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Australia Chapter

24 APRIL 2017

TURNAROUND MANAGEMENT ASSOCIATION (TMA) AUSTRALIA RESPONSE TO SAFE HARBOUR EXPOSURE DRAFT LEGISLATION

1. SUMMARY - THE TMA SUPPORTS THE BILL

We refer to our previous submissions of 26 May 2016 (**First Submissions**) and 23 December 2016 (**Second Submissions**) in respect of the National Innovation and Science Agenda (**NISA**) inquiry into improving bankruptcy and insolvency laws. We are grateful that NISA has invited us to comment on the Treasury Laws Amendment (2017 Enterprise Incentives No 2) Bill 2017 (the **Bill**). We express our support for the Bill.

As foreshadowed, our submissions will focus solely on Schedule 1, Part 1 of the Bill: Safe Harbour for Insolvent Trading. We may provide submissions in relation to other aspects of the Bill at a later date.

2. OVERVIEW

The TMA supports the introduction of a Safe Harbour. The TMA considers that the Bill (subject to the amendments proposed below), when passed, will strike a better balance between the protection of creditors and encouraging the sort of reasonable risk taking by directors of Australian companies that will nurture the entrepreneurship that is necessary to usher in the next age of Australian economic prosperity.

The TMA hopes that the following submissions will be of assistance in finalising the Bill and assist in its speedy passage through the legislative process.

3. EARLY INTERVENTION – TIMING

The language employed in s 588GA will encourage the early implementation of a restructuring plan. The TMA welcomes this position.

Section 588GA presently provides that if "at a particular time after the person starts to suspect the company may become or be insolvent" s 588G(2) will not apply if the person starts taking a course of action that is reasonably likely to lead to a better outcome.

The TMA supports the intended timing. The time at which the director "starts to suspect the company may be or become insolvent" is an appropriate point at which the directors should to make an election between entry into Safe Harbour and Voluntary Administration.

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As expressed in our First Submissions, we consider that the "twilight zone" of insolvency is precisely the time during which there is the best prospect of restructure or turnaround through informal workout measures. This is because the company has not yet defaulted on obligations to major investors, bankers or trade counterparties and is not yet associated with the stigma of insolvency. There is a good chance of working with these key stakeholders to find an solution to the company's liquidity issues at this time.

However, we consider that the wording "at a particular time after" gives rise to some temporal imprecision and may result in unintended complexity in application and interpretation of the provision. We suggest that the section could be rephrased as follows:

> *Subsection 588G(2) does not apply in relation to a person and a debt if*
>
> *(a) ~~at a particular time after~~ within a reasonable time after the person starts to suspect the company may become or be insolvent, the person starts taking a course of action …*

4. CARVE-OUT VS DEFENCE

The TMA supports the carve-out structure proposed. As we have previously submitted, while a defence is a useful tool to promote the use of Safe Harbour, it may be cold comfort to directors (particularly directors of SMEs and start-ups) who are not properly insured or otherwise cannot afford to take the risk of being sued and defending their conduct in court.

The model adopted by the Treasury is clearly more than a defence as the directors will bear an evidential onus of establishing the steps they took to try to effect the restructure, while the liquidator will bear the legal onus of establishing that the director did not properly invoke Safe Harbour and proving the offence of insolvent trading.

However, we consider that the intended carve-out operation of the legislation could be made clearer on its face (without recourse to the explanatory memorandum). We consider that simplicity and clarity of drafting is important, particularly when viewed through the prism of directors seeking to comprehend their obligations and make full use of Safe Harbour.

4.1 Technical amendments

The TMA considers that the following technical drafting issues should be addressed in order to make the legislation clearer:

(a) removal of the word "defence" from the notes to s 588GA. The words "carve-out" could be substituted in its place; and

(b) use sign posting to clearly differentiate between s 588GA (as a carve-out) and s 588H (as a defence), including the use of clear headings to differentiate between the two sections.

