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

Comments by Australian Bankers' Association (ABA)

April 2017

1. Safe harbour for insolvent trading

The ABA is broadly supportive of the proposed regime.

1.1 Section 588GA(2)

We do, however, suggest some changes to clarify this proposed section as marked up below in red.

For the purposes of (but without limiting) subsection (1), in working out (including by the Court) whether a course of action is reasonably likely to lead to a better outcome for the company and the company's creditors, have regard to whether the person:

a) is taking appropriate steps to prevent any misconduct by officers or employees of the company that could adversely affect the company's ability to pay all its debts; and

b) is taking appropriate steps to ensure that the company is keeping appropriate financial records consistent with the size and nature of the company; and

c) is obtaining appropriate advice from an appropriately qualified entity who was given sufficient information to give appropriate advice; and

d) is properly informing himself or herself of the company's financial position; and

e) is developing or implementing a plan for restructuring the company to improve its financial position in a timely manner.

2. Stay on enforcement rights merely because of arrangements, restructures or administration.

As noted previously, the ABA broadly accepts the concept of an "ipso facto stay" of termination of a company's commercial contracts to preserve value in financially distressed entities for the benefit of all creditors.

The ABA confirms its feedback provided to Treasury on its Draft Working Document on 25 November 2016 that a stay on reliance/enforcement of an ipso facto clause triggered by an insolvency event (as described in the Working Draft Document) should be made rather than rendering the relevant clause void. The Draft Working Document stated that as part of the NISA the Government's commitment was to make ipso facto clauses "unenforceable during a restructure." Imposing a stay rendering an ipso facto clause unenforceable during the period of a restructure and ensuring that the clause cannot be reinvigorated if the restructure is successful (key performance criteria to be determined) would achieve the same outcome as making the ipso facto clause unenforceable during the restructure period. The ABA's additional restriction ensures the clause could not be reinvigorated where the restructure is successful. Otherwise, a successful restructure could be undone where an ipso facto clause is revived.

However, the ED Bill (if passed as drafted) would substantially alter some fundamental aspects of Australia's corporate insolvency law. The ABA wishes to highlight its concerns with these changes for the reasons discussed below.

2.1 Secured creditor's right to appoint a receiver

The ABA has strong concerns that the ED Bill will significantly undermine section 441A of the Corporations Act and therefore greatly reduces the scope for Australian financiers and particularly banks to appoint a receiver in circumstances where they have security over "all or substantially all" of a company's assets.

If implemented as drafted, the ABA is concerned the ED Bill would result in significant changes in the Australian commercial secured lending landscape. These changes may include:

a) a material increase in the cost to financiers in secured lending to Australian companies particularly cash flow lending; and

b) implications for many Australian companies which are higher risk businesses accessing funding due to the risk to financiers of not having their loan security rights protected are they are currently under section 441A of the Corporations Act.

In a draft working document provided by Treasury to the ABA for discussion purposes in October 2016, it was indicated that –

There are many types of contracts where the continued operation of ipso facto clauses may be required" such as *"Contracts providing for the enforcement rights of creditors holding security over all or substantially all of a company's assets or where creditors are permitted under existing law to enforce their security (including by appointing a receiver to the company) following the appointment of an administrator to the Company".*

The ED Bill is a clear departure from this working draft proposal.

2.1.1 Implications

It is not certain that a financially distressed company will be turned around to operate viably. There needs to be a better balancing of the rights of secured creditors and the company which under the ED Bill seems to prefer the uncalculated chance of the company's success over the known risks faced by secured creditors.

2.1.2 Banks' expectations of loss

One effect of this reform appears to subject a financier such as a bank to a voluntary administration regime unless another event is available to the bank for the appointment of a receiver within the 10 day decision period under s.441A of the Corporations Act).

A bank's average expectation of loss on all secured loans to Australian companies is likely to increase materially.

This could lead to a higher "loss given default" being ascribed by banks than would presently be the case with associated impacts on a bank's capital allocation and pricing of credit facilities provided to Australian companies. For higher risk businesses, access to funding may be affected.

2.1.3 Pre-emptive appointments and other consequences

Secured creditors are likely to move more quickly in appointing receivers to avoid this right being stayed due to the appointment of an administrator. In fact, the same may be said of companies appointing an administrator to thwart an anticipated receivership. Neither scenario is an appropriate outcome.

