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Mr James Mason
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Dear Mr Mason

Treasury Laws Amendment (2017 Enterprise Incentives No. 2) Bill 2017

This submission comments on the Treasury Laws Amendment (2017 Enterprise Incentives No. 2) Bill 2017 (the draft Bill), the accompanying Explanatory Memorandum and an explanatory document for the proposed regulations.

1. Summary of Ashurst Submission

1.1 Safe harbour

Ashurst supports the provision to directors of a safe harbour from liability for insolvent trading, to enable them to pursue corporate restructuring.

However, Ashurst has the following comments on the safe harbour provisions in the draft Bill.

- The "better outcome" criterion should be amended to:
  - refer only to a better outcome for the company's creditors as a whole
  - contain a reference to the company going into liquidation in place of the reference to the company becoming a "Chapter 5 body corporate".
- The safe harbour should not be described as a "defence", but should be a clear carve-out from insolvent trading liability.
- The safe harbour should require that the debt be incurred while the course of action is being taken, rather than "in connection with" the course of action.
- There should be a presumption, unless the contrary is proved, that directors have satisfied the safe harbour if the five factors to which regard should be had "in working out whether a course of action is reasonably likely to lead to a better outcome for the company and the company's creditors" are satisfied.
- The governance prerequisites for the operation of the safe harbour should be removed.
- If the governance prerequisites are retained, there should be a substantive provision incorporating the *Corporations Act* s 596AA(2) definition of "entitlements of an employee" into the safe harbour provisions.
- A safe harbour similar to the one that will be enacted as s 588GA should be provided for holding companies.
- The references to an administrator in the parts of the draft Explanatory Memorandum that relate to proposed s 588GB (for instance, paras 1.20, 1.49, 1.50) should be deleted, as that draft provision is applicable only to liquidators.

1.2 Ipso facto clauses

Ashurst supports a restriction on ipso facto clauses, with appropriate exceptions and other safeguards, but has the following reservations and comments about the provisions in the draft Bill.

- The prohibited triggering events should cover a wider range of insolvency events than mere entry into the form of external administration to which the ipso facto clause restriction applies, such as entry into any form of external administration and matters relating to the insolvency or financial condition of the company.

- The legislation should cover ipso facto clauses that come into effect automatically on the happening of a prohibited triggering event, not just ipso facto clauses that confer rights on a counterparty.

- Consideration should be given to providing for a stay on the enforcement of ipso facto clauses for a brief period when a company goes into a winding up that does not follow a voluntary administration (VA), to enable the liquidator to consider whether to appoint an administrator. The period could be similar to the convening period for an administrator.

- When a company is in transition from a scheme of arrangement or a VA to a winding up, the end of the stay on ipso facto clauses should be the date the liquidator is appointed, rather than when the company is "wound up".

- There should be an automatic stay on ipso facto clauses in relation to deeds of company arrangement (DOCAs), without the need to apply for an extension order.

- If the requirement for an extension order to extend the stay to DOCAs is retained:

    - the link to *Corporations Act* s 444F should be removed

    - the legislation should make clear what happens if an ipso facto right is enforced after the end of an administration that has resulted in a DOCA, but before an application is made to the court to extend the stay.

- The legislation should explicitly acknowledge that the restriction on ipso facto clauses does not affect other contractual obligations.

- The exception for contracts made after the commencement of a scheme should be brought into line with that for VAs. Under the draft Bill, the scheme exception applies to contracts entered into after the day the order approving the scheme compromise or arrangement takes effect (that is, at the point equivalent to the execution of a DOCA), whereas the VA exception applies "after the day the administration of the company begins" (that is at the beginning of the VA process).

- There should be a specific provision, along the lines of s 256(d) of the *Personal Property Securities Act 2009* (Cth), stating that the *International Interests in Mobile Equipment (Cape Town Convention) Act 2013* (Cth) will prevail over the ipso facto restrictions to the extent of any inconsistency between the two laws. If such a provision is not introduced, the relevant item in the regulations should extend to all international interests covered by the Cape Town Convention.

- It should be made clear that the ipso facto amendments do not interfere with:

    - the current rights of a secured creditor with security over all or substantially all of a company's property to enforce its security within 13 business days of the appointment of an administrator, notwithstanding the VA moratorium (*Corporations Act* s 441A)

    - the current protection of the rights of a secured creditor to enforce its security interest prior to the commencement of an administration (*Corporations Act* s 441B).

- There should be an exception for escrow arrangements that involve a third party holding source code in proprietary software of a supplier. Consideration might be given to providing a more general exception for escrow arrangements.

- The legislation should enable those in control of a company during the scheme of arrangement process and an administrator or a deed administrator to permit the enforcement of an ipso facto clause.

