ARITA
AUSTRALIAN RESTRUCTURING INSOLVENCY & TURNAROUND ASSOCIATION

24 April 2017

Mr James Mason
Financial System Division
The Treasury
Langton Crescent
PARKES ACT 2600

Dear Mr Mason

National Innovation and Science Agenda – Improving Corporate Insolvency Law (Exposure Draft Legislation)

Thank you for the opportunity to lodge a submission on the draft legislation to amend the *Corporations Act 2001* to provide for safe harbour for insolvent trading and a stay on enforcing ipso facto clauses.

Given that ARITA first began the push for these reforms some 15 years ago,[1] ARITA supports the Government's stated intention to 'drive cultural change amongst company directors' through these reforms.

Clearly, a balance must be struck between the importance of creditors' rights and the imperative that directors are able to explore options for the turnaround of a financially distressed company or its business. It is our view that these are vitally important reforms to be able to preserve jobs and avoid value destruction in distressed businesses and must be put in place before any future financial downturn occurs.

ARITA is, therefore, generally supportive of the broad settings and direction reflected in the draft legislation.

That said, drawing on our domain expertise in this area, ARITA's submission highlights some detailed and technical aspects of the draft legislation which could be improved,

[1] See ARITA's submission of 30 April 2003 to the Parliamentary Joint Committee on Corporations and Financial Services Inquiry into Australia's Insolvency Laws and the joint submission of 2 March 2010 made by Law Council of Australia, Insolvency Practitioners Association of Australia (as ARITA was then known) and Turnaround Management Association of Australia to the Treasury in response to the discussion paper "Insolvent trading: A safe harbor for reorganization attempts outside of external administration".

clarified or calibrated so that the legislation strikes an appropriate balance while still driving the cultural change sought from these important reforms.

Yours sincerely

John Winter
Chief Executive Officer

About ARITA

The Australian Restructuring Insolvency and Turnaround Association (ARITA) represents practitioners and other associated professionals in Australia who specialise in the fields of restructuring, insolvency and turnaround.

We have more than 2,200 members including accountants, lawyers, bankers, academics and other related professionals.

ARITA's mission is to support restructuring, insolvency and turnaround professionals in their quest to restore the economic value of underperforming businesses and to assist financially challenged individuals.

We deliver this through the provision of innovative training and education, upholding world class ethical and professional standards, partnering with government, and promoting the work of the profession to the public at large.

Some 84 percent of registered liquidators and 89 percent of registered trustees choose to be ARITA Professional Members.

ARITA promotes best practice and provides a forum for debate on key issues facing the profession. We engage in thought leadership and advocacy underpinned by our members' knowledge and experience.

1 Safe Harbour for insolvent trading

1.1 ‘Appropriately qualified entity’

In our earlier submission, ARITA contended that only a registered liquidator, or a specially qualified sub-class thereof, is appropriate to provide the advice necessary for ‘safe harbour’ restructuring. We do, again, draw the attention of the Government to the importance of this issue.

The perils of inadequate qualifications of advisers are evident in the financial planner space, where the Government has been forced to take dramatic action across the sector to enforce qualification and continuous professional education standards. This consequence of the lack of qualifications in that space has been significant loss to countless individuals and small businesses who were taken advantage of.

We also note the current issues presented by the proliferation of unregulated ‘pre-insolvency advisers’, again to the detriment of innocent stakeholders.

The same situation is likely to arise if adequate professional standards are not put in place requiring a qualified and regulated professional to be formally engaged for a safe harbour protection to be effective. Indeed, the simple engagement may afford directors a higher level of protection both through qualified advice and to give certainty that they are provided a safe harbour protection. Taking account of the interests of all stakeholders in a distressed entity, we do not accept that this is, or needs to be, an onerous requirement.

However, ARITA notes the Government’s decision to refrain from imposing prescriptive expectations of the course of action directors may take or what advice directors may obtain.

On that basis, ARITA supports the inclusion of the factors set out in s 588GA(2) which will be considered in establishing ‘whether a course of action is reasonably likely to lead to a better outcome’, including ‘whether the person is obtaining appropriate advice from an appropriately qualified entity’. However, the provision as drafted raises the obvious question as to who and what is an ‘appropriately qualified’ entity.

