the stated objective of improving bankruptcy and insolvency laws to encourage innovation and a restructuring culture are very welcome. Many key stakeholders, such as the Australian Institute of Company Directors (AICD) and the Australian Restructuring, Insolvency & Turnaround Association (ARITA) have advocated for reform to Australia's insolvent trading regime for many years. The Corporations and Markets Advisory Committee (CAMAC) made a series of reform recommendations in 2010 in relation to insolvent trading and we are pleased to see that these issues are back on the reform agenda.

We appreciate the opportunity to engage in the consultation process in relation to this important law reform project.

This submission analyses the current operation of Australia's insolvent trading regime in the context of its purpose and historical evolution. The submission then assesses the Commonwealth's two proposed Safe Harbour models and discusses some alternative options for reform.

2 The current Australian insolvent trading regime

The insolvent trading prohibition is presently contained in section 588G of the *Corporations Act 2001* (Cth) ("**Act**"). That section places a duty on directors to actively prevent their company from incurring debts at any time when they ought to know that the company is insolvent. Specifically, it applies to directors if:

- the company is insolvent at the time it incurs a debt, or becomes insolvent by incurring that debt, or by incurring at that time debts including that debt;
- at that time, there are reasonable grounds for suspecting that the company is insolvent, or would become insolvent by incurring the debt; and
- the directors are aware at that time that there are such grounds for suspecting insolvency so or a reasonable person in a like position in that company's circumstances would be so aware.

There are currently four defences to the "insolvent trading" contravention under section 588H of the Act. These include:

- When the debt was incurred, the director had reasonable grounds to expect, and did expect, that the company was solvent at that time and would remain solvent even if it incurred that debt and any other debts that it incurred at that time.[1]
- When the debt was incurred, the director had reasonable grounds to believe, and did believe, that a competent and reliable person was responsible for providing them with information about whether the company was solvent and was doing so.[2]

[1] *Corporations Act* 2001 (Cth) s 588H(2).

[2] *Corporations Act* 2001 (Cth) s 588H(3).

- The director did not take part in the management of the company at the time the debt was incurred because of illness or for some other good reason.[3]

- The director took all reasonable steps to prevent the company incurring debt.[4]

The Act provides both civil and criminal penalties for the contravention of this provision. Criminal liability applies if the contravention is shown to be dishonest[5].

On the issue of solvency, the legislation adopts a cash flow test – that is, a person will be insolvent when that person is unable to pay all of their debts as and when they become due and payable.[6] However, the balance sheet test is still relevant[7] on the basis that an excess of liabilities over assets can be an indicator of insolvency[8] and can be of assistance in distinguishing between true insolvency and a mere temporary lack of liquidity.

In recent years, the Courts have held that the assessment of insolvency calls for a degree of *"forward looking*" in order to identify debts which will become due and payable in the future.[9] In *The Bell Group (in liq) v Westpac*,[10] Owen J considered the Bell Group's ability to pay its debts during the following 12 months in assessing the Bell Group's solvency. This sort of approach to insolvency expands the circumstances in which a company may be considered to be insolvent because, a company can be considered to be insolvent today if there is a liability falling due and payable in the foreseeable future which it does not have the ability to pay.

2.1 The history and rationale behind the current insolvent trading regime

The earliest forms of the insolvent trading regime in Australia were designed to deter directors from using the shield of limited liability to fraudulently obtain credit which could not be repaid.

The first fraudulent trading provision in Australia was based on the *Companies Act 1929* (UK) and was enacted in Queensland in 1931,[11] followed by Victoria in 1938. The Queensland provision provided that, if, in the course of the winding up of a company, it appears that any business has been carried on with intent to defraud creditors, the Court may declare that any of the directors who were knowingly parties to the fraudulent conduct be personally responsible for any of the debts.[12]

The subsequent Victorian provision was essentially as set out in section 303(3) of the *Companies Act 1961* (Vic). This section was primarily concerned with the liability of an officer of a company where proper accounts were not kept and subsections (1) and (2) went directly to that point. Section 303(3) provided that an officer of a company will be guilty of an offence where, at the time a debt was

3 *Corporations Act* 2001 (Cth) s 588H(4).

4 *Corporations Act* 2001 (Cth) s 588H(5).

5 *Corporations Act 2001* (Cth) s 588G(3).

6 *Corporations Act* 2001 (Cth) s 95A.

7 *Keith Smith East West Transport Pty Ltd (in liq) v Australian Taxation Office* (2002) 42 ACSR 501; *Bell Group Ltd (in liq) v Westpac Banking Corp (No 9)* [2008] WASC 239; David Richardson and Anthony LoSurdo, 'In brief: the court focuses on the meaning of "insolvency"' (2009) 9(9) *Insolvency Law Bulletin* 186.

8 *Australian Coal Technology v Hanson Construction Materials Pty* Ltd (2009) 254 ALR 650; [2009] NSWSC 232; BC200902222; David Richardson and Anthony LoSurdo, 'In brief: the court focuses on the meaning of "insolvency"' (2009) 9(9) *Insolvency Law Bulletin* 186.

9 *Melbase Corporation Pty Ltd v Segenhoe Ltd* (1995) 17 ACSR 187; *Lewis v Doran* (2005) 219 ALR 555.

10 [2008] WASC 239.

11 *Companies Act 1931* (Qld) s 284.

12 Ibid.

contracted, they had '*no reasonable and probable ground of expectation, after taking into consideration the other liabilities, if any, of the company at the time, of the company being able to pay the debt*'.[13] That is, the director did not have reasonable grounds to expect the company would be able to pay that specific debt, at the time it was incurred.

A member of Parliament, when introducing the sub-section, stated that:

> *"…justice should be tempered with mercy, but I do not consider that persons who fraudulently obtain large sums of money are entitled to any mercy."*[14]

Each State and Territory introduced an identical provision as a result of the enactment of uniform legislation by the *Uniform Companies Code 1961*.

Gradually, the prominence and scope of this prohibition increased during the second half of the 20th century. In 1966, this subsection was moved to a standalone provision in section 374c of the *Companies (Defaulting Officers) Act 1966* (Vic), which amended the 1961 Act.[15] The Second Reading Speech for this amending Act stated that:

> *"Proposed new sections 374c and 374n re-enact the provisions which make it an offence for an officer knowingly to contract a debt at a time when there is no reasonable prospect of the company being able to pay that debt…"*[16]

This amendment was an attempt by the Government to respond to community concerns of directors fraudulently or recklessly obtaining credit and then hiding behind a *"shield of limited liability"*.[17] Section 374c provided a means to effectively deal with a director who carried on a company in this way and enabled the court to make an order against them to personally repay the debt incurred.[18]

The introduction of a national scheme followed, in the form of the *Companies Act 1981* (Cth), resulting in a considerable expansion to the scope of the regime. Each State adopted this legislation via the enactment of the State-based *Companies (Application of Laws) Acts.* Section 556 of the Commonwealth Act extended the liability of directors to the incurring of debt in circumstances where they had reasonable grounds to expect that the company would be unable to pay *'all its debts as and when they come due'*.[19] This removed the "*attention from the incurring of a particular debt or debts…to the director's responsibility for the overall management of the company"*.[20]

This new provision was designed to:

> *"…place greater responsibility on persons who are directors or managers of a company at the time that unreasonable debts are incurred by the company…"*[21]

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13 *Companies Act 1961* (Vic) s 303(3).

14 Victoria, *Parliamentary Debates,* Legislative Assembly, 23 November 1961, 1527 (Campbell Turnbull).

15 *Companies Act 1961* (Vic).

16 Victoria, *Parliamentary Debates,* Legislative Assembly, 27 September 1966, 360 (R. J. Hamer).

17 Ibid.

18 Ibid; Victoria, *Parliamentary Debates,* Legislative Assembly, 7 December 1966, 2754 (Turnbull).

19 *Companies Act 1981* (Cth) s 566.

20 Law Reform Commission, Parliament of Commonwealth, *General Insolvency Inquiry* (the *Harmer Report*) (1988) 1, 128.

21 Explanatory Memorandum, Companies Act 1981 (Cth).

This provision was then moved to the *Corporations Law Act 1989* (Cth), and again was adopted by the States through the creation of enacting legislation.[22]

In 1992, the *Corporate Law Reform Act 1992* (Cth) recast the fraudulent trading regime to establish a positive duty on directors and introduced the language of 'insolvent trading' in section 588G. This amendment was based on recommendations by the 1988 *Harmer Report.*[23]

The Harmer Report stated that:

> *"The responsibility of a director with regard to insolvent trading has not, thus far, been expressed as a positive duty owed to the company to prevent the company from engaging in that activity…the real abuse is permitting a company to trade after a point where, on an objectively considered basis, the company is unable to pay all its debts."*[24]

The new section 588G also expanded the circumstances in which the *mens rea* element of the insolvent trading prohibition would be satisfied. Liability would be triggered under section 588G if there are reasonable grounds to *suspect* insolvency at the time the debt is incurred. This requires a higher standard of care from directors than the previous provision which would only be triggered if the director had reasonable grounds to *expect* that the company would not be able to pay all of its debts as and when they fell due. The rationale for the more onerous duty was stated to be that:

> "*…most persons would nowadays expect all the directors of a company to acquaint themselves with the general financial position of the company, and to take positive steps where necessary to protect the interests of members and creditors."*[25]

The new section 588G focussed on the ability of a company to pay *all* its debts, rather than *the particular* debt being incurred. The explanatory memorandum pointed to the Harmer Report to clarify the justification of this approach which stated that:

> *"Former and existing legislation has centred upon the incurring of a particular debt or debts…This produces a series of isolated examinations of each instance of the incurring of debt."*[26]

One of the purposes of the new provision was to permit all creditors to share equally in the sums recovered. Finally, section 588G was later relocated to the *Corporations Act 2001* (Cth) which forms the current law.

Therefore, the current incarnation of the insolvent trading prohibition is of much broader scope than its previous incarnations, largely to reflect directors' responsibility for the overall financial management of the company and the higher standard of care imposed upon Australian directors.

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22 *Corporations Law Act 1989* (Cth) s 592; adopted by each state by relevant *Corporations ("State") Act 1990* (Vic) s 7.

23 Explanatory Memorandum, Corporate Law Reform Act 1992 (Cth).

24 Law Reform Commission, Parliament of Commonwealth, *General Insolvency Inquiry* (the *Harmer Report*) (1988) 1, 125.

25 Explanatory Memorandum, Corporate Law Reform Act 1992 (Cth).

26 Law Reform Commission, Parliament of Commonwealth, *General Insolvency Inquiry* (the *Harmer Report*) (1988) 1, 125.

2.2 The international context and the apparent harshness of the Australian approach

Australia is considered to have some of the harshest insolvent trading laws in the world.[27] The Australian insolvent trading laws have been criticised as focusing on punishing directors rather than protecting creditors and, as a result, inhibiting risk-taking decision-making by directors.[28]

New Zealand places a less onerous obligation on directors. Directors in New Zealand are prohibited from carrying on the company's business in a manner likely to create a substantial risk of serious loss to the company's creditors.[29] A director must not incur a debt unless they *believe at that time* on reasonable grounds that the company will be able to fulfil *those* obligations.[30] This is distinct from the approach in Australia where directors are prohibited from permitting a company to incur a debt where there are reasonable grounds to suspect insolvency, even if that particular debt is likely (even certain) to be paid when due. However, the Australian legislation does provide defences to insolvent trading offences whereas the New Zealand law does not.