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4.2 An additional leave requirement could be imposed

Further, the carve-out could be strengthened by requiring the liquidator to seek leave of the Court to bring proceedings against a director for insolvent trading under s 588G, in circumstances where the director has provided material in connection with the evidential onus under s 588GA.

This would provide directors with greater comfort. It would encourage proper record-keeping and re-inforce that the legal burden of proof in respect of s 588G rests squarely with the liquidator. It would also require the liquidator to fully assess the evidence provided by the director, and engage with the director as required to understand the steps taken during the Safe Harbour period without recourse to the Court. This engagement may bring matters to an early conclusion, but would still allow the liquidator to pursue directors who fall short at the first hurdle.

5. HOW ARE THE FACTORS IN S 588GA(2) TO BE APPLIED?

The TMA supports the list of factors provided by s 588GA(2). We consider that the list of factors recognise that the most effective and appropriate course of action will vary greatly depending on the size, complexity and nature of the relevant business.

However, it is presently unclear on the face of the legislation how the factors are to be applied. If they are matters that may be taken into account by the Court in assessing whether Safe Harbour has been properly invoked this could be made clearer, for example:

> *For the purposes of (but without limiting) subsection (1), in ~~working out~~ assessing whether a course of action is reasonably likely to lead to a better outcome ~~for the company and the company's creditors,~~*[1] *the Court may have regard to whether…*

6. THE POSITION OF HOLDING COMPANIES

Under section 588V of the Corporations Act, holding companies have a duty to prevent insolvent trading by their subsidiaries. In order to round off the application of Safe Harbour, holding companies should be absolved from their obligations under s 588V in circumstances where Safe Harbour is properly invoked by the directors of the subsidiary.

It would be an unfortunate (and likely unintended) consequence of the legislation if directors were impeded from taking advantage of Safe Harbour due to the holding company's concerns that should the restructuring plan fail, the holding company would be exposed to liability, even if the subsidiary directors were not.

[1] We also consider that since "better outcome" is a defined term, the references to "for the company and the company's creditors" throughout 588GA and 588GA(2) are unnecessary. In any event, we set out our proposed revision of the "better outcome" test more generally in section 2.5 below.

7. THE "BETTER OUTCOME" TEST

The TMA's most significant drafting comments relate to the definition of "better outcome" in subsection588GA(5) of the Bill.

While we appreciate that this test closely mirrors that recommended in our Second Submissions, having regard to the form of the draft Bill, the TMA considers that in the context of the current Bill, the present form of the test may have unintended consequences and should be reframed. We set out our reasons and propose some alternative drafting below.

7.1 Reference to "becoming a Chapter 5" body corporate

There are a wide array of outcomes provided for in Chapter 5 of the *Corporations Act*. Chapter 5 includes restructuring tools such as voluntary administration, schemes of arrangement and Deeds of Company Arrangement, in addition to liquidation.

While it is likely that as a practical exercise, the directors will weigh the entry into an informal work out against the alternative of appointing voluntary administrator, in our view, for simplicity, the "better outcome" test should be narrowed to a comparison against liquidation alone.

This would be consistent with various existing tests, including: the test for when creditors may approve a DOCA; the test for termination of a DOCA;[2] and the test for an order of payment that differs from that of s 556 of the *Corporations Act* and related provisions.[3]

As such, we recommend removing the reference to a "Chapter 5 body corporate" from the drafting, and instead substituting the word "liquidation".

Revising the test in this manner would allow the test to be more easily applied by reducing the variety of outcomes which directors (and their advisors) must consider in determining whether the "course of action" produces the requisite "better outcome" and would also take advantage of existing judicial guidance in its application.

7.2 Reference to "both" the company and its creditors

The draft test (if our amendments proposed above were implemented) would provide that a "better outcome" will mean an outcome that is:

> *"better for **both**:*
>
> (a) the company; and

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[2] See, eg, *University of Sydney v Australian Photonics Pty Ltd* (2005) 53 ACSR 579.

[3] See, eg, *Lam Soon Australia Pty Ltd (Administrator Appointed) v Molit (No 55) Pty Ltd* (1996) 14 ACLC 1737, 1750.