ARITA submits that the provision should specify a minimum base line for the notion of ‘appropriately qualified’, namely that the adviser entity holds professional indemnity insurance that covers that entity for the provision of relevant advice. This would invariably ensure that the entity is either:

- a member of a recognised professional body and/or is required by law to hold insurance (e.g. lawyer, registered liquidator or member of an accounting professional body); or
- has independently applied for and obtained insurance against the risk of liability for acts or omissions in providing advisory services.

In short, ‘uninsured advisers’ should not be considered ‘appropriately qualified’ for the purposes of s 588GA(2). ARITA concurs with the tenor of the statement in the draft

Explanatory Memorandum at [1.35] that, while the nature of any advice may vary according to the size of a business and its circumstances, it should be a bona fide ‘professional’ whose advice is sought.

This is consistent with a significant focus of the *Insolvency Law Reform Act 2016* – that registered liquidators must carry the appropriate type and level of professional indemnity insurance to protect stakeholders. The same public policy approach must be adopted here, in that it would be unthinkable that a director of a company that relies on the advice of a safe harbour adviser could not also rely on them being appropriately insured.

1.2 Holding companies and s 588V

ARITA notes the independent liability of holding companies under s 588V for failing to prevent insolvent trading. ARITA considers it anomalous if a safe harbour is afforded to a person exposed to an alleged contravention of s 588G but not afforded to a holding company exposed to a contravention of s 588V. If the intention is to prevent premature instigation of a Part 5.3A voluntary administration, the position of holding companies also needs to be addressed in order to ensure the goal of creating a safe harbour is achieved.

1.3 Section 588GB and failure of directors to meet statutory obligations

ARITA supports the approach reflected in s 588GB of the draft legislation. However, it seems that the statutory obligations referred to in s 588GB(1) should include the analogous obligations to which directors are subject in any voluntary administration which might precede a liquidation.

Thus, if a director ‘fails to permit the inspection of, or deliver, any books of the company’ or ‘fails to give any information about the company’ in accordance with ss 438B and 438C of Part 5.3A of the Corporations Act, then the director should be similarly prevented from relying on those books or that information as admissible evidence in a ‘relevant proceeding’ (as defined in s 588GB(6)). This would seem to accord with the stated intention at [1.49] of the draft Explanatory Memorandum that s 588GB ‘sets out rules to prevent a director relying on books or information … where these materials have been withheld from a liquidator <u>or administrator</u>.’

It might be considered whether some sort of ‘safety valve’ should be built into s 588GB(1) and (2) – e.g., that the inadmissibility of books or information is subject to court leave – in order to guard against potential injustice where, for instance, certain books or information are not provided to a liquidator due to a genuine or ‘innocent’ oversight.

Provision of Report as to Affairs (‘RATA’) should be a condition of any safe harbour

Given the importance of directors’ obligations to provide information and assistance to administrators and liquidators, ARITA submits that safe harbour protection be denied to directors in circumstances where directors:

- do not provide, within time, a RATA required by either ss 438B, 475 or 497 of the *Corporations Act 2001* (the Act); and
- fail to comply with their obligation under s 530A(3) of the Act to do whatever the liquidator reasonably requires of the director to help in the winding up.

In respect of a failure to provide a RATA, rather than providing that the relevant information is not admissible for the safe harbour protection, ARITA submits that any safe harbour should be simply denied, in a similar vein to the condition of compliance with tax returns, notice and statements imposed by s 588GA(4).

In short, a director who does not comply with the most basic and fundamental obligations in an administration or winding up should not be afforded – and does not warrant - a safe harbour.

