

27 May 2016

The Manager, Corporations and Schemes Unit  
Financial Systems Division  
The Treasury  
Langton Crescent  
PARKES ACT 2600

*via email: insolvency@treasury.gov.au*

Dear Sir / Madam

### **Improving bankruptcy and insolvency laws**

The Australian Institute of Company Directors (**AICD**) welcomes the opportunity to comment on the proposals put forward by the Australian Government in its paper *Improving bankruptcy and insolvency laws (Proposals Paper)*. We recognise that a well-functioning insolvency regime that supports innovation is integral to the nation's long-term interests.

The AICD is committed to excellence in governance. We make a positive impact on society and the economy through governance education, director development and advocacy. Our membership of more than 38,000 includes directors and senior leaders from business, government and the not-for-profit sectors.

This submission addresses the safe harbour and ipso facto measures presented in the Proposals Paper.

#### **1. SUMMARY**

Proposed changes to insolvency laws will begin a transformation of the Australian economy by allowing companies and directors to take the necessary risks to innovate. The potential of these changes – subject to getting the legislation right – cannot be underestimated. They will save rather than destroy billions in wealth and tens of thousands of jobs. Directors of an ailing company should be given a fair opportunity to take reasonable steps to turnaround viable businesses for the benefit of all.

In summary, the AICD supports insolvency reforms that:

- sustain viable businesses for the benefit of corporate stakeholders, including members, employees, suppliers, customers and creditors;
- appropriately balance the need for certainty with flexibility, given they would apply to large listed companies with global businesses and boards comprising a majority of independent non-executive directors to small privately owned firms with a single director to not-for-profits;

- are accessible and workable in practice, bearing in mind the complexity, pressure and time constraints under which decisions must be made when a company's solvency is doubtful;
- provide a safe harbour from liability for insolvent trading which is based on Model B in the Proposals Paper (as modified in this submission);
- adhere to generally accepted legal principles, including that a person alleging misconduct bears the onus of proving the breach; and
- prohibit the operation of ipso facto clauses which purport to terminate or amend agreements during formal insolvency processes (subject to defined exceptions and appeal rights).

## **2. SAFE HARBOUR**

### **2.1 A vital national reform**

Innovation is crucial to Australia's prosperity. As the OECD has observed, "innovation provides the foundation for new businesses, new jobs and productivity growth and is thus an important driver of economic growth and development".<sup>1</sup> Key among the determinants of a nation's innovation and entrepreneurship are its laws and regulations regarding business distress and failures. This fact has been widely recognised by governments and policymakers from around the world,<sup>2</sup> with various countries undertaking legislative reviews and reforms to encourage businesses to restructure rather than prematurely trigger a value destroying formal insolvency mechanism.<sup>3</sup> It is in this context that the Australian Government recently announced that our insolvency laws will be improved in order to encourage entrepreneurship and innovation.<sup>4</sup>

As the Government acknowledges, Australia's current insolvency laws "put too much focus on penalising and stigmatising the failures".<sup>5</sup> This regime has negative implications for startups and business closures. Concerns over inadvertent breaches of insolvent trading laws are often cited as a reason early stage investors and professional directors are reluctant to become involved in startups.<sup>6</sup> And fear of liability arising from restructuring a distressed company can lead to unnecessary or premature invocation of insolvency processes, with the negative consequences of job loss, contract terminations, goodwill destruction and overall value diminution.

It is in the public interest that our laws support genuine attempts to restructure ailing businesses. We commend the Government's recognition that the Australian regime needs to be recalibrated so that honest directors can work to save businesses that can be saved without the risk of personal liability. The AICD believes it is possible to craft a safe harbour that facilitates rehabilitation of distressed businesses, while protecting corporate

---

<sup>1</sup> *OECD Innovation Strategy 2015: An Agenda for Policy Action*.

<sup>2</sup> See, for example: Industry Canada's *Statutory Review of the Bankruptcy and Insolvency Act and the Companies' Creditors Arrangement Act 2014*; *OECD Innovation Strategy 2015: An Agenda for Policy Action*; and the European Commission's announcement of a series of common principles for national insolvency procedures for businesses in financial difficulties (press release dated 12 March 2014).

