MinterEllison's comments in response to: *Improving Bankruptcy and Insolvency Laws*

Proposals Paper of April 2016

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MinterEllison

MinterEllison welcomes the opportunity to provide comments to the Australian Government on the proposed models for law reform set out in the 'Improving Bankruptcy and Insolvency Laws' Proposals Paper of April 2016 (**Proposals Paper**).

MinterEllison's reconstruction team is consistently recognised by independent, international surveys as among the leading practices in Australia (including 'top tier' *Chambers Global, Asia Pacific Legal 500, PLC Which Lawyer?* and *IFLR 1000: Guide to the World's Leading Financial Law Firms*).

Our recent reconstruction and insolvency expertise includes work on well known formal administrations, as well as advising directors, senior executives and financiers on methods to avoid a formal appointment.

We do not comment on each issue canvassed in the Proposals Paper, but rather confine ourselves to some key issues that we consider should be addressed, namely:

- Section 2: 'Safe harbour' from directors' insolvent trading liability; and
- Section 3: Unenforceability of 'ipso facto' clauses in certain circumstances.

In providing these comments, MinterEllison bases observations and recommendations on practical experience in advising companies and directors.

Executive Summary

- MinterEllison believes that if the Government's policy objectives are to further the Innovation and Science Agenda (**Agenda**) and promote a cultural shift to reduce the stigma associated with business failure and strike a better balance between encouraging entrepreneurship and protecting creditors, promote Australians to embrace risk, learn from mistakes, be ambitious and experiment to find solutions, then law reform is required by way of:
  - introducing a safe harbour from directors' insolvent trading liability; and
  - rendering ipso facto clauses unenforceable in certain circumstances.
- In relation to <u>safe harbour</u>: consideration and detail of the two proposed models is required to work towards a more desirable model. To this end, we have suggested an alternative model and further matters for consideration. However, we broadly prefer Model B over Model A, but have incorporated elements of both models into our recommended alternative model.
- In relation to <u>ipso facto clauses</u>: the prohibition should not apply to security agreements or agreements for the supply of financial accommodation. Nor should it apply where the only 'insolvency event' is the appointment of a receiver. Where the prohibition applies and a counterparty is prevented from terminating a contract for the provision of goods or services because of an insolvency event, there must be a guarantee that the counterparty will receive payment for supplies that are continued. The prohibition should not render contractual provisions 'void', but merely suspend their operation while restructuring is attempted.

Section 2 – Safe Harbour

Background

Creditors should be protected in insolvency and we consider that directors' personal liability for insolvent trading is an appropriate exception to corporate limited liability. However, the current insolvent trading laws are of limited benefit in protecting creditors, particularly unsecured creditors. In our experience, insolvent trading cases are difficult and expensive to prosecute and rarely, if ever, produce any real return for unsecured creditors Against this, law reform is required to encourage directors to explore restructuring options, instead of prematurely appointing voluntary administrators chiefly to mitigate their insolvent trading liability risk, which is a regrettable incident of an existing defence to insolvent trading incentivising directors to appoint voluntary administrators.[1]

We support the Government's proposal to introduce a safe harbour for directors from insolvent trading liability. However, we think further consideration and more detail of the two proposed models is required to work towards a more desirable model. We prefer Model B over Model A; chiefly because Model A is overly prescriptive and creates the prospect of entrenching a new form of quasi-external administration, which may not best further the Agenda.

Under Model B, the onus of proof appears to shift to a liquidator or prosecutor to prove that a director did not honestly and reasonably believe that incurring the debt was in the best interests of the company and its creditors as a whole. Model B does not by its terms encourage directors to seek professional advice, although Model A does. It appears that Model A cannot be effectively utilised if a company is hopelessly insolvent, and it also does not contemplate creditors receiving any return. Model B emphasises ensuring that all creditors are repaid in full; not just having a better return than liquidation which is an object of Part 5.3A.

There is at least one realistic limitation to any model of safe harbour: that unless a company can be returned to solvency within the meaning of s 95A, the company will almost certainly be placed into external administration. Introducing a safe harbour from insolvent trading liability does not and cannot address this reality. If a company is hopelessly insolvent, the directors should appoint a voluntary administrator or liquidator. What safe harbour should do is ensure that directors of insolvent companies focus on the best interests of the company and its creditors as a whole. Depending on a company's circumstances, this could mean that the directors diligently pursue an informal restructure. In other cases voluntary administration will be the only option.

Context

Duty to prevent insolvent trading

Directors currently owe a positive duty to prevent insolvent trading under s 588G. The provision has a role in deterring insolvent trading and encouraging directors to act responsibly and in the best interests of the company and its creditors as a whole. Breach of s 588G can be a civil penalty and/or a criminal offence. Directors face the risk of substantial personal liability if the company of which they are a director trades and thereby incurs debts whilst it is insolvent.[2]

The legislative definitions of solvency and insolvency (s 95A) require directors to make difficult factual solvency assessments during uncertain business situations. The position is further complicated by the fact that in the event of proceedings, the Court will make a hindsight determination of whether or not the

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[1] See s 588H(6) of the *Corporations Act* 2001 (Cth) (**Corporations Act**). Unless indicated, references to sections and parts are to sections and parts of the Corporations Act.