2. Safe harbour

2.1 Overview

This section contains:

- a summary of the current Australian law on insolvent trading
- a summary of the safe harbour provisions in the draft Bill
- Ashurst's comments on the draft Bill and accompanying Explanatory Memorandum.

2.2 Current law on insolvent trading

Under the current law, directors of a company who allow the company to trade while it is insolvent can be liable to pay for the loss or damage caused by the company's insolvent trading. If the directors act dishonestly, they commit an offence.

There is currently no safe harbour defence to this potential liability that would leave directors in control of the company and protect them while they seek to develop and implement a restructuring for the company.

A director of a company is civilly liable for insolvent trading if, when the company incurs a debt:

- the company is insolvent or becomes insolvent by incurring that debt and any other contemporaneous debts

- the director is aware at that time of reasonable grounds for suspecting that the company is already insolvent, or would by incurring the debt become insolvent, or a reasonable person in a like position in a company in the company's circumstances would be so aware.[1]

Once a director concludes that the company is insolvent, the only course of action to avoid liability is to cause the company to cease trading (where trading involves the incurring of debts) or appoint a voluntary administrator.

There are the following defences to civil liability for insolvent trading:[2]

- reasonable grounds to expect that the company was solvent when the debt was incurred and would remain solvent even if it incurred that debt and any other contemporaneous debts

- reasonable reliance on a competent and reliable person who is responsible for providing adequate information about the company's solvency

- non-participation in the management of the company because of illness or for some other good reason

- taking all reasonable steps to prevent the company from incurring the debt, including by the appointment of an administrator under Part 5.3A of the *Corporations Act 2001* (Cth) (the *Corporations Act*) (the reasonable steps defence).

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1 *Corporations Act 2001* (Cth) (*Corporations Act*) s 588G(1), (2).
2 *Corporations Act* s 588H.

A director can also seek whole or partial relief from this civil liability if the director has acted honestly and, having regard to all the circumstances, ought fairly to be excused,[3] though the grant of this relief is at the court's discretion.

A director is criminally liable for insolvent trading if, when the company incurs a debt:

- the company is insolvent or becomes insolvent by incurring that debt and any other contemporaneous debts (this element is identical to the equivalent civil liability element)

- the director suspected the company's insolvency

- the director's failure to prevent the company incurring the debt was dishonest.[4]

The court can order a person found guilty of this offence to pay compensation.

The amount for which a director can be liable, whether the relevant contravention is civil or criminal, is an amount equal to the amount of the loss or damage suffered in relation to the debt because of the company's insolvency.[5] This amount can be recovered by the liquidator[6] or by a creditor who has obtained the liquidator's consent or the leave of the court.[7]

2.3 Draft Bill safe harbour provisions

2.3.1 Elements of the safe harbour

The draft Bill proposes a safe harbour from civil liability for insolvent trading having the following features (s 588GA(1)):

- it applies where directors have taken a course of action that is reasonably likely to lead to a "better outcome" for the company and its creditors
- the debt must have been incurred in connection with the course of action
- the protection will start from when the director starts to take the course of action after beginning to suspect that the company may become or be insolvent
- the protection will end when the first of the following occurs:
  - the person ceases to take the course of action
  - the course of action stops being reasonably likely to lead to a better outcome; or
  - the company goes into administration, is wound up, goes into receivership, has executed a DOCA or is under a scheme of arrangement.

2.3.2 Better outcome

A "better outcome" means an outcome that is better for both the company and its creditors as a whole than the outcome of the company going into administration, being wound up, going into receivership, executing a DOCA or being under a scheme of arrangement (s 588GA(5)).

2.3.3 List of factors

The draft bill sets out an indicative, but not exhaustive, list of factors to which regard is to be had in determining whether a course of action is reasonably likely to lead to a better outcome for a company and its creditors:

- taking appropriate steps to prevent misconduct by the company's officers and employees
- taking appropriate steps to ensure that the company maintains appropriate financial records

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3 *Corporations Act* ss 1317S, 1318.
4 *Corporations Act* s 588G(3).
5 *Corporations Act* s 588M.
6 *Corporations Act* s 588M(2).
7 *Corporations Act* ss 588M(3), 588R, 588S, 588T.

- obtaining appropriate advice from an appropriately qualified entity (who was given sufficient information to give appropriate advice)
- keeping properly informed about the company's financial position
- developing or implementing a plan to restructure the company to improve its financial position (s 588GA(2)).

2.3.4 Onus of proof

The directors will have the evidential onus of demonstrating that the safe harbour exception is available (s 588GA(3)). However, the explanatory memorandum suggests that, once a director provides some evidence that the safe harbour is available, the liquidator or other party who is seeking to make directors personally liable for insolvent trading will bear the onus of establishing that the director's course of action was not reasonable in the circumstances (para 1.18).

