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24 April 2017

Email

Dear Mr Mason

National Innovation and Science Agenda – Improving Corporate Insolvency Law – Insolvent Trading Safe Harbour and *Ipso Facto* Reforms

Thank you for the opportunity to respond to Treasury's proposed amendments to the *Corporations Act 2001* (Cth) in relation to an insolvent trading safe harbour and *ipso facto* restrictions. We attach the submission of Herbert Smith Freehills.

If you would like to discuss any aspect of the submissions, please do not hesitate to contact us.

Yours sincerely

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Improving Corporate Insolvency Law Exposure Draft – submission to Treasury from Herbert Smith Freehills

24 April 2017

Submission from Herbert Smith Freehills

1 Introduction

This submission has been prepared by Herbert Smith Freehills in response to the Australian Federal Government's (**Government**) draft legislation released on 28 March 2017 in relation to two major reforms to Australia's insolvency laws (the **Draft Legislation**).

The Draft Legislation comes about following the Government's public consultation process in relation to its Improving Bankruptcy and Insolvency Laws Proposal Paper (**Proposal Paper**) which was released 29 April 2016. The Proposal Paper made proposals in relation to an insolvent trading safe harbour, *ipso facto* restrictions and the bankruptcy period for individuals. The Government called for responses in relation to the issues and focus questions contained in the Proposal Paper.

On 30 May 2016, Herbert Smith Freehills made submissions to Treasury on the Proposal Paper (**Previous Submission**), outlining the background to which the proposals were made, and recommendations in response to the focus questions contained in the Proposal Paper.

Set out below in this submission are our observations, comments and recommendations on the Draft Legislation.

Our submission and the observations herein are based on our extensive experience acting on both the 'front end' of large, complex financial and other commercial transactions in which the risks of potential insolvencies must be considered and satisfactorily negotiated in order for the transactions to be successfully concluded, and a large number of significant corporate restructuring, distressed debt and formal insolvency transactions in Australia and in other jurisdictions around the world. Herbert Smith Freehills is a top tier international law firm with market-leading commercial and restructuring, turnaround and insolvency practices both nationally and globally. In Australia, our national team has advised on a number of the significant corporate restructuring transactions and complex insolvencies in the last 10 years, including advising:

- TPG on the restructuring and recapitalisation of the Alinta Energy Group;
- Centro Properties Group on its restructuring;
- the senior lending syndicate on the fully consensual restructuring and recapitalisation of the I-MED Network group;
- Goldman Sachs, as holder of mezzanine bonds, on the restructuring of Nine Entertainment Group;
- the administrators and liquidators of the Retail Adventures Group in relation to its administration and subsequent liquidation;
- Seven Group Holdings in respect of its acquisition of debt interests in Nexus Group and the subsequent 'DOCA takeover' of the Nexus Group;
- the receivers of SubZero Group Limited;
- Liberty Metals & Mining LLC in relation to the administration of, and deed of company arrangement for, Cockatoo Coal Limited;

- Arrium Limited in relation to its proposed restructuring and recapitalisation and advising the initial administrators to Arrium Limited in relation to the administration of the Arrium group; and
- the senior lenders to, and receivers of, the Keystone Group.

A number of members of our restructuring, turnaround and insolvency team in Australia have also practised in other jurisdictions, including the United Kingdom (**UK**) and the United States of America (**USA** or **US**), and have accordingly had significant experience with the restructuring and insolvency systems in those jurisdictions.

2 General comments

As a general comment, we welcome the Government's initiative to introduce legislation to improve Australia's insolvency law regime. We are supportive of reform that allows greater flexibility to restructure businesses and encourages corporate rescue.

However, there remain a significant number of issues arising from the detail of the reforms contained in the Draft Legislation. We discuss below a number of these issues that we think require further consideration and where appropriate make some suggestions in respect of adjustments to the Draft Legislation.

We also note the reforms contained in the Draft Legislation are relatively narrow. In our view more significant review and reform of Australia's insolvency laws, in relation to matters other than the proposed insolvent trading safe harbour and stays on *ipso facto* clauses, is warranted, especially in light of the much more substantive reforms being undertaken in other jurisdictions.

In particular, we noted in some detail in our Previous Submission a number of key reforms that should be made to Australia's creditor scheme of arrangement procedure to make it more effective as a restructuring tool. Since the date of our Previous Submission many of these suggestions have been enacted by Singapore, as part of a broad reform package intended to make Singapore an international hub for debt restructuring.

We therefore encourage the Government to undertake a much more fundamental review of Australia's restructuring and insolvency laws, akin to the Harmer Report.[1]

3 Insolvent trading safe harbour

3.1 General comments

As a general comment, we welcome the introduction of legislation which provides for a safe harbour for directors from insolvent trading claims.