[2] In the modern economy it is simply impossible for a company to conduct a trading business without incurring debts.

company was solvent. Directors may be unqualified to make solvency assessments in a timely manner without taking complex legal and financial advice. Typically this advice is risk-averse, in the sense that it is sought by the company in the context of avoiding or limiting directors' personal liability, and can result in an overly cautious assessment that the company is or is likely to be insolvent. In all these circumstances, there is an inherent bias in favour of directors making a formal appointment to manage their personal risk of legal liability. On the other hand, there appears to be no legal brake upon the prospect of them doing so 'too soon'.

Available defences

There are four defences to insolvent trading liability available under s 588H. The burden of proving the elements of a defence lies with the director. The defences are:

- they had reasonable grounds to expect the company was solvent;
- a reasonable, competent person produced information that would reasonably lead to a belief that the company was solvent;
- they had a good reason for not taking part in the company's management at the relevant time; and
- they took all reasonable steps to stop the company incurring the debt (including attempting to appoint a voluntary administrator to the company).

The current defences available to directors under s 588H have been interpreted narrowly by the courts.

Other relief

There are two other relief provisions available to directors if the court finds that they have breached their duty to prevent insolvent trading.

Where a liquidator brings a civil penalty claim, directors can rely on s 1317S. However, this requires the court to be satisfied that if there has been a contravention that the person has acted honestly, but having regard to all the circumstances of the case, ought fairly to be excused.

Section 1318 also applies to any civil proceeding against a person for negligence, default, breach of trust or breach of duty. If the person is liable and shown to have been negligent in default or breached their duty, but has acted honestly and having regard to all the circumstances the person ought to be fairly excused and the court can relieve them from that liability.

In isolation, provisions of this kind provide cold comfort for directors endeavouring to 'work out' the problems of a potentially insolvent company, as they require the directors to seek assistance from the Court – usually at their cost – after a liquidator has otherwise proven all the elements of the insolvent trading claim.

Status quo

In light of the above, we make the following observations about the current insolvent trading liability regime:

- it is based on formal legal procedure;
- it imposes significant risks of personal liability for directors which may outweigh any potential benefits for directors from attempting to continue a company's business;
- it exposes directors to reputational risk as claims of this kind are investigated by voluntary administrators and liquidators, including by public examinations;
- it punishes directors who persevere and continue trading the business of a legally insolvent company which may be viable in the long term;
- it inherently does not promote an informal corporate restructuring and rescue culture, and may even inhibit such culture (unlike Chapter 11 of the United States *Bankruptcy Code* and the different position in the United Kingdom);
- it denies companies in trouble the opportunity to appoint new or additional directors with appropriate work out experience;

- it is inconsistent with the Agenda, which is to encourage entrepreneurship because it is central to economic growth, job creation and future prosperity;
- it is also inconsistent with capitalist market values because it inhibits capital recycling and imposes unnecessary transaction and agency costs;
- it stigmatises corporate business failure; and
- it disincentivises calculated risk taking by directors of distressed companies to facilitate business reconstruction.

In this context, directors currently have an incentive to appoint a voluntary administrator given the defence in s 588H(5) (i.e. taking reasonable steps to prevent incurring debt). Moreover, there may be inadvertent breaches of directors' duties by virtue of directors' attempts at restructuring.

Proposal 2.2 – Safe Harbour Model A: Defence to insolvent trading liability

Query 2.2 – The Government seeks views from the public on whether this proposal provides an appropriate safe harbour for directors

Observations

First, we note that Model A is the restructuring adviser defence model, and it is supported by the Australian Restructuring Insolvency and Turnaround Association (**ARITA**).[3] We broadly prefer Model A to the continuation of the status quo as described above. However, we submit that Model A may not be the *best* model to achieve the desired policy outcomes of safe harbour; including encouraging entrepreneurship and facilitating informal work outs by directors. This is because Model A focuses exclusively on the restructuring efforts of professional restructuring advisers; not directors. By definition, Model A encourages outsourcing the critical assessment of the company's overall business viability to a restructuring adviser. Although directors' subjective views of a distressed company may often be unrealistic, they generally know the company's business better than anyone else, and should remain the focal point of any informed restructure process.

We perceive a risk that Model A will maintain the status quo to the extent that the onus and burden of proving the elements of the defence lies with the director, like the current defences available under s 588H. Moreover, Model A appears to have a doubtful ability to strike a satisfactory balance between creditor interest of keeping the company trading as usual without falling into external administration, and protecting them against reckless and negligent conduct by directors. Model A does not expressly incorporate a creditor protection mechanism.

We nevertheless fully accept that there is scope for Model A to promote genuine restructuring efforts without the need for formal external administration procedures under Chapter 5 of the Corporations Act; particularly voluntary administration.

We also agree that Model A be restricted to circumstances in which restructuring advisers are provided with sufficient books and records within a reasonable period to enable them to reach an informed opinion that the company can avoid insolvent liquidation and can be returned to solvency.

