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

By email: insolvency@treasury.gov.au

Dear Sir/Madam

Submission by Farid Assaf in response to Improving Bankruptcy and Insolvency Laws Proposals Paper dated April 2016

1. I welcome the opportunity to comment on the Government's Proposals Paper *Improving Bankruptcy and Insolvency Laws* ("**Proposals Paper**").

2. I am a barrister in private practice in Sydney having been called to the bar in 2000. I am the author of *Statutory Demands and Winding Up in Insolvency*, LexisNexis, 2012 and *Voidable Transactions in Company Insolvency*, LexisNexis, 2014. In April 2016, I became a fellow of INSOL International graduating with honours and achieving a ranking of first in class. Prior to being called to the bar I was an in-house lawyer for the Australian Securities and Investments Commission.

3. These submissions are restricted to topics 2 and 3 in the Proposals Paper, namely the proposed safe harbour models and the proposals relating to ipso facto clauses. The opinions expressed in this paper are those of the author alone.

Safe Harbour Model A

General response

4. The proposal to introduce a safe harbour to ameliorate the strictures of the insolvent trading provisions of the *Corporations Act,* 2001 are laudable. However, this commentator is not convinced that the proposed safe harbour models will be successful in facilitating the restructure of businesses in Australia for a number of reasons which are explained below. The proposals, in themselves, although a good start, are insufficient to significantly promote a

restructuring culture within Australia as contemplated by the Productivity Commission Inquiry Report, *Business Set-Up Transfer and Closure.*[1] There are a number of reasons for this.

5. Firstly, the proposals (both safe harbour and ipso facto), although desirable, provide an insufficient statutory mechanism in which a true restructuring culture in Australia can thrive. It is unfortunate that the Productivity Commission summarily dismissed a detailed consideration of the possible adoption of a Chapter 11 style legislative regime in Australia. It is worthy to note that the American Bankruptcy Institute has recently completed a comprehensive three year review of Chapter 11 and concluded the continuation of the debtor in possession Chapter 11 model albeit with changes.[2] Had it done so, the Commission would have considered and opined upon the following desirable features of the US Model:

   - a comprehensive, detailed and well considered statutory regime whose primary focus and philosophy is rescue and rehabilitation

   - the notion of debtor in possession to permit existing management who are best placed to understand a company's issues when proposing a restructuring or rehabilitation plan

   - the existence of debtor in possession finance which is integral to maximise the chances of success of any restructure or rehabilitation

   - the existence of specialised insolvency (bankruptcy) courts to assist in any restructuring proposal.

6. Each of the above features should have at least been considered. In particular, the absence of any consideration or proposal for financing for distressed companies is likely to hamper the efficacy of any safe harbour and ipso facto proposals.

7. Second, the proposals still ensure that the Australian insolvency regime is overwhelmingly pro-creditor (such as England and New Zealand) as opposed to pro-debtor (such as the US and Canada). To that end, there is an incongruity between the Government's desire to foster entrepreneurial activity and the commitment to maintaining a pro-creditor insolvency regime albeit with some move towards reform.

8. Third, each of the proposals have a number of limitations and raise some practical problems which are discussed in more detail below.

Response to Query 2.2 - whether proposed Safe Harbour Model A provides an appropriate safe harbour for directors.

9. It is considered that proposed Safe Harbour Model A does not provide an appropriate safe harbour for *all* directors for the reasons below.

[1] No. 75, 30 September 2015.
[2] American Bankruptcy Institute, *Final Report and Recommendations*, 2014 at 21.

Model A is aimed towards the big end of town

10. The key problem with Model A is that it is tailored towards larger corporations, or the 'big end of town' for at least three reasons.

11. Firstly, in my experience, the books and records of many SMEs are inadequate, not up-to-date and do not accurately explain the company's transactions and financial position. This is not to question the honesty and competence of the owners and operators of SMEs but merely reflects the fact that most small business owners do not view record management as a major priority when operating their business (the same could be said for some larger corporations).

12. Second, for the most part directors of SMEs are unlikely to be deterred by the prospect of insolvent trading in any event as ARITA has previously submitted.