We also welcome a move away from the requirement to appoint an 'appropriately experienced, qualified and informed restructuring adviser' (or 'harbour master'), one of the hallmarks of the proposed 'Model A' set out in the Government's Proposal Paper. In our view, it is important that any safe harbour is flexible enough to allow protection for directors who are pursuing sensible good faith steps regardless of the size of and resources of the company.

We make the following observations at the outset:

[1] Law Reform Commission, General Insolvency Inquiry, Report No 45 (1988) ('Harmer Report').

- The legislation already contains a reasonable expectations defence to insolvent trading under section 588H(2) of the *Corporations Act 2001* (Cth) (**Corporations Act**). If a further defence is to be introduced, it should be clear as to whether this is separate and distinct in terms of its requirements and purpose. We are concerned that the proposal is not sufficiently clear in this regard which may lead to the two defences becoming fused in practice. As currently proposed, it is likely that in most cases and based on existing judicial authority, compliance with the requirements with section 588GA would be sufficient to satisfy the ‘reasonable expectation’ defence in section 588H. There is a danger that the safe harbour requirements will become the de facto minimum standard in which case they may fail to achieve their intended purpose by merely making the existing defence more prescriptive.
- It is unclear what situations this defence is intended to apply in and what it is intended to solve. The Draft Explanatory Memorandum and Draft Legislation suggest the purpose of the safe harbour is to encourage restructures outside of formal processes – i.e. to fully consensual restructurings only. Consensual restructurings are frequently undertaken with respect to the capital structure of large corporates with substantial indebtedness to sophisticated financial creditors. However, in our experience, fully consensual restructuring is not realistic for many distressed SMEs where corporates may have a range of financial and operational creditors that are difficult to coordinate without a formal process. If the safe harbour defence is limited to fully consensual restructurings then its application will be limited and for the reason stated above it may operate as an impediment to restructuring with the assistance of a formal process.

3.2 Specific comments

(a) Exception or defence (section 588GA(3))

In our submission, some clarification is required as to whether it is proposed that the safe harbour operates as an exception or a defence. We note that:

- Section 588GA(1) provides that section 588G(2) (the civil penalty provision) does not apply to debts incurred within the protection of the safe harbour. As such it operates as an exception rather than a defence (which is the correct approach in our submission – a safe harbour which has as its starting point a *prima facie* commission of a civil penalty offence would be a perilous port) notwithstanding that the director bears an evidential burden of establishing the operation of the exception. This is consistent with the statement in the Draft Explanatory Memorandum (paragraph 1.11) that the safe harbour operates as a carve-out from the insolvent trading provisions in section 588G(2);
- However, the Draft Explanatory Memorandum and Draft Legislation are replete with references to the ‘defence’ in section 588GA (for example, by amending section 588E(8)(d) to refer to section 588GA, by specifying as such in the notes to section 588GA and in the text of section 588GB and by amending the heading of section 588H to read ‘Other Defences’).

In our Previous Submission we stated that we consider it preferable for the safe harbour to operate as a ‘carve out’ rather than a defence. Our view remains as such, as the safe harbour operating as a carve-out will help underline that there should not be stigma attached to taking proper steps. We therefore strongly support amendments to the Draft Legislation and Draft Explanatory Memorandum such that it is clear that the provisions operate as a carve-out.

> ***Recommendation 3.2(a):*** *The Draft Legislation and the accompanying Draft Explanatory Memorandum are clarified such that the safe harbour operates as a carve-out. This will require amendments to the proposed section 588H and the removal of the word 'defence'.*

(b) 'Better outcome' test – 'the company' (section 588GA)

Section 588GA(1)(a) proposes that insolvent trading liability will not apply to a director if the person starts taking a course of action that 'is reasonably likely to lead to a better outcome for the company and the company's creditors'. 'Better outcome' is defined in section 588GA(5) as being, for the company and the company's creditors, an outcome that is better for both the company and the company's creditors as a whole than the outcome of the company becoming a Chapter 5 body corporate.

In our view, it is not clear why there is a reference to 'the company' in determining whether the course of action is a 'better outcome', or what this means if distinct from the company's creditors.

We assume it is not intended to connote that the outcome needs to be better for shareholders given that (in most cases) shareholders will no longer have an economic interest in the company at a time when the company is unable to pay its debts.

In our Previous Submission, when responding to the question posed about the appropriate test for determining viability, we submitted that:

- in restructuring, the fundamental question is whether the business (or a substantial part of it) is viable on a going concern basis;
- this requires consideration as to whether the business itself is, or can be, feasibly restructured to become profitable;
- viability of the business may not necessarily involve the continuation of the company itself; and
- the ability to return the company to solvency may not always be the correct measure of a successful restructuring; rather, it may be more appropriate to consider the treatment of the company's stakeholders, and whether the restructuring offers creditors a better outcome.

We reiterate those submissions.