The United Kingdom operates a wrongful trading model which imposes liability on a director when a debt is incurred in circumstances where they knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation.[31] This offers more scope to directors as it allows for debt to be incurred in an attempt to prevent the liquidation of a company (so long as the recovery plan has reasonable prospects). In Australia, the fact that the debt was incurred in an attempt to save the company does not excuse the directors from liability for trading while insolvent (save for the limited circumstances where the defence applies because it is found that the rescue attempt was "likely" to result in the restoration of solvency). The UK legislation also provides a defence to directors where the director took every step with a view to minimising the potential loss to the company's creditors.[32]

An entirely different approach is adopted by the United States and Canada. In the United States and Canada, there is no legislation which imposes liability on directors for insolvent or reckless trading. However, through the concept of "deepening insolvency" a director in the US may be liable for conduct which, in attempting to sustain an insolvent company's life, causes the company to incur additional debt.[33] In Canada, legislation also provides some protection to creditors through the ability to bring a derivative or oppressive suit in respect of an act or omission of the corporation or any of its affiliates.[34] However, this protection is very limited as leave from the Court is required before creditors may pursue such a

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27 Wayne Martin, Chief Justice of Western Australia, 'Official Opening Address' (2009) *Insolvency Practitioners' Association of Australia* (16th National Conference).

28 Ian Ramsay, 'Company directors' liability for insolvent trading' (2000) *Centre for Corporate Law and Securities Regulation (Faculty of Law, University of Melbourne);* Scott Butler, 'Insolvent Trading – The harsh reality' (2009) *Keeping Good Companies* (61), 375-377; Jason Harris, 'Lessons from abroad: it's time to reform insolvent trading laws' (2009) 10(1) *Insolvency Law Bulletin, 2;* Wayne Martin, Chief Justice of Western Australia, 'Official Opening Address' (2009) *Insolvency Practitioners' Association of Australia* (16th National Conference). His Honour stated that: "The laws of Australia which expose directors to personal liability in the event that a company trades while insolvent are arguably the strictest in the world."

29 *Companies Act 1993* (NZ) s 135.

30 *Companies Act 1993* (NZ) s 136.

31 *Insolvency Act 1986* (UK) s 214.

32 *Insolvency Act 1986* (UK) s 214(3).

33 Although, recent case law has raised doubt as to the validity of this doctrine as an independent cause of action. *Trenwick American Litigation Trust v. Ernst & Young* 2006 WL 2333201, No.CIV.A. 1571 (Del. Ch. Court, June 2, 2006); Jassmine Girgis, 'Deepening Insolvency in Canada?' (2008) 53 *McGill Law Journal,* 170.

34 *Canada Business Corporations Act* (R.S.C., 1985, c. C-44) (CAN), s 241.

claim. Furthermore, directors owe a fiduciary duty to the corporation[35] and, in addition, have a duty to "exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances".[36] However, this duty does not extend to the interests of creditors.[37]

Germany has traditionally applied a strict insolvent trading prohibition in circumstances where a company becomes "over indebted" (on a balance sheet assessment) or subject to illiquidity (defined as insufficient cash to pay debts that are already due).[38] However, in late 2008, in response to the global financial crisis, these provisions were suspended to provide that over-indebtedness will not be shown where the continuation of a company's business is highly likely.[39] A probability of more than 50% is required to demonstrate that a company's survival is highly likely.[40]

3 The need for reform: does it actually exist?

3.1 Current level of insolvent trading

Superficially at least, the current regime may be considered to be working well to discourage the unacceptable behaviour of Australian directors. As noted in the Productivity Commission's Inquiry Report:

> "*The rate of successful enforcement of insolvent trading actions is low. There were only 103 insolvent trading cases between the law's introduction in 1961 and 2004. While the court ordered that compensation be paid in three quarters of those cases, more serious sanctions were extremely rare. Only 15 per cent of cases involved criminal proceedings, and only two cases involved an order banning directors from managing companies.*
>
> *Since 2004, ASIC reports that they have commenced action for insolvent trading for circumstances involving five companies only between 2005 and 2011.*
>
> - *Two cases involved civil action, both resulting in the winding up of a company.*
> - *The remaining three cases involved criminal action. In one instance, the action was abandoned. In another, a director was fined and required to perform community service, but was*

35 *Canada Business Corporation Act* (R.S.C., 1985), c. C-44 (CAN), s 122(1)(a).

36 *Canada Business Corporation Act* (R.S.C., 1985), c. C-44 (CAN), s 122(1)(b); Jassmine Girgis, 'Corporate Directors' Disqualification: The new Canadian Regime?' (2009) 46 *Alberta Law Review.*

37 *Peoples Department Stores Inc. (Trustee of) v Wise* [2003] R.J.Q. 796; Jassmine Girgis, 'Corporate Directors' Disqualification: The new Canadian Regime?' (2009) 46 *Alberta Law Review,* 1; Jassmine Girgis, 'Deepening Insolvency in Canada?' (2008) 53 *McGill Law Journal,* 167-198.

38 Jason Harris, 'Lessons from abroad: it's time to reform insolvent trading laws' (2009) 10(1) *Insolvency Law Bulletin*, 2; Jason Harris, 'Director liability for insolvent trading: Is the cure worse than the disease?' (2009) 23 *Australian Journal of Corporate Law*, 266.

39 *Insolvency Statute of 5 October* 1994 (Germany) s 19; Georg Streit and Fabian Bürk, *Restructuring and insolvency in Germany: overview* (1 July 2015) Practical Law Company <http://uk.practicallaw.com/2-501-6976?q=insolvent+trading+and+germany#null>.

40 Georg Streit and Fabian Bürk, *Restructuring and insolvency in Germany: overview* (1 July 2015) Practical Law Company <http://uk.practicallaw.com/2-501-6976?q=insolvent+trading+and+germany#null>.

subsequently imprisoned for failing to complete the community service."[41]

Of course, the low incidence of civil actions for "insolvent trading" might be disproportionately low, as compared with the number of actual contraventions, due (at least in part) to the fact that many directors of companies in liquidation will themselves be insolvent, or have limited resources, such that it would be uneconomic for a liquidator to pursue a civil action against them. Furthermore, D&O insurance may not respond to insolvent trading claims owing to the usual exclusion for liability arising out of conduct involving criminal conduct or "wilful" breach of duty.[42]

An ASIC report[43] released in November 2015, containing statistics drawn from reports by administrators and liquidators, reveals that the incidence of insolvent trading is actually much higher than that suggested by the number of actions commenced. The findings show that insolvent trading has been the most frequently alleged form of misconduct in all administrators' reports since 2012. Furthermore, of the reports lodged between 8 December 2014 and June 2015, administrators alleged a civil breach of section 588G in 57.1% of all reports. 74.9% of those reports advised that there was evidence in support of the allegations. In relation to criminal contraventions, there were fewer alleged breaches, with a total of 1.8% of reports containing allegations of a criminal contravention and 51.9% of those with supporting evidence.

The duration of insolvent trading alleged by administrators is also significant. In 49.6% of instances in which administrators reported that evidence existed for an alleged civil breach, the administrator believed that the company had been trading whilst insolvent for more than 15 months.[44]

It appears from the ASIC report that the total debts typically incurred by companies whilst insolvent are relatively modest. In 78.6% of reports alleging a civil breach during the period of 8 December 2014 to 30 June 2015, administrators estimated that the debt incurred while the company was insolvent was of an amount of less than $1 million.[45] In 50.6% of reports the total debts incurred while the company was insolvent were less than $250,000.[46] Only two reports estimated that the amount of debt incurred was more than $5 million.[47] The ASIC report also indicates that most companies which fail are small businesses; 64.2% of failed companies in 2014-2015 had fewer than five employees,[48] 62.7% owed less than $250,000 to unsecured creditors[49] and 85% of failed companies had estimated assets of $100,000 or less[50].

The Australian Bureau of Statistics has also reported that, in 2014-15, business entry and exist rates were highest for businesses with no employees, with business

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41 Productivity Commission, Parliament of Australia, *Inquiry Report on Business Set-up, Transfer and Closure* (2015), 378-379.

42 D&O policies typically contain this exclusion in response to sections 199B and 199C of the Act which prohibit a company from paying the premium for insurance of an officer against conduct involving criminal conduct or a wilful breach of duty. D&O policies also frequently include an exclusion in respect of liabilities arising from insolvency or financial distress.

43 Australian Securities and Investment Commission, 'Insolvency statistics: External administrators' reports (July 2014 to June 2015)' *Report 456* (2015).

44 Ibid 31.

45 Ibid 28-29.

46 Ibid.

47 Ibid.

48 Australian Securities and Investment Commission, 'Insolvency statistics: External administrators' reports (July 2014 to June 2015)' *Report 456* (2015), 17.

49 Ibid 50.

50 Ibid 6.

exit rates being the highest for businesses with an annual turnover of less than $50,000.[51]

This data may provide further explanation as to why the number of civil actions commenced is relatively low, as the amount at stake in any particular instance may be insufficient to justify incurring the significant costs and associated risks with legal action.

Overall, the data supports a view that the insolvent trading regime is not currently providing an effective deterrent to insolvent trading. Furthermore, owing to the low enforcement rates, the insolvent trading regime may not be providing the protection to creditors that it was designed to achieve.

3.2 Attitude of directors

Potential personal liability for insolvent trading is a matter of considerable concern to Australian directors. In the King & Wood Mallesons and the Australian Institute of Company Directors (AICD) '*Directions 2016'* survey of over 300 directors of Australian companies, 44.8% of directors responded that they have had to make a decision where they believed that the organisation was in financial difficulties. 50.4% of those respondents said the risk of personal liability or prosecution for insolvent trading was very important in making this decision.[52]

A 2008 Federal Treasury/AICD *'Survey of Company Directors'* similarly found that 27.7% felt at risk of personal liability (under any law) for decisions they made in good faith, with 11.7% of those directors stating that section 588G was highly responsible for this overly cautious approach to business decision making.[53]

The AICD discussed the impact of insolvent trading laws on decision-making by directors in its submission to the Productivity Commission, arguing that the law:

- *"… not only encourages, but effectively mandates directors to move to external administration as soon as a company encounters financial difficulties in order to avoid personal liability and consequent reputational damage;*
- *discourages directors from taking sensible risks when considering other kinds of informal corporate reconstructions or 'work-outs' to deal with a company's financial problems;*
- *provides an incentive for creditors, especially secured creditors, to act in their own self-interest and arrange for the disposal of key assets and the termination of continuing contractual arrangements as soon as possible;*
- *can lead to financially viable companies suffering the consequences of external administration, including ceasing to be a 'going concern', suffering the loss of value and goodwill and incurring the expense of engaging administrators or receivers when it may have been possible under a less prescriptive legislative regime for the company to restructure itself and secure its financial standing …"*[54]

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51 Australian Bureau of Statistics, *Counts of Australian Businesses, including Entries and Exists, Jun 2011 to Jun 2015* (26 February 2016) ABS <http://www.abs.gov.au/ausstats/abs@.nsf/mf/8165.0>.

52 King & Wood Mallesons, *Directions 2016: Current issues and challenges facing Australian directors and Boards* (2016) KWM <http://www.kwm.com/en/au/knowledge/downloads/directions-2016-issues-challenges-australian-directors-boards-20160304>.

53 Federal Treasury, *Survey of Company Directors* (18 December 2008) Treasury Archive <http://archive.treasury.gov.au/content/Company_Directors_Survey/SurveySummary.html>.

54 Productivity Commission, Parliament of Australia, *Inquiry Report on Business Set-up, Transfer and Closure* (2015), 378.

The Productivity Commission appears to have accepted this submission and has concluded in its report that director concern about insolvent trading was a driver behind premature administrator appointments.[55] However, there is no empirical evidence that this is in fact occurring. On the contrary, the data set out in paragraph 3.1 above clearly indicates that, if anything, administrator appointments are taking place too late, especially in relation to distressed SMEs.