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(b) the company's creditors as a whole,

than <u>*liquidation*</u> ~~*the outcome of the company becoming a Chapter 5 body corporate.*~~*"*

[emphasis added]

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 all creditors and shareholders to receive their full entitlements in due course.

However, there is scope for a divergence of interests between classes of stakeholders. It may not always be possible for directors to deliver an outcome that is reasonably likely to be better for both each and every class of stakeholders. This is a very high bar, and in some cases may be unattainable. We provide some examples by way of illustration only.

7.3 **Competing interests between shareholders and creditors**

A particular course of action may benefit creditors over shareholders, for example the implementation of a restructuring plan that implements a "loan to own" strategy by creditors and results the dilution of existing shareholders' holdings, resulting in them receiving a significantly reduced return on their investment over time. In a complex restructuring, certain unprofitable or non-core aspects of the business may need to be jettisoned. This may take the form of a fire sale of the non-core business by way of fire sale of its shares, perhaps to the detriment and protest of minority shareholders.

Conversely, the course of action taken by a director may involve a restructure of assets within a corporate group that may benefit shareholders but deprive the unsecured creditors of recourse to a class of assets.

7.4 **Competing interests between classes of creditors**

Further, it is possible that a deal made in an attempt to restructure a company may benefit one class of creditors over another. This may be done with the best of intentions, for example a secured financier may postpone a loan maturity date or compromise some of its debt in order to maximise the chance of the company's continued existence, while unsecured trade creditors receive full payment of their debts.

The Courts, in interpreting the *Corporations Act 2001* (Cth), have found that when balancing the competing interests of various classes of creditors, the anticipated benefit to creditors of one option over another does not have to be equal across all classes of creditors, if there are reasonable grounds for any differentiation.[4]

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[4] *Fleet Broadband Holdings Portinex Pty Ltd* (2000) 156 FLR 453, 476 [102] (Austin J); *Lam Soon Australia Pty Ltd v Molit (No 55) Pty Ltd* (1996) 14 ACLC 1737.

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7.5 Caselaw – examples of difficulties in balancing classes of stakeholders

Weighing the competing interests of different classes of stakeholders can be a complex and difficult task, even for an insolvency practitioner with extensive experience in making such assessments. The cases of *Nexus Energy Ltd* [2014] NSWSC 1041 and *Intergen Energy Holdings (Australia) Pty Ltd (Administrators Appointed) (Receivers and Managers Appointed)* [2016] FCA 1585 are both recent examples of where the administrators found it necessary to seek court directions under s 447D that the course of action proposed (entry into new funding arrangements) was justified. This was due to a divergence of interests between different categories of stakeholders and difficulty for the administrators in finding a path forward that would produce an outcome that was satisfactory for all classes of stakeholders.

7.6 Concern that the current test may have unintended consequences

The "better outcome" test in its current form could be difficult to apply and may have the unintended consequence that an honest director may be prevented from reliance on Safe Harbour because the chosen course of action was not reasonably likely to produce a "better outcome" for "both the company and the company's creditors" and/or "for the company's creditors as a whole".

The test in its present form could be difficult, or even impossible, for a director to satisfy in certain cases.

7.7 Proposed position: the paramount duty to creditors

Turnaround often involves a compromise. Ideally, that compromise is a short-term one that sees all stakeholders better off in the long run than they would have been in liquidation. However, as we have submitted, this may not always be the case. Restructuring can involve difficult decisions, and not all stakeholders can always walk away happy or better off.

The question is where there is a divergence of interests: whose interests should have primacy, shareholders or creditors?

The Courts have posed this same question and have held that if the company is insolvent, in the vicinity of solvency or embarking on a venture which it cannot sustain without relying totally on creditor funds, the interests of the company are in reality the interests of existing creditors alone.[5] At this time, the company is effectively trading with the creditors' money and thus the creditors may be seen as the key stakeholders in the company.

