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Dear Sir

National Innovation and Science Agenda: Improving Corporate Insolvency Law – Submission in Relation to Exposure Draft of Implementing Legislation

Thank you for the opportunity to make a submission on the exposure draft of the legislation (**Exposure Draft**) designed to implement the Australian Government's insolvency law reform package originally set out in its 2016 'Improving Bankruptcy and Insolvency Laws Proposals Paper' (**Proposals Paper**).

We note that Jones Day previously made a submission in relation to the Proposals Paper.

A – Safe Harbour Reforms

1. As we noted in our Proposals Paper submission, Australia has arguably the strictest insolvent trading laws in the world. The existing substantive liability provision in section 588G of the *Corporations Act 2001* (Cth) (**Act**) has, in our experience, had a strong deterrent effect on corporate risk-taking, creating significant uncertainty for directors with respect to their possible personal liability and causing risk-averse behaviour which has led in many cases to a company's premature entry into a formal insolvency process.

2. To that extent, the proposed safe harbour reforms in the Exposure Draft are an improvement on what presently exists. However, to achieve a true cultural shift which enhances the prospect of corporate and/or business rescue and which encourages responsible risk-taking by directors, it is necessary for directors to be provided with clear and unambiguous guidelines about the circumstances in which their personal liability may arise.

3. We are concerned that, in several respects, the Exposure Draft does not provide the required clarity.

'The person' starts taking a course of action

4. First, the threshold requirement for insolvent trading liability for a director is that the *company* incurs a debt.[1]

5. However, according to proposed sections 588GA(1)(a) and 588GA(1)(b) of the Exposure Draft, the safe harbour will apply when a debt is incurred when:

   at a particular time after the person starts to suspect the company may become or be insolvent, 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 (emphasis added).

6. On their face, sections 588GA(1)(a) and 588GA(1)(b) of the Exposure Draft could be taken to authorise a director, of his or her own volition, to commit a company to a course of action without having obtained the approval of the company's board of directors as a whole or otherwise complying with the company's constitution (a typical 'rogue director' scenario).

7. That cannot have been the intention of the Government. To ensure consistency with section 588G(1)(a) of the Act, as well as established legal corporate governance doctrine which upholds the primacy of a company as a separate legal entity and compliance with a company's internal governance processes, the Exposure Draft should be amended so that:

   (a) section 588GA(1)(a) applies when *the company* starts taking a course of action that is reasonably likely to lead to a better outcome for the company and the company's creditors; and

   (b) section 588GA(1)(b) applies when the debt is incurred *by the company* in connection with that course of action.

'Better outcome'

8. Second, 'better outcome' is defined in section 588GA(5) of the Exposure Draft to mean an outcome that is better for *both* the company *and* the company's creditors as a whole than the company entering external administration. We believe that this definition will cause confusion for directors and that it is inconsistent with current legal standards.

9. In that regard, the courts have recognised that, while ordinarily the interests of the 'company' are taken to mean the interests of its present and future shareholders as well as the interests of the company as a commercial entity, when the company is operating in the 'zone of insolvency', the interests of the company correspond with the interests of its creditors.[2] While the precise scope of the 'zone of insolvency' has not been

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[1] Section 588G(1)(a) of the Act.

[2] See, for example, *Spies v R* (2000) 201 CLR 603 and *Westpac Banking Corporation v The Bell Group Ltd (in liq) (No 3)* [2012] WASCA 157.

determined by the courts, it is clear that it extends at least to where there is a real and not remote risk of insolvency.[3]

10. Accordingly, in the very circumstances in which section 588G of the Act and the proposed safe harbour provisions may be invoked, a company will be operating in the zone of insolvency and hence the interests of the company's creditors will take priority.

11. Yet, under the existing *cumulative* definition of 'better outcome', it could be argued that:

    (a) 'the company' means the company as a commercial entity and its shareholders, with creditors left in a separate category; and

    (b) the interests of shareholders are therefore equal to the interests of creditors in assessing what course of action is best for a company.

12. That is clearly inconsistent with the existing legal position. While, if it is possible for it to be achieved, an outcome that is in the interests of *both* the company as a commercial entity (including its shareholders) *and* creditors should be encouraged, to ensure consistency with existing law, which directors and practitioners have become accustomed to apply as the accepted industry practice for legal compliance purposes, we suggest the definition of 'better outcome' should be modified by adding the following phrase to the end of the existing definition:

    provided that, where there is any inconsistency between the interests of the company and the interests of the company's creditors as a whole, the interests of the creditors as a whole should prevail.

Prescribed matters in applying the safe harbour

13. Third, we believe that the five prescribed matters in section 588GA(2) of the Exposure Draft relevant to the court's assessment of whether a director has taken a course of action reasonably likely to lead to a better outcome for the company and the company's creditors as a whole appropriately reflect the material actions that a director should take in seeking to avail himself or herself of a safe harbour defence.

14. However, we note those matters are not conclusive and highlight in particular the statement in the explanatory memorandum to the Exposure Draft that:

    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.[4]

15. We do not believe this provides the certainty directors require to be prepared to pursue responsible risk-taking rather than prematurely causing a company to enter external administration. While we are not in favour of an irrebuttable presumption of a defence arising if the five prescribed matters are established, we believe the Government should explore alternative wording which, for example, would require 'clear and convincing'

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[3] See *Kalls Enterprises Pty Ltd (in liq) v Baloglow* [2007] NSWCA 191.