Possible shortcomings

Model A implies that the company will avoid insolvent liquidation and be returned to solvency and that creditors will be repaid in full unless the restructuring plan fails. The restructuring plan must involve returning the company to solvency within a reasonable time. This could involve negotiating with creditors to accept a discounted return for their participation.

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[3] ARITA, *Submission on Business Set-up, Transfer and Closure Productivity Commission Draft Report May 2015* (6 July 2015), p 9, at http://www.pc.gov.au/__data/assets/pdf_file/0003/190893/subdr053-business.pdf.

Model A requires that the restructuring adviser remains of the requisite opinion, and that the company is likely to return to solvency within a reasonable period of time. This proposal begs the following questions (at least):

- how often does this opinion need to be reviewed?
- what is considered to be a reasonable period of time?
- what constitutes a director taking reasonable steps?

First, the continuing obligation on the restructuring adviser to remain of the requisite opinion may have the undesirable consequence of over-involvement by the restructuring adviser in the company's business during a restructuring effort. If the adviser does not remain of the requisite opinion, it is unclear whether the adviser will be required to recommend to the directors to resolve to appoint a voluntary administrator. The ongoing obligation to hold the requisite opinion could mean that the adviser is becomes entrenched in the management of the affairs of the company, and is called upon to assist by the directors and other managers on a frequent basis. This may be a good thing, but care needs to be taken to ensure that the directors' roles and *responsibilities* do not become subordinate to the advice of the restructuring adviser.

Second, we suggest a 'reasonable time' should be a short time frame, but would need to depend on the circumstances including the nature of the company's business and, if it is known, its future liabilities.[4]

Third, it is unclear what would be considered as 'reasonable steps' to return the company to solvency. It might include acting on reasonable restructuring advice including implementing and adhering to any restructuring plan, exercising business judgment in the best interests of the company and its creditors as a whole and ceasing to cause the company to incur debts if it is no longer viable. What constitutes reasonable steps is a critical element of Model A; but the paper does not provide any great detail on this aspect of the proposal. It is probably right to assume that guidance may emerge from legal and commercial precedent. In addition, we can see scope for industry participants to develop and promulgate codes of best practice.

The application of Model A in the context of corporate groups adds another layer of complication to the proposal. Under s 588V, a holding company can be liable for insolvent trading by its subsidiary. Similar defences to those under s 588H are available to holding companies under s 588X. However, the proposal does not also consider whether the safe harbour should also be available to a holding company, which may not itself be trading the 'operating companies' which is primarily indebted to trade creditors.

Model A also has an imprecise and uncertain application in relation to different companies in the same corporate group with common ownership, but having different directors. In this situation, can an uncommon director of a parent holding company rely on the restructuring plan provided by an adviser appointed to a trading subsidiary company, so as prevent the holding company from being liable for that subsidiary's insolvent trading under s 588V? In the same vein, can an uncommon director of a subsidiary rely on advice provided to the directors of a related subsidiary within a corporate group structure? As Model A stands, it would appear that directors can only rely on restructuring advice if it is provided to the particular company appointing the adviser. In common with many aspects of corporations regulation, Model A is silent in its possible application to corporate groups and that directors within those groups are uncommon and have different risk profiles.

Presumably a restructuring adviser can be concurrently appointed to a whole group of companies. Further thought needs to be given to the model's application to corporate group structures, and how the restructuring adviser can assist all group companies and directors restructure a distressed business being operated within a group, even where those directors may not be common.

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[4] *Lewis v Doran* [2005] NSWCA 243 at [103].

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

Insolvency practitioners are often referred to act as the gatekeepers of the insolvency law regime. Under Model A, this role would be sensibly extended to restructuring advisers, who would play a key role in preventing companies from falling into external administration and furthering the creditor interest.

The base qualifications of a restructuring adviser should be prescribed in the Corporations Act or at least in the *Corporations Regulations* 2001 (Cth). Although professional membership of an organisation such as ARITA is not currently prescribed for external administrators, if Model A is to be implemented perhaps professional membership should be in the context of restructuring advisers, given the role to be played by ARITA (as a 'prescribed body') in the procedures for registration of liquidators under the *Insolvency Law Reform Act* 2016 (Cth) and the Insolvency Practice Rules, commencing on 1 March 2017.

Directors should also take into account the adequacy of the adviser's expertise and resources for the type and size of the appointment, or the capacity to call in that expertise and those resources as needed.[5]

Principles-based regulation (e.g. Australian Securities and Investments Commission (**ASIC**) regulatory guides or by further amendment to the ARITA Code) would be more flexible and effective than rules-based legislation and executive regulation.

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 understand that ARITA's view is only professionals (e.g. lawyers and accountants) who have obtained the qualification of ARITA Professional Membership or are a registered liquidator (i.e. under s 1282) should be able to oversee this process given their innate high level understanding of insolvency law, which is required to ensure directors appropriately discharge their duties. Persons without this level of qualification may place creditors and other stakeholders in an otherwise worse off position.[6] Qualification levels of restructuring advisers will need to be considered to ensure that directors are relying on competent advice.