1.4 Drafting issues: clarity required

ARITA considers that the following aspects of the draft legislation require further clarity:

- Section 588GA(1)(a): The subjective requirement that the safe harbour protection only apply 'at a particular time after the person starts to suspect the company may become or be insolvent' may have the unintended consequence of unduly narrowing the protection which it is intended the provision will provide. Given that there can only be an actionable contravention of s 588G where the director has reasonable grounds for suspecting that the company is insolvent, we think that this subjective requirement of suspicion of insolvency should be removed from s 588GA(1)(a). This provision might also be simplified to merely refer to a 'better outcome' (without need for the words 'for the company and the company's creditors'), given that 'better outcome' is a defined term in s 588GA(5);

- Section 588GA(1)(b): ARITA supports the intention of a required 'connection' or nexus between the course of action and the relevant debt incurred to enjoy the protection afforded by the safe harbour defence.

  That said, it might be that this aspect of s 588GA(1)(b), as drafted, is ambiguous and open to potential arguments that the safe harbour defence applies more narrowly than is intended. For example, if the first step in the 'course of action' is to obtain professional advice then presumably the safe harbour should extend to protect the incurring of debts in the ordinary course of business (at least until that advice is obtained). Naturally, any new 'outlier' debts – e.g., signing up to a new long-term lease – would not have the necessary nexus to the course of action and would fall outside the safe harbour. However, a narrow interpretation of the provision might be that it is only the fee for the professional advice which is sufficiently connected to the course of action, significantly narrowing the director's safe harbour.

  While we agree that this aspect of the provision is necessary to strike the necessary balance, we submit that further clarity is needed.

- Guarding against ‘hindsight bias’ in a court’s application of s 588GA(1): In addition to the points raised above, the safe harbour provision must be clear that both:

  - the reasonable likelihood of the course of action leading to a better outcome (s 588GA(1)(a)) and
  - the cessation of that reasonable likelihood (s 588GA(1)(b))

  are assessed according to the circumstances at the time the relevant course of action was taken. That is, these two matters should not be determined by a court according to what follows the time at which the safe harbour is claimed to apply (including the fact that a liquidation has in fact eventuated). Given that the safe harbour provision will only ever be tested in the event of a subsequent liquidation, it is important to ensure that directors are not afforded or denied safe harbour according to a test of ‘reasonable likelihood’ which is susceptible to hindsight bias.

- Section 588GA(4): The reference to ‘a standard that would reasonably be expected of a company that is not at risk of being wound up in insolvency’ appears relevant to the provision for employee entitlements (subsection (4)(a)) but does not appear relevant to the notion of giving returns, notices and statements under tax laws (subsection (4)(b)). As currently drafted, this ‘standard’ applies to both matters which appears erroneous. ARITA submits that, so far as tax lodgements are concerned, a company has either complied with these obligations or it hasn’t.

  ARITA also considers that clarity is required in relation to the notion of ‘providing for’ employee entitlements ‘to a standard reasonably expected of a company that is not at risk of being wound up in insolvency’. The s 596AA(2) definition of ‘entitlements’ includes retrenchment payments in respect of termination of employees. Section 588GA(4), as drafted, raises questions as to how and to what extent contingent or accrued obligations must be ‘provided for’ in order to enjoy the safe harbour. For example, would this require companies in financial distress (and looking to restructure) to hold sufficient cash to meet or ‘cover’ accrued entitlements?

  Indeed, the requirement of ‘providing for’ employee entitlements may be inconsistent with a ‘better outcome’ for the company and its creditors *as a whole*. We suggest that the requirement for the provision for employee entitlements be amended and clarified to require that entitlements due and payable in the ordinary course be remitted and paid – i.e. a condition of safe harbour is that superannuation, PAYG instalments, wages and leave entitlements be remitted and/or paid as when they are due and payable;

- Section 588GB(1)(a) makes reference section 477 at both subparagraphs (i) and (iii). We are unsure of the distinction between the dual references and suggest that a single reference at section (1)(a)(iii) is sufficient.

2 The stay on ipso facto clauses

2.1 ARITA supports general approach

As stated in its earlier submission of 27 May 2016, ARITA supports the notion of a stay on the enforcement of ipso facto clauses upon a company's entry into formal insolvency proceedings such as a scheme of arrangement or voluntary administration.

However, ARITA submits that the rationale of preserving business and enterprise value – and with it the preservation of jobs – equally extends and applies to <u>any</u> insolvency process where an external administrator has the power to manage, trade and/or sell a business. That is, there is ample justification for the operation of a similar stay where a company enters liquidation or a managing controller is appointed to all of a company's assets and undertaking.

