McGrathNicol

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

By email: insolvnecy@treasury.gov.au

Dear Sir

McGrathNicol appreciates the opportunity to provide our views on the Governments Proposal paper on Improving Bankruptcy and Insolvency Laws.

McGrathNicol is a leading firm in the restructuring and insolvency profession with more than 170 partners and staff in six office across Australia engaged in assisting business to restructure and recover from financial distress.

In the attached document we provide our comments in respect of each of the following reform areas:

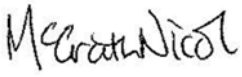
- safe harbour prospects
- ispo facto clauses

We do not practise in bankruptcy and accordingly make no comment in regard to the bankruptcy proposal other than to support ARITA's submission.

We are engaged with ARITA and support its efforts to promote long needed reform in the sector. In this regard the tranche of reform dealt with as part of the Government's Innovation Agenda is welcomed and we hope a harbinger of further important reform necessary to fully modernise and improve Australia's insolvency laws to better serve the community.

If you have any questions in regard to this submission, please do not hesitate to contact me.

Yours sincerely



Robyn McKern

Partner, CEO, Registered Liquidator

McGrathNicol

McGrathNicol submission in response to the Government proposal paper "Improving bankruptcy and insolvency laws"

1 Proposal 2: Safe Harbour

1.1 *Underlying premise*

McGrathNicol is on record through our submissions to the Productivity Inquiry as being sceptical as to the premise that the lack of safe harbour for directors, and the fear of personal liability as a result of our insolvent trading laws, results in reticence to engage in effective and timely restructuring to avert formal insolvency or alternatively, premature entry into formal insolvency. It is simply not our experience.

Rather, the difficulty, cost and unpredictability of prosecuting insolvent trading claims has resulted in a situation where in many cases, particularly in the SME sector, they are not an effective deterrent. This is one of a number of factors which has created an environment where unscrupulous pre-insolvency activities can flourish without fear of consequence, to the detriment of creditors, competitors and indeed often the business owners themselves.

Notwithstanding, we acknowledge the Government is intent on introducing a safe harbour to encourage behaviours aligned with the concepts of its Innovation Agenda and we comment on the proposals as follows.

1.2 *Support for ARITA's submission*

McGrathNicol broadly supports the ARITA submission. Our comments below should be considered as supplementary to ARITA's submission – we have only made comment to reinforce what we consider to be key matters or where our experience and perspective may provide constructive additional ideas.

1.3 *Model A – the defence model. Submission in relation to queries*

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.

Consistent with the position put by ARITA, we support Model A in principle.

However, we note the following concerns which we believe require further thought and clarity if the proposal is to achieve its desired objectives without introducing unintended consequences:

- Like ARITA, we do not believe that the provisions should include a test that requires the restructuring adviser to advise that the company can be returned to solvency within a reasonable time. Very valuable restructuring in terms of preserving business, jobs and value may be achievable in cases where restoring solvency is not. Further, it is critical that the opinion upon which the defence will rest is one that a professional is likely to be able to give in an unqualified form. In our view, a more appropriate test would be that the restructuring adviser forms an opinion that *a restructuring which would preserve a viable business without significant additional loss to creditors as a whole is feasible within a reasonable timeframe*.
- The protection afforded under the safe harbour defence should apply from when a restructuring adviser ("RA") is engaged and subsist until;
  - the RA forms the view that the information, co-operation or access provided by the company is insufficient to enable an opinion to be formed; or
  - the RA forms an initial adverse view on the feasibility of restructure; or

  - having formed an initial view that a restructure is feasible the RA changes that view due to changed circumstances, new information, lack of capability to implement the restructure or lack of progress in achieving the restructure milestones; or
  - the RA forms the view that the board is not genuinely committed to the restructure.

- We believe it is necessary to build some time parameters into the process if the defence is to succeed. It cannot be the case that an extended period of safe harbour ensues without demonstrable development of a feasible plan or progress on its implementation. We recognise that this is difficult to prescribe, but there may be scope for guidance to the effect that for example a small company restructure plan must be formally accepted by the board within 4 weeks of the RA appointment, perhaps 8 weeks for larger company. The plan should involve clear milestones and timeframes for achievement, performance against which creates a basis for the RA maintaining the opinion that the restructure is feasible. If the restructuring is to provide a defence against insolvent trading, there must be contemporaneous evidence that it was undertaken on an informed, expeditious and diligent basis.