Whilst we welcome the move away from the concept of viability, in our view the reference to 'the company' in determining a better outcome does not factor in the realistic possibility that in many cases the corporate entity itself may not survive the restructuring. A definition of 'better outcome' that requires a better outcome for the company risks directors not being able to achieve that outcome for creditors if the course of action required to achieve that outcome ultimately results in the company entity becoming a Chapter 5 body corporate.

We therefore submit that it would be clearer to refer to the 'company's creditors as a whole' rather than to both the company and the company's creditors.

> ***Recommendation 3.2(b):*** *The reference to 'the company' is removed from the reference to 'better outcome' in the bill and in the accompanying legislative documents.*

(c) 'Better outcome' test – Chapter 5 body corporate (section 588GA(5))

The definition of 'better outcome' in section 588GA(5) requires the outcome to be better than the outcome of the company becoming a Chapter 5 body corporate.

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We note that the definition of Chapter 5 body corporate in section 9 of the *Corporations Act* is broad and includes a company:

- that is being wound up;
- in respect of property over which a receiver, or a receiver and manager, has been appointed;
- that is under administration;
- that has executed a deed of company arrangement (**DOCA**) that has not yet terminated; or
- that has entered into a compromise or arrangement with another person, the administration of which has not been concluded.

As discussed above, in our experience, most restructurings in Australia involve the use of one or more of the processes referred to in the definition of 'Chapter 5 body corporate'. Therefore, requiring that the course of action achieves a better outcome than the entity becoming a Chapter 5 body corporate sets the test unrealistically high. We recognise that this may be the intention as the Draft Explanatory Memorandum states that the aim of the safe harbour protection is to facilitate more successful company restructures outside of formal insolvency process (paragraph 1.25) but if the protection is limited to fully consensual restructurings only it will have limited application.

Furthermore, it would be difficult for a director to evaluate the availability of the safe harbour (and therefore whether to continue pursuing a restructuring) at the time of safe harbour as to whether the course of action is better than the outcome under all of the Chapter 5 tools. Does this require a director to consider all of the possible outcomes under any of the Chapter 5 regimes? Is this realistic given the possible outcomes that may result from any or all of those regimes, and the timing that may be involved in making such decisions? Any 'contra-factual' comparator needs to be clear and reasonably certain so it can be applied in practice, especially given parties will be under stress, time pressure, significant uncertainty and delay in the restructuring process.

In our submission, given that consensual restructurings generally involve similar elements to a DOCA, the relevant comparator should be the same, namely liquidation. We consider it would be simpler and clearer to require that the course of action is reasonably likely to lead to a better outcome for creditors as a whole than the liquidation of the company. The effect of section 588(1)(b) will be that this test should be required to be satisfied on an ongoing basis so that if the course of action ceases to be reasonably likely to provide a better outcome than liquidation, the safe harbour protection will cease.

Recommendation 3.2(c): *The words 'the company becoming a Chapter 5 body corporate' should be removed from the definition of better outcome in section 588GA(5) and replaced with the words 'the liquidation of the company'.*

(d) End of safe harbour – timing (section 588GA(1)(b))

We understand that it is proposed, under section 588GA(1)(b), that the safe harbour will come to an end at the earliest of any of the following times:

- when the person ceases to take that course of action;
- when that course of action ceases to be reasonably likely to lead to a better outcome for the company and the company's creditors; or
- when the company becomes a Chapter 5 body corporate.

As stated above, in our submission it is possible for a restructuring to be pursued, or a course of action to be adopted, notwithstanding the company becoming a Chapter 5 body corporate. However, it is not clear that all of those steps would relieve a director from insolvent trading liability. It is clear that appointment of an administrator or liquidator would do so, but the position is less clear (and/or will depend on the factual circumstances) in respect of the appointment of receivers, or entry into a compromise or arrangement. Accordingly, we think that this limb should be limited to when an administrator or a liquidator is appointed to the company.

Recommendation 3.2(d): *Section 588GA(1)(b)(iii) be amended to state 'when an administrator or liquidator is appointed to the company'.*

(e) Incurring new debts

The new section 588GA does not provide explicit guidance on the extent to which directors are required to turn their minds to the appropriateness of incurring new debts. In this regard we note that the Draft Explanatory Memorandum states:

> *Where a director takes on debt from new creditors and they do not believe they can repay the debt in accordance with its terms this would be ostensibly a breach of the general director's duties as well as being dishonest. As such, a director would not be protected in relation to incurring debts of this nature*.[2]

The Draft Explanatory Memorandum also indicates that the phrase 'the company's creditors as a whole' is intended to cover both existing creditors and new creditors (as a result of incurring new debt).[3] However, there is a natural tension between the two groups – existing creditors might be better served by trading on, but generally new creditors will not (unless they are paid in full).

If the Draft Explanatory Memorandum is to be read literally, the safe harbour would offer little additional protection to directors from insolvent trading liability as there is likely to be at least uncertainties as to whether creditors will be paid in full. This tension, and the inescapable trade off, needs to be recognised in formulating any policy regarding insolvent trading. We note in this regard that most other jurisdictions have adopted a policy position which is more comfortable with the possibility of losses being suffered by new creditors of the company.