The state Law Societies, CPA Australia and Chartered Accountants Australia and New Zealand do not provide targeted supervision to their members who may be engaged in restructuring and insolvency activities, and therefore cannot be reasonably regarded as comparator bodies to ARITA as industry self-regulators. To ensure consistency of standards, ARITA should be approved to provide accreditation to restructuring advisers, if such approval is incorporated into Model A.

Other organisations seeking recognition for these purposes must have similar member qualifications, certification, complaint and disciplinary procedures.

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

Company 'viability' is the ability of it to survive, which necessarily involves considerations of financial performance and position. The proposed test of viability importing concepts of avoiding insolvent liquidation and returning to solvency within a reasonable period of time is a necessarily low threshold in the distressed company context.

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[5] ARITA, *Code of Professional Practice* (3rd ed), principle 13, at http://www.arita.com.au/docs/default-source/code-third-edition-2014/009b-code-3rd-edition---final-arita-version-v3.pdf?sfvrsn=0.

[6] ARITA, *Submission on Business Set-up, Transfer and Closure Productivity Commission Draft Report May 2015* (6 July 2015), p 10, at http://www.pc.gov.au/__data/assets/pdf_file/0003/190893/subdr053-business.pdf.

By way of contrast, the Australian Taxation Office (**ATO**) considers that 'a business is viable where either:

- it is returning a profit that is sufficient to provide a return to the business owner while also meeting its commitments to business creditors; and
- it has sufficient cash resources to sustain itself through a period when it is not returning a profit'.[7]

The proposed method of viability appears to have a lower threshold than in the non-distressed company context. That is necessary in the sense that viability is being assessed from a rescue and salvage perspective, rather than from a business as usual perspective.

By the time a company is being wound-up in insolvency, the company and its business will generally be unviable and it is being prepared for orderly deregistration. To this end, a company may be said to be viable to the extent that it is able to 'avoid insolvent liquidation'. This is a low threshold for viability, in the sense that other non-insolvent liquidation forms of external administration do not necessarily mean that as a result of being externally administered, the company will cease to trade its business, be wound-up and eventually deregistered.

Similar questions in respect of what is considered to be a reasonable period of time (raised above) also arise in the context of the proposed viability test.

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 restructuring adviser should be appropriately qualified (addressed above) to determine a company's viability. At present, insolvency practitioners are often called upon to make difficult solvency assessments. By no means is it suggested that a viability assessment is any easier than a solvency assessment, but it should be able to be performed by a restructuring adviser exercising their professional judgment.

If any factors are to be set out in any regulation, they should be non-prescriptive and principles based, so that their application is sufficiently flexible to meet the circumstances of the particular company.

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

It appears that the restructuring adviser would be an 'officer' of the company (s 9) and therefore owe officers' duties to the company (ss 180, 181, 182, 183 and 184).

Defence to civil liability for an erroneous opinion provided that it was honestly and reasonably held should be a broadly available defence to all third party civil liability claims, whether under statute or general law. This should have a broader application than the current business judgment rule in s 180(2).

A requirement to seek leave of the Court may be too strict, especially since it is currently only imposed in respect of liquidators (s 532) and voluntary administrators (s 448C) to ensure their independence in a formal appointment. However, it is likely that in most circumstances, a restructuring adviser's appointment would lead to a lack of independence (i.e. in fact and in appearance) in any subsequent insolvency appointment.

Imposing a legislative requirement to seek leave of court would not improve the existing body of law on independence. Moreover, Chapter 6 of the ARITA Code sufficiently deals with a insolvency practitioner's independence. Insolvency practitioners are already sufficiently regulated in that regard.

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[7] ATO, *Business viability assessment tool*, at https://www.ato.gov.au/Calculators-and-tools/Business-viability-assessment-tool/?page=1#Using_the_tool.

Restructuring advisers should be specifically carved-out of the s 9 definition of 'director', such that they are not liable under s 588G and other directorial liability as shadow or de facto directors.[8]

2.2.2 Model A operates as only a defence to the insolvent trading provisions contained in s 588G of the Corporations Act

Query 2.2.2a – Do you agree with this approach?

We refer to our comments above on holding company liability under s 588V and the inability of holding company directors to rely on the defence in respect of a restructuring adviser appointment to a subsidiary.

As a separate but related point, we consider that the defence should also operate as a defence to s 588FGA liability under s 588FGB, which is a defence to directors' liability to indemnify the ATO for any loss or damage arising under an order in respect of a voidable transaction.

Additionally, the defence should operate as a defence to directors' penalty notices under s 269-15 of the *Taxation Administration Act* 1953 (Cth) (**TAA**) for non-payment of unremitted tax deductions and superannuation, available under s 269-35 of the TAA. The defences available under s 588FGB and s 269-35 are analogous to the existing defences to insolvent trading liability under s 588H.

Making the restructuring adviser defence available in respect of debts owed to general unsecured creditors but not in respect of debts owed to the ATO, creates an imbalance between different creditor groups, noting that the ATO lost its statutory priority as a creditor voluntary administration was introduced in June 1993.