[4] Explanatory memorandum, paragraph 1.34.

evidence that a course of action was not reasonably likely to lead to a better outcome for the company and the company's creditors as a whole if the five matters are shown to exist. We believe this would provide additional certainty for directors to facilitate the stronger rescue culture in Australia which is the motivation of the Government's reforms.

B – Ipso Facto Reforms

Expanding the scope of the moratorium during a scheme of arrangement or voluntary administration

16. The primary moratorium with respect to ipso facto clauses is contained in sections 415D and 451E of the Exposure Draft.

17. Those sections apply automatically, without the need for the leave of the Court and subject only to an order of the Court lifting the moratorium upon the application of a counter-party, following a company's entry into (or an application relating to) a scheme of arrangement or the appointment of a voluntary administrator. We note the potential to extend the moratorium under section 451E(3) of the Exposure Draft if a deed of company arrangement is executed.

18. Crucially, however, the moratorium only prevents the enforcement of contractual rights (appropriately, we submit, not confined to *termination* rights) conditioned merely on an application relating to or entry into a scheme of arrangement or the appointment of a voluntary administrator.

19. Yet in practice, it is almost universally the case that counter-parties provide for a range of termination and other rights (such as modification of a contract or accelerated payments) conditioned far more broadly on the financial condition of a company, not just its entry into external administration. Common examples include where a company:

    (a) is subject to a 'material adverse change'; or

    (b) where a company becomes, or is 'likely' to become, insolvent.

20. On the current drafting of sections 415D and 451E of the Exposure Draft, a counter-party would not be automatically prevented from relying on contractual rights argued to be exercised on either of the above grounds, *separate* from any scheme of arrangement or period of voluntary administration.

21. This is in contrast to the ipso facto moratorium which exists in the context of a Chapter 11 proceeding in the United States (the broad equivalent of voluntary administration in Australia). In that regard, section 365(e)(1) of the *Bankruptcy Code* states:

    (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) the insolvency or financial condition of the debtor at any time before the closing of the case;

    (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.

22. We submit that it appropriate for the moratorium in sections 415D and 451E of the Exposure Draft to operate in similar circumstances, such that it extends to the exercise of a right under a contract, agreement or arrangement conditioned not only on an application or order in relation to a scheme of arrangement or the appointment of a voluntary administrator but also *any insolvency or financial condition of the company*.

23. In the absence of this extension, the prospect of a successful restructuring attempt is likely to continue to be undermined.

24. We recognise that sections 415F and 451G of the Exposure Draft are drafted to allow the Court to order a stay on the enforcement of contractual rights not *expressly* conditioned on a company's adoption of a scheme of arrangement or its entry into voluntary administration but where it can reasonably inferred that the rights are being exercised for that reason. The example provided in both sections is a right to terminate for convenience.

25. While we favour the retention of those provisions, we believe that the primary moratorium in sections 415D and 451E of the Exposure Draft should still extend to rights conditioned on a company's insolvency or financial condition. In those cases, a stronger rescue culture would be most optimally promoted by *automatically* imposing a moratorium rather than requiring an application to the Court for leave to extend the scope of the moratorium. The onus would then properly be on the counter-party, in circumstances where rights are conditioned on a company's insolvency or financial condition, to apply to the Court to lift the moratorium.

26. Necessarily, sections 415F(2) and 451G(2) of the Exposure Draft should also be amended (to facilitate rights to terminate for convenience and other 'catch all' rights) so that they also apply when the Court is satisfied that rights are being exercised or are likely to be exercised, or where there is a threat to the exercise of the rights, merely due to a company's insolvency or financial condition. That will ensure a counter-party cannot resort to 'catch all' rights, such as rights to terminate for convenience, to evade the scope of the ipso facto moratorium.

The need for a moratorium in other circumstances

27. Additionally, further to our Proposals Paper submission, we believe it is important for the ipso facto moratorium to apply during an informal restructuring attempt (when a director will seek to rely on the safe harbour pursuant to section 588GA of the Exposure Draft). This is not currently contemplated in the Exposure Draft, which limits the duration of the ipso facto moratorium to the period in which a scheme of arrangement is implemented or a period of voluntary administration (as extended by order of the Court under section 451E(3) during a period of deed administration).

28. It is one thing to introduce a safe harbour to encourage directors to pursue an informal restructuring attempt; it is quite another to ensure the support of a company's creditors for that restructuring attempt. If a key creditor or supplier does not wish to support a restructuring attempt and instead elects to enforce ipso facto rights, the appointment of a voluntary administrator, or possibly a liquidator, may be inevitable. Accordingly, if the ipso facto moratorium does not extend to informal restructuring attempts, the prospect of

a successful corporate and/or business rescue will be diminished, thereby undermining the primary motivation of the Government's insolvency law reform agenda.

29. We also believe the ipso facto moratorium should apply following the appointment of a receiver. This was originally contemplated by the Government in the Proposals Paper but has been omitted from the Exposure Draft.

We thank you again for the opportunity to make a submission in relation to the Exposure Draft. Please do not hesitate to contact us if you would like to discuss any matter raised in this submission in further detail.

Yours faithfully

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