Recommendation 3.2(e): *Discussion in the Draft Explanatory Memorandum should be adjusted to reflect the reality that a safe harbour means directors will incur debts that they do not know they can repay.*

(f) Appropriately qualified entity (section 588GA(2)(c))

In our Previous Submission we suggested that, if a restructuring advisor was to be required (something which we did not recommend), the directors should determine who is an appropriately qualified and experienced adviser, after having regard to the nature and unique circumstances of the business. We also noted that we considered it important that directors have the flexibility to appoint restructuring advisers that are appropriate to their circumstances. We do not see merit in prescribing this any further.

[2] Draft Explanatory Memorandum, Treasury Laws Amendment (2017 Enterprise Incentives No, 2 Bill) Bill No. X, 2017, 14 [1.40].

[3] Draft Explanatory Memorandum, Treasury Laws Amendment (2017 Enterprise Incentives No, 2 Bill) Bill No. X, 2017, 13–14 [1.39].

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(g) Providing for employee entitlements (section 588GA(4)(a))

We note that it is envisaged that the safe harbour does not apply if the company is failing to ‘provide for the entitlements of its employees’ to a standard that would be reasonably expected of a company that is not at risk of being wound up in insolvency.

We have concerns about this requirement for a number of reasons.

In our view, it is not clear what ‘providing for the entitlements of its employees’ means. The Draft Explanatory Memorandum does not provide any further clarity other than suggesting it means that these entitlements are ‘provided for’ or ‘met’.[4] Does this mean that money for all employee entitlements not yet due is to be set aside? Solvent companies do not generally set aside specific funds to satisfy employee entitlements that will become payable in the future. If this is intended it should be made explicit but given employee entitlements include accrued and untaken leave, retrenchment and termination payments, it is unlikely to be feasible for a company which is already at risk of insolvency to set aside additional funds to satisfy employee entitlements. Alternatively, if the requirement is that the company continue to meet its obligations to employees when due during the safe harbour period (including superannuation payments) this should be explicitly stated.

Employees already have protection from actions undertaken with the intent of preventing or reducing the recovery of entitlements under section 596AA of the *Corporations Act.* That provision will continue to apply when a company is trading in a safe harbour. Employees are also afforded priority in a liquidation under sections 556 and 561 of the *Corporations Act*. A better outcome test which has liquidation as its comparator as recommended above will require directors to monitor on an ongoing basis that the course of action being undertaken is reasonably likely to provide a better outcome to employees than liquidation.

Recommendation 3.2(g): *The requirement to ‘provide for the entitlements of employees’ in section 588GA(4)(a) should be clarified.*

(h) Debts incurred with pursuing the course of action

Section 588GA(1)(b) protects directors from liability for a debt that is incurred in connection with the course of action. The Draft Explanatory Memorandum makes references to ‘debts’ generally in parts, suggesting that the phrase ‘incurred in connection with the course of action’ may be intended to cover all debts incurred in the ordinary course of business whilst the course of action is being taken.

If the safe harbour does not cover all debts incurred in the ordinary course of business then the protection afforded to directors will be illusory.

We recommend that this is further considered and clarified. At the very least, we suggest that debts incurred ‘in connection with’ the course of action include debts incurred in the ordinary course of business.

Recommendation 3.2(h): *The concept of what debts are incurred ‘in connection with’ the course of action should be clarified.*

[4] Draft Explanatory Memorandum, Treasury Laws Amendment (2017 Enterprise Incentives No, 2 Bill) Bill No. X, 2017, 9 [1.17], 15 [1.45]–[1.47].

(i) Holding companies

We note that the Draft Legislation and Draft Explanatory Memorandum have not dealt with how the proposed safe harbour will impact on the liability of holding companies under section 588V of the *Corporations Act* for the insolvent trading of subsidiaries.

As the liability of a holding company does not depend on the liability of the directors of the subsidiary for insolvent trading under section 588G, it appears that the holding company could be liable for insolvent trading while the directors of the subsidiary may have the safe harbour available to them. We submit that consideration should be given to whether a safe harbour for holding companies should exist and on what terms it should operate.

Recommendation 3.2(i): *The insolvent trading safe harbour should apply to holding companies that would otherwise attract liability under section 588V of the Corporations Act.*

(j) Unfair Preferences

Consideration also needs to be given to the position of suppliers and other creditors of the company. The effect of section 588GA is that directors will be protected whilst the company seeks to develop and implement a restructuring plan which will inevitably require engagement with some or all of the company's creditors. During this period, it is likely that creditors will obtain information which will prevent them from relying on the defence in section 588FG to an unfair preference claim. We submit that consideration should also be given to whether or to what extent creditors should be afforded protection during the safe harbour period recognising that a blanket protection could also be open to abuse.

