Australian Private Equity &
Venture Capital Association Limited

26 April 2017

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

Dear Mr Mason,

Thank you for the opportunity to put forward a submission in relation to the draft legislation which proposes to reform key aspects of Australia's insolvency laws, and the accompanying draft explanatory documents for public consultation released in March 2017.

As you know, the Australian Private Equity & Venture Capital Association (AVCAL) is a national association which represents the private equity and venture capital industries. AVCAL's members comprise most of the active private equity and venture capital firms in Australia, who together manage over A$27 billion on behalf of Australian and offshore superannuation and pension funds, sovereign wealth funds and family offices.

Private equity (PE) and venture capital (VC) firms provide capital for early stage companies, later stage expansion capital, and capital for management buyouts of established companies. These businesses help contribute more than 4% per annum to Australia's national output and support, both directly and indirectly, over 500,000 jobs.[1] In the financial year ending 30 June 2016 alone, PE and VC funds invested $3b into Australia.

1. Background – relevance of private equity and venture capital to the draft legislation

We support the Government's focus on reinvigorating the Australian economy via the implementation of reforms outlined in the December 2015 National Innovation & Science Agenda (NISA). We believe that PE and VC funds can play an essential role in guiding important elements of this economic transition. Much of the capital invested by PE and VC funds is directed into smaller, high growth Australian companies, with a particular focus on commercialisation of research & development, and innovating and expanding established businesses. PE and VC fund managers have both the capital and expertise necessary to drive this growth.

As part of their model, some PE firms undertake investments into financially distressed companies in an attempt to turn around those businesses. Ultimately the aim of such investments is to return companies to financial health and profitability, which leads to direct benefits for employees, investors, creditors, and the broader economy. Our comments on the proposed reforms to stay the enforcement of ipso facto clauses and a new safe harbour for company directors are discussed below in sections 2 and 3 of this submission.

In summary, we support Government efforts to improve the balance between encouraging entrepreneurship and protecting creditors. In particular, the current operation of insolvency-related ipso facto clauses regularly has the effect of eroding the commercial value of companies – which is ultimately to the detriment of employees, investors and creditors. For a number of years, AVCAL has supported reforms in this area that would improve the capacity of firms to make investments which give distressed companies the best opportunity to avoid insolvency and continue to trade (or be sold) as a going concern with underlying commercial value.

[1] Deloitte Access Economics, *The Economic Contribution of Private Equity in Australia*, 2013

2. Ipso facto clauses

AVCAL is supportive of the proposed reforms in the draft legislation to stay the enforcement of ipso facto clauses, recognising that such contractual terms often have the effect of eroding an enterprise's value, and can contribute to a company under financial stress being unable to continue as a going concern even if it is viable over the longer term.

As noted above, some private equity firms carry out investments in struggling companies with a view to turning them around and restoring them to profitability. In practice, although ipso facto clauses may reduce the price a potential buyer may pay for a business, they are likely to deter the investment from proceeding. The ability of a company's suppliers, customers and partners to terminate a contract solely due to an 'insolvency event' results in greater uncertainty for a potential buyer of the business, and means that the company loses much of its attraction as an investment opportunity.

Accordingly, the pool of struggling companies that could be turned-around by private equity specialists with significant expertise in this area would be reduced, resulting in adverse outcomes for creditors, employees and the general business environment.

The proposed legislation provides companies and potential investors with a greater level of certainty in relation to contractual agreements that underpin a business's operations and dealings. If the contractual obligations are being met by both parties, the ability of one party to terminate or vary the contract terms solely due to the fact that an insolvency event has occurred erodes business certainty and the value of corporations. In instances of non-payment or non-performance, parties to a contract should rightly be entitled to the right of termination or amendment. However, in other instances where the terms of the agreement remain intact and are satisfied, but one of the parties is in financial stress and enters administration to turn itself around, opportunistically amending or terminating the contract through an ipso facto clause would only serve to further impact on the financial well-being of the distressed entity, and could be fatal to the ability of the enterprise to remain solvent. The negative flow-on effects would be wide-ranging, impacting other parties that have contractual agreements with the distressed company, including employees, creditors, suppliers, and customers.