2.3.5 Governance prerequisites

The safe harbour will not be available to directors who fail to meet the following governance standards "to a standard that would reasonably be expected of a company that is not at risk of being wound up in insolvency":

- providing for employee entitlements
- giving returns or other documents required by taxation laws (s 588GA(4)).

Further, directors may not be entitled to rely on books, records and information in supporting their entitlement to use the safe harbour if the directors:

- have concealed, destroyed or removed books of the company
- fail to provide liquidators with access to books or other material following an appropriate request (unless they did not have the materials and there were no reasonable steps that they could have taken to obtain them or they were not notified of the consequences of failure to provide them) (s 588GB).

2.4 Ashurst submission

As a general proposition, Ashurst supports a safe harbour from insolvent trading liability as a means of encouraging directors to explore corporate restructuring where possible.

However, Ashurst makes the following points on the provisions in the draft Bill.

2.4.1 The concept of "better outcome"

A "better outcome" is defined in terms of an outcome that is better for the company as well as for the company's creditors as a whole.

This formulation is consistent with the key principle that the duty of a director is always to the company, even though the interests to which the director may have regard in performing that duty can vary from time to time.

On the other hand, the duty of directors to "the company" tends to require them to take greater account of the interests of the company's creditors as the company moves towards insolvency (*Walker v Wimborne* [1976] HCA 7; (1976) 137 CLR 1 and *Kinsela v Russell Kinsela Pty Ltd (in liq)* (1986) 4 NSWLR 722). Given this, where insolvent trading is a concern, a separate reference to a better outcome for "the company" may be superfluous. It may be simpler and clearer to refer only to a better outcome for the company's creditors as a whole.

Also, the comparison in the "better outcome" test with "becoming a Chapter 5 body corporate" may not be appropriate, given that schemes of arrangement (*Corporations Act* Part 5.1) and VAs/DOCAs (*Corporations Act* Part 5.3A) are common corporate restructuring procedures. The comparison should be with the company going into liquidation. This would be consistent with the test for when creditors may approve a DOCA that provides for an order of payment that differs from that in *Corporations Act* s 556 and related provisions, "that the deed is no less beneficial to all creditors than liquidation is likely to be" (*Lam Soon Australia Pty Ltd (Administrator Appointed) v Molit (No 55) Pty Ltd* (1996) 14 ACLC 1,737 at 1,750).

2.4.2 Description of the safe harbour as a "defence"

The safe harbour seems intended to provide a carve-out from insolvent trading liability, rather than a defence.

Proposed s 588GA(1) says that the civil liability in s 588G(2) "does not apply" if certain conditions are satisfied and proposed s 588GA(3) imposes an evidential burden on the director.

The interpretation that the safe harbour is a carve-out rather than a defence is supported by the Explanatory Memorandum. Para 1.11 of the Explanatory Memorandum says that the safe harbour "will operate to carve directors out from the civil insolvent trading provisions of section 588G(2)" and para 1.43 says that:

> Once a director provides some evidence to meet this low initial evidential burden, it will be up to a liquidator (or other party) alleging a contravention of section 588G to provide evidence and argue that the safe harbour does not apply because the director did not take a reasonable course of action.

Despite these indications that the safe harbour is a carve-out, it is described as a "defence" in various places (s 588GB(6), as well as in the notes and headings). The legislation should make clear that the safe harbour is a carve-out, not a defence.

2.4.3 "in connection with" the course of action

The safe harbour requires that the debt be incurred "in connection with" the course of action. It is not clear what this phrase is intended to convey. The phrase is potentially quite limiting, as it is possible that most debts would be considered to be incurred in the ordinary course of the company's business, rather than specifically "in connection with" the course of action.

It should be sufficient that the debt is incurred while the course of action is being taken.

2.4.4 The specified factors that may constitute the safe harbour

The rationale for the safe harbour is to provide directors with the necessary reassurance that they can pursue appropriate restructuring options without running the risk of incurring liability for insolvent trading.

Directors are most likely to feel that they have this reassurance if their advisers can say that the safe harbour will apply if they take specified steps. While the draft Bill specifies five factors to which regard should be had "in working out whether a course of action is reasonably likely to lead to a better outcome for the company and the company's creditors", para 1.34 of the Explanatory Memorandum states:

> There may also be, in some circumstances, cases where a Court is satisfied that all five factors are satisfied but that the course of action is still not found to be reasonable.

It is clearly necessary to leave open the possibility of insolvent trading liability even if all five factors are satisfied. Conversely, it is obviously desirable that a director's actions could come within the safe harbour even if not all of the five factors are satisfied.

Nevertheless, it may provide a greater level of comfort to directors if the legislation were to state that a better outcome would be presumed, unless the contrary is proved, if the five factors were satisfied.