Recommendation 3.2(j): *That consideration be given to what protection, if any, creditors who deal with the company during a safe harbour period are to be afforded protection from unfair preference claims by a subsequent liquidator.*

(k) Commencement of safe harbour protection

In its proposed form, section 588GA applies if at a particular time after a person starts to suspect insolvency, the person starts taking a course of action. It is currently unclear if the safe harbour protection applies if the directors have commenced developing or implementing a restructuring plan before suspicion of insolvency arises. For clarity, we recommend that section 588GA be amended so that it applies where the person 'is taking or starts to take' the relevant course of action.

Recommendation 3.2(k): *That proposed section 588GA(1)(a) be amended by inserting the words 'is taking or' after the words 'the person' where second appearing in the subsection.*

4 *Ipso facto* clauses

4.1 General comments

As a general comment, we are supportive of reform to introduce a stay on the operation of *ipso facto* clauses in appropriate circumstances. We note that the Draft Legislation differs from the proposals contained in the Proposal Paper.

In our Previous Submission, we recommended that the operation of an *ipso facto* prohibition apply only in certain circumstances, as opposed to a general 'anti-avoidance' provision. We are pleased to see that the general anti-avoidance provision has been replaced with a prohibition that applies to the specific circumstances. However, there is further work to be done in clarifying and extending the scope of the prohibition to ensure it works as intended and there are appropriate exceptions and protections for stakeholders.

We also note that when considering the manner in which the *ipso facto* regime applies to administration and schemes of arrangement, it should be borne in mind that these are quite different processes. For example, administration is a formal insolvency process subject to the appointment of an independent administrator. In contrast, a scheme of arrangement process is not a formal insolvency process and the board and management stay in control of the company.

4.2 Specific comments

(a) Factual insolvency (section 451E)

The draft section 451E only creates a stay on the operation of *ipso facto* clauses by virtue of the company entering into administration. However, as noted in our Previous Submission, it is unclear whether a prohibition in this form will prohibit the operation of clauses that are triggered by other factors such as when a company is factually insolvent (i.e. unable to pay its debts), or its financial position has otherwise deteriorated.

Almost every company in administration will be factually insolvent prior to, and during, the company's entry into administration. As the draft section 451E is only triggered when a company is under administration, it is unlikely this will be effective if counterparties can still exercise their *ipso facto* rights upon the factual insolvency or financial condition of a company.

The automatic stay in the United States Chapter 11 process is more broadly framed in order to address this issue. It provides at section 365(e)(1):

> *Notwithstanding a provision in an executory contract or unexpired lease, or in applicable law, an executory contract or unexpired lease of the debtor may not be terminated or modified, and any right or obligation under such contract or lease may not be terminated or modified, at any time after the commencement of the case solely because of a provision in such contract or lease that is conditioned on —*
>
> (A) ***<u>the insolvency or financial condition of the debtor at any time before the closing of the case</u>****;*
>
> (B) *the commencement of a case under this title; or*
>
> (C) *the appointment of or taking possession by a trustee in a case under this title or a custodian before such commencement.* [emphasis added]

If an *ipso facto* regime is to be introduced in respect of administration, we expect this will not be workable in practice unless the regime also prevented the operation of *ipso facto* clauses in situations where they are triggered solely because of the insolvency or financial condition of the company at any time before or during its administration.

However, as in the United States, the *ipso facto* regime should not operate to prevent counterparties from exercising their contractual rights in relation to other events such as non-payment of the counterparty of an amount due.

Consideration could also be given to whether a similar approach is appropriate in respect of schemes of arrangement under section 415D. However, schemes of arrangements are not formal insolvency processes, they typically only effect certain creditors of the company and the company is not subject to independent control and supervision during the scheme process. Accordingly we do not think it is necessary to extend the *ipso facto* prohibition to situations where a contract is terminated or modified due to the scheme company's factual insolvency or financial condition.

Recommendation 4.2(a): *If an ipso facto regime is to be introduced in respect of voluntary administration, consideration should be given to whether it needs to be more broadly framed to be effective in practice. In particular, consideration should be given to whether section 451E should provide that, once a company has entered administration, counterparties cannot exercise their rights under an ipso facto clause by virtue of a company's factual insolvency or financial condition, either before, or during, formal entry into administration.*

(b) Receiverships – should there be an *ipso facto* regime for receivers appointed in response to administrator appointments?

Under the Draft Legislation, the *ipso facto* prohibition does not apply in respect of receiverships. Technically receivership is a security enforcement mechanism rather than a corporate rescue regime for the benefit of all creditors, and therefore there is consistency in principle that receivership is excluded from the *ipso facto* regime.

However, in practice, receivership is a common regime in Australia pursuant to which practitioners often try to sell the business on a going concern basis. It is common for companies in receivership to be subject to a parallel administration, either because the directors appoint an administrator following the receiver's appointment, or because a secured creditor holding all assets security chooses to appoint a receiver 'over the top' of an administrator following the administrator's appointment.