Model A should only operate as a defence to directors' personal liability for insolvent trading liability and analogous provisions imposing personal liability discussed above, so as to facilitate genuine restructuring efforts by directors with a restructuring adviser and to protect them from potential insolvent trading liability in the course of undertaking a restructure.

Directors should remain subject to all other legal obligations. Safe harbour should not be a shield from all director liability or else it might create a 'moral hazard' by potentially operating to exculpate directors from other personal legal liability. The law imposes directorial liability in certain circumstances for other sound policy reasons.

Where restructuring fails, and the company enters liquidation:

- directors should remain subject to potential civil liability under s 596AC, as that provision may operate as a general deterrence of 'phoenix' company behaviour (and a moral hazard), despite questions about the effectiveness of Part 5.8A, given that those provisions do not appear to have been the subject of legal proceedings.
- liquidators should retain their powers to commence recovery actions against directors (e.g. for breaches of directors' duties or misfeasance under s 598).
- the period during which the safe harbour defence applies should be disregarded for the purposes of calculating any reach-back period for unreasonable director-related transactions (ss 588FDA and 588FE(6A)). However, it is unclear whether this applies to all voidable transactions involving a director (being a 'related entity' (s 9)), or specifically under s 588FDA. Perhaps directors should not be treated equally because they are more likely to be aware of the company's financial affairs and may be able to exert influence to obtain an advantage, and experience suggests that when a company is suffering

[8] *Grimaldi v Chameleon Mining NL (No 2)* [2012] FCAFC 6; *Buzzle Operations Pty Ltd v Apple Computer Australia Pty Ltd* [2010] NSWSC 233.

financial difficulties the directors may be favoured.[9] Such provisions should be anti-avoidance provisions aimed at preventing errant directors from stripping benefits out of companies to their own advantage.[10]

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

It appears that under Model A, directors will not have to announce that the company is operating in safe harbour, having appointed a restructuring adviser. However continuous disclosure obligations would apply in the case of a listed public company. Hence there is inconsistent treatment of public and proprietary companies under Model A.

Notwithstanding the absence of any disclosure obligation, directors should be personally liable in respect of their misleading or deceptive conduct or unconscionable conduct engaged in during a restructure if that conduct results in an unlawful advantage to them or the company, and they seek to invoke the safe harbour to avoid liability to repay creditors by reason of the conduct.[11]

In the case of listed public companies, directors have continuous disclosure obligations to inform the Australian Securities Exchange (**ASX**) if they suspect that the company was insolvent and face potential personal liability for any breach. Safe harbour provisions should protect directors from continuous disclosure obligations and liability. To this end, there should be an exception to a company's continuous disclosure obligations during a restructure. If there is not, directors of listed entities could be personally liable for misleading the market during complex and uncertain restructuring negotiations.

Nevertheless it is presently unclear to us whether this approach strikes a desirable balance between the competing interests of informing creditors (and the market) and the need for privacy and confidentiality, in order to successfully complete the restructure.

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

In addition to the certain situations listed in the Proposals Paper, safe harbour should not be extended to directors where the company has failed to keep adequate books and records and is presumed insolvent (ss 286 and 588E).

Making the defence unavailable where a company has failed to lodge multiple BAS or there has been significant failure to pay certain employee claims may be harsh and inflexible, especially where the failures are attributable to innocent oversights, but not reckless or fraudulent behaviour.

Other than where a director is disqualified by a set of defined situations, any determination that a director cannot rely on the safe harbour provisions should be made by the Court, rather than by ASIC as an executive body.

By the time the defence is invoked, the matter would be before the Court and it exercising judicial power should determine whether a director is prevented from relying on the defence. Any inefficiency or cost concerns with delayed court processes in that regard are quelled.

It is proposed that safe harbour would not be available in two certain situations:

- (in hindsight) if the director is disqualified when debt is incurred, or is determined by ASIC or the Court to be ineligible to rely on the defence because of prior conduct; and

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[9] Australian Law Reform Commission, *ALRC Report 45 General Insolvency Inquiry* (13 December 1988) at [636], available at http://www.alrc.gov.au/sites/default/files/pdfs/publications/alrc45_Summary.pdf.

[10] *Vasudevan v Becon Constructions (Australia) Pty Ltd* [2014] VSCA 14 at [19] (Nettle JA).

[11] See, e.g. *Con-Pac Systems (Aust) Pty Ltd v Wijeyewardene* [2006] FMCA 985.

- (in advance) if the director is determined by ASIC or the Court to be ineligible to rely upon the defence for a specified future period upon satisfaction that the director previously has breached their duties.

First, we note that the Court does not presently have the power to make a declaration of contravention based on an agreement between ASIC and a director expressed in terms of contravention of s 206A.[12] The Court only has a power to disqualify a person from managing corporations for a period.[13] Secondly, it is unclear whether such determination could occur after the fact. In circumstances where one of a number of directors on a board is either disqualified or determined to be ineligible to rely on the defence, the effect of this on the other directors is also unclear. Finally, it seems that if there is to be such regime, a register of disqualified and ineligible directors from relying on the safe harbour defence would need to be maintained at a public cost, probably by ASIC.