<sup>3</sup> For example, Singapore (*Insolvency Law Review Committee Report* issued on 4 October 2013 and the Ministry of Law's response dated 6 May 2014) and the United States (ABI Commission's *Final Report and Recommendations on the Reform of Chapter 11 of the Bankruptcy Code 2012-2014*). See also the European Commission's *Recommendation on a new approach to business failure and insolvency* for EU member states, issued 12 March 2014.

<sup>4</sup> *National Innovation & Science Agenda (NISA)*.

<sup>5</sup> Proposals Paper, p3.

<sup>6</sup> NISA, *Improving insolvency laws to encourage innovation*.

stakeholders such as employees, suppliers, customers, creditors and shareholders from reckless and unscrupulous actions.

To achieve this objective, a safe harbour will need to provide sufficient:

- certainty to guide honest and reasonable directors as they steer distressed companies through the complexities of the “twilight zone of insolvency”;
- flexibility so that it can be applied by all directors, irrespective of the circumstances of the company; and
- utility so that it can be readily and practically applied by directors in a timely manner with due recognition of stakeholder interests.

## **2.2 AICD reform recommendation**

The AICD recommends the introduction of an insolvent trading safe harbour based on Safe Harbour Model B, with several important modifications (set out in detail in Sections 2.4 and 2.5 below).

For the reforms to achieve their objective, it is critical that directors have confidence in their application and coverage. In considering the models proposed, the AICD has consulted widely with our members. Of the two reform models put forward in the Proposals Paper, we believe that Model B better balances the certainty, flexibility and utility needed to best achieve the Government’s policy objective.

Below we outline our concerns with Safe Harbour Model A and provide detail on the benefits of Model B and the improvements needed to deliver a workable safe harbour.

## **2.3 Safe Harbour Model A**

The AICD considers Safe Harbour Model A to be overly complex, narrow and inflexible. It fails to reflect the practical realities faced by many financially distressed companies and the real-time, complex decision-making that is required of directors in such circumstances. The AICD is concerned that Model A would be unworkable except in the rarest of circumstances and consequently directors would be unlikely to avail themselves of it in practice. Our key reservations with this model follow.

### ***Onus of proof***

As a defence, Model A inappropriately casts the onus of proof on directors. This approach would significantly reduce (in our view, almost entirely) the circumstances in which boards would take the informed risk of restructuring that safe harbour reforms seek to encourage.

As the Chief Justice of Western Australia observed, “[t]he laws of Australia which expose directors to personal liability in the event that a company trades while insolvent are arguably the strictest in the world”.<sup>7</sup> To then require that directors prove they are innocent of breaching these laws is, we believe, hard to justify. This is especially so given that any examination by a court of whether the safe harbour is available to directors will necessarily expose directors to hindsight review. A situation that courts, particularly in the United States, have appreciated is an inappropriate state of affairs. When a company is close to the brink of insolvency, directors are often confronted with making difficult

---

<sup>7</sup> The Hon. Wayne Martin, ‘Official Opening Address’, Insolvency Practitioners’ Association of Australia 16<sup>th</sup> National Conference, Perth, 28 May 2009.

decisions in short time frames, under considerable pressure and based on complex information that may later prove to be imperfect. Where directors act honestly and reasonably, the AICD considers that they should be protected from liability, even if that decision later proves to be flawed with the benefit of hindsight.<sup>8</sup>

The need to raise a defence only arises after a breach is established. This can have reputational implications for directors. A finding of breach can cast a stain on a director's reputation, notwithstanding that the director successfully mounts a defence. As a director's good name is a valuable asset upon which board appointments will be based, a model which fails to preserve a director's reputation when invoked is not a safe harbour. A defence may also further entrench the stigma of failure in the Australian psyche rather than supporting the cultural change that the insolvency reform package seeks to deliver.

Placing the burden of proof on directors perpetuates the unfair and overly harsh legislative approach for which our insolvency regime is currently criticised.<sup>9</sup> While the AICD is opposed to this as a matter of principle, in the context of the proposed safe harbour we believe it will deter directors from seeking to rehabilitate businesses outside of formal administration processes. Put simply, it will undermine the reform's objectives.