Further, this could lead to less earlier communication between the secured creditor and the company where the company's financial difficulties become evident.

Anticipating the risk of losing the right of enforcement provided under s441A secured creditors may be less prepared to waive defaults by companies under their loan documents. These outcomes appear to be inconsistent with the policy rationale behind this reform.

2.2 Secured creditor's associated loss of value

An additional disadvantage for the financier arose in the 2015 decision of the Supreme Court of New South wales In the matter of Bluenergy Group Limited (subject to a Deed of Company Arrangement)

(administrator appointed) [2015] NSWSC 977 (21 July 2015) (see also at http://www.austlii.edu.au/au/cases/nsw/NSWSC/2015/977.html.

The court held that a deed of company arrangement limited a secured creditor's security to the assets existing when the deed was passed. This meant the secured creditor's charge would no longer capture later "future assets" (which, practically speaking, the secured creditor's security position would diminish.

Currently, the ability for secured creditors to appoint receivers can help to avoid this diminution but they must do so within the 10 day decision period set out in section 441A.

The ABA's position is that in order to preserve and protect a secured creditor's security which will be put at risk if the ED Bill becomes law as presently drafted the law should go on to provide a specific exemption to allow a secured creditor to appoint a receiver if a voluntary administrator has been appointed. Additionally, if a secured creditor elects to do so, it should be made clear that the secured creditor is not prevented from exercising any default related acceleration or termination rights.

To amend the law so that the decision period does not start until there is an event of default that the secured lender may rely upon, would not address the Bluenergy Group security risk problem for the secured creditor if the administrator were to continue to service a secured loan during the administration (thereby avoiding any additional defaults) until such time as a DOCA is executed. The secured creditor would have to wait until this point (DOCA execution) to appoint its receiver but would be subject to the relevant security risk arising from the confinement of assets.

2.3 Receivership – ipso facto stay should apply also

The ABA submits that a receivership should also receive the benefit of an ipso facto stay to prevent the termination of a company's commercial contracts in order to achieve the objective of preserving value in a distressed company.

The potential termination of a company's commercial contracts merely because a receivership has commenced impacts not only secured creditors but also unsecured creditors who, arguably, are even more dependent on the preservation of company value when any insolvency process commences.

The preservation of the company's value also benefits its employees.

2.4 Other aspects

There are several drafting aspects in the ED Bill on which the ABA would welcome clarification or further explanation.

2.4.1 Section 451E (6)

Under section 451(E) (6) more clarity is needed on what "the provision of additional credit" means. It is unclear whether this applies to further credit drawn under an existing approved limit or just new credit.

The ABA submits this clause should clearly capture any further drawing under any existing bank credit arrangement.

2.4.2 Section 451G - Orders for rights to be enforceable only with leave of the Court

If the right under section 441A for a secured creditor holding security over all or substantially all of the assets of the company to appoint a receiver is intended to be preserved and not affected by the proposed stay, it should be made clear in the Bill that the Court would not be able under section 451G to interfere with that right.

Further, while section 451G is intended to be an anti-avoidance provision, the ABA believes that this section should not prevent a bank from relying on its right to enforce its contract with the company by reason of the company's default in complying with a term of the contract.

2.5 Regulations

The Explanatory Memorandum states that the Government is proposing to make regulations to set out types of contracts and contractual rights which will be excluded from the broad stay operation on the

operation of ipso facto clauses. This will apply in addition to the general exclusions in relation to certain financial products set out in the ED Bill.

The Government is seeking feedback on the appropriateness of the proposed exclusions and whether further exclusions may be warranted.

The ABA makes the following submissions in its response subject to us considering submissions of other stakeholders seeking further exclusions.

2.5.1 Set off

The right of set off has been included in the list of proposed exclusions to the stay applied to ipso facto clauses.

The ABA supports the position that set-off rights as well as a bankers' right to combine accounts will be available in all circumstances, to secured and unsecured creditors. For example, situations can exist where a bank continues to provide unsecured transactional facilities and would only do so where set-off or a banker's right to combine accounts, is available. One consequence would be that if bank lenders were required to wait until the end of the administration, set off rights would lose priority to administrators' liens for their fees and disbursements.

The proposed list of contracts to be prescribed covered by the regulations (as being excluded from the operation of the stay) should also ensure that associated rights of acceleration under those contracts, where they exist, which can be exercised, subject to any existing limits on enforcement of that accelerated amount that already exists at law (such as the regimes for voluntary administration and receivership).