2.4.5 Governance prerequisites

The draft Bill deprives directors of the safe harbour if they fail to meet certain governance requirements "to a standard that would reasonably be expected of a company that is not at risk of being wound up in insolvency". The governance standards relate to:

- provision of employee entitlements
- the giving of documents required by taxation laws.

Ashurst maintains the view it took in its submission on the Government Proposals Paper *Improving bankruptcy and insolvency laws* (April 2016) (the 2016 Government Proposals Paper) that directors should not be deprived of the safe harbour because of governance failures. It seems inappropriate to make the safe harbour conditional on a director having met these governance requirements, which have their own enforcement regimes. Problems in these governance areas should be dealt with by improved enforcement and, if necessary, by amending the relevant provisions. It seems counterproductive to remove a director's safe harbour, in effect as an additional penalty for prior governance breaches that may not be related to the current circumstances, given that the safe harbour is aimed at preserving viable enterprises by promoting corporate restructuring.

However, Ashurst supports limitations on the entitlement of directors to rely on books, records and information in the circumstances specified in the draft Bill.

If the governance prerequisites are retained, there should be a substantive provision incorporating the *Corporations Act* s 596AA(2) definition of "entitlements of an employee", as that definition only applies to entitlements of an employee protected under Part 5.8A of the *Corporations Act* and would not automatically apply to the new s 588GA. The current draft Bill merely contains a note stating that "Employee entitlements are defined in subsection 596AA(2)".

2.4.6 Holding company liability

Section 588V of the *Corporations Act* imposes insolvent trading liability on holding companies in terms similar to those in s 588G.

A safe harbour similar to the one that will be enacted as s 588GA should be provided for holding companies.

2.4.7 Explanatory Memorandum

Various parts of the draft Explanatory Memorandum (for instance, paras 1.20, 1.49, 1.50) refer to an administrator as well as a liquidator. However, the relevant draft legislative provision (s 588GB) relates to provisions that are applicable only to liquidators.

3. Ipso facto clauses

3.1 Conceptual framework

Ashurst's analysis of the restrictions on ipso facto clauses proposed in the draft Bill considers the following matters:

- the ***types of contract*** affected by the restrictions
- the characteristics of ipso facto clauses that are targeted by the restrictions, being:
  - the ***prohibited triggering events*** (for instance, insolvency of the company, entry of the company into external administration)
  - the ***prohibited contractual consequences***, including the ***nature of the consequences*** (for instance, termination of the contract, modification of the contract, acceleration of a payment under the contract) and the ***way those consequences come about*** (that is, whether the clause gives the counterparty a right to bring about the consequence or the consequence occurs automatically on the happening of the prohibited triggering event)

- the ***types of external administration*** in which the restrictions on the operation of ipso facto clauses should apply
- the manner in which the restrictions operate, in particular:
  - the ***effect of the restrictions*** (voiding of the clause or suspension of its operation for a defined period)
  - ***how the restrictions take effect*** (automatically, by court order or at the option of an external administrator)
  - whether the provisions imposing the restrictions explicitly acknowledge that they ***do not affect other contractual obligations***
- the circumstances in which the restrictions would not apply, in particular:
  - ***exceptions***
  - a ***power for the court*** to override the restrictions
  - ***consent to enforcement of an ipso facto clause by those in control of the company*** (the external administrator, the directors).

3.2 Current Australian law

There are restrictions on the operation of ipso facto clauses in relation to individuals[8] and certain types of commercial entities.[9]

There are no restrictions on ipso facto clauses in relation to companies generally: ipso facto clauses are enforceable when a company goes into VA[10] or liquidation. However, there are restrictions on the exercise of possessory rights (for instance, restrictions on a lessor repossessing equipment) when a company goes into VA,[11] as well as a limitation on the right of suppliers of essential services to insist on payment as a condition of supply in certain circumstances.[12]

3.3 Affected agreements

3.3.1 Draft Bill approach

The proposed restrictions would apply to any type of contract, agreement or arrangement (proposed ss 415D(1), 451E(1)), subject to the specified exceptions (proposed ss 415D(4)-(6), 451E(4)-(6)).

3.3.2 Ashurst submission

Ashurst agrees that there should be no limitations on the type of contract, agreement or arrangement to which the restrictions would apply, other than those that come within the exceptions.

Ashurst proposes exceptions additional to those set out in the outline of the draft regulation (see Section 3.9.2 of this submission).

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8 *Bankruptcy Act 1966* (Cth) ss 301, 302. Similar provisions apply to superannuation funds, retirement savings accounts and trust deeds: ss 302A, 302AB, 302B.

9 Authorised deposit-taking institutions (ADIs), general insurers, life companies. See *Banking Act 1959* (Cth) ss 11CD, 14AC, 15C; *Insurance Act 1973* (Cth) ss 62V, 62ZB, 105; *Life Insurance Act 1995* (Cth) ss 165B, 168C, 230C; *Financial Sector (Business Transfer and Group Restructure) Act 1999* (Cth) s 36AA.