### ***Elements of the defence***

Under Model A, the safe harbour defence would only be available if, at the time the debt was incurred, a reasonable director would have an expectation based on advice from an appropriately experienced, qualified and informed restructuring adviser that the company can be returned to solvency within a reasonable period of time. This means that before the safe harbour would arise:

- the restructuring adviser must have:
  - been appointed;
  - been provided with appropriate books and records;
  - investigated the company's situation;
  - formed a view that the company can avoid insolvent liquidation and is capable of being returned to solvency within a reasonable period of time; and
  - communicated that view to the directors; and
- the directors, having received the restructuring adviser's opinion, must have:
  - considered the advice (which will invariably be provided subject to many assumptions, qualifications and exclusions);
  - formed the necessary expectation; and

---

<sup>8</sup> AICD submission on Treasury's discussion paper *Insolvent trading: A safe harbour for reorganisation attempts outside of external administration*, dated 2 March 2010.

<sup>9</sup> See, for example, Singapore's *Final Report of the Insolvency Law Review Committee* (2013), p204 at [18]:

"The Australian provisions are considered to be some of the strictest provisions amongst the major jurisdictions, in the sense that they effectively prohibit trading once there are 'reasonable grounds for suspecting' that a company is insolvent. ... A wide notional cessation of trading even prior to the commencement of insolvency proceedings may further endanger a financially-troubled company's ability to trade through a period of crisis, and thus worsen the company's financial difficulties. It does not strike the best balance between the interest in protecting creditors against the reckless or unreasonable incurring of debts by an insolvent company, and the interest in allowing the directors of a distressed company a fair opportunity to take reasonable steps to avoid the company's financial ruin. **There should be more latitude afforded to a director to continue to trade in the reasonable expectation that, although the company is insolvent, it is most likely to be able to trade out of its present difficulties.**" [Emphasis added.]

- started taking reasonable steps to ensure the company is returned to solvency within a reasonable period of time.

Such a process fails to capture the realities within which directors of a financially distressed company invariably find themselves. The directors and the company's professional advisers are likely to be considering various issues and exploring multiple options at any one time, many of which may be out of the directors' control or contingent upon some third party or external event or information. Forming an opinion on the company's prospects may, for legitimate reasons, take time to complete. Under this model, directors would be exposed to personal liability should the company become insolvent (even if only technically) before the restructuring advice had been received and the necessary expectation formed. Such a "safe harbour" would be illusory.

Also, decisions may need to be made with imperfect information, not because of any lack of diligence or misconduct on the part of directors, but rather due to the complexity and speed at which events are unfolding.

It follows that the sequence and timing of the defence's preconditions would effectively put many, if not most, genuine restructuring attempts beyond its protection.

### ***Restructuring adviser***

The Model A defence mandates the appointment of an accredited restructuring adviser. In the AICD's view, this is problematic. Directors should not be disempowered by the safe harbour's prescriptions, particularly as they bear the risk of liability should a defence fail. Companies should be able to draw upon internal expertise (eg existing directors or management with relevant experience) or obtain additional resources (eg new directors or executives) to assist with a restructure, instead of or as well as seeking external advice.

More importantly, the accreditation requirement would unnecessarily restrict the class of persons from whom advice may be sought (especially where limited funds preclude more than one adviser appointment). Companies should be free to take advice from persons possessing appropriate skills and experience, irrespective of whether or not they belong to an accredited profession (eg insolvency specialist, lawyer, accountant, etc...) or hold the necessary membership (eg ARITA, Law Society, CPA, etc...). For example, a real estate specialist, investment banker or hotelier may have the skills needed to assist in a specific turnaround.

Also, it may be possible and appropriate for a company to appoint multiple advisers, all tasked with assisting in specific areas, and whose advices collectively inform the decisions of the board.

The AICD believes that a principles-based approach is preferable to such a prescriptive approach, particularly as the safe harbour must be scalable across all companies. Instead of mandating the appointment of an accredited restructuring adviser, we advocate that guidance be given on the factors that director should take into account when taking reasonable steps to turnaround a company or its viable businesses.

### ***Focus on solvency***

Model A depends on whether or not the "company can be returned to solvency". This conception of the safe harbour fails to recognise that while the company itself may remain insolvent and ultimately be liquidated, the company's business (or a part of it) may be viable. Realising the value of a business or assets before a formal insolvency process

may enhance the return to creditors. Directors should be protected, not penalised, for taking such steps.