2.5.2 Margin lending

The enforcement of margin lending facilities is time critical with dynamic and potentially volatile securities markets. This right of enforcement in margin lending should be added to the list of excluded financial products to which the stay does not apply.

2.5.3 Financial markets products

The Explanatory Memorandum indicates the Government policy is to exclude close-out netting contracts such as ISDA Master Agreements and other "agreements under the Payment Systems and Netting Act (Netting Act) from the stay. It is noted that this phrase isn't used in the Netting Act or other Acts.

Current legal opinion is that the manner in which these agreements are excluded differs from the approach which has been taken in other legislation. The current drafting of the ED Bill applies the stay to all contracts, agreements or arrangements (including Master Agreements), and will exclude these agreements through the regulations. This approach could cause some conflict with the provisions of the Netting Act which provide that the protections of the Netting Act apply "despite any other law".

The primacy of the protections of the Netting Act is important to banks as it is essential for the conclusions in netting and collateral legal opinions to ISDA.

Further, the primacy of the operation of and protections afforded by the Netting Act is critical not only to the financial stability of banks but also the effective operation of netting arrangements already established in relation to payment and settlement systems, such as RTGS systems, ASX Settlement and Austraclear and certain approved stock exchanges, clearing facilities and central clearing counterparties. The protections afforded by the Netting Act also extend to the enforcement of security provided under collateral arrangements with financial markets counterparties.

For these reasons, it is critically important that the ED Bill clarifies its interaction with the protections of the Netting Act. The legal opinion with which the ABA agrees and submits as its view is for the ED Bill to specifically state that:

"If there is any inconsistency between this Act and the Payment Systems and Netting Act 1998, the Payment Systems and Netting Act 1998 prevails to the extent of the inconsistency."

This aligns with the approach already taken by the Australian legislature in other Acts, including the Personal Property Securities Act 2009 (Cth) and would be consistent with the existing policy of the Australian Government which would ensure that the protection of key financial market infrastructure and arrangements under the Netting Act continues to apply in a clear manner.

In addition, by way of additional technical legal drafting recommendations, the ABA's view is that –

a) the definition of "specified provisions" in the Netting Act should be amended to include those sections of the Corporations Act which trigger the stay (i.e. sections 415D and 451E). This will enable the amendment to align with the existing provision of the Netting Act that provides for it to apply, "despite any other law (including the specified provisions)", and

b) the "contracts, agreements and arrangements" which should be excluded from the stay, should include-

   i) RTGS systems

   ii) approved netting arrangements

   iii) close-out netting contracts, and

   iv) Market netting contracts

all of which are referred to in the Netting Act, as well as all other arrangements and contracts protected by the Netting Act, such as the security granted in respect of close-out netting contracts and market netting contracts. By way of comment, current legal views are that the provisions of sections 415D(4)(c) and 451 (4)(c) while intended to exclude close-out netting contracts from the operation of the stay, use the terms, "commercially necessary" and "manages financial risk" will not be easy to apply to specific derivative agreements and transactions, in practice.

2.5.4 Conracts under Cape Town Convention ("CTC")

We understand that a further exclusion will be proposed to ensure that the ED Bill will not be inconsistent with the provisions of the CTC relating to mobile equipment which has been adopted into Australian law and its associated Protocol.

The ABA submits that the primacy of CTC should be recognised or, alternatively for the regulations to exclude all CTC contracts from the proposed stay provisions.

In the interest of certainty, the ABA supports and agrees with the view that all transactions in respect of aviation transactions covered under the CTC should be excluded. To limit the exclusions relating to CTC contracts to leasing, financing and sale transactions would be to disregard the interests of secured parties under security agreements in connection with secured loan facilities, the interests of purchasers under contracts of sale and the interests of sellers under conditional sale agreements and assignments of associated rights in connection with international and national interests intended to be covered under the CTC.

Otherwise, market participants will seek to use one particular type of structure which will not be distorted by differential treatment as a consequence of the ED Bill.

An over-riding section should be inserted into the ED Bill which recognises this principle in order to give market participants the certainty and stability required to give effect to the objects of the International Interests and Mobile Equipment (Cape Town Convention) Act (Cwth) 2013. This is consistent with the approach taken in other Commonwealth legislation, for example the Personal Property Securities Act.