However, director concern about insolvent trading is likely to be at least one of the drivers of the high rate of director resignations of distressed companies as compared with companies which are in a secure financial position. ASIC identifies "*director resignations*" as a sign that may indicate a company is in financial difficulty.[56] The 2008 Federal Treasury/AICD Survey of directors of top 200 listed companies found that close to half had resigned from a board because of the risk of liability and three-quarters knew of others who had resigned for the same reason.[57]

The case of *Jack Hames As Administrator of Zyl Ltd*[58] provides a recent example of a public company which was left with an insufficient number of directors to pass a resolution to appoint administrators. The judgment of the New South Wales Supreme Court in this case identifies various other cases in which the number of directors remaining in office had fallen below the statutory minimum (of three) required to validly appoint an administrator by resolution.[59] For example, in *Re Darin (As Administrators of Palamedia Ltd)*[60] the company had one director remaining in office at the time a resolution was purported to be passed appointing an administrator. Similarly, in *Re Ethan Minerals Ltd (Administrators Apptd)*[61], one director resigned immediately before the scheduled meeting to appoint an administrator. Obviously, companies which are left with insufficient directors to even appoint an administrator will find any sort of alternative restructuring of the company's business also impossible to achieve. In this regard, the resignation of directors may be much more damaging to the prospects of a distressed company than a premature administrator appointment.

3.3 Difficulties in identifying insolvency

There is an obvious tension between all of the statistics which suggest that directors are taking steps to prevent "insolvent trading" too late, and the anecdotal evidence that directors are placing companies into voluntary administration too early due to fear of contravention and personal liability. This tension is sometimes sought to be rationalised by the drawing of a distinction between SMEs (which are the source of the most of the "acting too late" statistics) and large corporations (where boards of non-executive directors are the source of the "acting too early" anecdotes).

That distinction only partly explains the confusion. One of the matters driving the low enforcement rate (notwithstanding statistics suggesting high levels of contravention) and the high level of director concern in relation to the current insolvent trading prohibition is the uncertainty surrounding its application. The current regime causes directors of companies with financial difficulties to be

[55] Productivity Commission, Parliament of Australia, *Inquiry Report on Business Set-up, Transfer and Closure* (2015), Chapter 14.

[56] Australian Securities and Investment Commission, *Directors – Is my company in financial difficulty* (2 February 2015) <http://asic.gov.au/regulatory-resources/insolvency/insolvency-for-directors/directors-is-my-company-in-financial-difficulty/>.

[57] Federal Treasury, Survey of Company Directors (18 December 2008) Treasury Archive <http://archive.treasury.gov.au/content/Company_Directors_Survey/SurveySummary.html>.

[58] [2015] WASC 57.

[59] *Corporations Act 2011* (Cth) s 201A(2).

[60] [2010] NSWSC 451.

[61] [2011] NSWSC 899.

uncertain as to their position and duty because the contravention has, as its central pillar, the somewhat uncertain concept of "insolvency".

Even in the rare cases where "insolvent trading" allegations find their way into a courtroom, there is often conflicting evidence, including expert opinion from insolvency professionals, as to whether or not the company was insolvent at relevant times. This conflicting expert testimony is generally provided by the same insolvency professionals who lodge the administrator and liquidator reports containing allegations of "insolvent trading" and which form` the basis for the statistics published by ASIC which are referred to above [at 3.1]. The fact that these professionals can honestly hold different opinions as to the existence or otherwise of insolvency means that those statistics, based as they are on untested opinions on that subject, must be treated with caution.

A prohibition against incurring a debt when a company is "insolvent" requires a comprehensive analysis of all of the companies' debts (current, future and contingent), and whether they are likely to be paid, rather than an analysis focussed more on the debt which is under contemplation and the likelihood of that debt being paid. As discussed above, this uncertainty may cause a directors to act, or fail to act, in response to fear of personally liability, as well as causing companies to be more likely to unintentionally trade while insolvent.

By way of example, take the common case of a company, Tough Times Ltd, which has a large secured debt owing to a syndicate of banks. The debt is not due for repayment for two years but, based on careful cash-flow forecasting, the company is aware that a covenant (eg net leverage ratio) will be breached in nine months – giving rise to an Event of Default entitling the syndicate to accelerate the debt and enforce its securities at that time. As is often the case, enforcement in that scenario might be expected to give rise to a recovery shortfall to the banks, let alone the unsecured creditors.

As discussed in section 2 above, under Australian law, insolvency is defined by reference to the ability to pay all of one's debts, *'… as and when they become due and payable'*.[62] If there does not exist a reasonable basis to believe that the bank debt can be repaid by Tough Times when due in two years' time then, technically, Tough Times is already insolvent.

Many would argue that such a conclusion is overly technical; and harsh. It may be, for example, that it can reasonably be concluded that the *'when they became due and payable'* part of the equation is likely to shift, by way of renegotiation with the banks, or that refinancing elsewhere is likely, such that the company is not presently insolvent. Although the courts have said that there is no fixed maximum time frame for this analysis,[63] two years is a long time and a lot could change. However, the pending covenant breach makes the situation, and the requirement for credible evidence as to what is reasonable and likely, more immediate for the directors of Tough Times.

The matter might become even more stark if Tough Times were to receive notification from its bankers that they are aware of the pending covenant breach and that they intend to immediately act on the breach when it occurs. Under the current Australian "insolvent trading" regime, the directors of Tough Times are already at risk of contravention, notwithstanding that the covenant breach (giving rise to a contingent liability to repay secured debt) is nine months away and the formal repayment date two years away.

Under Australian law, the directors of Tough Times are in an uncomfortable position because, on a daily basis, operations are continuing and trade debts are being incurred to suppliers. Even though trade debts to suppliers are on 30 or 45

62 *Corporations Act 2001* (Cth) s 95A.

63 *Bell Group Ltd (in liq) v Westpac Banking Corp (No 9)* [2008] WASC 239.

day terms and are, therefore, likely to be repaid long before the real crunch comes, the directors are forced to immediately consider administration.

There currently exists the following defence to the "insolvent trading" contravention:

> 'It is a defence if it is proved that, at the time when the debt was incurred, the person had reasonable grounds to expect, and did expect, that the company was solvent at that time and would remain solvent even if it incurred that debt and any other debts that it incurred at that time'.[64]

So, the oddity of Australian "insolvent trading" law is that the contravention prima facie occurs if the company is insolvent and the director had reasonable grounds to suspect insolvency at the time a debt is incurred; but the director escapes liability if, at that time, the director has reasonable grounds to expect that the company was solvent. It is a contradiction which is somewhat difficult to reconcile. However, the above example of Tough Times Ltd demonstrates how it works in practice. As the directors of the company are aware of a debt on the horizon (being the large bank debt) which the company has no current ability to repay when it falls due, those directors have reasonable grounds to "suspect" that the company is insolvent. However, the directors are entitled (and should) assess whether there are events which are likely to occur, prior to the debt actually falling due, which are likely to resolve the issue; for example, a refinancing of the debt, a sale of assets resulting in discharge of the debt on time or simply a renegotiation with the bank resulting in a binding extension of the due date. If, acting reasonably, the directors can conclude that they "expect" the situation to resolve itself, then the section 588H(2) defence will apply.

In fact, if the matter unfolds as reasonably expected and the bank debt issue is resolved, then the better view is that the company was not actually insolvent to begin with; rather, it was at risk of insolvency which did not eventuate. If, on the other hand, the unexpected happens and, despite the directors' reasonable expectations, the banks take a hard line, call in the debt and a shortfall is ultimately suffered (to secured debt and/or to unsecured debt) then, under Australian law, the directors face a real risk that the company was insolvent at an earlier time, such that each incurrence of unsecured debt (eg trade debt) in the interim comes under scrutiny from an "insolvent trading" perspective.

3.4 Conclusion – the case for reform is compelling

On the basis of the matters set out above, it appears that the current insolvent trading regime is not serving the interests of any key stakeholders of distressed companies particularly well. While the prohibition was expanded from the earlier fraudulent trading prohibitions in order to reflect increasing director responsibilities for a company's financial management, the result has been to create a high level of uncertainty for directors at a critical time in the life of a distressed company. Furthermore, the high levels of insolvent trading which are being reported by administrators and the low enforcement rates indicate that the regime is plainly failing those creditors it was designed to protect. Therefore, there is a strong case for reforming Australia's insolvent trading regime. The question then is whether either of the Safe Harbour models which have been proposed by the Government are the answer?

4 Proposed Safe Harbour Models

The Commonwealth's Proposals Paper sets out two alternative models to implement a Safe Harbour for directors, both aiming to facilitate the restructure of businesses. The proposed reforms seek to address the deficiencies of the current insolvent trading regime at differing levels but neither provides a comprehensive

64 *Corporations Act 2001* (Cth) s 588H(2).

resolution of those deficiencies. The essential features of the two proposed models are set out below together with an analysis of the respective advantages and disadvantages of those models.

4.1 Proposal 2.2: Safe Harbour Model A

The proposed Model A Safe Harbour is as follows:

> *"It would be a defence to s588G if, at the time when the debt was incurred, a reasonable director would have an expectation, based on advice provided by an appropriately experienced, qualified and informed restructuring adviser, that the company can be returned to solvency within a reasonable period of time, and the director is taking reasonable steps to ensure it does so.*
>
> *The defence would apply where the company appoints a restructuring adviser who:*
>
> *a) is provided with appropriate books and records within a reasonable period of their appointment to enable them to form a view as to the viability of the business; and*
>
> *b) is and remains of the opinion that the company can avoid insolvent liquidation and is likely to be able to be returned to solvency within a reasonable period of time.*
>
> *The restructuring adviser would be required to exercise their powers and discharge their duties in good faith in the best interests of the company and to inform ASIC of any misconduct they identify."*

This model is similar to that which was recommended by the Productivity Commission[65] and is proposed with the intention of providing "*directors with a restructuring option that allows them to retain control of the company while receiving formal advice rather than necessarily surrendering control to an external administrator".*[66]

It would be a precondition of the appointment of an adviser that the company maintain adequate, up-to-date financial records which explain the company's transactions and financial position. Also, to be valid, a restructuring adviser's opinion that the company can avoid insolvent liquidation and be returned to solvency must be properly informed.

In order to carry out their role, the restructuring adviser would have a number of obligations and protections.

The restructuring adviser would be:

- appointed by the company, not the directors, and thus owe any duties to the company;
- required to exercise their powers and discharge their duties in good faith in the best interests of the company and to inform ASIC of any misconduct they identify;

[65] A significant difference is that the Productivity Commission recommended a more absolute defence; subject to certain conditions being met, if a Safe Harbour adviser had been appointed, then the directors were effectively immunised against personal liability for "insolvent trading".

[66] Treasury, Australian Government, *Improving bankruptcy and insolvency laws* (2016), 11.

- not be civilly liable to third parties for an erroneous opinion provided that it was honestly and reasonably held;

- unable to be appointed in any subsequent insolvency without the leave of the Court; and

- specifically cared out of the expanded definition of director contained in the Act (ie would not be a shadow or de factor director).

4.2 Analysis of Model A

Query 2.2

Subject to the further information on the proposal set out in the sections below, the Government seeks views from the public on whether this proposal provides an appropriate Safe Harbour for directors.

There are many aspects of the Model A which are commendable. Our experience demonstrates that the involvement of high quality restructuring advisers who develop a positive and collaborative working relationship with the board can significantly improve the prospects of a company which finds itself in distress in certain circumstances. In many cases, owing to the existence of entrenched business structures and vested stakeholder interests, it can be difficult for a board to make the changes to the business that need to be made in order for a distressed company to restructure and survive without the assistance of an independent third party. The other commendable aspect of Model A is that it encourages directors to develop a plan as to how the company can be returned to solvency within a reasonable period of time and it encourages directors to take reasonable steps to ensure that it does so. However, there are a number of significant limitations to the Model A approach which are set out below.