## **2.4 Safe Harbour Model B**

The AICD support a safe harbour based on elements of Model B because it:

- rightly places the onus of proof on the person alleging the breach;
- encourages directors to attempt a turnaround outside of formal insolvency processes while balancing the interests of members and creditors;
- appropriately focuses on the reasonableness of what is being done by the director to effect a recovery, as opposed to disproportionately emphasising the role of a mandatory restructuring adviser; and
- is sufficiently flexible to be capable of application irrespective of a company's size, industry, sector and circumstances.

Our comments on specific aspects of Model B follow.<sup>10</sup>

### ***Onus of proof***

For the reasons set out above in Section 2.3, the AICD is firmly of the view that the onus of proof should rest with the person alleging a breach of the duty to prevent insolvent trading. This is particularly important given that the person instituting proceedings need only establish that one of Model B's elements has not been satisfied.

Further, we urge the Government to make it *expressly* clear in the amending legislation that the burden of proof lies with the person instituting the proceedings. Certainty on this point is required to avoid the situation that exists in relation to the current statutory business judgment rule. As Parliament did not expressly indicate whether the plaintiff or defendant bears the onus of proving the rule's elements, it was observed in *ASIC v Rich*<sup>11</sup> that the issue would eventually need to be resolved by the courts at an appellate level. This is an unsatisfactory situation for such a fundamental issue.

***“The debt was incurred as part of reasonable steps to maintain or return the company to solvency within a reasonable period of time”***

While we support this limb in principle, we wish to draw the Government's attention to four factors.

First, we are concerned that this limb could be construed narrowly so that debts which are incurred in *indirectly* maintaining or returning the company to solvency (for example, operational expenses such as maintenance costs), would fall outside the safe harbour protection. The legislation enacting this limb should be carefully drafted so that debts incurred in the ordinary course of business would clearly fall within the ambit of the safe harbour.

Secondly, guidance on what might constitute “reasonable steps” is welcome provided it is clear and not prescriptive or de facto regulation. Preserving is essential as the steps required in any particular situation will very much depend on the nature and operations of the distressed company and the specific issues requiring resolution.

---

<sup>10</sup> We have assumed that the reference to “Section 588” in Proposal 2.3 is intended to be to “Section 588G”.

<sup>11</sup> [2009] NSWSC 1229, [7262] and [7269].

Guidance could include giving *consideration* to:

- seeking advice, including external professional advice if necessary;
- the qualifications, experience and independence of a proposed adviser;
- providing advisers with sufficient information to enable them to perform their roles; and
- engaging with relevant stakeholders.

Also, while guidance in the explanatory memorandum (as has been suggested) may be useful, ASIC guidance would be more accessible and could be updated (after proper consultation) as economic and regulatory conditions evolve.<sup>12</sup>

Thirdly, the imposition of solvency being achieved within a “reasonable period of time” is appropriate to ensure the diligent pursuit of restructuring steps and to prevent distressed companies from attempting to trade out indefinitely. Importantly though, any guidance on this requirement must recognise that reasonableness will vary according to each company’s particular circumstances. Directors need to be given sufficient time to determine whether a business can be saved and to implement any turnaround plan.

Fourthly, like Model A, we are concerned that Model B focuses solely on solvency. Consequently, the safe harbour would not be available to directors who, knowing that a return to solvency is unlikely, permit a debt to be incurred in order to realise the value of a viable business or asset with the intention of enhancing the returns to residual beneficiaries. There can be important benefits to securing business or asset sales outside of formal insolvency in that enterprise value can be better preserved and a “fire sale” discount would be avoided. That directors acting reasonably to preserve value, jobs and returns would not be afforded protection is unsound. This should be rectified.

***“The person held the honest and reasonable belief that incurring the debt was in the best interests of the company and its creditors as a whole”***

Directors owe fiduciary and statutory duties to act in good faith and in the best interests of the company, meaning the current and future interests of members as a whole.<sup>13</sup> Relevantly, the courts have long recognised that directors who fail to consider the interests of creditors as the company approaches insolvency risk breaching these duties. For example, in an insolvency case before the High Court, Mason J warned that “[a]ny failure by the directors to take into account the interests of creditors will have adverse consequences for the company as well as for them”.<sup>14</sup> Significantly though, the need to consider creditors’ interests in this way is not a separate duty owed by directors to creditors.<sup>15</sup>

It is unclear to us whether the intention behind Safe Harbour Model B is that directors must act in the company’s best interests in addition to creditors’ best interests. Given the difficulty of determining the precise moment at which a company is insolvent,<sup>16</sup> and the fact that the law is unclear on the weight that directors must give to creditors’ interests in

---

<sup>12</sup> In this context we note that ASIC Regulatory Guide 217 (RG 217) provides guidance for directors on the existing duty to prevent insolvent trading.