Typically in a scenario where a receiver is appointed either before or after a voluntary administrator, the receiver will take primary control of the company for the benefit of the secured creditor and the administrator will take a 'back seat'. In these circumstances, the receiver effectively obtains the benefit of the voluntary administration moratorium.

Assuming the appointment of receivers (or other security enforcement action) is to continue to be permitted by holders of security over the whole, or substantially the whole, of a company's property (see discussion below) following its appointment of an administrator, there is a question as to whether an *ipso facto* prohibition should apply in respect of the appointment of such receivers (or other controllers) when appointed to a company in administration.

Without such an *ipso facto* prohibition applying to receivers (or other controllers) in such circumstances, the administration *ipso facto* prohibition could effectively be circumvented by counterparties terminating on the basis of the appointment of the receivers (or other controllers) rather than on the basis of the appointment of the administrators.

In our view, the facilitation of value protection justifies the *ipso facto* restrictions that apply under the Draft Legislation to administrations to also apply in cases where a secured creditor appoints a receiver (or other controller) following the appointment of an administrator. This would help preserve value in such situations and could assist in enabling the business to be sold as a going concern with key contracts in place which may, in some circumstances, result in surplus funds for unsecured creditors.

Recommendation 4.2(b)*: Consideration should be given to whether any receiver (or other controller) appointed following the appointment of administrators also has the benefit of an ipso facto regime, such that counterparties are not able to use the appointment of such receiver (or other controller) as justification for terminating contracts with the company.*

(c) DOCAs (section 451E)

A DOCA is essentially a restructuring plan between a company in administration and its creditors. It is the means by which a company can successfully restructure and exit administration.

The Draft Legislation does not contain explicit *ipso facto* restrictions in respect of DOCAs. This differs from the approach contemplated by the Proposal Paper.

We note that this raises a policy question as to whether the *ipso facto* stay is intended to merely give the company 'breathing space' following the appointment of an administrator, or whether it is intended to prevent counterparties from terminating in response to a DOCA that may affect their contractual rights.

The latter approach is essentially the regime adopted pursuant to Chapter 11 under the US Bankruptcy Code, and appears to be the approach adopted in the draft legislation in respect of schemes of arrangement.

Assuming this is the Government's intended approach, it would also be consistent for the *ipso facto* prohibition to apply to a company entering into a DOCA.

We do not think that any further protection, such as protections for factual insolvency or financial difficulty (as considered in relation to a company entering into administration) should apply in relation to the DOCA *ipso facto* prohibition as the ongoing financial condition of the company should have been resolved by the terms of the DOCA once it takes effect (and the financial condition of the company until that point could be addressed by virtue of the administration *ipso facto* regime).

Recommendation 4.2(c): *The ipso facto prohibition should apply to a company entering into a DOCA. There is no need for the prohibition to be extended to situations of factual insolvency or financial difficulty once the DOCA takes effect.*

(d) Liquidation

Under the Draft Legislation, the *ipso facto* prohibition does not apply directly to the situation where a company enters into liquidation. However, under draft sections 415D(2)(b)(iii) and 451E(2)(c) the period of the *ipso facto* stay may be extended to the situation where the company is wound up.

It is unclear whether it is intended that the stay should extend until the conclusion of the winding up of the company, or whether the stay extends until the point when the winding up begins. If the wording in section 509 of the *Corporations Act* were included – '[when] the affairs of the company are fully wound up' – this could clarify the meaning to be given to the section. However, for the reasons discussed below, we do not think it makes sense to extend the *ipso facto* stay to liquidation.

On either interpretation of the section, it is unclear what is intended to be achieved by including an *ipso facto* stay extension in relation to the winding up of the company. It also results in an inconsistency where the stay applies to liquidations following administration, but not where liquidation is entered into immediately. We submit that there is no policy objective for this, and that the legislation should be amended to resolve the inconsistency.

In any event, we do not think that it is appropriate for the *ipso facto* restriction to apply to liquidations as they are not a business rescue procedure, and creditors and counterparties generally have self-help remedies available in a liquidation. The commencement of a liquidation usually also implies that the company is irredeemably insolvent and that its business has come to an end, such that there is no longer a need to preserve the going concern business by way of *ipso facto* restrictions.

In these circumstances it seems difficult to justify a restriction on *ipso facto* clauses where a company has entered liquidation on policy grounds.

Recommendation 4.2(d): *The ipso facto prohibition should not apply where a company enters into liquidation. Therefore, the extension of the stay to situations where the company is wound up should be deleted.*

(e) Schemes of arrangement and administration – period of the stay (sections 415D(2), 451E(2))

Under the Draft Legislation, the *ipso facto* stay will cease to apply where the scheme takes effect or the administration ends.