Further consideration should be given by the Government to other contractual clauses which can similarly hamper companies facing financial distress. For example, "change of control" clauses can impair the effectiveness of a proposed restructuring strategy if consent to a change of control (e.g. a new investor acquiring the company) isn't obtained. We propose that for contracts which are not for "personal services" (i.e. can be performed by any party – such as a lease agreement), an objective test be applied so that the change of control right must be waived by the counter-party unless the counter-party is put in a worse position by the change of control.

Likewise, consideration should be given to expanding the legislation to stay the enforcement of "termination for convenience" clauses so as to ensure they are not used to deliberately circumvent the proposed ipso facto reforms.

The draft legislation on staying the enforcement of ipso facto clauses applies only if the entity in question enters into a scheme of compromise or arrangement, or to companies that enter into administration. However, as recommended in AVCAL's previous submission on insolvency reform from May 2016, we believe that the moratorium on the operation of ipso facto clauses should also be extended to other circumstances of a company restructure, such as where a company has appointed a restructuring adviser in order to extricate itself from financial difficulty, or when the company enters into liquidation. This would allow a company to take urgent action without the fear that appointing such an expert adviser would make certain contracts voidable.

In our view, it is appropriate that the law cover only those agreements entered into from 1 January 2018, to allow time for market participants to adjust to the new arrangements.

3. Safe harbour for insolvent trading

AVCAL supports the proposed legislative measures being introduced which serve to provide directors with protection from personal liability for insolvent trading. As mentioned in the explanatory memorandum of the draft legislation, the current law in relation to directors' duties to prevent a company from trading while insolvent can lead

to perverse outcomes. This is due in part to the unnecessary focus that company directors may place on their own personal liability instead of their general directors' duties and the long-term financial well-being of the company, in some instances choosing to move to formal insolvency prematurely.

In other cases, business people that have the right skills, expertise and experience to serve as company directors may be discouraged from taking up these positions because of the inherent personal liability risks that arise under current law. This is especially important in the context of startup companies that are developing new and innovative products or services, and hence face higher risk (as well as the consequential potential for higher financial returns) and need capable stewardship at a board level to help the company grow and succeed.

In our opinion, the proposed safe harbour rules strike the right balance between providing directors more flexibility in helping their companies avoid going into administration, and affirming that directors take reasonable steps to seek a better outcome for the company and its creditors, thereby giving due protection not only to creditors, but also employees and other relevant parties.

The proposed legislation would help to alleviate the pressures that directors of companies going through financial stress may face, and aid them in being able to preserve the value of their companies if they have the ability to trade out of their financial difficulties. This would create positive outcomes not only for company directors, but also for employees, customers, suppliers, creditors and the broader economy.

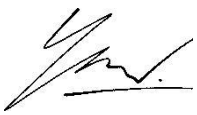
AVCAL also supports the feature of the proposed legislation that renders a company ineligible to use the safe harbour rules if it does not make provisions for employee entitlements (including superannuation) or taxation reporting obligations. Both of these obligations are necessary in order to protect worker's rights and maintain compliance with tax obligations. Similarly, the protection of books and records is essential to ensuring the integrity of the safe harbour proposal.

4. Conclusion

In our view, the proposed safe harbor and ipso facto reforms under the broader National Innovation & Science Agenda are critically important. Sometimes companies that find themselves in financial distress may have products or services that would be of significant market value, but become insolvent or enter voluntary administration before that potential can be realised. The proposed legislation will help to address some of these issues, allowing directors of companies additional breathing space to set about turning-around an enterprise and putting it on a solid financial footing for future growth.

Thank you for the opportunity to put this submission to you as part of the consultation process, and we look forward to continuing our discussions with you on these issues over the period ahead. If you have any queries in relation to this submission, please contact Christian Gergis, Head of Policy & Research, on 02 8243 7010 or me on 02 8243 7000.

Yours sincerely



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