2.2 Extension of ipso facto stay to liquidations

Where a company is wound up, the liquidator has specific power to trade the company's business 'so far as is necessary for the beneficial disposal or winding up of that business': s 477(1)(a) of the Act. Section 477(2) of the Act also provides for the express power of a liquidator to sell the company's property which includes its business.

Indeed, a liquidator may appoint an administrator under s 436B of the Act. While rare, a liquidator has the option of such a course of action where the interests of the company and/or its creditors might be served by a Part 5.3A voluntary administration.

ARITA also notes the exposure draft provision contemplates the extension of an ipso facto stay in voluntary administration to any subsequent winding up (i.e., the stay will remain in force until the company has been wound up following a voluntary administration). ARITA supports this extension of any stay and contends that the policy underlying such an extension equally justify an extension of the ipso facto stay to any liquidation, however commenced.

It would be undesirable if directors considering the appointment of an external administrator are minded to opt for voluntary administrations rather than immediate creditors' voluntary windings up because of a perceived advantage in taking the Part 5.3A 'scenic route' to a winding up (i.e., because an ipso facto stay will extend to a CVL following a VA but will not extend to a 'direct' CVL).

Again, for the intent of these reforms to deliver on the intention to preserve jobs and avoid value destruction, ARITA considers that the ipso facto stay should apply to any company which enters liquidation, whether voluntarily or by court order.

2.3 Ipso facto stay for managing controllers

ARITA renews its submission of May 2016 supporting the implementation of a stay on the operation of ipso facto clauses against companies where a managing controller is appointed to the whole (or substantially the whole) of a company's assets and undertaking (business).

Again, ARITA considers this to be consistent with the stated goal of a turnaround and restructuring culture and the preservation of business value and jobs.

Any exclusion of managing controllerships from such protection would further encourage the concurrent appointment of a voluntary administrator to ensure a business could be afforded the benefit of the stay.

2.4 List of 'Excluded Contract' types

Replacement of trustees

The intersection of the law pertaining to corporate trading trusts and Chapter 5 of the Act continues to have a detrimental effect on the cost and efficiency of winding up corporate trustees.

While there are a variety of issues afflicting corporate trading trusts which warrant legislative attention, one key issue is the effect of 'ejection clauses' in trust instruments which automatically remove a corporate trustee in the event of a winding up or other external administration appointment. The operation of such clauses casts doubt upon the power of sale of a liquidator appointed to a company which has been removed as trustee.[2]

Trust deeds may contain provision for automatic removal of (or right to replace) a trustee upon an insolvency event such as the commencement of a winding up. The new trustee's right to the trust assets will conflict with the right of the 'old' corporate trustee (in external administration) to assert a charge over the trust assets to secure its right of indemnity in relation to debts incurred in the proper administration of the trust (that right of indemnity and charge is of value to creditors in a winding up). There is conflicting authority among states as to whether the interest of the outgoing trustee takes priority over the right to possession of the new trustee.[3]

The 1988 Harmer Report recommended limits on clauses in trust instruments which automatically remove, or provide power to remove, a company as trustee upon an external administration. The Report noted that 'the operation of such a provision may lead to conflict between the liquidator and the new trustee and impair the efficient winding up of the affairs of the company, resulting in additional expense and delay.' The Harmer Report recommended that if a corporate trustee was subject to a winding up application, 'any

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[2] See D'Angelo N, 'Trustee "ejection clauses": consequences for liquidators, receivers and creditors', (2016) 17(6) *Insolvency Law Bulletin* 96.
[3] See Hannan N, 'Liquidators dealing with trust assets', (2015) *Insolvency Law Bulletin* 7, citing *Re Suco Gold Pty Ltd (in liq)* (1983) 33 SASR 99 and *Lemery Holdings Pty Ltd v Reliance Financial Services Pty Ltd* (2008) 74 NSWLR 550.

provision in the trust instrument allowing for the removal of the company as trustee or the exercise of any power that allows for the removal of the company as trustee shall have no effect.' The Harmer Report's recommendation was that such limitation be subject to existing court powers to remove trustees.