(a) Fails to resolve the issue of the "twilight zone"

The provision is framed as a defence to "insolvent trading" because the company may be "insolvent" at the time of incurrence of a debt, but it only operates if the advice of a restructuring adviser has already been obtained. Therefore, in order for directors to be fully protected, the Safe Harbour would need to be activated whilst the company is still solvent.

At the time a company is solvent, why would a defence to "insolvent trading" be required at all? If the company is solvent, then the directors should be, as always, doing everything they reasonably can to make the company flourish. Consistently with their general duties, that might include commissioning advice and recommendations from a variety of experts, including restructuring experts if necessary. It might also include the taking of some risk. For the directors to be concerning themselves with establishing protections against their own potential personal liability, in those circumstances, is an unnecessary distraction and an unnecessary cost.

In light of the above discussion [at 3.3] regarding the uncertainty around the concept of "insolvent", it is difficult to see how this approach will assist in clarifying ambiguity. It can be expected that, in many if not most instances, the board will be considering whether or not to make the adviser appointment, at a time when the company is already insolvent, or arguably so. In such circumstances, the dilemma for directors is not resolved. If there is a risk that they made the adviser appointment too late, then there is a risk that they are not "immunised" and that

their "insolvent trading" risk remains (at least in respect of those debts incurred prior to the activation of the Safe Harbour).

In this regard, how will the defence operate on start-ups and innovators? It is likely that it will operate particularly unfairly as, with the benefit of hindsight, they may be viewed as insolvent from their very establishment. The reform might, therefore discourage rather than encourage innovation. As discussed above [at 3.1], most businesses which fail are SMEs and start-ups. So as to ensure the availability of the proposed defence, such companies would be required to appoint a restructuring adviser from day one, on the basis that they may be "insolvent", which may not be what such companies need to facilitate innovation and risk-taking at the inception of their business.

At the other end of the corporate spectrum, the introduction of the proposed Model A Safe Harbour may create additional dilemmas for directors of listed companies in respect of their continuous disclosure obligations. The Commonwealth states in the Proposals Paper that, while a company does not need to necessarily disclose whether they are operating in Safe Harbour, there is "*no relaxation of a company's continuous disclosure obligations*".[67] Query 2.2.2b of the Proposals Paper invites consideration of whether this is the correct approach to disclosure. We submit that this places directors in a difficult situation as the very act of appointment of a restructuring adviser by the board to initiate a Safe Harbour may constitute information which could have a material effect on the value of securities and which must be disclosed to the market under existing continuous disclosure laws. Our experience is that such public disclosure during sensitive restructuring negotiations can be very damaging to those negotiations and to the prospects of a successful turnaround.

(b) The "one-size fits all" approach

The proposed Model A Safe Harbour assumes that all companies which may potentially face distress require the services of a restructuring adviser. There is no doubt that this assumption is correct for many companies. The ASIC data referred to in the Productivity Commission report indicates that 42% of external administrators' reports in 2013-14 nominated 'poor strategic management of business' as one of the causes for failure of a company.[68] More recent ASIC data confirms this with the finding that 3,518, of 20,014 (42.1%) external administrators' reports nominated 'poor strategic management of business' as the cause of failure.[69] This data suggests that many distressed companies would benefit from the services of a restructuring adviser.

However, this "one-size fits all" approach is unlikely to meet the needs of every company. As discussed above [at 3.1], most businesses which fail are SMEs and start-ups. Questions must be raised as to how much benefit a restructuring adviser is likely to provide to these types of companies. For companies which are under-capitalised or failing due to inadequate cash flow, a restructuring adviser may offer little value to the business and may, in reality, constitute just further "red tape" and an additional cost burden.

The same issue arises in respect of the selection of the restructuring adviser. The question of solvency is both a legal and an accounting question. The development of a plan to achieve solvency may require operational turnaround expertise, legal expertise (in relation to the negotiation of forbearances with financiers or the restructuring of the balance sheet), accounting expertise (in developing cash flow forecasts) and investment banking expertise (to source additional equity). The

67 Treasury, Australian Government, *Improving bankruptcy and insolvency laws* (2016), 13.

68 Productivity Commission, Parliament of Australia, *Inquiry Report on Business Set-up, Transfer and Closure* (2015), 350.

69 Australian Securities and Investment Commission, 'Insolvency statistics: External administrators' reports (July 2014 to June 2015)' *Report 456* (2015).

skills which will be required by a distressed company of its restructuring adviser will vary depending on that company's circumstances and the distressed company will often require the assistance of several advisers from different disciplines to achieve a successful restructure and turnaround.

It is the very nature of diversity inherent in Australia's insolvency landscape that requires flexibility in approach and it is unclear how a "one-size fits all" Safe Harbour defence can provide this.

(c) Directors already have a clear duty to obtain expert advice

Australian directors already have a clear duty to seek and obtain expert advice and opinion on any matter pertaining to the conduct of their corporation which might fall outside their own expertise. This applies not only to advice on restructuring options in times of financial hardship. Depending on the type of company, this duty might only apply to high level matters. In smaller corporations, it might even touch upon operational matters of some detail.

The duty arises from the long standing duty of care and diligence, now encapsulated in section 180 of the Act. Directors are required to exercise the degree of care and diligence of a reasonable person in their position. It is obvious that, if a company faces financial difficulty, a reasonable person would engage appropriate external expertise to assist with identifying options and working through solutions.

If it is not clear enough, under the existing law relating to directors' duties generally, that directors are required to obtain` appropriate expert advice and guidance, as is reasonable, then that could be made clearer by way of amendment to section 180. However, to require directors, in times of financial difficulty, to seek the advice of a restructuring adviser about the company for which they are ultimately responsible and to take reasonable steps to implement that advice, may derogate from this holistic duty. In this regard, to what degree will the proposed reform, in practice, distract Australian company directors from their primary mandate and duty? That is, to direct - in the best interests of the company (being the whole if its array of shareholders, not just creditors) and for purposes that are "proper".

It may be that delegation of responsibility to a restructuring "expert" is thought to be an antidote for such directorship responsibility. The defence does leave the decision, on whether or not to continue trading, to the director but this is to be "based on" the advice provided by the restructuring adviser. Therefore, while the director may "*retain control*" in a theoretical sense, in practice it is unlikely that a director would not follow the advice of the adviser.

We consider that much of the thinking that this should be delegated to an adviser stems from:

- (to the extent that the proposed reforms are supported by company directors) a lack of confidence of Australian directors; and
- a flaw that does exist in the "insolvent trading" laws which will be more effectively remedied directly, rather than by way of introducing a further defence.

From a philosophical point of view, it is doubtful how it is appropriate to address a fundamental obligation of directors, namely, the decision to obtain appropriate advice and guidance when directing a company in (and hopefully out of) financial distress, by creating a defence to an ancillary personal exposure of those directors.

(d) Insufficient protection to creditors

Under the Model A Safe Harbour, once the board has obtained advice from a restructuring adviser that the company **can** be returned to solvency within a reasonable period of time, so long as the directors are taking reasonable steps to ensure that it does so, the directors may cause the company to incur debts which the directors know the company does not have the ability to pay. Therefore, once the directors have the protection of the Safe Harbour, they effectively have a "blank cheque" in terms of the debts which are then incurred during the Safe Harbour period. Under the current insolvent trading regime, directors need to undertake detailed cash flow projections and carefully manage the incurring of each debt. Typically, during times of distress, this will result in directors deferring non-essential expenditure to avoid exposing creditors to unnecessary risk. Such careful management of expenditure would not be required under the Model A Safe Harbour which may, thereby, lead to an increase in the amount of debt incurred by companies whilst insolvent. Such insolvent trading may not be problematic if the company succeeds in returning to solvency. But what prospects of future solvency would be sufficient to satisfy this test? Would a 10% prospect of survival be sufficient to give rise to a reasonable expectation that the company **can** be returned to solvency? The word "can" may conceivably encompass such low prospects of survival. What constitutes a reasonable period of time? From our experience, most significant restructures or turnarounds take at least 9 to 12 months to execute. This is a long period of time during which creditors would be exposed to potential losses if the company does not return to solvency. The Australian Restructuring, Insolvency & Turnaround Association (ARITA), in its *'ARITA's Policy Positions'* paper and submission to the Treasury, submitted that there should be an additional requirement in the Safe Harbour defence for directors to consider the interests of the company's body of creditors as a whole, as well as members. This is clearly an improvement to the proposed Model A and would provide better protection to some creditors. However, it would not resolve this issue entirely, particularly for individual creditors who may be providing credit to the company during the safe harbour period which may be to the benefit of creditors as a whole but to the detriment of the individual creditor advancing the funds.

(e) Safe Harbour is a patch instead of a holistic response

Any consideration of reform to the laws pertaining to the duties of directors, by the imposition of specific obligations, ought to be undertaken at the level of the primary duties themselves, rather than by way of defence to the very specific insolvent trading prohibition. Therefore, in response to Query 2.2.2a we disagree with the approach taken for the Safe Harbour to operate as a defence.

The key challenge of the current regime is not that it causes precipitous administrations, though this may be an upshot of the issue, but rather, more broadly relates to director uncertainty. Insolvent trading laws should encourage active and vigilant directors to not participate in reckless decision-making, but equally, the laws should not completely discourage risky but potentially beneficial management.

Defining the issue more broadly is important because it demonstrates how it demands a broader response in order to be effectively addressed. Amendment of the primary offence is more likely to address the uncertainty faced by directors; as opposed to the introduction of an additional defence which is likely only to increase the legal uncertainties.

4.3 Proposal 2.3: Safe Harbour Model B

The proposed Model B Safe Harbour operates as a carve out of s588G, rather than as a defence. Therefore, the burden of proof would lie on any liquidator bringing a claim to show that a director had breached the Safe Harbour. The proposed Model B Safe Harbour provides:

"Section 588G does not apply:

a) if the debt was incurred as part of reasonable steps to maintain or return the company to solvency within a reasonable period of time; and

b) the person held the honest and reasonable belief that incurring the debt was in the best interests of the company and its creditors as a whole; and

c) incurring the debt does not materially increase the risk of serious loss to creditors."

This model does not include a strict requirement that a restructuring adviser is appointed; however, such appointment would be considered when determining whether a director has taken "*reasonable steps to maintain or return the company to solvency within a reasonable period of time".* Early engagement with key stakeholders, such as creditors, is also considered under this "*reasonable steps*" evaluation.[70]

4.4 Analysis of Safe Harbour Model B

Query 2.3

The Government seeks your feedback on the merits and drawbacks of this model of Safe Harbour.

The proposed Model B Safe Harbour, which is similar to the Safe Harbour currently operating in the UK, has many advantages over the current regime and over the proposed Model A Safe Harbour.

In particular:

(a) The proposed Model B Safe Harbour encourages directors to develop a plan as early as possible to maintain or return the company to solvency within a reasonable period of time and to implement that plan.

(b) Directors retain full responsibility for developing the plan, analysing whether that plan is in the best interests of the company and its creditors and for taking the reasonable steps to implement that plan. While the board may obtain advice in developing the plan, it is not constrained as to the type of adviser it may retain, thereby providing greater flexibility than Model A.

(c) The "twilight zone" pressure on directors will be greatly reduced. While directors in the "twilight zone" will still need to grapple with the difficult questions of solvency, under the proposed Model B Safe Harbour directors will not be compelled to immediately appoint administrators upon determining that the company is insolvent but, rather, will have available to them the less drastic option of developing a plan and taking reasonable steps with a view to returning the company to solvency within a reasonable period of time.