13. Third, SMEs are unlikely to have the resources to be able to afford to appoint a restructuring adviser.

14. Fourth, Model A restricts the steps that can be utilised by a distressed company when seeking to restructure or turnaround its fortunes. Although desirable (and in some circumstances necessary) the appointment of a restructuring adviser is not the only manner in which a company be implement a restructuring or turnaround. The manner in which this can be achieved should be left to the market and not restricted by statute.

15. Model A should not be adopted. It would be undesirable for there to exist a safe harbour for larger companies while effectively making it effectively inaccessible to the directors of SMEs. Any safe harbour model should be attractive to all company directors. Model B is the preferred model for reasons which are articulated below.

Response to query 2.2.1a - qualifications and experience directors should take into account when appointing a restructuring adviser and whether those factors should be set out in regulatory guidance by the Australian Securities and Investments Commission, or in the regulations.

16. In the event that Model A is adopted, please consider my responses to the balance of the questions set out in paragraph 2.2.1 of the Proposals Paper regarding Model A.

17. The qualifications and experience directors should take into account when appointing a restructuring adviser will depend on a case by case basis. The qualifications and experience to be taken into account include:

    - accounting and/or legal qualifications
    - specialist post-graduate courses such as those offered by ARITA and INSOL International
    - membership of professional organisations
    - experience in restructuring and turnaround generally
    - experience in a particular industry

- experience developed in the context of appropriately sized organisations.

18. The qualifications and experience should be set out in the regulations to have the force of law.

Response to query 2.2.1b - which organisations, if any, should be approved to provide accreditation to restructuring advisers if such approval is incorporated in the measure

19. ARITA, Insolvency and Turnaround Association, the Turnaround Management Association, CPA Australia, Chartered Accountants, ARITA and the various law societies. There is no reason why appropriately qualified and experienced lawyers should not be able to be appointed a restructuring adviser.

20. In order to ensure a minimum level of competence, it is important that there be consistent and appropriate accreditation for any restructuring adviser.

Response to query 2.2.1c - an appropriate method of determining viability?

21. No. Merely avoiding insolvency and returning to solvency within a reasonable time is not an appropriate method of determining viability. Viability needs to take into account other factors as explained below.

Response to query 2.2.1d - What factors should the restructuring adviser take into account in determining viability? Should these be set out in regulation, or left to the discretion of the adviser?

22. Ultimately, this should be left to the discretion of the adviser although some minimum criteria should be identified. It would be unrealistic and unwise for the legislature to dictate criteria to take into account when determining viability. The particular factors to take into account will vary from company to company. That said, the minimum criteria should entail:

    - solvency
    - profitability
    - the distressed company adequately addressing the causes of decline.[3]

23. That said, and although court's are reluctant to second guess the commercial decision making of professionals, Parliament should also amend s 1321 of the Corporations Act to permit any person aggrieved by a decision of a restructuring adviser to appeal that decision.

Response to query 2.2.1e - whether these are appropriate protections and obligations for the restructuring adviser, and what other protections and obligations the law should provide for.

24. All of the proposed protections are appropriate. In addition however, consideration will need to be given to the following:

[3] See in particular Slatter and Lovett, D, *Corporate Turnaround: Managing companies in distress, Penguin Business* (1999), pp 107 – 113.

- what precisely will be the status, rights, duties and liabilities of a restructuring adviser? Will these matters be similar or analogous to that of current insolvency professionals such as liquidators and administrators? Or will these matters be more akin to an external adviser?

- how long must the restructuring adviser *remain* of the opinion that a company can avoid insolvent trading and be able to be returned to solvency within a reasonable period of time?

- is it proposed to amend the Corporations Act to introduce a statutory duty upon a restructuring adviser to act in the best interests of the company? If so, how is such a duty to be enforced?

- what is the position when 2 or more restructuring advisers are appointed? What are the respective duties in that situation?

- what is the position when a restructuring adviser is appointed to a group of companies? Further or alternatively what is the position when 2 or more advisers are appointed to multiple entities within a group?

- in the event a restructuring adviser confronts a difficulty, will the adviser be able to approach the Court for directions as is the case with liquidators and administrators?

- in the event of subsequent insolvency will the adviser's remuneration be susceptible to being clawed back as a voidable transaction?

25. Much insight may be able to be derived from the analogous position with liquidators and administrators.

Response to query 2.2.2a - Do you agree with this approach?

