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Treasury Laws Amendment (2017 Enterprise Incentives No. 2) Bill 2017 - Submission to Treasury from Clayton Utz

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1. Introduction

This submission is prepared by Clayton Utz in response to the Australian Government's release of draft legislation namely, the Treasury Laws Amendment (2017 Enterprise Incentives No. 2 Bill) 2017 (**Bill**), which seeks to reform Australia's insolvency laws.

As a general comment, we welcome the Government's initiative to reform Australia's insolvency laws and the introduction of the Bill to reform Australia's current insolvency trading laws which currently focus on stigmatising and penalising failure. The Bill goes a long way to drive cultural change and encourage directors to engage early with a possible insolvency to facilitate a company's recovery to achieve a better outcome for all stakeholders at the same time giving directors a real, flexible and viable alternative to placing a distressed company prematurely into voluntary administration or liquidation driven by a director's fear of personal liability for insolvent trading.

2. Chapter 1, Schedule 1, Part 1 - Safe harbour for insolvent trading - section 588GA

Subject to our comments below, we support the proposed amendments to the *Corporations Act* 2001 (Cth) (**Act**) in Schedule 1, Part 1 of the Bill (by the insertion of the new section 588GA). We believe the language of section 588GA will be effective in creating a safe harbour for company directors from personal liability for insolvent trading under subsection 588G(2) of the Act, where a company is undergoing a restructure.

Whilst the intention and object of the existing Voluntary Administration (Part 5.3A of the Act) legislation is to maximise the chances of survival of an insolvent company, we agree that the appointment of an administrator, often by directors who are more concerned and focused on their personal liability under section 588G (where the threshold is "*reasonable grounds for suspecting*"), is value destructive making it harder for the company to restructure and continue to operate for the benefit of the company and its creditors.

2.1 Section 588GA, Safe harbour - taking course of action reasonably likely to lead to a better outcome for the company and its creditors

We note and support the safe harbour amendments to operate as a carve out from the civil insolvent trading provisions of section 588G(2) of the Act (para 1.11 of the Explanatory Memorandum of the Bill) rather than operate as a defence. However, the wording of the section as currently drafted could be clearer that it is intended to operate as a crave out rather than a defence with the word "defence" removed from the notes to section 588GA.

(a) Suspects the company may become or is insolvent

The proposed safe harbour protection as currently drafted in subsection 588GA(1) of the Bill, seeks to provide protection (outside of a formal insolvency process) to a director who at the time when the debt is incurred <u>suspects</u> the company <u>may become or be insolvent</u> and who then takes reasonable steps to restructure the business and allow it to trade out of its difficulties.

As a first limb therefore, a director is to ask whether the company may become or be insolvent and whether the company can be restored to solvency by taking a particular course of action likely to lead to a better outcome for the company and its creditors. This test is similar to and appears consistent with that under section 436A of the Act, which similarly provides a company may appoint an administrator where the opinion of the directors is that the company is insolvent or likely to become insolvent.

We support the avoidance of the use of indicia of reasonable grounds of solvency, which often involves complex accounting or legal questions that may be beyond the personal expertise of directors such that a director would be required to have a "reasonable expectation" of the ability of the company to pay its debts as and when they fall due. That requires more than a suspicion and there exists judicial guidance as to the meaning of "*suspicion*" as it was considered in *Queensland Bacon Pty Limited v Rees* (1965) 115 CLR 266, to be an actual apprehension, mistrust or fear that the company is insolvent.

The subjective criteria used in the carve out of section 588GA, although inconsistent with the approach to the insolvent trading defences available under the Act (which have subjective and objective tests), is more appropriate where a course of action is to be taken to lead to a better outcome for the company and the company's creditors.

(b) **Reasonably likely to lead to a better outcome**

We agree that the course of action taken by a director not be prescriptive and we support the flexibility that the list of factors set out in subsection 588GA(2) of the Bill provides.

It is not clear however, how these factors are to be applied or whether they are matters that a Court is to consider when determining whether safe harbour has been properly invoked.