10 The matters covered by the moratorium provisions in Part 5.3A Div 6 do not include the enforcement of contractual rights generally. The moratorium only covers winding up the company, rights to sell property or otherwise enforce a security interest, rights to take possession of property, and beginning or proceeding with court proceedings or enforcement process.

11 *Corporations Act* s 440B.

12 *Corporations Act* s 600F.

3.4 Prohibited triggering events

3.4.1 Draft Bill approach

Schemes of arrangement

The prohibited triggering events in the draft Bill in the case of schemes of arrangement are:

- an application for a court order to approve meetings of creditors where a compromise or arrangement is proposed between the company and its creditors (proposed s 415D(1)(a))
- entry into a scheme of arrangement (proposed s 415D(1)(b))

(but only where the company's application to commence the scheme states that it is being made for the purpose of the company avoiding being wound up in insolvency) (proposed s 415D(3)).

Voluntary administrations

The prohibited triggering event in the draft Bill in the case of VA is the company being under administration (proposed s 451E(1)).

Ashurst notes that the draft Explanatory Memorandum states the triggering event as "the company enters into **external** administration" (para 2.37), rather than simply "administration".

3.4.2 Ashurst submission

The draft Bill conflates the prohibited triggering events and the forms of external administration in which the ipso facto restrictions should apply.

These elements should be treated as separate issues.

Ashurst agrees that the ipso facto restrictions should only apply in relation to reconstruction procedures (subject to a possible limited application in the early stages of a liquidation that does not follow a VA, as discussed in Section 3.6.2 of this submission).

However, the ipso facto restrictions will be too narrow unless the prohibited triggering events extend to a wider range of "insolvency events", such as entry into any form of external administration or, as under the United States Bankruptcy Code, matters relating to the insolvency or financial condition of the company.

For instance, a company may go into receivership at or around the same time as it goes into administration. The proposed legislation would not prevent enforcement of an ipso facto clause that was triggered by the company going into receivership.

A contractual counterparty may even stipulate the company's "insolvency" as an event that would activate an ipso facto clause. Because the clause was not enforceable merely because the company went into a scheme or VA, its enforcement would not be prohibited by the restriction in the draft Bill.

3.5 Prohibited contractual consequences

3.5.1 Draft Bill approach

The sole ***prohibited contractual consequence*** would be the enforcement of any right that would be activated by the relevant prohibited triggering event.

The prohibition in the draft Bill is not limited to particular types of contractual consequences, such as:

- amending an agreement
- terminating an agreement

- the acceleration of payments
- the imposition of new arrangements for payment
- a requirement to provide additional security for credit.

3.5.2 Ashurst submission

Ashurst supports the concept of having a broadly drafted sole prohibited contractual consequence, as it would:

- discourage drafting techniques intended to give the contractual counterparty enforcement rights that would fall outside the prohibition
- avoid the potential for loopholes.

Any potential overreach arising from this broad prohibited contractual consequence would be counteracted by the court power to override the ipso facto clause restrictions "in the interests of justice" and by ensuring appropriate exceptions.

However, while the formulation in the draft Bill would cover ipso facto clauses that confer rights on a counterparty, it would not cover clauses that come into effect automatically on the happening of a prohibited triggering event, without the need for any action by the counterparty. The legislation should cover both types of ipso facto clause.

Ashurst notes that the discussion of the prohibited contractual consequences in the Explanatory Memorandum does not line up with the language of the draft Bill. Rather than referring to the broad prohibited contractual consequence in the draft Bill, the Explanatory Memorandum refers to ipso facto clauses that allow a contract to be "terminated or varied" (para 2.8) and clauses that "amend or terminate" an agreement/contract (para 2.12, the first and third boxes in the first column of the table **Comparison of key features of new law and current law** after para 2.16, paras 2.17, 2.18, 2.20, 2.27).

The broad language in the draft Bill is preferable to the specific language in the Explanatory Memorandum and avoids potential loopholes. In particular, a prohibition on a contract being "amended" or "varied" by an ipso facto clause would not cover a clause that leaves the terms of the contract the same, but changes the manner in which the contract operates. While a prohibition on "modification of the operation of a contract" would fix this particular loophole, the broader language of the draft Bill is a better approach.

3.6 Type of external administration

3.6.1 Draft Bill approach

Under the draft Bill, the ipso facto restrictions would apply where a company is:

- embarking on, or entering into, a scheme of arrangement where the application to the court to commence the scheme states it is being made for the purpose of the company avoiding being wound up in insolvency (proposed s 415D)
- under administration (proposed s 451E).