<sup>13</sup> See, for example, *Re Smith and Fawcett Ltd* [1942] Ch 304, and section 181 of the *Corporations Act 2001* (Cth).

<sup>14</sup> *Walker v Wimborne* (1976) 137 CLR 1 at [13].

<sup>15</sup> *Spies v R* [2000] HCA 43.

<sup>16</sup> *Hall v Poolman* 65 ACSR 123, Palmer J at [266].

the “twilight zone of insolvency”,<sup>17</sup> care must be taken in legislating the safe harbour to ensure it does not contradict directors’ existing fiduciary and statutory duties. If the safe harbour is inconsistent with directors’ general duties, then reasonable steps taken to turnaround an ailing business may attract liability under those duties even though protected from liability for insolvent trading. Such a perverse outcome would create unacceptable uncertainty and risk for directors and clearly undermine the Government’s goal of encouraging responsible innovation and entrepreneurship.

***“Incurring the debt does not materially increase the risk of serious loss to creditors”***

The third limb of Model B is problematic. In our view it is superfluous. Reckless trading or sales of assets for nominal value (which this limb is designed to deter) would constitute a breach of the other safe harbour requirements, namely:

- to take recent reasonable steps to pursue loss minimisation or solvency; and
- to reasonably believe the debt is in the company’s best interests (which necessarily involves consideration of creditor’s interests).

Accordingly, the first and second limbs of Model B adequately protect the interests of creditors, especially as they both include objective tests of ‘reasonableness’.

This limb may also cause uncertainty because it could be construed to require that the risks posed by the debt be considered in isolation from the restructure. This arises because each limb of Model B stands alone (ie only one limb needs to be breached for the safe harbour to fail). It is conceivable that a specific debt may materially increase the risk of loss to creditors, however, incurring the debt may be reasonable in the context of a turnaround plan. We note that this limb is very similar to the second element of New Zealand’s reckless trading prohibition which relevantly provides that:

*“A director of a company must not... (b) cause or allow the business of the company to be carried on in a manner likely to create substantial risk of serious loss to the company’s creditors.”*<sup>18</sup>

New Zealand’s provision rightly contextualises the risk posed by referencing the company’s business.

If it is still felt necessary to include the third limb of Model B, which we do not believe it is, then its mechanics will need to be carefully considered. To avoid unintended consequences, the risk to creditors posed by the debt should be assessed in the context of the restructure. Also, while “materiality” is a concept commonly used in Australian accounting and legal rules, the notion of a “serious loss” is not.

## **2.5 Availability of the safe harbour**

We understand it is the Government’s intention that the safe harbour only be available to directors of companies with good corporate governance and who are acting in accordance with their duties. The AICD supports excellence in governance. Accordingly, we agree that a safe harbour from insolvent trading should not be available to a person who was

---

<sup>17</sup> Contrast the views of Owen J in *The Bell Group Ltd (in liq) v Westpac Banking Corporation (No 9)* [2008] WASC 239 [4436] to [4440], and Drummond AJA, Lee AJA and Carr AJA in *Westpac Banking Corporation v Bell Group Ltd (in liq)* [2012] WASCA 157.

<sup>18</sup> Section 135 of New Zealand’s *Companies Act 1993*.



disqualified from managing a corporation at the time the debt was incurred (**Disqualification Exemption**).

The AICD also endorses effective efforts to prevent and punish fraudulent phoenix activity. However, we question whether it is appropriate for ASIC or the court to be permitted to determine that directors cannot rely on the safe harbour due to their “prior conduct”. An exclusion based on “prior conduct” is potentially very broad and could capture conduct that was unrelated to the present circumstances, was not unlawful or, if unlawful, had been appropriately dealt with by the regulatory system at the relevant time. It also assumes that past behavior dictates future behavior. Consequently, this exclusion may create sufficient uncertainty for directors so as to deter the very restructures the reforms are intended to encourage.