The consequence of this is that once the company has been successfully restructured counterparties could exercise their contractual rights to terminate, based on the *past* insolvency events, so long as their contractual rights did not require a *subsisting* insolvency event for their exercise.

Allowing for a more permanent stay on the operation of *ipso facto* rights will ensure that the regime is effective in promoting its objectives. It should be noted that under this recommendation, there would still be the option to have the stay lifted pursuant to the sections in the draft legislation where the criteria are met.

However, our recommendation for a permanent stay assumes that the parties are still entitled to exercise *ipso facto* rights upon the company entering liquidation. Accordingly, as noted above, the current proposal in the Draft Legislation that the stay may be extended to a winding up of the company should be deleted.

We note for comparative purposes that in Chapter 11 proceedings under the US Bankruptcy Code, there is a comprehensive regime applicable to the treatment of contracts to which the *ipso facto* prohibition applies. Broadly, this regime provides for the Chapter 11 debtor to assume the contract, assign it to a third party or ‘reject’ the contract, subject to certain conditions, exceptions and creditor protections. A Chapter 11 debtor is not required to cure pre-existing insolvency defaults in order to assume or assign the relevant contracts – thus avoiding the risk that currently exists under the proposed Australian legislation for historical *ipso facto* rights to be enforced after the restructuring.

Recommendation 4.2(e): *The ipso facto prohibition in connection with the appointment of an administrator or proposal of a scheme should operate on a permanent basis so that following a successful restructure historical ipso facto rights cannot be enforced.*

(f) Exclusions – enforcement of security over all or substantially all of the assets of the company

Currently, notwithstanding the administration moratorium, a person holding security over the whole or substantially the whole of the property of a company that has appointed an administrator may enforce that security within a short ‘decision period’ following that appointment pursuant to section 441A of the Corporations Act. This recognises that where the whole or substantially the whole of the company’s property has been provided as security to a creditor, that creditor has the first claim on its assets and business and accordingly should not be thwarted by the appointment of an administrator.

We assume that the Government does not intend to change this position by virtue of introduction of the *ipso facto* regime. If so, there will need to be a specific carve-out from the administration *ipso facto* restrictions allowing such secured creditors to enforce their security in response to a voluntary administration appointment during the decision period pursuant to section 441A.

We think it would be consistent with this approach for there also to be an exclusion to the *ipso facto* regime for schemes of arrangement to allow secured creditors with security over all or substantially all of the assets of the company to enforce their security in response to the proposal of a scheme of arrangement by a company.

Recommendation 4.2(f): *We assume the Government does not intend to change the existing policy position that secured creditors with security over all or substantially all of the assets of the company may appoint receivers to the company in response to the appointment of an administrator to the company during the 'decision period'. If so:*

1) *There should be an exception from the ipso facto regime for administrations that permits secured creditors with security over all or substantially all of the assets of the company to exercise their contractual rights to enforce their security during the 'decision period' following the appointment of administrators.*
2) *Consistent with 1), there should also be an exception from the ipso facto regime for schemes of arrangement that permits secured creditors with security over all or substantially all of the assets of the company to exercise their contractual rights to enforce their security in response to the proposal by the company of a scheme of arrangement.*

(g) Exclusions – administrator permission

Where a company is in administration, there should also be an exception allowing *ipso facto* rights to be exercised by counterparties with the consent of the administrator. Whilst this could be achieved in practice through agreement of the administrator and the relevant counterparty, we think it would be helpful for the legislation to include a 'short cut' to specifically allow this, and to make clear that parties would not need to seek court permission to exercise such rights if approved by the administrator.

Recommendation 4.2(g): Where a company is in administration, there should also be an exception allowing *ipso facto* rights to be exercised by counterparties with the consent of the administrator.

(h) Exclusions - acceleration and set-off rights (sections 415D(4), 451E(4))

The draft Explanatory Document indicates that set-off rights and a number of other similar arrangements are excluded from operation of the *ipso facto* restrictions. However, acceleration rights under loans and financial instruments (depending on their nature) are not necessarily excluded. This may limit the ability of counterparties to exercise set-off rights in question if not all of the debt sought to be set off is actually due.

This can be a particular issue in an administration where it has been held that an administrator can assert its lien in respect of amounts owed to the company in priority to rights of set-off exercisable by the relevant debtor, and accordingly the value of any right of set off will be effectively eroded as amounts due to accruing under the administrator accrue that are secured by the administrator's lien take priority to such set-off rights.

Recommendation 4.2(h): *Consideration should be given to whether the exercise of rights to accelerate or crystallise a debt should not be subject to the stay to the extent that it is required to exercise a right of set-off or other right protected by the exceptions.*

(i) Exclusions – lease contracts in respect of aircraft objects in aviation transactions (ss 415D(4)(b), 451E(4)(b), Explanatory Document)

The Explanatory Document indicates that lease contracts in respect of aircraft objects in aviation transactions (*International Interests in Mobile Equipment (Cape Town*

Convention) Act 2013 (Cth) (**CTC Act**) and *Protocol on Matters Specific to Aircraft Equipment*) are excluded from the operation of the *ipso facto* stay.