The ipso facto restrictions will continue once a DOCA comes into force if an application is made for an extension order (proposed s 451E(3)). However, an extension order can only be made if an order under *Corporations Act* s 444F to limit the rights of a secured creditor, owner or lessor is also in force for the benefit of the company (proposed s 451E(3)(a)).

The restrictions would not apply to companies under any other form of external administration.

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3.6.2 Ashurst submission

Reconstruction procedures

Ashurst supports the application of ipso facto restrictions only to companies undergoing a ***reconstruction procedure*** (VA, scheme of arrangement, DOCA), subject to a possible limited application to liquidations, as discussed below.

However, Ashurst queries the requirement to obtain an extension order before the ipso facto stay applies to a company subject to a DOCA and, if that requirement is retained, has concerns about the conditions for obtaining an extension order. These matters are discussed in Section 3.7.2 of this submission.

Liquidations

It may be appropriate for the ipso facto restrictions to apply for a brief period where a company goes into a winding up that does not follow a VA. A liquidator has the power to appoint an administrator (*Corporations Act* s 436B). A brief stay would give the liquidator time to decide whether to do so. If this suggestion is adopted, the period of the stay when a liquidator is in control could be similar to the convening period for an administrator (*Corporations Act* s 439A(5)).

Ashurst does not favour a lengthier stay for companies in liquidation, even though the *General Insolvency Inquiry* report of the Australian Law Reform Commission (the Harmer Report) recommended rendering ipso facto clauses void against the liquidator in a winding up[13] and the United States Bankruptcy Code restrictions apply in corporate bankruptcies as well as corporate restructurings. In Ashurst's view, it would be an unreasonable imposition on contractual counterparties to require continued performance of contracts with companies in liquidation for an extended period.

3.7 The operation and length of the stay

3.7.1 Draft Bill approach

The stay for both types of external administration (schemes and VA) is automatic, without the need for a court order, and for a specified period.

In the case of a scheme, that period:

- starts when the scheme application to the court is made
- ends:
  - when the application is withdrawn or the court dismisses it, or
  - at the end of any compromise or arrangement approved by the court, unless this occurs because the company is to be wound up, or
  - when the company is wound up (proposed s 415D(2)).

In the case of VA, the period starts when the company enters into administration and ends when the administration ends, unless:

- an application for an ***extension order*** is made to the court within 7 days of the administration ending, in which case the stay ends when:
  - the application is withdrawn, or
  - the court dismisses the application, or
  - an extension order granted by the court ceases to be in force
- the administration ends because the company is wound up, in which case the stay ends when the company is wound up (proposed s 451E(2)).

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13 Australian Law Reform Commission, *General Insolvency Inquiry* report (ALRC 45), vol 1 para 705, vol 2 draft s AT10.

The court may make an extension order if:

- an order under *Corporations Act* s 444F to limit the rights of a secured creditor, owner or lessor is in force for the benefit of the company
- the court is satisfied that it is appropriate in the interests of justice for the period to be extended
- the applicant for the extension order is the same as the applicant for the order under s 444F (the administrator and the deed administrator are eligible applicants under s 444F) (proposed s 451E(3)).

3.7.2 Ashurst submission

Ashurst favours the draft Bill's approach of staying, rather than completely voiding, ipso facto clauses, without the need for a court order.

If the restriction were to void ipso facto clauses, a counterparty would not be able to enforce an ipso facto clause if the reconstruction effort failed, even though the purpose of the legislative restriction had not been fulfilled.

However, Ashurst has concerns about:

- the provision for the stay in schemes and VAs to end when the company "is wound up"
- the proposed circumstances in which the stay will apply to DOCAs.

End of the stay when the company "is wound up"

In the ipso facto restrictions for schemes and VAs, the draft Bill provides for the stay to end when the company "is wound up" (proposed ss 415D(2)(b)(iii), 451E(2)(c)).

A company might only be said to be "wound up" when the winding up process has been completed. If that is the case, the result appears to be inconsistent with the decision not to extend the ipso facto restrictions to liquidations.

It should be made clear that the end of the stay on ipso facto clauses where a company goes into winding up is the date the liquidator is appointed, rather than when the company is "wound up".

Application of the stay to DOCAs

Ashurst notes that one of the stipulated end-dates for the stay in relation to a scheme is "the end of any compromise or arrangement approved under this Part [that is, Part 5.1] as a result of the application" (proposed s 415D(2)(b)(ii)). By contrast, the equivalent provision for a VA links the continued application of the stay when the company moves from administration to a DOCA with a court extension order (proposed s 451E(2)(b)). The reason for this difference in approach is not clear. Ashurst considers that ipso facto restrictions should apply to DOCAs without the need to seek an extension order.

If the requirement for an extension order for DOCAs is retained, Ashurst has two concerns.