While we do not excuse misconduct, we are also concerned with the proposal to confer power on ASIC or the court to determine that directors are ineligible to use the safe harbour for a “specified future period” because the directors had previously breached a duty which resulted in creditors suffering a loss. In our view, ASIC may not be adequately equipped for this role. Such a power, if necessary (which we question), should reside with the courts and would need to be very carefully crafted in order to avoid unintended consequences. Specifically, it should only apply in instances of intentional and unlawful diversions of corporate assets, not inadvertent breaches. That said, this exclusion focuses on a director’s past behaviour, not on whether a viable business exists to be saved. Should a company’s creditors suffer for a director’s misconduct in prior circumstances? Focusing on retribution rather than on facilitating commercial rehabilitation is contrary to the reform objectives. We query whether the existing powers of disqualification under Part 2D.6 of the *Corporations Act 2001* (Cth) (**Corporations Act**), and the Disqualification Exemption, are not a sufficient mechanism for putting the safe harbour beyond the reach of directors who have perpetrated illegal phoenix activity.

We note that the Government proposes denying a safe harbour to the directors of companies who have failed to meet their obligations regarding Business Activity Statements (**BAS**) or employee entitlements. As the roles of the board and management are separated in many companies, these exclusions should only apply where the directors “knew or ought reasonably to have known” of the transgressions. Subject to this change, the AICD supports the Government’s retraction of the safe harbour where:

- the company has “failed to lodge *multiple* BAS”; or
- there has been a “*significant* failure by the company to pay employee claims, PAYG or employee superannuation”.<sup>19</sup> [Emphasis added.]

Importantly, both of these exclusions have built in materiality considerations which recognise that inadvertent failures will not revoke the safe harbour. This gives due recognition to the uncertainties inherent in operating a business.

As to the proposition that protection would also be unavailable to a director whose company is unable to pay employee claims accruing during the safe harbour period, we agree that employees should be no worse off as a result of a restructure. However, care should be taken to ensure that the test is based on the company’s existing obligations to accrue entitlements, and is not predicated on the company’s ability to pay entitlements that are not yet due and payable.

---

<sup>19</sup> Proposals Paper, p14.

## **2.6 Disclosure**

According to the Proposals Paper, market experience has shown that privacy is an important factor in the success of informal workouts.<sup>20</sup> We note it is for this reason that the Government does not propose requiring companies to disclose when they are operating in a safe harbour.

The AICD acknowledges that disclosure of financial difficulties or of a workout may result in:

- suppliers requiring cash on delivery, accelerating payments or terminating contracts;
- creditors increasing pressure to receive payment for existing debts (including by issuing statutory demands or commencing legal proceedings), requiring additional security or rejecting otherwise reasonable requests for a further extension of credit; and
- customers may acquire goods and services from competitors due to concerns regarding the company's ability to deliver on its promises and warranties,

all of which would distract directors and management, divert resources, further strain cashflows and otherwise impair the company's ability to rehabilitate.

Further, if the restructure fails and the company is liquidated, suppliers who were on notice of the company's potential insolvency may be pursued by the liquidator for amounts received during the restructure on the basis that they had received an unfair preference.<sup>21</sup>

We therefore agree that notification of a restructure should not be mandated as it may impede the reform objectives, particularly given the existing culture of stigmatising failure. Directors should remain empowered decision makers throughout the safe harbour, including in relation to issues of disclosure and stakeholder engagement.

Corporate stakeholders should take comfort from the fact that throughout any restructure, directors would still be subject to their general duties and would only have the protection of the safe harbour if they were meeting the requirements of all elements of the safe harbour. Additionally, listed entities would need to carry on complying with their continuous disclosure obligations.

## **2.7 Sufficiency of safe harbour**

The Proposals Paper notes that the safe harbour proposed by the Government would only apply to the director's duty to prevent insolvent trading contained in s588G of the Corporations Act, and asks whether this approach is appropriate.<sup>22</sup>

The AICD continues to hold the view that reform of director liability in the context of insolvency should extend beyond s588G.<sup>23</sup> In addition to navigating all of the other requirements in the Corporations Act and the *Australian Securities and Investments Commission Act 2001* (Cth) while the company is in distress, a director may be personally

---

<sup>20</sup> Proposals Paper, p13.