In addition, the phrases "*appropriate steps*" , "*appropriate advice*" and "*appropriately qualified entity*" are not given any guidance in the Explanatory Memorandum as to what is meant by the word "*appropriate*". We do not believe it is entirely clear, whether a subjective or objective test (or one or the other) is to be applied to the word "appropriate" however, rather than be dictated by legislation we suggest that some further guidance be given as to its meaning in the Explanatory Memorandum to the Bill.

(c) **Appropriately qualified entity**

There appears to be no provision in the Bill for the disqualification of an insolvency practitioner, who may be acting as the "appropriately qualified entity" assisting the director to develop or implement a plan for restructuring to the director in safe harbour, from subsequently taking an appointment as a voluntary administrator to the company under section 436A of the Act.

As the aim of safe harbour is to provide a viable alternative to voluntary administration, if the amended legislation were to prohibit an "*appropriately qualified entity*" if a registered insolvency practitioner, from subsequently taking an appointment as a voluntary administrator to the company, we believe that this would increase the willingness of the "*appropriately qualified entity*" to effectively implement any restructuring plan or develop a new restructuring plan, rather than simply placing the company into some form of external administration.

(d) **Restructuring plan**

Also included in the section 588GA(2) list of factors to be considered by a director in working out whether a course of action is reasonably likely to lead to a better outcome, is the development or implementation of a restructuring plan to improve the company's financial position. Whilst the Explanatory Memorandum to the Bill says that it is not necessary for all of the factors listed in subsection 588GA(2) to apply for a director to have the protection of safe harbour and whilst we are in favour of not having a prescriptive list, it ought be necessary that not only the directors be developing a restructuring plan likely to lead to a better outcome but also, that the legislation provide the directors <u>take reasonable steps towards implementing</u> the restructuring plan.

(e) **Risk to new creditors**

At paragraph 1.36 of the Explanatory Memorandum to the Bill, it is said that the safe harbour may apply to a director even where the end result of taking on additional debt as a part of the course of action, is a worse outcome for the company and its creditors, so long as the course of action was reasonably likely to lead to a better outcome.

In many informal workouts, the interests of creditors and the company will be aligned, as the continuation of the company in existence provides scope for creditors and shareholders to receive their full entitlements in due course. However, where the interests are not aligned, the interests of creditors should be paramount, given the risk of actual or imminent insolvency.

In some instances where safe harbour might be utilised, it is likely that a company will take on additional debt as part of the director's course of action reasonably likely to lead to a better outcome. The issue then for the director under section 588GA is, that in considering if the course of action is likely to lead to a better outcome, the director must not just consider existing creditors but also new creditors who engaged with the company after it entered safe harbour and who will bear the evidential burden if the director wishes to rely on the safe harbour in any proceedings for contravention of section 588G(2) of the Act.

It is not clear under the Bill what impact safe harbour has for those new creditors who engaged with the company for a period of time after it entered safe harbour (at the time the director suspected the company may become or be insolvent) and whether they will be subject to voidable transactions such as any unfair preference claims by a liquidator appointed to the company. There may be a real risk to creditors dealing with a company during a safe harbour period of serious loss if a company is in safe harbour, who may be forced to return payments received during the safe harbour period.

Whilst those new creditors who began engaging with the company after it entered safe harbour will be entitled to rely upon the defences to any voidable/unfair preference claims under section 588FG of the Act, we are of the opinion that the current draft Bill should reflect that during the safe harbour period, it should be the creditors who are in most need of protection and reflected in the definition of section 588GA(5). We recommend that this be achieved by removing the words "*both the company and*" from the definition of a better outcome in subsection 588GA(5).

(f) **Safe Harbour within a corporate group**

Whilst a solvent restructuring of a company or a corporate group is considered to be the best outcome for the company and the company's creditors as a whole, we query whether section 588GA of the Bill allows a restructuring that utilises former insolvency of one or more companies in a corporate group given the definition of a "better outcome" in subsection 588GA(5). Such circumstances described may become apparent when dealing with larger restructurings and give rise to some complexity.

