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Restructuring

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Mr James Mason
Financial System Division
The Treasury
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By email: insolvency@treasury.gov.au

Dear Sir

Improving Corporate Insolvency Law – Exposure Draft 2017

This submission is made by KordaMentha. This submission supports the position outlined in the submission of the Australian Restructuring Insolvency and Turnaround Association ('ARITA') dated 24 April 2017.

We have not repeated ARITA's submission in its entirety but would like to specifically comment on the following in the context of KordaMentha's experience in large corporate insolvencies and restructurings:

PART 1 - SAFE HARBOUR FOR INSOLVENT TRADING

If the objective is to foster a turnaround culture and save businesses, then unquestionably the best course of action is to delete the section 588G Director's Duty to Prevent Insolvent Trading by Company (which we note is draconian even when benchmarked against global insolvency laws). Notwithstanding this we make the following comments.

Appropriately Qualified Entity

Whilst we note there are a number of factors to have regard to in the proposed s 588GA(2) in respect of working out whether a course of action is reasonably likely to lead to a better outcome for the company and the company's creditors, we are concerned in particular that there is currently no guidance on what or who constitutes an 'appropriately qualified entity'.

In the context of large corporate insolvencies and restructurings, (we recognise that the nature of advice may vary according to the size of a business and its circumstances), there should be a minimum base line for the notion of 'appropriately qualified'. The explanatory memorandum suggests that 'a large listed entity might retain an entire team of turnaround specialists, insolvency practitioners, and law and accounting firms to advise on a reasonable course of action'. This suggests that there is expected to be a base line of what or who constitutes an 'appropriately qualified entity' in these circumstances. We agree with ARITA's position that uninsured advisers should not be considered 'appropriately qualified'.

Debt incurred as part of the course of action

We are concerned there is some ambiguity in the drafting of s 588GA(1)(b). Neither the Exposure Draft nor the Explanatory Memorandum give comfort that debts incurred in the 'ordinary course of business' are covered by the wording '…incurred in connection with that course of action'. We agree with ARITA that there may be a narrow interpretation of that clause which would see the utilisation of the safe harbour provisions narrowed.

Section 588GA(4)

As currently drafted, there are difficulties arising from this subsection in determining whether a person is eligible for safe harbour.

The subsection creates a new standard or benchmark being the reasonable standard applied by a 'company that is not at risk of being wound up in insolvency'. What this means is unclear given the breadth of companies that may not be at risk of winding up and the wide variance in compliance standards across corporate Australia. Is the reference set to be those companies that have never been subject to winding up proceedings or is there a higher financial standard to be met to be a reference company? Even amongst wholly solvent companies, compliance standards for employee entitlements and taxation compliance vary widely. By applying a subjective test of whether a company has reasonably met its compliance obligations, the Exposure Draft creates uncertainty around whether directors may rely on the safe harbour provisions.

The uncertainty created by this subsection is further amplified by the language used when identifying the matters than 'must be being done to a reasonable standard' by that company.

Firstly, the company must be providing for the entitlements of its employees. The Exposure Draft indicates that entitlements will be defined by reference to subsection 596AA(2) and so the entitlements to be provided for include retrenchment and termination payments. However, the Exposure Draft does not define what is meant by 'providing' for these entitlements. The Explanatory Memorandum provides no more clarity on the meaning of 'providing' with various references to providing or having met employee entitlement obligations. Is it sufficient that any employee entitlements that have fallen due are paid when due? Is an accounting provision for entitlements sufficient even though accounting provisions do not usually extend to retrenchment and termination payments? Does it mean that the company needs to provide for the entitlements by fully cash backing or otherwise segregating sufficient value to protect all employee entitlements in the event of formal insolvency proceedings? If so, how are issues such as security interests over circulating assets or employees in corporate service companies to be considered?

An accounting provision for entitlements provides no real comfort for protection of employee entitlements. Compliance by a company in paying all employee entitlements that have fallen due is a good start for access to the safe harbour but it does little to protect unpaid employee entitlements from risk. Given the inclusion of retrenchment and termination entitlements in the definition of entitlements, is the intent that more is required than payment of entitlements falling due. Further, in respect to providing for entitlements, if providing means a requirement to fully secure all employee entitlements, that will be a liquidity hurdle that will further challenge a company facing solvency concerns as well as cause concern for companies that are not in financial distress The legislation then starts to impact on existing and well established accounting standards and the very definition of solvency.

Secondly, the company must comply with the taxation reporting obligations of the Income Tax Assessment Act 1997. It would seem a simple test to determine whether a company is compliant or non-compliant with its taxation reporting obligations. However, the subsection sets the compliance standard by reference to the hypothetical 'company that is not at risk of being wound up in insolvency'. The subsection should be amended to reflect clearly that all taxation reporting obligations must be up to date to obtain access to the safe harbour provisions.

To maximise the accessibility of the safe harbour provisions, we believe consideration should be given to:

- Excluding the new subjective test of the standards applied by a company that is not at risk of being wound up in insolvency.
- Making clear what the test is regarding 'providing' for employee entitlements. If the test is payment of all employee entitlements that have fallen due, that is a simple test that can be applied. If it is to fully secure payment of all employee entitlements if the company is subject to either voluntary administration or winding up, the legislation should set that test, even though it is likely that this will substantially limit the number of companies' directors that can access the safe harbour provisions.
- Excluding any reference test in relation to compliance with taxation reporting obligations. A company is either compliant or non-compliant by reference to the Income Tax Assessment Act 1997.

PART 2 – STAY ON ENFORCING RIGHTS MERELY BECAUSE OF ARRANGEMENTS OR RESTRUCTURES

Limitation of proposed changes to Schemes of Arrangement and Voluntary Administration

The explanatory memorandum includes discussion on the fact that the operation of ipso facto provisions can reduce the scope for a successful restructure, destroy the enterprise value of a business entering formal administration, or prevent the sale of the business as a going concern.

Loss of value through the operation of ipso facto provisions also occurs in Managing Controller appointments and use of these provisions can severely curtail a Managing Controller's ability to continue to operate a business on a 'business as usual' basis to then sell the business as a going concern. Generally, the sale of a business as a going concern maximises outcomes for creditors. We would like to see the operation of the stay extended to Managing Controller and Liquidation appointments (including Provisional Liquidation appointments) to maximise the chances of the sale of businesses as a going concern, which in turn maximises the returns available to creditors.

Only applies to contracts entered into after enactment date

We note that there will not be an immediate benefit in respect of the new legislation if the bulk of a company's contracts were entered into before the enactment date. It is likely to be a number of years before companies in financial distress will see the benefit of these changes. Consideration should be given to the stay extending to existing contracts in relation to new insolvency administrations which commence after the enactment date.

Yours faithfully

M. Korda

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