(d) Model B provides much better protection to creditors than the proposed Model A Safe Harbour in that there must be a nexus between the debt

[70] Treasury, Australian Government, *Improving bankruptcy and insolvency laws* (2016), 16.

incurred and the "*reasonable steps*". This nexus requirement should encourage directors to be rigorous and disciplined in relation to expenditure and to avoid the moral hazard associated with Model A. In addition, subsections (b) and (c) of the Model B Safe Harbour also focus directors' attention on the interests of creditors.

(e) While directors of listed companies would need to continue to comply with continuous disclosure obligations during the Safe Harbour period, the Model B Safe Harbour does not have the same obvious potential disclosure trigger as the Model A Safe Harbour (namely, the appointment of a restructuring adviser to activate the Safe Harbour).

(f) Model B allows for a debt to be incurred in an attempt to save the company and is thereby more closely aligned with the aim of encouraging restructure and recognises the need for risks to be taken to achieve long term benefits.

However, the proposed Model B Safe Harbour also has a number of limitations. In particular, the proposed Model B Safe Harbour is unlikely to be of great assistance to start-ups and innovators. As a consequence of the speculative nature of these ventures, directors of such ventures are unlikely to be able to develop a comprehensive plan to achieve solvency within a reasonable period of time. As discussed above, start-ups will typically require numerous phases of capital investment during the early years to fund research and development costs and the costs associated with achieving necessary permits and licences before the start-up venture will begin to generate revenue and put the company in a position where it can repay its debts. It is often not possible to have all of the necessary funding in place or even to plan how such funding will be obtained at the commencement of a venture. Therefore, while the Model B Safe Harbour is a significant improvement on the current insolvent regime and is preferable to the Model A Safe Harbour, it fails to achieve the Commonwealth's stated objective of encouraging "*Australians to be more innovative and ambitious and having a go at starting a small business*".[71]

Another difficulty with Model B is that it doesn't address the real problem created for directors by the current insolvent trading laws, as exemplified by the Tough Times example discussed above – that is, it leaves directors exposed to personal liability for routinely incurred debts (ie ordinary trade debts which are not incurred "as part of" a rescue plan) incurred at a time when the company is insolvent.

5 Alternative suggestions for reform

There are three alternative ways in which the current issues with Australia's insolvent trading regime could be addressed. These different options are:

(a) abolishing the prohibition on insolvent trading altogether;

(b) limiting the prohibition in the primary offence to the incurring of a debt when the company is not able to pay that debt; and / or

(c) amending the "reasonable expectation defence".[72]

[71] The Hon Kelly O'Dwyer MP and Senator the Hon George Brandis QC, *Consultation on improving bankruptcy and insolvency law* (29 April 2016) <http://kmo.ministers.treasury.gov.au/media-release/049 2016/?utm_source=wysija&utm_medium=email&utm_campaign=Media+Release+%E2%80%93 +Consultation+on+improving+bankruptcy+and+insolvency+law>.

[72] *Corporations Act 2001* (Cth) s 588H(2).

We set out below a discussion of the advantages and disadvantages of each of these options.

5.2 Abolishing the prohibition on insolvent trading

As set out above [at 2.2], the prohibition on trading whilst insolvent is not ubiquitous. In particular, the United States and Canada do not have any such statutory prohibition.[73] However, the lack of an insolvent trading regime in the United States and Canada is not without criticism.[74] In Australia, those criticisms are at least partly answered by reason of the fact that creditors may be better protected from the conduct of directors of distressed companies, during the "twilight zone" and otherwise, due to the general directors' duties provisions. As stated above [at 4.5], existing *Corporations Act* provisions already impose clear duties on directors to act with care and diligence in their operation of a company.[75] While those duties are owed to the company, the duties are often enforced by administrators, liquidators and (sometimes) ASIC, in an insolvency scenario, for the benefit of creditors. Standard D&O policies will sometimes respond to such enforcement action, resulting in a source of recovery for creditors.

The difficulty for creditors in seeking to rely on the law of directors' duties for protection is that Australian directors do not owe an independent duty to creditors (as distinct from the duty owed to the company) and that duty is not directly enforceable by creditors.[76] Furthermore, the content of the duty is currently unclear in circumstances where the relevant company is in an insolvency context.[77] In *Walker v Wimbourne*,[78] the High Court warned directors that, in attending to the affairs of a company when it was approaching insolvency, they must have regard to the interests of creditors.[79] Since that warning was issued by Mason J, judges and commentators have struggled with the formulation of the role to be played by the interests of creditors in the exercise of directors' powers and duties.[80] It was expected that this issue would be resolved by the High Court in the appeal that it was due to hear from the decision of the Western Australian Court of Appeal in *Westpac Banking Corporation v Bell Group Ltd (in liq)* [No 3] (2012) 44 WAR 1.[81] However, this proceeding was settled before the High Court heard the appeal.

The view that the duties of a director should be to the company as a whole, rather than particularly to specific stakeholders or stakeholder groups, gives due regard to the business judgments of directors as to what is in the interests of the company.[82] It is also consistent with the Court of Appeal decision in *Bell Group* which set the scene for greater recognition of the need for entrepreneurial encouragement of directors.[83] However, the need for directors to consider the interests of creditors, when performing their duty to a company, was brought into

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73 Patrick Lewis, 'Insolvent trading defences after Hall v Poolman' (2010) 28 *Company and Securities Law Journal* 396, 397.

74 Productivity Commission, Parliament of Australia, *Inquiry Report on Business Set-up, Transfer and Closure* (2015), 24; Stephen J. Lubben, 'Some realism about reorganization: Explaining the failure of Chapter 11 theory (2000) 106 *Dickinson Law Review* 267; Bob Wessels and Rolef J. de Weijs, 'Revision of the iconic US Chapter 11: its global importance and global feedback' (2014); Bob Wessels and Rolef J. de Weijs**, '**Proposed recommendations for the reform of Chapter 11 U.S. Bankruptcy Code' (2015) *Centre for the Study of European Contract Law;* Ian M Ramsay, *Company Directors': Liability for Insolvent Trading* (CCH Australia Limited and Centre for Corporate Law and Securities Regulation, 2000) 10.

75 *Corporations Act 2001* (Cth) s 180.

76 King & Wood Mallesons, *Australian Finance Law* (Thomson Reuters, 7th ed, 2016) 884.

77 King & Wood Mallesons, *Australian Finance Law* (Thomson Reuters, 7th ed, 2016.

78 (1976) 137 CLR 1.

79 King & Wood Mallesons, *Australian Finance Law* (Thomson Reuters, 7th ed, 2016) 884.

80 Ibid.

81 Ibid 885.

82 Ibid 886.

83 King & Wood Mallesons, *Australian Finance Law* (Thomson Reuters, 7th ed, 2016) 886.

doubt by The Honourable Kenneth Hayne AC, speaking extra-judicially.[84] Hayne AC was expected to preside over the anticipated *Bell Group*[85] appeal in the High Court. While he makes it clear that his comments are not to be understood as expressing his opinion as to what that case would have decided, they do suggest that the formulation by Mason J has been divorced from its context and that the *"consider creditor" theory is "a solution in search of a problem"*.[86] Therefore, the situation remains uncertain and, in many respects, the current law in relation to directors' duties in the "twilight zone" suffers from similar problems to the current insolvent trading regime.

Consequently, if the prohibition on insolvent trading is to be abolished and if directors' duties are going to cover the field in this regard, the content of directors' duties as regards creditors in an insolvency would need to be clarified by way of legislative amendment. The preferred approach in this regard may be to adopt the New Zealand approach [at 5.3] of introducing a separate prohibition on directors from allowing the business of the company to be carried on in a manner likely to create a substantial risk of serious loss to the company's creditors (discussed further below).

5.3 Limiting the prohibition in the primary offence

Much if not all of the difficult dilemma faced by Australian directors would be resolved if the primary offence of "insolvent trading" was limited to the incurring of a debt in circumstances where the directors have *no reasonable basis to expect that debt* to be repaid in accordance with its terms. In other words, if the primary offence were detached from the concept of "insolvency". This would avoid the unnecessary complexity of establishing an exception to this provision.

The primary convention could be redrafted to establish that a director will be liable when they have *reasonable grounds to expect* that the company will be unable to fulfil *those obligations,* rather than when they have reasonable grounds to suspect insolvency.[87] Adopting such a provision in Australia would require redrafting of section 588G, but would render much of section 588H (the current defences) unnecessary.

This approach was taken in New Zealand in 1993 and has worked well there since then. It provides greater certainty for directors, as compared with the current Australian regime, because directors of distressed companies are able to avoid potential liability for the offence by carefully managing their company's cash flow to ensure that there is sufficient cash to pay each debt which is incurred while the directors develop and pursue a turnaround strategy or a restructure. This approach also protects creditors in that it should ensure that debts incurred by a distressed company in the "twilight zone" are generally repaid.

An additional provision could also be introduced in Australia, as in New Zealand, to provide further protection to creditors by prohibiting a director from agreeing to, causing or allowing the business of a company to be carried on in a manner *likely to create a substantial risk of serious loss to the company's creditors.*[88]

This New Zealand provision was based on a recommendation by the New Zealand Law Reform Commission to recast an earlier provision "*to reduce its tendency to*

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84 Ibid.

85 *Westpac Banking Corporation v Bell Group Ltd (in liq)* [No 3] (2012) 44 WAR 1.

86 King & Wood Mallesons, *Australian Finance Law* (Thomson Reuters, 7th ed, 2016) 886.

87 *Companies Act 1993* (NZ) s 136.

88 *Companies Act 1993* (NZ) s 135.

deter risk-taking by directors".[89] The Commission emphasised the importance of allowing a degree of risk taking by directors:

> *"A company may legitimately be formed to embark on a speculative or very risky joint venture, or may undertake such a venture later. The chance of failure-and the prize for success- may be high. Indeed success may greatly benefit the community."*[90]

This is also consistent with the recognition by the Government in the Proposals Paper that "*it may be in the best interests of both the company and its creditors as a whole to trade out of its difficulties…even if there is some risk of loss in the short-term".*[91]

An immediate effect of this approach would be to resolve the dilemma faced by the directors of our hypothetical company, Tough Times Ltd. Whether or not, as matters play out, the company is in fact insolvent at the present time, no question of "insolvent trading" arises because the directors have a reasonable expectation or belief that the trade debts incurred in the interim period would be repaid in the ordinary course of business.

As the time for repayment of the large bank debt draws nearer, the directors, if they have been acting prudently and in accordance with their general duty of reasonable care and diligence, will by then have a clearer picture of the "likelihood" of the bank debt being resolved in time. If, by the time the bank debt issue comes within the period of the normal cycle of ongoing trade debt, it remains the case that the bank debt is unlikely to be resolved, only then will the directors find themselves within the "insolvent trading" regime, such that they must, in one way or another, cause the company to cease incurring fresh debt (which is due for payment after the "crunch", such that the directors have no reasonable grounds to believe it will be paid).

Even in those circumstances, if the board is receiving advice from a competent restructuring adviser, to the effect that a credible solution is likely, the directors are (at least arguably) protected. The solution proposed above would also mean that entrepreneurial directors could allow their company to continue to trade, even if technically insolvent, by raising their own capital to "cover" ongoing trade debts.

A potential criticism of this approach is that directors could evade the prohibition by engaging in a narrow "debt by debt" analysis. That is, the director may seek to set aside funds to pay a particular debt in order to satisfy itself that the company would be able to pay that particular debt when it became due for payment in the knowledge that the company had several other substantial debts falling due for payment shortly which the company did not have the ability to pay. However, in such circumstances, the director would surely have difficulties in establishing the requisite "reasonable grounds". The early uniform State-based legislation in Australia addressed this issue directly and provided that a director would not be liable if they had a reasonable expectation that the company would be able to pay *the specific debt* being incurred '*after taking into consideration the other liabilities*'.[92] Overall, we think that this sort of modification to a New Zealand style approach would be unnecessary.