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[5] *Brady v Brady* (1987) 3 BCC 535, 552 (Nourse LJ). See *Equiticorp Finance Ltd (in liq) v Bank of New Zealand* (1993) 32 NSWLR 50, 146 (Clarke and Cripps JJA). *Kinsela v Russell Kinsela Pty Ltd (in liq)* (1986) 4 NSWLR 722, 730 (Street CJ) (***Kinsela***); R M Goode, *Principles of Corporate Insolvency Law* (Sweet & Maxwell, 2nd ed, 1997) 455; Stephen McDonnell, "*Geyer v Ingersoll Publications Co*: Insolvency Shifts Directors' Burden from Shareholders to Creditors" (1994) 19 *Delaware Journal of Corporate Law* 177, 185; Andrew Keay, "The Director's Duty to Take into Account the Interests of Company Creditors: When Is It Triggered?" (2001) 25 *Melbourne University Law Review* 315.

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At this point, the shareholders may have little or nothing to lose as they have likely already lost some or all of the money that they invested in the company (by way of the depreciation of the company's equity value) and have the significant benefit that they cannot be pursued by creditors because of the concept of limited liability. A restructure at this time, could conceivably turn the company around and provide the shareholders with some greater return that presently available. However, if this course of action fails, the creditors will likely suffer an even greater loss than if the company is placed immediately into external administration.[6] Creditors can only receive the maximum sum of the debt owed to them, irrespective of how well the company performs. Therefore, while they have much to gain by way of a successful restructure, they also have the most to lose from a failed turnaround plan.[7] Given that the doctrine of limited liability shifts the risk of the company's failure from the shareholders to the creditors, the duty to take account of creditors' interests is the only way to mitigate the shift.[8]

While there is still some judicial ambivalence as to whether the directors owe a duty *directly* to creditors, or whether (as suggested above) the duty is owed to the company, to take into account of the interests of creditors, the more prevalent view appears to be that the duty is mediated through the company.[9]

There is a significant amount of judicial opinion that supports the view that the duty is triggered before a company actually becomes technically insolvent.[10] While there is no prescribed test as to the degree of financial instability required to enliven the duty to

6 *Kinsela* (1986) 4 NSWLR 722, 732–3. See David Thomson, "Directors, Creditors and Insolvency: A Fiduciary Duty or a Duty Not to Oppress?" (2000) 58 *University of Toronto Faculty of Law Review* 31, 33.

7 Stephen McDonnell, "*Geyer v Ingersoll Publications Co*: Insolvency Shifts Directors' Burden from Shareholders to Creditors" (1994) 19 *Delaware Journal of Corporate Law* 177. Andrew Keay, "The Director's Duty to Take into Account the Interests of Company Creditors: When Is It Triggered?" (2001) 25 *Melbourne University Law Review* 315.

8 Richard Posner, *Economic Analysis of Law* (Little, Brown and Company, 4th ed, 1992) 394; Andrew Keay, "The Director's Duty to Take into Account the Interests of Company Creditors: When Is It Triggered?" (2001) 25 *Melbourne University Law Review* 315.

9 Mason J in *Walker v Wimborne* (1976) 137 CLR 1 did not exclude a direct duty to creditors, and one can perhaps read the judgments of Lord Templeman in *Winkworth v Edward Baron Development Co Ltd* [1987] 1 All ER 114 and the Full Court of the Supreme Court of Western Australia in *Jeffree v National Companies and Securities Commission* [1990] WAR 183 as providing some support for an independent duty being owed to creditors. However, recent judicial comments are set against such a duty. For example, Gaudron, McHugh, Gummow and Hayne JJ of the High Court in a joint judgment in *Spies v The Queen* (2000) 201 CLR 603 said by way of obiter that it is "extremely doubtful" whether Mason J "intended to suggest that directors owe an independent duty directly to creditors".