3. Chapter 2, Schedule 1, Part 2 - Stay on enforcement rights merely because of arrangements or restructures

Subject to our comments below we support the proposed amendments to the Act in Schedule 1, Part 2 of the Bill. We believe the amendments will be a positive step towards a more flexible regime in which to effect company restructures aimed at preserving goodwill and value in enterprises where the entity concerned may be in financial distress, but the underlying business remains commercially viable.

We consider the "ipso facto" provisions under Part 2 of the Bill as going hand-in-hand with the "safe-harbour" provisions under Part 1 of the Bill and recommend, subject to what is stated below, that any amendments to the one Part must be made in the context of any implications such changes may have on the other. In particular, we consider that in order for directors to be able to develop a restructuring plan and work within the safe harbour protections, they will need certainty in relation to any potential termination of contracts under ipso facto clauses whilst the restructuring plan is being implemented (and prior to any application for a scheme or appointment of an administrator). In this regard please note our comments in part 3.2 below.

3.1 Automatic Stay on enforcement

We note that the period of the stay begins and ends within the time periods set out in Sections 415D(2) and 451E(2) respectively, subject to an application for extension order in the case of Section 451E(3).

We query the need for a legislated end-date for the stay, if the potential result is that a contract counterparty would be entitled to terminate the relevant contract after the "restructure" (whether by way of scheme or administration) had been successfully completed and the entity had been restored to financial health. This would appear to be contrary to what the draft legislation is seeking to achieve.

We recommend a change to the Bill which allows for the stay to be permanent other than in circumstances where the scheme or the administration ends because of a resolution or order for the relevant entity to be wound up.

3.2 Insolvency events

We note that the proposed insolvency events under Part 2 of the Bill that will trigger the stay on enforcement are limited to:

(a) Part 5.1 bodies that apply for a scheme of arrangement under Section 411 of the Act; and

(b) companies that enter into administration.

We query whether such limited application will have the desired effect which the legislation is seeking to achieve. In this regard we note that other jurisdictions have chosen to adopt a far wider approach in relation to the "Insolvency Event" that triggers the operation of the stay.

Most commercial contracts that rely on an "Insolvency Event" as a right on termination will include a comprehensive definition that will extend further than these two limited events. An example of such a definition may read as follows:

> ***Insolvency Event*** *means:*
>
> *(a) a controller (as defined in section 9 of the Corporations Act), administrator or similar officer is appointed in respect of a person or any asset of a person;*

(b) a liquidator or provisional liquidator is appointed in respect of a person;

(c) any application (not withdrawn or dismissed within 7 days) is made to a court for an order, an order is made, a meeting is convened or a resolution is passed, for the purpose of:

(i) appointing a person referred to in paragraph (a) or (b) of this definition;

(ii) winding up or deregistering a person; or

(iii) proposing or implementing a scheme of arrangement, other than under a solvent scheme of arrangement pursuant to Part 5.1 of the Corporations Act;

(d) any application (not withdrawn or dismissed within 7 days) is made to a court for an order, a meeting is convened, a resolution is passed or any negotiations are commenced, for the purpose of implementing or agreeing:

(i) a moratorium of any debts of a person;

(ii) any other assignment, composition or arrangement (formal or informal) with a person's creditors; or

(iii) any similar proceeding or arrangement by which the assets of a person are subjected conditionally or unconditionally to the control of that person's creditors or a trustee,

or any agreement or other arrangement of the type referred to in this paragraph (d) is ordered, declared or agreed to;

(e) as a result of the operation of section 459F(1) of the Corporations Act, a person is taken to have failed to comply with a statutory demand (as defined in the Corporations Act);

(f) any writ of execution, garnishee order, mareva injunction or similar order, attachment or other process is made, levied or issued against or in relation to any asset of a person;

(g) anything analogous to anything referred to in paragraphs (a) to (f) inclusive of this definition, or which has a substantially similar effect, occurs with respect to a person under any law; or

(h) a person is, or admits in writing that it is, or is declared to be, or is taken under any applicable law to be (for any purpose), insolvent or unable to pay its debts.

The practical consequence is that any contract counterparty which exercises its right to terminate under an ipso facto provision at a time where one of the other "Insolvency Events" has occurred (including, for example, the appointment of a receiver) but prior to the appointment of an administrator or the date of an application for a scheme of arrangement will not be prevented from doing so under the Bill.