Query 2.2.1a The Government seeks views from the public on what qualifications and experience directors should take into account when appointing a restructuring adviser and whether those factors should be set out in regulatory guidance by the Australian Securities and Investments Commission, or in the regulations.

Query 2.2.1b The Government seeks views from the public on which organisations, if any, should be approved to provide accreditation to restructuring advisers if such approval is incorporated in the measure.

We believe that the restructuring adviser should be registered or licensed by ASIC in accordance with one of the new categories of registered liquidator contemplated by the *Insolvency Law Reform Act 2016*.

The criteria to be registered should include having appropriate qualifications and demonstrated experience and capability in undertaking insolvency and restructuring assignments. In our view the role of a restructuring adviser will require strong skills in performing financial analysis and therefore an accounting qualification would be essential.

The high level elements of the qualifications and experience requirements to be registered as a restructuring adviser could be provided for in legislation, as is currently the case for registered liquidators, with more detailed guidance being provided for applicants by ASIC as the licensing body.

The requirement to hold a licence to undertake this work ensures that there is an appropriate level of regulatory control over the quality and conduct of restructuring advisers.

We also support the requirement that the restructuring adviser be a member of a professional body that provides relevant specialised training and has an ethical and disciplinary framework – ARITA being the prime example.

Query 2.2.1c The Government considers that the test of viability is whether the company can: avoid insolvent liquidation and be returned to solvency within a reasonable period of time. Is this an appropriate method of determining viability?

Query 2.2.1d What factors should the restructuring adviser take into account in determining viability? Should these be set out in regulation, or left to the discretion of the adviser?

The proposed test of viability in the Proposals Paper focuses on avoiding liquidation and returning the company to solvency in a reasonable time. In our opinion this requirement is too limiting; for example it doesn't recognise that successful restructuring outcomes may still involve some element of formal insolvency, for example a restructure

may require that a business be sold for good value, but the company may yet be insolvent with a liquidation of the company being the final restructure element.

Hence, as noted above, very valuable restructuring in terms of preserving business, jobs and value may be achievable in cases where restoring solvency is not.

Our preferred approach is one which focusses on the whether a company's restructure is feasible based on criteria such as:

- Is there an underlying business or businesses worthy of preservation?
- Are there genuine restructuring options available?
- Does the company have the resources – financial and management, to effect the restructure?
- Can the restructuring options be implemented in a reasonable or available timeframe? The timeframe to be considered with reference to the urgency of the financial distress.
- Are the management and the business owners sufficiently committed and capable to implement the restructuring plan?
- Can the restructure deliver an outcome for the creditors as a whole which is better than an insolvent liquidation? This is a matter for ongoing consideration through the course of a restructure. At any point where this criteria is not met, the safe harbour period should cease.

In general terms we would support the factors to be taken into account in determining feasibility of a restructuring plan being left to the discretion of an appropriately qualified RA. The factors that are relevant to each case may vary significantly according to numerous factors such as the size of the business, the industry in which it operates, geographical location(s), structure of secured debt, degree of financial difficulties.

Equally, including criteria in regulation may prove helpful as a reference for a liquidator's subsequent investigation into the effectiveness of a claimed safe harbour defence, but it is better framed as guidance or expectation such that it does not obviate the need for the RA to take into account other factors which may be relevant in any particular case.

In addition, regulation could usefully address the indicia that would be expected to evidence a bone-fide restructure including:

- Reporting to the company and the board accepting the restructure plan within a reasonable timeframe (we suggest no more than 4 weeks for a small company up to 8 for a large one)
- The restructure plan to include a point in time assessment of its feasibility based on up to date financial information.
- The restructuring plan to include triggers and milestones for its timely implementation.
- The restructuring plan to contain the RA's basis for assessing the restructure plan will deliver an outcome for the creditors as a whole which is better than an insolvent liquidation.

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Query 2.2.1e The Government seeks views from the public on whether these are appropriate protections and obligations for the restructuring adviser, and what other protections and obligations the law should provide for.

We support the proposed protections and obligations applying to the restructuring adviser as provided for on page 13 of the Proposals Paper.