Proposal 2.3 – Safe Harbour Model B: Carve-out of insolvent trading liability

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

Presumably this carve-out applies to liability under s 588G, and the reference to s 588 in the Proposals Paper is an unintentional error.

Merits of Model B

The potential merits include:

- promotes director self-help in returning a company to solvency;
- drastically alters the legal liability landscape of directors with respect to insolvent trading;
- modifies the operation of s 588G so that directors may not be liable under s 588G, as opposed to operating as a defence to liability under s 588G;
- does not require the appointment of a restructuring adviser (cf Model A);
- requires legislative and executive guidance (through any legislative explanatory memoranda (**EM**)) and court interpretation of the terms 'reasonable steps' and 'reasonable time' and this should permit sufficient flexibility to apply the carve-out to the facts and circumstances surrounding the particular director and the company's circumstances;
- the cited examples of 'reasonable steps' including the appointment of a restructuring adviser and early engagement with shareholders, creditors (including employees) and other stakeholders are sound broad examples, but the concepts should be elaborated on with further examples in any EM; and
- provides for a high level of creditor protection (thus balancing the competing tensions between facilitating restructuring and turnaround, and creditor and public protection) by way of not allowing the carve-out to apply in the circumstances where incurring the debt does materially increase the risk of serious loss to creditors (at proposed paragraph (c)). It is important that new creditors should be looked after because they need an incentive to continue with trading the business. The emphasis appears to be on ensuring that all creditors are repaid for participating in this process; not just having a better return which is an object of Part 5.3A.[14]

Potential drawbacks of Model B

The potential drawbacks include:

- introduction of a subjective test inquiring into the director's reasonable and honest belief;

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[12] *ASIC v Edwards* [2004] NSWSC 1044.

[13] ss 206C, 206D, 206E and 206EAA.

[14] s 435A.

- possibly weakens the deterrence effect of the insolvent trading regime as directors could engage in potentially criminal behaviour, as an exception is potentially available;
- a liquidator or prosecutor may face considerable obstacles in positively proving the three limbs of the proposed provision;
- it encourages director self-help methods which do not necessarily involving a professional restructuring adviser. However, the appointment of a restructuring adviser should generally constitute 'reasonable steps' for the purposes of the carve-out;
- requires legislative and executive guidance (perhaps through any EM) and judicial interpretation of the terms 'reasonable steps' and 'reasonable time' and this may lead to uncertain application of the carve-out in certain circumstances (at least while there is no case law), particularly where directors need to make urgent decisions; and
- the collectivisation of the interests of all classes of creditors implied by the term 'creditors as a whole'. This may be undesirable in circumstances where a restructure is likely to involve further indebtedness being incurred to both existing and new creditors. The model does not distinguish between creditors with debts existing as at the time an insolvent company incurs a debt, and creditors to whom the company becomes indebted during the course of trading-on during a restructure (which may be existing creditors with new debts). Where a restructuring fails and a company is wound-up, it may be desirable to treat creditors with debts incurred during the restructure as priority creditors (perhaps as priority creditors under s 556) as a matter of fairness because of their ongoing relationship with the company during the restructuring. Those creditors' support of the trade-on or restructuring of the company should be recognised, and their willingness to participate should be rewarded. Section 556 identifies and prioritises certain classes of unsecured debts and claims; they do not all rank equally. The interests of new or future creditors should be further considered if Model B is advanced.

Other options

Separate insolvent trading regimes for large and small to medium-sized entities (SME)

A key drawback of both Models A and B is that they do not address the deficiency in the current insolvent trading regime arising out of the different risk profiles of directors of large (often public and listed) companies and SME (often proprietary) companies in respect of insolvent trading liability. The risks and consequences of insolvent trading liability facing directors of larger companies are typically more significant than those faced by directors of SMEs.

In this context, a key issue to consider would be the potential abuse of a defence or carve-out by SME directors, particularly where those directors are self-interested in the company and its uninterrupted business continuity. In order to prevent abuse in such situations, any safe harbour model should factor in that SME directors may seek to rely on safe harbour in circumstances where the risk of insolvent trading liability is already typically lower for them than for directors of large companies. In any model of safe harbour to be implemented, it may be desirable to exclude its operation in relation to SMEs or otherwise limit its operation to certain circumstances in respect of them. This could mean that the safe harbour is limited to directors of large companies, who would presently be incentivised to put a company into voluntary administration to manage insolvent trading risk. However, it is directors of larger companies who stand most to benefit from safe harbour and it is those directors whose behaviour should be changed in order to encourage a genuine restructuring culture in corporate Australia.

Eliminate civil liability

Another option is to confine insolvent trading liability to a criminal offence (i.e. s 588G(3) involving dishonesty) and not in respect of any civil contravention.