<sup>21</sup> Unfair preference is defined in s588FA of the Corporations Act.

<sup>22</sup> Refer to Query 2.2.2a on p13.

<sup>23</sup> The view was first espoused in the AICD's 3 July 2015 submission on the Productivity Commission's discussion paper *Business Set-Up, Transfer and Closure*.

liable to the Commissioner of Taxation either under the Director Penalty Notice regime<sup>24</sup> or in respect of unfair preference payments subsequently recovered from the Commissioner by a liquidator<sup>25</sup>. To create an effective “ecosystem”<sup>26</sup> for entrepreneurs, directors should be similarly protected from these sources of liability in their efforts to restructure.

While the AICD recommends these additional reforms, we strongly believe that the introduction of a safe harbour is very valuable in itself. Implementation of a safe harbour should not be impeded by these other considerations, as they can be progressed independently of the s588G reforms.

## **IPSO FACTO CLAUSES**

### **3.1 Background**

As the Government,<sup>27</sup> commissions<sup>28</sup> and many other stakeholders<sup>29</sup> have recognised, a counterparty’s enforcement of an ipso facto clause can devalue a company entering insolvency and seriously hinder, if not destroy, prospects of business restructures under formal insolvency processes. Significantly, these clauses operate independently of whether or not the insolvent company is fulfilling its contractual obligations and may continue to do so. In the AICD’s view, this situation is counterproductive. Contracts in good standing should be respected by all parties.

While imposing a moratorium on the operation of ipso facto clauses would, to some extent, restrict the contractual rights of individual creditors of insolvent companies, creditors as a whole will benefit from the increased prospect of a meaningful turnaround of the business or of a higher return should a restructure ultimately be unsuccessful. Besides, the moratorium would not affect creditors’ rights should the insolvent company fail to perform the contract.

For these reasons, we continue to support a moratorium on the operation of ipso facto clauses, subject to the checks and balances outlined below.<sup>30</sup>

### **3.2 Scope of the moratorium**

As a general principle, the AICD believes the proposed moratorium should apply to ipso facto clauses that purport to terminate or amend an agreement, irrespective of whether the termination or amendment is optional or automatic. Provided all other contractual terms are being met, the counterparty should not be able to vary the agreement to accelerate payment, impose new terms of payment, require additional security for existing obligations or claim forfeiture of the contract term. This position is broadly consistent with the approach taken in Australia’s personal bankruptcy laws,<sup>31</sup> and the insolvency laws of

---

<sup>24</sup> Set out in Division 269 of the *Taxation Administration Act 1953* (Cth).

<sup>25</sup> Pursuant to s588FGA of the Corporations Act.

<sup>26</sup> Proposals Paper, p3.

<sup>27</sup> Proposals Paper, p17.

<sup>28</sup> For example, the Australian Law Reform Commission (in ALRC Report 45 *General Insolvency Inquiry* (1988), ie the “Harmer Report”, paras 703 to 705 and Recommendation AT10) and the Productivity Commission (in the Inquiry Report *Business Set-up, Transfer and Closure* (30 September 2015), Recommendation 14.5).

<sup>29</sup> For example, the Law Council of Australia – Business Law Section (Submission in response to Productivity Commission’s Draft Report *Business Set-up, Transfer and Closure* (21 May 2015) and Australian Restructuring Insolvency & Turnaround Association (*A Platform for Recovery 2014*).

<sup>30</sup> AICD submission to the Productivity Commission’s Draft Report *Business Set-up, Transfer and Closure* (3 July 2015).

<sup>31</sup> Section 301 of the *Bankruptcy Act 1966* (Cth).

the United States<sup>32</sup> and Canada<sup>33</sup>. A failure to extend the moratorium to variations could frustrate the chances of business recovery or increased returns to creditors.

That said, the moratorium should not require any further advances of money or credit. Nor should it impair the enforcement rights of a creditor with a security interest over the whole, or substantially the whole, of the property of a company under administration.

Our endorsement of a broad moratorium is predicated on the exclusions and appeal rights discussed below in Sections 3.6 and 3.7 respectively.