The Harmer Report also recommended that its draft legislation regarding the winding up of corporate trustees 'should, so far as relevant, also be made applicable to the situation of a company under administration.'

ARITA endorses and renews the observation of the Harmer Report that 'the administration of a corporate trustee will be more efficient if the … [external administrator] is able to take complete control of trust assets and if there are limits on the power to remove the company as trustee.' The cost-effectiveness and efficiency of external administrations will be served if the new stay on enforcing ipso facto clauses prevents the removal of a company as trustee in the event of the appointment of an external administrator.

Therefore, ARITA submits that 'replacement of trustees' be removed from the proposed list of excluded contract types.

Consultation on types of contracts and rights excluded from stay

ARITA acknowledges the need to update or adjust the types of excluded rights 'in a timely way' (as explained at [2.24] of the draft Explanatory Memorandum). However, ARITA suggests that Government commits to a process of consultation with industry (including ARITA) on the question of further additions to the list of 'excluded rights' prescribed by regulation.

ARITA submits that consultation is vital to ensure that the intended effect and operation of the stay on ipso facto clauses is not unduly diluted by an uninformed (or premature) use of regulation-making power.

2.5 Court extension orders and s 444F orders

ARITA supports the provision of the capacity for a court order extending the period of the stay pursuant to proposed s 451E(3) of the Act. However, ARITA does not see why any such order should be limited to circumstances where an order has been made under s 444F.

If, for example, a supplier's ability to enforce an ipso facto clause was the only thing standing in the way of a workable deed of company arrangement (DOCA), it would be appropriate that an administrator or deed administrator could apply to Court for an order extending the stay for the duration of the proposed DOCA. Indeed, such a situation is analogous to the very situation s 444F addresses in the context of owners, lessors or secured creditors who could otherwise circumvent the achievement of the purposes of a DOCA.

There may also be circumstances where it would be beneficial to apply to Court to seek an extension order where a DOCA has not been approved by creditors or executed, but an administration may still have ended under s 435C due to some procedural failing (e.g., expiry of the convening period without the convening of a s 439A meeting: s 435C(3)(d)). In such a situation, no s 444F order would (or could) be in force as there would be no DOCA either approved or executed.

We support the submission of the Law Council of Australia calling for further clarity regarding the factors relevant to 'the interests of justice' for the purposes of s 451E(3). We agree that the terms of s 444F provide a useful reference point in this regard.

2.6 Drafting issues: clarity required

ARITA also considers that the following aspect of the draft legislation requires further clarity:

- Section 451E(2)(c): The intention appears to be that, where a voluntary administration transits to a creditors' voluntary liquidation, the stay extends until the conclusion of the winding up (that is, until the point in time when all of the company's property and affairs have been fully wound up). This could be made clearer, perhaps by drawing upon the terms of s 509 of the Act which refers to a time when 'the affairs of the company are fully wound up'.

  If the intention instead is that the stay ends when a winding up 'starts', and the company is being wound up, then it would appear that subsection (c) is redundant and subsection (a) will suffice. (Note however, our comments above in respect of extending the stay on ipso facto clauses for all liquidations, no matter how commenced.)

2.7 Application of amendments (transitional issues)

We support the submission of the Law Council of Australia that the stay provisions affect all contracts, agreements and arrangements existing after a transitional period (excluding those expressly excluded by regulation).

2.8 Schemes of Arrangement – Standalone moratorium

As noted above, ARITA supports the introduction of a stay on ipso facto clauses in a Scheme of Arrangement. Notwithstanding we assert that the effectiveness of such a stay will be limited unless a standalone moratorium against creditor claims is also available.

As noted in ARITA's Policy Position paper of February 2015, we believe that schemes of arrangement can be made more usable via a moratorium, the limitation of ipso facto clauses and the use of a schemes panel to limit the involvement of the court. However, the implementation only of a moratorium and limitation of ipso facto clauses still provides significant improvement to the process and we note that any company using a Scheme is likely to be large enough to bear the cost of court involvement.