First, the requirement that an extension application can only be made if an application is also made under s 444F could in practice be a significant limitation on the operation of the stay during a DOCA. A company may well need to keep its key contracts on foot, even if there is no need for continuing restrictions on the rights of secured creditors, owners or lessors (for instance, because those creditors support the restructuring and a court order is therefore unnecessary).

Secondly, the requirement to obtain an extension order before the stay applies to a company subject to a DOCA appears to create the potential for a gap, the consequences of which are unclear. The application for an extension order must be made "within 7 days ***after*** the administration ends". The administration ends when the DOCA is executed by the company and the deed administrator (*Corporations Act* s 435C(2)(a)). In practice, the administrator/deed administrator should make the application for an extension order as soon as the company executes the deed, to ensure that the ipso facto right is not exercised before the application is made. The need to do this makes the 7 day period to make an application more theoretical than of any real use. Nevertheless, if there is in fact a delay in making application, the legislation does not make clear what would happen if the contractual counterparty exercises its ipso facto rights before the application is made.

3.8 Effect on other contractual obligations

3.8.1 Draft Bill approach

The draft Bill does not contain an explicit statement that the restriction on ipso facto clauses does not affect other contractual obligations.

3.8.2 Ashurst submission

The Productivity Commission recommended that the legislation should make clear that other contractual obligations not containing the prohibited ipso facto element continue to apply.[14]

For the sake of commercial certainty, the legislation should explicitly acknowledge that the restriction on ipso facto clauses does not affect other contractual obligations.

3.9 Exceptions

3.9.1 Draft Bill approach

The stay will not apply to rights:

- in contracts made after the commencement of a scheme of arrangement or VA
- prescribed by the regulations, which are proposed to include:
  - netting agreements
  - rights of set-off
  - flexible priority arrangements
  - flawed asset arrangements
  - replacement of trustees
  - securities underwriting agreements
  - arrangements under an ISDA Master Agreement
  - repurchase agreements, forward contracts, commodity contracts, swaps, and structured financings that include "flip clauses"
  - certain securitisations
  - aircraft leases
  - securities settlement facilities
  - covered bond transactions
  - debt factoring agreements
  - Real Time Gross Settlement arrangements
  - contracts for personal services
- that manage financial risk associated with a financial product (within the meaning of Chapter 7 of the *Corporations Act*) and are commercially necessary for the provision of that type of financial product
- declared in a Ministerial determination where:
  - the relevant contracts are referred to in a specified law of the Commonwealth, or
  - the rights are commercially necessary for a specified kind of contract to be entered into.

[14] Productivity Commission Report *Business Set-up, Transfer and Closure* (September 2015) Recommendation 14.5.

The explanatory memorandum to the Bill notes that having the regulations prescribe types of contracts containing rights that may still be enforced ensures the list can be updated regularly in response to the development of new and innovative financial products. Treasury has indicated that the list seeks to ensure that the stay will not apply where an ipso facto clause is required or contemplated by a Commonwealth or State law, or an international obligation to which Australia is a party, or is inherent in the type of contract (ie removing the ipso facto clause would render the contract unworkable or a nonsense).

A contractual counterparty will not be forced to provide additional credit while its right to enforce ipso facto clauses is suspended (proposed ss 415D(6), 451E(6)).

3.9.2 Ashurst submission

Exceptions proposed in the exposure legislation

In relation to the first exception (contracts made after the commencement of the scheme/VA), there appears to be a difference of approach between schemes of arrangement and VAs. The scheme exception applies to contracts entered into after the day the order approving the relevant compromise or arrangement takes effect (that is, at the point equivalent to the execution of a DOCA) (proposed s 415D(4)(a)), whereas the VA exception applies "after the day the administration of the company begins" (that is at the beginning of the VA process) (proposed s 451E(4)(a)). The reason for this difference is not clear. The timing for schemes should be brought into line with the timing for VAs.

In relation to the specific exemptions proposed for inclusion in the regulations, the item "Lease contracts in respect of aircraft objects in aviation transactions *(Mobile Equipment (Cape Town Convention) Act 2013* (Cth) and *Protocol on Matters Specific to Aircraft Equipment)*" is not wide enough. The Cape Town Convention applies to various "international interests" that include, but are not limited to, leasing transactions. The wider categories of "international interests" covered by the Convention include:

- interests under a security agreement
- the interests of a conditional seller under a title reservation agreement

as well as assignment of rights in connection with those interests. All these international interests should be exempted from the ipso facto restrictions, preferably by a specific provision, along the lines of s 256(d) of the *Personal Property Securities Act 2009* (Cth), stating that the *International Interests in Mobile Equipment (Cape Town Convention) Act 2013* (Cth) will prevail over the ipso facto restrictions to the extent of any inconsistency between the two laws. If such a provision is not introduced, the relevant item in the regulations should extend to all international interests covered by the Cape Town Convention.