Abolish insolvent trading liability

Another alternative in pursuance of the Agenda is to abolish insolvent trading liability by repealing Part 5.7B Division 3. The insolvent trading provisions have failed to meet policy objectives because they do not effectively deter directors from trading insolvent companies, especially in the SME context. This still commonly occurs. However, it is likely that the existence of insolvent trading liability hinders a genuine restructuring culture and instead promotes use of the voluntary administration procedure. We note that the United States does not have an insolvent trading regime, and the United Kingdom regime includes a defence where every step has been taken to minimise potential loss to the company's creditors.[15]

Alternative model

We propose an alternative model to safe harbour from insolvent trading liability. Section 588H should be amended to add new defences to s 588G in s 588H based on the creditor interest element of Model B, but without the restructuring adviser requirement in Model A. Under our alternative model, it is a defence to s 588G if when a debt is incurred whilst the company is insolvent a person:

- had grounds to believe and did believe that incurring the debt was in the best interests of the company and its creditors (including contingent or prospective creditors) as a whole; and
- a reasonable person in the person's circumstances would also have had grounds to believe that incurring the debt was in the best interests of the company and its creditors (including contingent or prospective creditors) as a whole.

Unlike Model B, the alternative model expands the term 'creditors as a whole' to 'creditors *(including contingent or prospective creditors)* as a whole'. This contemplates the particular interests of new or future creditors to whom the company incurs debts during a trade-on or restructuring. This wording is especially desirable if the priority unsecured creditor regime in s 556 is not altered to include debts incurred during the restructure owed to new or future creditors (discussed above).

This model operates in a similar way to the current defence in ss 588H(5) and 588H(6) and includes an objective standard, rather than the subjective standard included in Model B. We have suggested the following specific matters for consideration as to whether the defence has been proved:

- any advice provided to the person by an appropriately experienced, qualified and informed professional adviser;
- any action the person took in reliance on that advice;
- the results of that action;
- the amount and nature of the debt and whether or not it was necessary to incur the debt to enable any business carried on by the company to be carried on as a going concern; and
- any action the person took to protect the interests of new or future creditors of the company.

It is intended that the proposed defence applies only to a civil contravention of s 588G(2), and does not apply to the criminal offence under s 588G(3), as is presently the position under s 588H(1).

Annexure A is a marked-up version of s 588H inserting recommended sub-sections based on our alternative model proposal as outlined above.

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[15] *Insolvency Act* 1986 (UK), s 214(3).

Section 3 – Ipso Facto Clauses

Background

MinterEllison senior consultant Lindsay Powers has reviewed the operation of ipso facto clauses in other jurisdictions, and has canvassed a number of important issues facing law reformers in Australia in his published article 'Ipso Facto Clauses: A Law Reform Challenge' (2016) 27 *Journal of Banking and Finance Law and Practice* 72. This submission draws on the commentary in that article.

Proposal 3.2 – The Ipso Facto Model

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.

The proposal seeks to address ipso facto clauses which give rise to a right of termination, but also seeks to address terms which 'amend' a contract or agreement. We gather that the intention is that a party should not be able to rely on a contractual term operating on the occurrence of an 'insolvency event' which, short of effecting a termination of the agreement nevertheless deprives the insolvent company of contractually promised benefits, for example, by conferring a right to suspend supply of goods or services. Section 301 of the *Bankruptcy Act* 1966 (Cth) achieves this in personal insolvencies by extending the prohibition to provisions which, on bankruptcy, 'modify' the operation of the contract. For consistency, similar wording should be used for corporate insolvencies.

As for the definition of the relevant 'insolvency events' which may not be relied on, the proposed inclusion of the appointment of a receiver or controller in the definition of 'insolvency event' is not justified, at least where the underlying basis for the appointment of such a person is the enforcement of rights under a private security contract. It is no part of the role of such a receiver to administer the affairs of a company with a view to its rehabilitation. The prime duty of a privately appointed receiver is to realise the secured assets to repay the debt of the secured creditor. We do not understand the Government's proposals as being directed to this. That said, there would be on objection to a receiver taking advantage of the prohibition if, at the same time, an administrator had been appointed (cf the situation arising under s 440B in a voluntary administration).

There may be justification for the inclusion of the appointment of a 'provisional liquidator' as a relevant 'insolvency event'. Prior to the introduction of voluntary administration as a means of potential corporate rehabilitation, the appointment of a provisional liquidator was often the method used to obtain 'breathing space' with a view to rehabilitation under a scheme of arrangement promoted by the provisional liquidator.

We note that the Government's proposals for dealing with ipso facto clauses do not seek to prevent their operation where the trigger is a contractual right arising upon the occurrence of a 'change in financial condition' (cf s 356(e)(1) of the United States *Bankruptcy Code*). We agree with this. For example, financial ratio covenants are important and carefully negotiated protections for financiers in loan agreements and should remain enforceable.

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 for credit.

The prohibition on the enforcement of contractual provisions which 'modify' the operation of a contract upon the occurrence of an insolvency event, would adequately address this.

Query 3.2.b – Should any legislation introduced which makes ipso facto clauses void have retrospective operation?

No. Any changes should apply only to contracts entered into after the amending legislation becomes operative. Legislative changes along the lines proposed – if applied to contracts negotiated and made before those changes became law – would be an unjustified retrospective interference with the rights of one of the parties.