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89 New Zealand Law Reform Commission, *Company Law: reform and restatement*, Report No 9 (1989).

90 Ibid (paragraph 516).

91 Treasury, Australian Government, *Improving bankruptcy and insolvency laws* (2016), 15.

92 For example, *Companies Act* 1961 (Vic) s 374C.

5.4 Amending the "reasonable expectation" defence

The final (and most modest) alternative reform option is that section 588H(2) (the "reasonable expectation" defence) could be amended to read as follows:

> It is a defence if it is proved that, at the time when the debt was incurred, the person had reasonable grounds to expect, and did expect, that the company would *pay or otherwise discharge the debt in accordance with its terms*.

If it were thought necessary to include a Safe Harbour concept, section 588H(2) could be further amended to include an additional refinement to the effect that, in assessing whether a person has the required "reasonable grounds to expect" that a debt would be repaid, the Court is to take into account whether or not the person (ie the director) had caused, or participated in causing, the company to appoint a Safe Harbour adviser, together with any other matter which might reflect on the credibility of the claimed "reasonable grounds".

This formulation would make the Safe Harbour a relevant consideration, rather than an absolute defence, thereby eliminating any prospect of misuse or misapplication of that process.

6 Final thoughts

The current insolvent trading regime is plainly failing creditors and directors alike and makes it very difficult for directors to trade on through the "twilight zone" even where they are genuinely attempting to find a solution to the company's solvency issues. Therefore, there is undoubtedly a strong case for reform.

While the introduction of a Safe Harbour defence raises relevant considerations and has superficial appeal, we consider that neither of the proposed Safe Harbour reforms provide Australian directors with sufficient certainty or protection to enable Australian directors to "*take a risk, leave behind the fear of failure and be more innovative and ambitious*".[93] We submit that the necessary certainty would be achieved by the adoption of one of the alternative approaches to reform above [at 5], and in particular, the approach set out in [5.3] which we consider to be the preferable approach. This approach would also protect creditors in that directors would be prohibited from permitting the company to incur debts which the company does not have the ability to pay; that being, after all, the wrong which the "insolvent trading" regime was always intended to address.

[93] Australian Government, *Insolvency laws reform* (7 December 2015) National Innovation & Science Agenda <http://www.innovation.gov.au/page/insolvency-laws-reform>.

B. Ipso Facto reform

1 Preliminary Comments

In framing the debate on Ipso Facto, we make the following observations:

1.1 Comparisons to Safe Harbour

In determining the next steps necessary to implement reform, it is useful to compare Ipso Facto reform to Safe Harbour reform, in particular:

(a) Safe Harbour is confined in scope to the personal liability of directors under the insolvent trading prohibition.

(b) Safe Harbour reform has developed in the Proposals Paper to two specific legislative models A and B which following this consultation period will have had the benefit of detailed submissions, as well as other consultation between Government, industry and interested stakeholders across the economy.

(c) The Safe Harbour consultation process has evolved to consider two proposed legislative structures in Model A and Model B, either of which could be enacted to deal with the concerns regarding the current insolvent trading prohibition under Australian law. Alternatively, other legislative amendments could be adopted as suggested in our submission.

(d) By contrast, Ipso Facto reform is broader in scope than Safe Harbour. It has implications for contracts and counterparty rights throughout the economy, given that many (if not most) contracts contain ipso facto provisions in one form or another.

(e) In respect of Ipso Facto reform, the Proposals Paper has introduced important concepts for consultation and has made a number of constructive proposals for further consultation in relation to Ipso Facto reform. We expect that the Ipso Facto reform consultation process will mature and deepen significantly through the Proposal Paper and submission process.

(f) As things stand, in relation to Ipso Facto reform, the "broad brush" approach of drafting generally and identifying exceptions as a means of framing legislation carries risks of unintended, unforeseen and potentially significant changes within the economy. Given this, we incline to a more selective and targeted approach, following further consultation and investigation of the effects and systemic policy issues which Ipso Facto reform raises.

1.2 Ipso Facto is not new to Australian law

The *Corporations Act 2001* (Cth) and the *Bankruptcy Act 1966* (Cth) already contain provisions which are analogous in some respects to the proposed Ipso Facto reforms. In particular:

(a) section 600F(1) of the *Corporations Act 2001* (Cth) restricts the exercise of contractual rights by suppliers of essential services to companies in insolvency procedures (**Essential Services Provision**);[94]

[94] *Corporations Act* 2001 (Cth) s 600F(1), which applies to companies in administration, liquidation, provisional liquidation, deeds of company arrangement and receivership. This provision has been in effect since 23 June 1993.

(b) section 301(1) of the *Bankruptcy Act 1966* (Cth) deems provisions in contracts for the sale of property, leases of property, hire purchase agreements, licences or PPSA security agreements void to the extent they contain bankruptcy triggers for termination, repossession or modifications;[95] and

(c) Divisions 6 and 7 of Part 5.3A of the *Corporations Act 2001* (Cth) contain moratoriums which, by and large, restrict the rights of creditors of companies in administration to enforce their contractual and proprietary rights for the duration of the administration procedure.[96]

In our view, the success (or otherwise) that these provisions have had in achieving their legislative intent since their enactment requires further consideration as part of the Ipso Facto consultation process. The valuable experience of the past must be fully utilised in this reform process.

We would welcome a report and further consultation between Government, industry and applicable stakeholders into the ways in which these three legislative regimes have been implemented and the success they have had in achieving their objectives.

2 Responses to Proposal Paper queries

2.1 The Ipso Facto model (section 3.2)

Query 3.2.a

Are there other specific instances where the operation of ipso facto clauses should be void. For example by prohibiting the acceleration of payments or the imposition of new arrangements for payment, or a requirement to provide additional security or credit.

We comment as follows:

Express contractual terms. We note that it is common to see express rights and triggers in contracts along the lines outlined in this query. Those rights in favour of financiers are particularly common in financing arrangements and related transaction and security documents.

We observe that if Ipso Facto reform was to curtail the rights of financiers to enforce their express contractual rights in this way, it would be a very significant change to the financing arrangements commonly used to supply credit in Australia. We caution against this approach given the risk that such a reform would pose to the availability and pricing of credit. We would describe this as an example of a systemic policy effect which would be undesirable from an Ipso Facto reform perspective, along with others we identify in this submission.

Second, exercising commercial leverage. It is also common for contractual counterparties exercising ipso facto rights to use termination rights as commercial leverage to re-negotiate terms following an insolvency event. For example, it is common for parties to seek to vary their post-appointment pricing and supply arrangements, or to make post-appointment supply contingent on the payment of unpaid pre-appointment debts. Contractual counterparties take these steps to

[95] *Bankruptcy Act* 1966 (Cth) s 301(1), which applies to bankrupts, acts of bankruptcy and the execution of personal insolvency agreements. This provision has been in effect since 1 June 1966.

[96] *Corporations Act* 2001 (Cth), Part 5.3A Division 6 (ss 440A to 440JA inclusive); Part 5.3A Division 7 (ss 441 to 441J inclusive). The majority of those provisions have been in effect since 23 June 1993, with some additional provisions enacted with the PPSA reforms which came into effect on 30 January 2012.

protect themselves against the increased risk that the counterparty will not perform its obligations of it becomes insolvent.

It is unclear whether the Proposal Paper raises the prospect of regulating this type of activity as part of the Ipso Facto reforms. The Essential Services Provision is an example of the restriction of this type of activity.[97]

On one view, the Ipso Facto reform is seen as being a specific reform aimed solely at the exercise of termination rights. We note that the Proposal Paper states, in section 3.2.1 as part of the anti-avoidance proposal:

"[n]othing in the proposal would extend the operation of the provision beyond ipso facto clauses; counterparties would maintain a right to terminate, amend accelerate or vary an agreement with the debtor company for any other reason, such as for breach involving non-payment or non-performance".

On another view, it could be said that if Ipso Facto is to have meaningful effect or "bite" in practice, the preservation of these types of rights alongside the new provisions is impractical. Counterparties will simply use alternative means of exercising rights against the insolvent company, either expressly in contract by alternative remedies or through the exercise of commercial leverage as noted above. Regulation of that type of activity similar to the Essential Services Provision may be necessary to achieve the legislative objective.

The right to enforce non-payment of pre-appointment debts, whether by termination or otherwise (subject to the various stays on enforcement during administration and winding up), is an example of a right which generally exists upon insolvency of a counterparty.

In practice, most contract counterparties will have accrued unpaid debts owed to them by a company when it enters an insolvency procedure. This is partly a result of the conduct of companies in the 'twilight zone' of insolvency, which tend to stretch creditors in the lead-up to an insolvency appointment. It is also a result of periodic invoicing cycles, where payments generally are made in arrears.

Given how common unpaid pre-appointment debts are, if counterparties are free to exercise non-payment termination rights or commercial leverage resulting from those rights, preserving those rights would appear to undermine the effectiveness and application of the Ipso Facto reforms.

Instead of preserving rights to escalate and enforce pre-appointment debts, further consideration could be given to adopting an equivalent provision to the Essential Services Provision as part of the Ipso Facto reform, restricting the exercise of those rights.[98]

This will not work if the Ipso Facto reform remains a "broad brush" structure as outlined below. We are not in favour of further broadening the (already very broad) scope of the Ipso Facto regulation unless, as we note in section 2.4 below:

[97] *Corporations Act* 2001 (Cth), s 600F(1)(c): post-appointment refusal to supply essential services; s 600F(1)(d): making it a condition of supply of the essential service that a pre-appointment debt is paid.

[98] If an extension of the Essential Services Provision was considered to achieve the desired policy objectives, consideration could be given to the United Kingdom reforms in 2015. See *The Insolvency (Protection of Essential Supplies) Order 2015* and Section 233 of the *Insolvency Act 1986* (UK).

- ***"carve outs" are adopted including for "financial contracts" and other key contract classes where there is a systemic policy reason for preserving ipso facto rights; or***

- ***the structure of the Ipso Facto reform is changed from the current "broad brush" approach to a more tailored reform applicable to specific classes of contracts only.***

2.2 Anti-avoidance (section 3.2.1)

First Query 3.2.b

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

In principle, we are not in favour of retrospective operation of Ipso Facto reform.

The reform should apply to companies which are subject to a Relevant Procedure which commenced after the legislation comes into effect. For this purpose, Relevant Procedure would have the meaning given under the second section 3.2.b below.

Second Query 3.2.b

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

In principle, our position is that the extension of the existing moratoriums applicable in the administration procedure to Ipso Facto is a sensible reform. The extension should be as far as possible made consistent with other moratoriums which apply during the administration procedure. Accordingly, it should not be extended to the deed of company arrangement procedure except under Court orders (which again is consistent with the other moratoriums which apply during the administration procedure).

There are other policy-based matters which require careful consideration as outlined elsewhere in this submission before the reform is enacted.

We wholeheartedly support the extension of the Ipso Facto reform to creditors' schemes of arrangement, which would be an excellent extension of the Australian restructuring regimes. Creditors' schemes of arrangement have been highly effective in restructuring Australian businesses in recent cycles. The proposed Ipso Facto reform can be expected to facilitate the access of distressed companies to the creditors' scheme of arrangement procedure and to incentivise companies to use that procedure.

The extension of Ipso Facto reform to receivership and other controller appointments would be a very significant extension of the breadth of the (already broad) receivership and controller rights which apply under Australian law. For that reason, we do not support the extension without further consultation with the various affected interests concerned with receivership.