An additional protection which we believe is necessary concerns the fees payable to the practitioner for the restructuring advice. If fees paid by the company undertaking restructuring are subsequently vulnerable to being set aside as preference claims in a liquidation, this will be a significant deterrent or distraction for RAs. We suggest that fees paid to an RA or security taken for such fees be carved out of the unfair preference regime.

We note ARITA's view that requiring the RA to inform ASIC of any misconduct they identify is a potential deterrent to a company pursuing a restructure. However, we believe if serious matters are identified they ought not go unreported. We also note that there is a prospect that this obligation may arise through evolution of the APESB standards, to the extent the RA is subject to those standards. On balance, we consider this an ethical matter which a qualified RA ought be able to navigate (by resigning or reporting) without a positive obligation being imposed through the safe harbour provisions.

2.2.2 Other features of safe harbour - Limited to defence of s588G

Query 2.2.2a Do you agree with this approach?

We agree that the safe harbour protection afforded to directors undertaking genuine restructuring attempts should be confined to the defence of an action for insolvent trading. The legislation should make it clear that the existing relation back period that applies to other voidable transaction claims against directors (such as unreasonable director related transactions, unfair preferences or uncommercial transactions) should be unaffected by the availability of the safe harbour defence in relation to section 588G.

2.2.2 Other features of safe harbour - Disclosure

Query 2.2.2a Do you agree with this approach?

Yes. Any provision that requires disclosure of the appointment of a restructuring adviser would undermine the incentive to appoint one, notwithstanding the potential defence to insolvent trading it may bring with it.

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

Subject to the following qualifications, we generally support the protections proposed on page 14 of the Proposals Paper to ensure that directors seeking to rely on the safe harbour defence are those that have undertaken genuine restructuring attempts in good faith:

- ASIC should have a broad discretion to intervene and not be fettered by the proposed criteria listed here.
- The failure to lodge Business Activity statements and pay employee entitlements as they accrue would be impractical fetter to a restructuring process.

In addition, we propose the following limitations:

- To be effective, the RA must be capable of providing objective advice and we would support a requirement that the RA attest to that capability to the company before accepting an appointment. For example, the RA must not be an officer of the company or its associates or an associate of any of the directors. In addition, where the RA has an ongoing professional relationship with the company, the RA must consider whether any aspect of the relationship may give rise to conflict of interest or lack of objectivity.
- The defence should be unavailable if, during the time when the director seeks the protection of safe harbour, the director becomes party to a voidable transaction (an unfair preference, unreasonable or uncommercial transaction)
- If no formal advice on the feasibility and implementation of restructuring alternatives is provided to the company by the restructuring adviser, then the safe harbour defence should not be available. Without a formal record of the restructuring process, the liquidator's ability to consider and evaluate whether the defence is legitimate will be significantly curtailed.

1.4 *Model B – the carve out option*

Query 2.3 The Government seeks your feedback on the merits and drawbacks of this model of safe harbour.

We do not support the safe harbour proposal 'carve out' contained in Model B. Our objection is primarily on the basis that it creates a further unacceptable challenge to liquidators seeking to make recoveries from directors for insolvent trading by shifting the burden of proof to the liquidator to establish that the carve out elements do not apply.

Insolvent trading claims are required to be considered and an estimated value attributed to them in a voluntary administrator's section 439A report. The introduction of the 'reasonable restructuring attempts' criteria listed at proposal 2.3 above will make this already difficult assessment process, which is undertaken in a very compressed timeframe, practically impossible.

In addition, were Model B to be implemented, we anticipate that directors subjected to insolvent trading claims will automatically point to these provisions, which will be difficult for the liquidator to refute where there is no requirement to involve an independent third party adviser.

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2 Proposal 3: Ipso facto clauses

Proposal 3.2 The Government proposes that any term of a contract or agreement which terminates or amends any contract or agreement (or any term of any contract or agreement), by reason only that an 'insolvency event' has occurred would be void. Any provision in an agreement that has the effect of providing for, or permitting, anything that in substance is contrary to the above provision would be of no force or effect.

We are of the view that the prohibition of ipso facto clauses triggered upon an insolvency event alone would significantly improve the prospects of retaining or building value in a business and thereby facilitate improved prospects of trading on and out of difficulty or, more likely, a going concern sale (which can be considered a totally valid restructuring outcome).

McGrathNicol supports ARITA's submission in relation to the queries set out in the Improving bankruptcy and insolvency laws paper.