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

As we understand it, the proposal is that ipso facto clauses would, in the context of an 'insolvency event', simply be 'void', rather than merely be suspended in their operation during some moratorium period (such as during the term of a voluntary administration). However, the question is whether it is, in fact, necessary to render such clauses void (presumably ab initio) or merely to suspend their operation while a potential rehabilitation or restructure is being investigated. The appointment of a liquidator is not proposed to be one of the insolvency events which gives rise to the prohibition. But if the prohibition rendered the clause void, if rehabilitation could not be implemented (for example, at the end of a voluntary administration after a vote of creditors to put the company into liquidation), it could not, at that stage, be relied on by the counterparty. It would be preferable for ipso facto clauses not to be made void ab initio, but rather have their operation suspended until it is known whether a successful corporate rescue can be implemented.

3.2.1 Anti-avoidance

Query 3.2.1 – Does this constitute an adequate anti-avoidance mechanism?

We do not consider that the wording proposed is necessary or desirable.

3.2.2 Exclusions

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

Agreements to provide financial accommodation should be excluded, at least where there remained an obligation on the part of the lender, to extend further credit despite the occurrence of an 'insolvency event'.

Security agreements should also be excluded. The occurrence of an 'insolvency event' is often an important trigger for the exercise of security rights. If the ipso facto prohibition applied, for example, to prevent a secured creditor from relying on the appointment of a voluntary administrator as the basis for appointing a receiver, this would be a significant impediment to the exercise of security rights, rights which, under the current legislation dealing with voluntary administration, recognise a secured creditor's right to take enforcement action during the 'decision period'.

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?

One of the most important consequences of depriving a party of their contractual right to terminate their dealings with an insolvent counterparty (especially where the contract obliges a continued supply of goods or services to the insolvent) is to potentially increase the loss that such a party will suffer, most notably where rescue plans for the insolvent company fail and debts for the continued supplies remain unpaid. It is one thing to deprive a party of the right to refuse supply because of the existence of past unpaid debts. It is quite another to oblige the party to make further supplies without a guarantee of payment, and in the knowledge that the company is insolvent. As noted in the journal article by Mr Powers, continuation of supplies under the terms of a pre-insolvency contract (as opposed to a contract made by an insolvency appointee) may not impose any personal liability on the insolvency appointee.

We therefore consider that any amending legislation should make it clear that supplies continued under a pre-insolvency contract give rise to a personal liability on the insolvency appointee to make payment. At the very least, similar provisions should be adopted to those which apply under the Insolvency (Protection of Essential Supplies) Order 2015 (UK) which oblige an insolvency office-holder to give a personal guarantee, failing which the supplier may rely on its right of termination. Alternatively, consideration could be given to a regime, similar to that which exists in the United States under Chapter 11 in relation to ipso facto clauses, where insolvency representatives are given a limited time in which to either accept or reject executory contracts. In the case of acceptance of the contract the representative would be obliged to honour all amounts that have fallen due.

The proposal that there be a right for affected counterparties to appeal to a court to modify the operation of the prohibition would be a sensible (but additional) safeguard.

Annexure A

588H Defences

(1) This section has effect for the purposes of proceedings for a contravention of subsection 588G(2) in relation to the incurring of a debt (including proceedings under section 588M in relation to the incurring of the debt).

(2) 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.

(3) Without limiting the generality of subsection (2), it is a defence if it is proved that, at the time when the debt was incurred, the person:

(a) had reasonable grounds to believe, and did believe:

(i) that a competent and reliable person (the other person) was responsible for providing to the first-mentioned person adequate information about whether the company was solvent; and

(ii) that the other person was fulfilling that responsibility; and

(b) expected, on the basis of information provided to the first-mentioned person by the other person, 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.

(4) If the person was a director of the company at the time when the debt was incurred, it is a defence if it is proved that, because of illness or for some other good reason, he or she did not take part at that time in the management of the company.

(5) It is a defence if it is proved that the person took all reasonable steps to prevent the company from incurring the debt.

(6) In determining whether a defence under subsection (5) has been proved, the matters to which regard is to be had include, but are not limited to:

(a) any action the person took with a view to appointing an administrator of the company; and

(b) when that action was taken; and

(c) the results of that action.

(7) It is a defence if it is proved that, at the time when the debt was incurred, the person:

(a) had grounds to believe and did believe that incurring the debt was in the best interests of the company and its creditors (including contingent or prospective creditors) as a whole; and

(b) a reasonable person in the person's circumstances would also have had grounds to believe that incurring the debt was in the best interests of the company and its creditors (including contingent or prospective creditors) as a whole.

(8) In determining whether a defence under subsection (7) has been proved, the matters to which regard is to be had include, but are not limited to:

(a) any advice provided to the person by an appropriately experienced, qualified and informed professional adviser;

(b) any action the person took in reliance on that advice;

(c) the results of that action;

(d) the amount and nature of the debt and whether or not it was necessary to incur the debt to enable any business carried on by the company to be carried on as a going concern; and

(e) any action the person took to protect the interests of new or future creditors of the company.

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