Apart from these points, Ashurst supports the proposed exceptions, but proposes that additional matters be either clarified in the ipso facto amendments to the *Corporations Act* or included in the regulations.

Additional exceptions

(i) Secured creditor rights

The interaction between the proposed ipso facto restrictions and existing exceptions to the VA moratorium should be clarified.

It should be made clear that the ipso facto amendments do not interfere with the secured creditor rights protected by *Corporations Act* s 441A, which permits a creditor with security over all or substantially all of a company's property to enforce its security within 13 business days of the appointment of an administrator, notwithstanding the VA moratorium. Section 441A is aimed at ensuring the continued availability of reasonably priced secured credit, particularly from banks, by preserving their ability to move quickly to take control of secured property and minimise the risk of an erosion in the value of their security. It is often relied upon by financiers to enforce an all asset security where a borrower goes into VA before an actual payment default.

Similarly, it should be made clear that the ipso facto amendments do not interfere with the current protection of the rights of a secured creditor to enforce its security interest prior to the commencement of an administration (*Corporations Act* s 441B).

(ii) Escrow arrangements

Consideration might be given to providing an exception for escrow arrangements.

A particular example of an arrangement that should be exempted from the ipso facto restrictions was given in a submission on the 2016 Government Proposals Paper. The exception would be along the lines of the intellectual property rights protection in the US Bankruptcy Code[15] and cover escrow arrangements that involve:

- a third party holding source code in proprietary software of a supplier where the software is critical to the operation of the systems or business of the supplier's counterparty
- the software being made available to the counterparty on the occurrence of an insolvency event affecting the supplier.[16]

Ashurst supports such an exception.

3.10 Court power to override restriction

3.10.1 Draft Bill approach

The court will have the power to override the stay and allow enforcement of an ipso facto right if satisfied that it "is appropriate in the interests of justice" (proposed ss 415E(1)(b), 451F).

The court will also have the power to override the stay in the case of a scheme if the scheme was not for the purpose of avoiding the company being wound up in insolvency (proposed s 415E(1)(a)).

3.10.2 Ashurst submission

Ashurst supports the proposed court power. The proposed criterion, "appropriate in the interests of justice", would give greater scope for appropriate exemptions than, say, "hardship".

3.11 Court anti-avoidance power

3.11.1 Draft Bill approach

The court will have the power to order that rights that are being exercised or are likely to be exercised merely because of entry into a scheme of arrangement or VA are only enforceable with leave of the court and in accordance with such conditions as the court imposes (proposed ss 415F, 451G). The court will also be able to make this type of order if there is a threat to exercise the rights.

In the case of a scheme of arrangement, the application for such an order must:

- be included in the application for a scheme meeting made under *Corporations Act* s 411 and the latter application must state that it is being made to avoid the company being wound up in insolvency (proposed s 415F(2)(c)(i), (d)), or

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15 US Bankruptcy Code s 365(n).

16 King & Wood Mallesons *Submission* on the 2016 Government Proposals Paper.

- if a compromise or arrangement has been approved under Part 5.1, be made by the person appointed to administer the compromise or arrangement (proposed s 415F(2)(c)(ii)).

In the case of a VA, the application must be made by the administrator (proposed s 451G).

The court will be required to specify the period for which this additional restriction applies (proposed ss 415F(3), 451G(3)) and any court-ordered restriction will not be able to apply:

- for longer than the period specified for the suspension of ipso facto clauses (proposed ss 415F(3), 451G(3))
- to rights that would fall within one of the specified exceptions to the ipso facto restrictions (proposed ss 415F(4), 451G(4)).

In considering an order for this stay on enforcement, a court will be able to give an interim order (proposed ss 415F(5), 451G(5)), but not require an undertaking as to damages as a condition for granting the interim order (proposed ss 415F(6), 451G(6)).

3.11.2 Ashurst submission

Ashurst supports this court anti-avoidance power, which is preferable to a general anti-avoidance provision that would run the risk of endangering legitimate commercial arrangements.

3.12 Provision for those in control of a company to consent

3.12.1 Draft Bill approach

The draft legislation does not provide for the directors or a scheme administrator (in the case of a scheme of arrangement) or an administrator (in the case of a VA) to permit the enforcement of an ipso facto clause.

3.12.2 Ashurst submission

The legislation should enable those in control of a company during the scheme of arrangement process and an administrator or deed administrator to permit the enforcement of an ipso facto clause.

This would be analogous to the ability of an administrator to consent to the exercise of third party property rights (*Corporations Act* s 440B(2)) or to a proceeding in a court against the company or the company's property (*Corporations Act* s 440D(1)).

There should be protection against liability to damages in respect of a refusal to give consent (cf *Corporations Act* s 440E).

Yours faithfully

Ashurst Australia