Further, it is not clear from the Bill whether termination based on one of the other "Insolvency Events" should be possible once application for a scheme of arrangement had been made or an administrator had been appointed. As currently drafted, we believe that such termination would be possible and the stay would not operate to prevent such termination. Thus, for example, the appointment of a receiver within the "decision period" under s441A of the Act would effectively "lift the stay". Note, however, our comments in relation to secured lenders and receivership under section 3.3(b) below.

We also note that the Bill does not seek to address a circumstance where, having so exercised a right of termination under an "Insolvency Event" which is not catered for by the Bill, the entity in question is subsequently placed into administration or the subject of a scheme of arrangement. We would suggest that in such a circumstance, any termination in reliance on an ipso facto provision within a certain period prior to the appointment of an administrator or the lodgement of an application for a scheme, should equally be subject to the automatic stay (with retrospective effect) as is the case in the US.

Lastly, we acknowledge (and support the provisions) that court orders may be sought under sections 415F and 451G respectively to deal with termination rights other than a scheme or administration, but note that such relief is only available once the relevant entity is already the subject of a scheme or in administration and as such any such court order will be of little use in relation to any termination or purported termination immediately prior to the date of application for the scheme or the date of appointment of the administrator, as applicable.

3.3 Excluded Contract types under subsection 415(D)(4) and 451(E)(4)

We agree that it is appropriate to prescribe the types of contracts which are excluded from the stay in the regulations so that the legislation is sufficiently flexible to address the changing landscape of financial products.

We have considered the current list of types of contracts and contractual rights which are proposed to be excluded from the stay on operation of ipso facto clauses and provide our commentary in relation to specific proposals (and in our view certain omissions) below.

We acknowledge that the proposed list sets out only specific categories of types of contracts and contractual rights and that in due course further detail will need to be included in the draft regulations at the appropriate time. As such our commentary is limited to questions and recommendations with respect to these categories at a general, conceptual level.

(a) **Securitisation arrangements involving special purpose vehicles**

We support the inclusion of the listed exemptions which appear to us to be sufficient to cover securitisation flip clauses. It is not clear, however, the extent to which this would cover more indirect rights such as termination of the appointment of service providers, or title perfection following a "Title Perfection Event", on the occurrence of the prescribed insolvency events. We submit that further detailed work is required in order to fully address all relevant provisions under securitisation arrangements which will be affected.

(b) **Acceleration of loans and enforcement of security by creditor having security over all or substantially all of the assets of the debtor**

The current draft of the Bill does not include a specific exception which would allow lenders under a typical credit agreement to accelerate their loans. Whilst sections 415D(6) and 451E(6) are helpful in providing a stay on the entity's right to additional credit, there does not appear to be any exception allowing lenders to accelerate, nor does the Bill appear to make any distinction between the rights of unsecured lenders and secured lenders to the relevant entity. It appears that both classes of lender would be treated in the same manner and would be stayed from accelerating their loans and, in the case of secured lenders, enforcing their security. We are not sure that it was the intention under the Bill to go this far, since the Bill contains no provisions dealing with the protection of lenders to an entity in such circumstances in the way that lenders are protected under Chapter 11 in the US.

It is also not clear to us how the stay on enforcement will apply to the ability of a secured creditor with security over the whole, or substantially the whole of the debtor's property to enforce its security by appointing a receiver to the debtor during the "decision period" under s441A of the Act. If the intention is to prevent such a creditor from enforcing its security and appointing a receiver, then we query what the purpose of the "decision period" under section 441A of the Act will have going forward. This does not appear to have been contemplated in the Bill.

In our view, a stay on enforcement should not apply to a secured creditor with security over the whole, or substantially the whole of the debtor's property who wished to accelerate its loan and enforce its right to appoint a receiver in such circumstances.

Equally, we believe that the stay on enforcement should not apply to a secured creditor with security over only part of the debtor's property where the secured creditor is exercising its rights of enforcement with the consent of the administrator under section 440B of the Act.