### **3.3 Insolvency event**

The AICD agrees that the moratorium should be triggered by a formal insolvency appointment or arrangement.

### **3.4 Grandfathering**

In the AICD's view, the moratorium should not be grandfathered. Instead, it should apply to all ipso facto clauses pertaining to any formal insolvency event occurring after the reforms are enacted and assented to, irrespective of when the clauses were agreed between the parties. For the avoidance of doubt, the prohibition should not extend to any administrations that were commenced before, but are ongoing at, the date of assent.

Grandfathering of the moratorium would, we believe, unnecessarily delay the benefits sought by its introduction because many contracts, such as leases and franchises, operate over long periods. Further, considerable uncertainty and disputes would likely arise from grandfathering as many contracts include options to renew or extension rights (with or without other rights of variations). For these reasons, the date of the insolvency event, not the date of individual contracts, should be used to determine whether or not the moratorium applies to particular ipso facto clauses. Unpredictable application of the constraint would have the potential to undermine confidence in insolvency proceedings.

It is also possible that a prohibition on ipso facto clauses will help to shift the present culture of creditors acting in their own self-interests to the detriment of corporate recoveries and overall value maximisation; both of which are fundamental objectives of our insolvency regime. It may even encourage creditors to stand still together before a formal insolvency event occurs, with obvious benefits to pre-insolvency restructures.

### **3.5 Anti-avoidance**

The proposed anti-avoidance mechanism is essential to the efficacy of the prohibition. Without it, the prohibition could be frustrated through "clever" drafting of agreements.

### **3.6 Exclusions**

The Proposals Paper contemplates excluding "prescribed financial contracts" (such as swaps, certain derivatives and close-out netting arrangements) from the scope of the moratorium. The AICD acknowledges that there are certain classes of contracts which, by their very nature, require that ipso facto clauses remain operational. We endorse the Government's proposal to clearly define these excluded contracts in regulations. However, as we are not securitisation experts, we are unable to identify the specific instruments that should be classed as "prescribed financial contracts". We do note

---

<sup>32</sup> Section 365(e) of the *U.S. Bankruptcy Code*.

<sup>33</sup> Section 34 of Canada's *Companies' Creditors Arrangement Act RSC 1985*.

though, that the Canadian insolvency laws contain a similar moratorium carve out for what are termed “eligible financial contracts”.<sup>34</sup>

### **3.7 Appeal rights**

It is appropriate for affected counterparties to have a right to appeal to the court for a declaration that the prohibition does not apply to a particular ipso facto clause or applies only to the extent declared by the court, if the applicant satisfies the court that the operation of the prohibition would cause the applicant significant hardship.

Appeal rights would preserve flexibility in the system, and enable the interests of individual counterparties to be balanced against the interests of creditors as a whole.

## **3. CULTURAL SHIFT**

As noted in Section 2.1 above, Australia’s insolvency laws penalise and stigmatise business failures. It is therefore no surprise that, as the Government has recognised, a cultural shift is required to foster innovation in this nation.<sup>35</sup> An effective safe harbour for directors will, in our view, go a long way towards encouraging a culture of restructuring and entrepreneurship.

In reshaping our culture, the Government may wish to also consider the benefits of opening Chapter 5 of the Corporations Act with an objects clause that explicitly identifies restructuring of distressed, but viable, businesses as a key objective of Australia’s insolvency regime.

Consideration of other initiatives, such as those explored by the Productivity Commission in its *Inquiry Report – Business Set-Up, Transfer and Closure*<sup>36</sup>, may also be warranted.

## **4. CONCLUSION**

The AICD supports the Government’s progression of the long-awaited insolvency safe harbour and ipso facto reforms with the modifications set out in this submission.

We hope this submission will be of assistance. If you would like to discuss our views, please contact Lysarne Pelling, Senior Policy Adviser, on (02) 8248 2708 or at [lpelling@aicd.com.au](mailto:lpelling@aicd.com.au).

Yours sincerely



**JOHN BROGDEN**  
Managing Director & Chief Executive Officer

---

<sup>34</sup> Section 34 of the *Companies’ Creditors Arrangement Act* (R.S.C., 1985, c. C-36).

<sup>35</sup> Proposals Paper, p3.

<sup>36</sup> Released on 7 December 2015.