For further explanation, our reasoning is outlined in detail in the following table:

Relevant Procedure	KWM Summary	Comment
Administration	In favour	A number of counterparties to contracts with companies in the administration procedure are already subject to moratoriums under

Relevant Procedure	KWM Summary	Comment
		Divisions 6 and 7 of Part 5.3A to the *Corporations Act* 2001 (Cth). For example, lessors, parties to court proceedings and creditors with security interests which do not extend to the whole or substantially the whole of the company's property.[99] An extension of those moratoriums to apply to contract counterparties in relation to their exercise of Ipso Facto rights makes logical sense and would support restructuring-related activity. For clarity and consistency with the moratoriums applicable under the administration procedure, it is important that the Ipso Facto moratorium is structured as a further moratorium and treated similarly to other moratoriums once enacted. The implications discussed elsewhere in this submission require further consideration in relation to the administration procedure. For example the treatment of pre-appointment debts which remain unpaid and other rights of termination or variation which arise. Extensions of the convening period require a Court order under section 439A(6) of the *Corporations Act* 2001 (Cth). Parties which are subject to moratoriums and are suffering prejudice as a result of a proposed extension should have rights to appear in extension applications and to oppose extensions on the grounds of an extension being oppressive or unfairly prejudicial to, or unfairly discriminatory against, a creditor or contrary to the interests of creditors as a whole.[100] The entitlements of parties which are the subject of an ipso facto moratorium to vote at creditor's meetings for the full amount of their loss of bargain should also be clarified.
Scheme of arrangement	In favour	In our view, this is an excellent proposal. A company that proposes a scheme of arrangement to one or more classes of its creditors places itself in a position of risk. It is not uncommon for Ipso Facto rights to be triggered by a company making a proposal to its creditors to compromise debts using the scheme of arrangement procedure. Targeting Ipso Facto reform to companies in that situation is consistent with fostering

[99] *Corporations Act* 2001 (Cth), ss 440B(1), 440D(1).

[100] This concept would adopt the common law applicable to challenges to deeds of company arrangement under sections 444D(f)(i) and 444D(f)(ii) of the *Corporations Act* 2001 (Cth).

Relevant Procedure	KWM Summary	Comment
		solvent creditors' schemes of arrangement and supporting constructive restructuring activity in the Australian market. The Ipso Facto moratorium should commence on the date of filing by the company of its Court proceeding under section 411(1) of the *Corporations Act* 2001 (Cth) and end on the earlier of: • formal approval of the scheme of arrangement by lodgement of the Court's order with ASIC under section 411(10) of the *Corporations Act* 2001 (Cth); and • dismissal of the court proceeding should the scheme not proceed. The latter trigger would give the company time to apply for alternative orders to support a Plan B restructuring should this be necessary if its scheme proposal was rejected by the court or creditors. The entitlements of parties which are the subject of an ipso facto moratorium to vote at creditor's meetings for the full amount of their loss of bargain should also be clarified.
Receivership or other controller appointment	Not in favour, pending further consultation	We note that the Essential Services Provision applies to the appointment of a "receiver or a receiver and manager". This is an example of an Ipso Facto moratorium applying to receivership which indicates, in principle, that the extension of the mooted Ipso Facto reform to receivership is a relevant consideration as part of the current consultation period. However, in our view the extension of the Ipso Facto reform to receivership would be a very significant extension beyond existing moratoriums for insolvency procedures in Australia. We note that receivership is not a collective procedure. Rather, it is a private remedy of enforcement for secured creditors. The support of the trading activity of the company through receivership is primarily to the benefit of the secured creditor. To the extent that Ipso Facto disadvantages other creditors and contractual counterparties, it does so to the benefit of the secured creditor. In our view, the policy justification for the extension of Ipso Facto to the receivership or

Relevant Procedure	KWM Summary	Comment
		other controller procedures requires further consultation before being implemented. We anticipate that many different sectors of the economy will have views on this question. It will require careful consideration before any reform of this nature is enacted.
Deed of Company Arrangement (**DOCA**)	Not in favour	We note that the existing moratoriums under Division 6 and 7 of Part 5.3A of the *Corporations Act* 2001 (Cth) apply only until the end of the administration procedure. If at the second creditors' meeting convened under section 439A(3) of the *Corporations Act* 2001 (Cth), the company's creditors resolve that the company enter into a DOCA, the moratoriums can only be extended by a Court order under section 444F of the *Corporations Act* 2001 (Cth). The extension of the Ipso Facto reform to a company entering into a DOCA would extend the Ipso Facto moratorium beyond other moratoriums. Consistent with other moratoriums, an extension of the Ipso Facto moratorium by Court order under section 444F of the *Corporations Act* 2001 (Cth) should be the appropriate procedure to achieve this outcome, should the Court be satisfied it is in the interests of creditors and appropriate in the given circumstances. Given that, a specific extension of the Ipso Facto reform to DOCAs is unnecessary.

2.3 Anti-avoidance (section 3.2.1)

Query 3.2.1

Does this constitute an adequate anti-avoidance mechanism?

In our view, the anti-avoidance wording outlined in section 3.2.1 of the Proposal Paper is sound.

We refer to our other comments in this submission relating to managing the breadth of the Ipso Facto reform and the difficult systemic policy issues which arise in the use of a "broad brush" approach, when compared to a more precise and targeted approach.

2.4 Exclusions (section 3.2.2)

Query 3.2.2

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

As we understand under the Proposal Paper, the Ipso Facto proposal is intended to have general application, with specific exclusions or "carve outs". We describe this structure as a "broad brush".

The "broad brush" structure raises difficult issues across the various contractual arrangements and structures used in the Australian economy. In our view, implementation of a "broad brush" structure for Ipso Facto reform would require extensive further examination of the intended and unintended effects of the reform before enactment. Significant further consultation over a longer period of time than the Proposal Paper would be necessary to identify and draft legislation including extensive carve-outs to avoid unintended and potentially harmful effects.

Anti-avoidance, although necessary to give proper effect to Ipso Facto reform, magnifies the risks and resulting concerns raised by the "broad brush" approach taken in the Proposals Paper.

For the purposes of this submission, we discussed the Ipso Facto reform with a number of clients across industry sectors. Discussions could be described as initial and in-principle, rather than an exhaustive examination of the issues which arise and the sectors and industries which could be adversely affected.

In relation to this, we highlight some specific examples below which we are aware of from our practice and discussions with clients. In our view, further consultation with the industry would likely identify a number of other examples where systemic policy issues arise from the broad application of Ipso Facto to contractual structures commonly used in those industries.

2.5 Source code access rights under escrow agreements as a specific exclusion

The anti-avoidance extension may capture escrow arrangements which give a counterparty access to source code in proprietary software of an entity (and related intellectual property rights) on the occurrence of an insolvency event affecting that entity.

Escrow arrangements are commonly used across industries where a party (**Licensee**) licenses proprietary software from a third party (**Supplier**), typically where that software and its ongoing maintenance is critical to the operation of the Licensee's systems or business. The Licensee and the Supplier enter an agreement with a third party escrow agent whereby the Supplier agrees to deposit the source code with the agent only for release to the Licensee on the occurrence of certain trigger events specified in the agreement. Those release events typically include an insolvency or similar event affecting the Supplier. Access to the source code for the software gives the Licensee the ability to modify the software (or to contract with a third party to do so) so that the Licensee's operations can continue without major disruption if the Supplier ceases to maintain the software as required by the Licensee.

Escrow arrangements are an important protection for Licensees to ensure that access to business critical software is not lost or the Licensee's operations disrupted as a result of an event affecting the Supplier, including an insolvency event which may impact on the Supplier's ability to maintain the software to the standard required by the Licensee.

Licensees would lose this important protection if a release event triggered on the occurrence of insolvency of the Supplier (or similar event) was held to be unenforceable under the Ipso Facto provisions (either as a variation or under the anti-avoidance extension).

Under the US Bankruptcy Code, specific exceptions have been introduced to preserve a licensee's rights to access intellectual property where a similar ipso facto prohibition under that Code applies to that proposed in the Proposal Paper.

Those exceptions were introduced to prevent trustees in bankruptcy disclaiming an escrow arrangement on the basis that it was an executory contract.[101]

Accordingly, in our submission it is necessary to consider an additional exclusion from any Ipso Facto reform for the operation of release triggers in escrow arrangements which apply on an insolvency event affecting a supplier of software.

2.6 Financial contracts as a specific exclusion

We note that certain derivatives and close-out netting arrangements are already identified by the Proposal Paper as a contract class requiring a carve-out from Ipso Facto. We agree with this. In addition, we note that, as a class of contracts, financial contracts cover a wide field of arrangements. The application of Ipso Facto to those contracts raises complex issues that require further detailed examination and consultation before an appropriate carve out could be formed.

A number of those issues could be described as systemic policy issues, potentially with far reaching effects through our financial systems and for cross-border dealings.

Below we make further comments in relation to the complex issues which arise in considering the implications of Ipso Facto reform for financial contracts. We have done so for two reasons specifically:

(a) the importance of the financial contracts carve-out itself as a systemic policy issue for Ipso Facto reform; and

(b) to use financial contracts as an example to illustrate the complexities that arise in identifying and working through exclusions to the Ipso Facto reform.

Financial contracts present some of the greatest complexity in implementing an ipso facto principle into our legal system. This can be shown through a few examples.

Acceleration of debt. It is very common for loans which have a fixed maturity date in the future to be able to be called for early repayment where specified default events have happened. One of these is very commonly the insolvency of the borrower. This ability to have a debt become presently due is important for participation in insolvency proceedings and enforcing security rights. Whilst the laws governing particular insolvency proceedings (such as administration) impose limitations on enforcing these rights, it is a significant further step to prevent a creditor from crystallising the amount due to it in the case of a borrower's insolvency. In concept, this would be similar to preventing derivative counterparties from closing out their position – which we note is not the intended policy.

Draw stop and commitment to lend. At the time of a borrower insolvency, a loan may not be fully drawn. In such circumstances, a lender will usually rely on an insolvency event of default in order to prevent the borrower from drawing down further funds under the loan. In the absence of such an event of default, the lender would ordinarily be liable under the terms of the loan to continue to advance funds to the borrower up to the facility limit and, thereby, to increase the lender's exposure to the insolvent borrower. Any ipso facto rule which is introduced should be crafted so as to ensure that lenders would not be required to advance additional moneys to an insolvent borrower under a pre-existing loan. As such, the statement in the Proposals Paper that the ipso facto rule would not "require any creditor to provide a further advance of money or credit" is welcomed.

[101] US Bankruptcy Code § 365(n).

Flawed asset arrangements. These are financial contracts which make it a condition of one party's payment obligation that the other party has not already failed in some way. Examples are deposit contracts which provide that the deposit is not repayable for as long as there is still money owing by the depositor. The security function of these arrangements means that it is important that they can be relied on even in the insolvency of the depositor.

Replacement of trustees. Trustees are commonly used in financing arrangements to hold security or other rights on behalf of a number of creditors. Because of the importance of these arrangements it is very important that the trustee can be replaced if it becomes insolvent. The trust property should not be available for the trustee's own creditors, but the operational "turbulence" which arises on insolvency mean that a new trustee is best positioned to continue to look after creditors. It would seem to be an unintended consequence of a broad ipso facto rule that the creditors would be unable to replace their trustee in the case of its insolvency.

Flexible priority arrangements. These are arrangements between secured creditors which govern the priority that the claims of each of them have to the secured property (often involving a security trustee). It is common for the priorities set out in these arrangements to change where one of the secured creditors has themselves failed, including by becoming insolvent. An example of this is in securitisation where the priority of a derivatives counterparty may be subordinated to the other creditors if the derivatives counterparty is in default – often included because the default of the derivatives counterparty is likely to have contributed to the failure of the securitisation vehicle. These arrangements were found to contravene the ipso facto principle in the United States in connection with the insolvency of Lehman Brothers but were upheld by the Supreme Court in the United Kingdom. Their effective operation in Australia is important to the operation of, and certainty in, markets such as the securitisation market.