See also *Kinsela* (1986) 4 NSWLR 722, 733 (Street CJ); *Re New World Alliance Pty Ltd* (1994) 51 FCR 425, 444 (Gummow J); *Nicholson v Permakraft (New Zealand) Ltd (in liq)* (1985) 3 ACLC 453, 459 (Cooke J); *Credit Lyonnais Bank Nederlander NV v Pathe Communications Corporation* (Unreported, Delaware Court of Chancery, Chancellor Allen, 30 December 1991); *Brady v Brady* (1987) 3 BCC 535, 553 (CA). See also the comments of Templeman LJ in the case of *Re Horsley & Weight Ltd* [1982] Ch 442, 455; *Geyer v Ingersoll Publications Co*, 621 A 2d 784 (Del Ch, 1992).

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creditors,[11] a review of the authorities suggests that the trigger point is probably close to "doubtful solvency" or a "risk of insolvency".[12]

In our view, this window (being the time of "doubtful solvency", "risk of insolvency" or where the company is in the "vicinity" of solvency) is the window of time to which the Safe Harbour is intended to apply. This is made clear by the wording in s 588G(2) of "*starts to suspect* the company *may become* or be insolvent". Of course, once the company is, in fact, insolvent it is abundantly clear that the paramount duty is owed to creditors.[13] Equally, if the company is clearly solvent at the time it embarks upon the restructure, that restructure will not attract the need for or operation of Safe Harbour. The usual set of fiduciary duties will continue to apply to directors engaged in solvent restructures.

The assessment of the timing of insolvency is clearly a very difficult issue, and we recognise that the present legislation is aimed at addressing the sliding scale of solvency/insolvency. This point could be addressed in the explanatory memorandum. However, we consider that there is a need for clarity and simplicity of interpretation of the legislation.

Having regard to the way the present legislation expresses the trigger point for the application of Safe Harbour, it is the TMA's view that **the paramount duty is owed to creditors during Safe Harbour**.

This position should be reflected in the legal test, as it is the creditors who are in most need of protection during the Safe Harbour period.

The views of shareholders and related bodies corporate will ordinarily be taken into account by directors, as a matter of commercial reality, having regard to the powers that reside in members prior to a formal insolvency appointment in the context of other provisions of the *Corporations Act*.

Unlike shareholders (who have the knowledge and ability to influence the directors in the Safe Harbour period) creditors will not necessarily have notice rights or significant powers. Creditors will also likely have the most to lose by the course of action taken in Safe Harbour. It is therefore appropriate, in our view, that creditors' interests are placed at the heart of Safe Harbour.

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11 *Kinsela* (1986) 4 NSWLR 722, 733 (Street CJ): "I hesitate to attempt to formulate a general test of the degree of financial instability which would impose upon directors an obligation to consider the interests of creditors."

12 The New South Wales Court of Appeal in *Linton v Telnet Pty Ltd* (1999) 17 ACLC 619, 626 recognised that the time when directors should pay attention to the interests of creditors was dependent on the facts.

13 A majority of the High Court in *Spies v The Queen* (2000) 201 CLR 603 (at 555) approved of the comments of Gummow J in *Re New World Alliance Pty Ltd* (1994) 51 FCR 425 (at 444) when his Honour said that insolvency created a duty to creditors.

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7.8 Drafting options

There are two approaches that are worth consideration, in order to reflect the paramount duty to creditors in the "better outcome" test.

The first option is to reframe the test as follows:

> *(5) In this section:*
>
> ***better outcome*** *means an outcome that is better for ~~both the company and~~ the company's creditors than liquidation*

The Government may also wish to consider including the following words at the start of section 588GA, if it wished to expressly preserve general law directors' duties: "without derogation from duties of officers at law and under this Act".

A second option, may be to reframe the test in the following terms:

> *(5) In this section:*
>
> ***better outcome*** *means an outcome that is better than liquidation, having regard to ~~for~~ ~~both~~ the interests of the company and the company's creditors as a whole*
>
> *For the avoidance of doubt, the paramount duty in this section is to creditors of the company.*

If either of these drafting options were adopted, consequential amendments would also be required throughout s 588GA to remove the reference to a "better outcome for the company and the company's creditors". This wording could be reduced simply to "better outcome" since that is a defined term.