The CTC Act gives effect to the Convention on International Interests in Mobile Equipment (**Convention**) and the Protocol to the Convention on International Interests in Mobile Equipment on Matters Specific to Aircraft Equipment (**Protocol**). It ensures an uniform application of the international legal framework created by the Convention, thereby creating certainty for those involved in the investment in high value mobile objects. Importantly, the CTC Act provides that to the extent of any inconsistency with other Commonwealth laws, the Convention and Protocol are to prevail.

We think it is consistent with the objects of the CTC Act that all transactions and interests covered by the CTC Act and Convention are excluded from the operation of the *ipso facto* prohibition, not just leasing transactions. A range of interests and agreements fall under the CTC Act and Convention, including the interests of secured parties, purchasers and sellers in relation to security, title reservation, sale and leasing agreements. It would create uncertainty for parties to transactions covered by the CTC Act if leasing transactions operated differently to other CTC Act transactions as a result of the *ipso facto* prohibition. As the CTC Act aims to achieve uniformity, we think that such a recommendation is consistent with its objects.

In addition, we think it is appropriate for the draft legislation to include a provision which states that to the extent of any inconsistency the CTC Act prevails. We note that the *Personal Property Securities Act 2009* (Cth) (**PPSA**) contains such a statement, and the CTC Act also provides that the Convention and Protocol prevail in the event of inconsistency. This would reflect the object and purpose of the CTC Act and ensure uniformity throughout the regime.

Recommendation 4.2(i)(i): *The excluded list of contracts in relation to aircraft objects in aviation transactions should include all transactions under the International Interests in Mobile Equipment (Cape Town Convention) Act 2013 (Cth) and not just those relating to lease contracts.*

Recommendation 4.2(i)(ii): *The draft legislation should contain a provision which states that to the extent of any inconsistency the CTC Act prevails.*

(j) Operation of stay on contractual rights and obligations (sections 415D(1), 451E(1))

The draft provisions now focus on contractual rights that are enforceable merely because of the occurrence of certain insolvency events (as opposed to the Proposal Paper that referred to termination or amendment of contracts).

It is therefore unclear whether other modifications to the rights and obligations of parties that occur under the terms of the contract upon the insolvency event are restricted or not. For example, would the discharge or extinguishment of a right or obligation upon the occurrence of a relevant insolvency event be permissible? If not, counterparties could potentially draft around these provisions by, for example, stating that a contract automatically terminates upon either party entering administration.

Recommendation 4.2(j): *The stay on ipso facto clauses should apply such that no contractual right or obligation should become enforceable, unenforceable or otherwise modified in its operation merely because of the occurrence of the relevant insolvency event.*

(k) Stay on right to additional credit (sections 415D(6), 451E(6))

In our Previous Submission, we recommended that appropriate safeguards for creditors be considered in order for them to contractually manage debtor insolvency risk. We are pleased to see that the Government has taken on board these concerns in providing that counterparties are not obliged to provide additional credit when restricted from exercising their *ipso facto* rights. While we think it is important to include appropriate safeguards in this regard, any such exceptions need to be carefully considered and clearly delineated.

Further, clarification will be needed as to the exact terms and scope of this stay. The following questions arise in relation to the Draft Legislation:

- Does the 'provision of additional credit' just refer to the advancing of actual funds to the company, or does it also include any contractual arrangement where the company pays in arrears?
- How would fluctuating balances be treated – for example would this permit a lender to refuse a 'rollover' of an existing loan (where it technically involved a repayment and readvance) or refuse to operate an overdraft within the balance on the date of the relevant insolvency event?
- Would a company be permitted to continue operating within existing credit limits with trade creditors?

Recommendation 4.2(k): *The terms of the stay on the right to additional credit under sections 415D(6) and 451E(6) should be given further consideration and clarified.*

(l) Lifting the stay (sections 415E, 451F)

The Draft Legislation provides that the stay on the operation of *ipso facto* clauses may be lifted if the court is satisfied this is 'in the interests of justice'.

However, there is no guidance in the Draft Legislation as to what this means, or what principles would be relevant to assessing the competing interests of the parties when assessing whether the stay should be lifted.

In the context of an administration, the stay on *ipso facto* clauses has a similar purpose to the stay on enforcement of security and other property rights contained at section 440B of the *Corporations Act*. Consideration should be given as to whether similar principles should apply to lifting the *ipso facto* stay as to the court giving leave to a third party exercising stayed property rights during an administration.

Recommendation 4.2(l): *Guidance should be provided in the legislation or explanatory memorandum as to the approach a court should take in determining whether the stay on an ipso facto should be lifted in the interests of justice.*

5 Concluding remarks

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