Suspension of participation in markets, clearing systems and payment systems. The rules of markets, clearing systems and payment systems often contain provisions which allow a member's rights to participate to be terminated in the case of their own failure, including insolvency. These provisions are important from a systemic perspective because it allows the other participants and the system itself to manage the risks associated with its exposure to the failed member. The ability to rely on these provisions is particularly critical on the insolvency of a participant.

Securities underwriting arrangements. It would be common for an agreement to underwrite the offering of securities of an entity would be conditional on the entity not being insolvent at the time at which the underwrite is to take place. The commercial arrangement is not intended to extend as far as binding underwriters to subscribe for the securities of an insolvent issuer. This becomes particularly important if a securities offering is made by a company in financial distress in order to better manage its position. An inability to withdraw from an underwriting on insolvency in this circumstance could cause a reluctance of underwriters to participate at all.

These are a class of contract where Ipso Facto causes significant difficulties, particularly in relation to an insolvency procedure such as administration. How can an underwriter be bound to perform its underwriting obligations in respect of the capital raise for an insolvent company? If the company is at risk of appointing administrators should restructuring discussions fail, is it fair or reasonable for underwriters to remain bound to perform their underwriting payment obligations post-administration? What would be the effect of Ipso Facto reform on the availability of underwriting for companies which are in the process of restructuring including an underwritten capital raise?

These are examples only and other examples of what may be considered unintended consequences of a broad application of a new ipso facto rule exist. It is not easy to define a simple common principle which unites these arrangements. In some cases the arrangements perform the economic function of security, others are systemically important, and others are contracts under which the solvent party has already performed everything which it is obliged to do.

The Proposal Paper acknowledges as much at section 3.2.2, where it recognises that unspecified circumstances will exist where *"preventing the operation of ipso facto clauses would be undesirable, impractical, or introduce unnecessary uncertainty into the market"*; and also that *"there are certain classes of contracts which, by their nature, require that types of ipso facto clauses remain operational"*.

Accordingly, we suggest that the scope of the ipso facto rule be defined by a precise focus on the policy outcomes which are sought to be achieved rather than a broad application with a series of named exclusions. This is because the absence of a clear common thread would make a list of exclusions unwieldy, and cause a risk that the list itself may become outdated. Also, in our view, a clearer focus on the precise policy change which is desired would reduce the likelihood of other unforeseen unintended consequences arising.

If the Government intends to pursue a "broad brush" approach to Ipso Facto reform, we would recommend significant further consultation on the appropriate "carve-outs" or exclusions from the reform.

The two examples above are only an initial selection of what we expect is a long list of exclusions necessitated by systemic policy issues which the application of Ipso Facto reform would create in industries.

An alternative approach would be to consult further with a focus on identifying:

- ***the specific issues which it is the objective of the Ipso Facto reform to address; and***
- ***from that, the specific classes of contract which Ipso Facto reform is seeking to regulate; and***
- ***drafting legislation around those specific requirements.***

3.2.3 Appeal

Query 3.2.3

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

Comments

If the "broad brush" approach to Ipso Facto reform is pursued, particularly if the exclusions or "carve-outs" are not more specifically consulted on and defined, the creation of a specific right of parties to approach the Court for relief and prospective variation of contract terms seems sensible.

The concept of "hardship" itself may not necessarily be apposite in relation to Ipso Facto reform. The Proposal Paper states at 3.2.1 (quoted above at section 2.1, that counterparties would retain their other rights to terminate and exercise rights under contracts outside of the confined ipso facto principle. We understand also that it is contemplated that parties would continue to perform contracts under the current regimes,

where, using the Relevant Procedures we endorse for the purposes of Ipso Facto reform in section 2.2 above:

- in the administration procedure, the administrators are personally liable for debts incurred for goods, services and other accrued liabilities;[102] and

- for companies undertaking a scheme of arrangement, they remain solvent and have continuing abilities to fulfil their contractual obligations.

The appeal right itself will create a new legal concept of "hardship" which we expect would be subject to a significant number of disputes between parties seeking to use the new avenue of recourse to leverage their commercial position in a restructuring situation. We would expect complex issues to arise in a number of respects in those Court proceedings, including for example:

- the judicial interpretation of the new legal concept of "hardship";

- competing submissions from parties on proposed variations to contractual terms; and

- commercial and timing considerations relevant to such disputes.

To the extent that the distressed company or an officeholder such as a voluntary administrator was required to defend additional Court proceedings where counterparties sought "hardship" relief or contract variations, the additional costs would be an impost on the estate which would further erode creditor returns.

We have reservations about the creation of a new legal concept of "hardship" which if established enables a court to vary contractual terms.

In our view, a safety net of an expedited Court or out-of-Court dispute resolution mechanism to resolve disputes would be preferable to the creation of a new legal concept of "hardship".

[102] *Corporations Act* 2001 (Cth), s 443A(1).

C. Bankruptcy reform

1 Introduction

KWM is supportive of the Government's aim of encouraging entrepreneurship.

However, it must be recognised that all entrepreneurs have two relevant defining characteristics: they are creditors as well as debtors.

We are concerned that the proposal to reduce the default bankruptcy period is overly focussed on the latter. It does not address the fact that an entrepreneurial culture is as much dependent upon the payment of debts as upon the incurring of them. This is clearly evidenced in the Background section to the proposal paper:

"The measure acknowledges that bankruptcy can be a result of necessary risk-taking or misfortune rather than misdeed, and encourages former bankrupts to continue entrepreneurial activity."

As the philosophical basis for the bankruptcy proposal, this statement is deficient in a number of respects, which we discuss below.

2 The good, the bad and the ugly

The first point to note is that, while it is true that bankruptcy can be a result of necessary risk-taking, it is equally true (if not truer) that bankruptcy can also be the result of unnecessary or simply reckless risk-taking. The blanket proposal to reduce the default bankruptcy period to one year does not address this issue, and thus ignores one of the most important aspects of the personal bankruptcy regime: its disciplinary effect.

Personal bankruptcy differs from corporate bankruptcy in one extremely important respect. The overwhelming majority of corporate bankruptcies ultimately result in the "death" of the corporate bankrupt through liquidation: the company cannot return to the marketplace and run up new debt. So important is this aspect of corporate bankruptcy that both legislation and considerable government resources are devoted to the detection and curbing of phoenix companies.

The same is obviously not true of personal bankruptcy. Individual bankrupts must, sooner or later, incur debts, become party to contracts, etc (whether in business or in the everyday course of living). The only protection that bankruptcy law currently offers to bankrupts' creditors, counterparties, etc is the knowledge that the person is or has been a bankrupt and the attendant restrictions on the bankrupt's financial capabilities. The proposal paper refers to this knowledge and the restrictions as "stigma". That language may be appropriate from the bankrupt's point of view. Its emotive force completely falls away when one looks at the situation from the point of view of those who deal with bankrupts: for them, the knowledge that a person is a bankrupt is an important piece of business information.

Indeed, persons dealing with bankrupts will generally not know whether someone became bankrupt through "necessary risk-taking", "misfortune" or "misdeed". In fact, it is a truth generally (if not universally) acknowledged that one rarely encounters a bankrupt who believes that they became bankrupt solely as a result of their own misdeeds, negligence or incompetence. Persons dealing with them therefore cannot rely on bankrupts' assurances that they are good businesspeople; the restrictions imposed on bankrupts are, as a result, the only objective protections that the law currently offers to their post-default creditors.

3 What about the creditors?

Viewed in this light, the proposals paper is deficient in not addressing the effect on creditors of the reduction in the protection which bankruptcy gives them.

As we stated above, KWM supports the ideal of encouraging an entrepreneurial business culture. As we also stated above, entrepreneurs are creditors as well as debtors.

Entrepreneurial risk-taking will often necessarily involve extending credit to other businesses. In the real world of everyday commerce, the ability of small businesses to protect themselves against debtor defaults is extremely limited (and probably has been further eroded by the PPS regime's restrictions on the use and effectiveness of retention of title clauses). One perverse – and hopefully unintended – consequence of reducing the default period for personal bankruptcy would be to increase the risk of debtor defaults.

It may be true that the shorter bankruptcy period would allow "competent but unlucky" businesspeople to re-engage in entrepreneurial activity more quickly than at present. However, it would also free up those who, to be frank, are either incompetent or borderline dishonest, to the detriment of those entrepreneurial businesspeople with whom they engage.

The result could be an increase in business failures (as incompetent businesspeople bring down the businesses with which they deal) and a resultant deadening of entrepreneurial activity. These outcomes would, we suggest, do more to "discourage innovation and business start-ups" than the current regime.

4 The stigma

Our third concern about the proposal is that the proposal paper appears to conflate two quite different aspects of current bankruptcy law: the practical legal effect of being bankrupt and its "reputational" effect.

We have already stated our concerns about the effect of reducing the legal protections that the law currently provides for persons who deal with bankrupts. We are equally concerned by what appears to be the major theoretical justification for that proposal – that reducing the default period will "reduce associated stigma". We cannot see either a practical or a principled justification for that rationale.

Once a person has become a bankrupt, they are forever labelled with that fact. Indeed, Proposal 1.3.1b reinforces both that reality and its business consequences for the former bankrupt. Reducing the formal period of bankruptcy does literally nothing to change that element of an individual's personal history. Accordingly, it is difficult to understand how the proposal to reduce the period of bankruptcy would reduce the "stigma" attaching to having been a bankrupt.

Difficult, but not impossible: there is only one conceivable way in which reducing the period of bankruptcy would reduce the "stigma" of having been a bankrupt. Such a result could be achieved if the reduction in the period of bankruptcy was seen as an official signal that bankruptcy was somehow less serious than it had previously been (when it had merited a three year restriction period). We have three concerns about this reasoning:

- there needs to be more research on the effect of reductions in sanctions on bankrupts on business confidence and entrepreneurial activity;[103]
- to the extent that the proposed change to the law reduced "stigma" in the minds of businesspeople who dealt with former bankrupts and thereby encouraged them to extend credit to former bankrupts, it would do the business community a disservice, since the "benefit/detriment" would extend as much to the incompetent as to the merely unlucky;[104]
- reduction of the "stigma" of bankruptcy in the minds of bankrupts themselves

103 Such research would have to be considerably more rigorous than a simplistic comparison of experiences in other jurisdictions (eg, the USA) and other eras (eg, the passage of the Debtors Act 1869 in England).

104 Especially since, as we have already noted, third parties who deal with former bankrupts often have no means of knowing what caused the particular bankruptcy.

might encourage more “unlucky” bankrupts to re-engage in entrepreneurial activity, but it would equally encourage the return to business of the incapable and the incompetent.

In relation to the third of these points, we believe that the current bankruptcy period has a benefit which the proposals paper does not address. An enforced period of time “on the sidelines” encourages bankrupts to reflect on the reasons for their bankruptcy, and to address those reasons (eg, through undertaking business training). Reducing the period to one year effectively stymies that enforced learning period, especially since the first year of bankruptcy is more likely to be spent on dealing with the practical consequences of the bankruptcy, such as providing assistance to the trustee, than on any objective evaluation of the factors leading to the bankruptcy.

5 Wag the dog

Finally, we are concerned about the fact that the proposals paper does not distinguish between “business related” and “non-business related” bankruptcies (as those terms are defined by AFSA).[105]

AFSA's statistics show that, in general terms, business related personal insolvency accounts for between 15% and 20% of personal insolvencies. It is therefore surprising that the proposals paper discusses the effect of reducing the bankruptcy period on entrepreneurial activity without discussing its potential effects on the statistically far more significant number of non-business related bankruptcies.

105 https://www.afsa.gov.au/resources/statistics/provisional-business-and-non-business-personal-insolvency-statistics/guide-to-business-and-non-business-personal-insolvency-activity-statistics – last accessed 27 May 2016.