26. It is considered that the provision of a carve-out as opposed to a defence is preferable from a practical perspective. This is because as a practical matter, the onus would be upon a liquidator to establish that s 588G has first been triggered whereas a defence places the onus upon the director to establish each and every element of the defence. At a practical level a carve out would be less onerous upon a director.

27. While ensuring the voidable transaction provisions would continue to apply during any safe harbour is admirable, it may hamper any attempts at restructuring. As pointed out above, in order to promote a true culture of restructuring the entire panoply of tools available to a Chapter 11 debtor would need to be properly considered and implemented in Australian law. At the very least there would need to be some mechanism promoting the provision of financing to distressed companies. For smaller companies, the provision of finance to distressed companies is usually facilitated by the director or those associated with the director. It is often the case that in providing such finance directors and their associates will require some security. Such transactions are susceptible to being set aside as voidable transactions despite the good intentions of those involved.

28. In order to prevent this, it is considered that there should be a carve-out which effectively quarantines any such transactions entered into good faith and in the

best interests of the company from being clawed back in any subsequent liquidation. This would in some part at least encourage the provision of finance to distressed entities during the so-called twilight period.

Response to query 2.2.2b - Do you agree with our approach to disclosure?

29. Agreed.

Response to query 2.2.3 - in what other circumstances should the safe harbour defence not be available.

30. As mentioned above, a carve-out as opposed to a defence is preferable. If however a defence is implemented then the following submission is made.

31. It is accepted that there should be appropriate mechanisms in place to ensure that any safe harbour is not abused. Those mechanisms should be delineated in statute. The Court should be capable of determining when the safe harbour defence will not apply. In that regard the Court should be left with a wide discretion to decide when the safe-harbour defence may be utilised. This can be achieved by incorporating into statute various examples of when the defence may not be utilised but ensuring the Court can refuse to allow the defence for "some other reason." It not possible to anticipate with precision what likely circumstances will render reliance on the defence unacceptable. These matters are best left to the Court.

32. ASIC should be given the power to determine that a director may not rely upon a safe harbour defence for a specified future period. It should not however be given any power which would conflict with the Court's power to decide if a defence may be relied upon when proceedings for insolvent trading are on foot.

Submissions in response to Safe Harbour Model B

Response to query 2.3 - merits and drawbacks of Model B

33. Model B is to be preferred for reasons set out above. In particular the merits of this proposal include:

- placing the onus upon liquidators to establish a contravention of s 588G has been triggered

- the width and non-prescriptive nature of the proposed model ensures that restructuring attempts can still be made by directors of a distressed company without being limited to the appointment of a restructuring adviser

- the proposal eliminates the prerequisite for accurate books and records as is the case for Mode A which is unlikely to be realistic for SMEs. This is not to suggest that encouragement should be given to company directors to not comply with their statutory obligations regarding proper record management. Rather it accepts the reality that books and records may not have been properly maintained.

34. There are however possible drawbacks to Model B:

- it would need to be made clear in either the Corporations Act or the Explanatory Memorandum to any amending legislation that the appointment of a restructuring adviser would comprise reasonable steps. The issues associated with a restructuring adviser as discussed above would apply *mutatis mutandis* to Model B

- paragraph (b) of proposal 2.3 introduces what appears to be a subjective element into the carve-out. This should be replaced with language ensuring an objective element to ensure congruity with the Court's interpretation and approach towards the current s 588H defences

- paragraph (c) of proposal 2.3 is vague and likely lead to uncertainty in the market. For example, what is a material loss? Would that loss be loss suffered by individual creditors or creditors as a whole? This limb should be replaced with a best interest of creditors test (or similar) as is the case with s 1129(a)(7) of the US Bankruptcy Code. Essentially, the test would entail that incurring the debt in the context of the reasonable steps contemplated by limb (a) was in the best interests of the creditors as a whole;

- there are other drafting challenges to ensure harmonious operation with ss 588G and 588H and in particular s 588H(3).

Ipso facto clauses

35. This is a long overdue reform which will be warmly welcomed by the Australian restructuring industry.

Response to query 3.2a - are there other specific instances where the operation of ipso facto clauses should be void?

36. Yes. The operation of ipso facto clauses should be void where:

- there is an attempt to modify or amend the contract

- any right or obligation under the contract is sought to be terminated or modified

- the creditor seeks to take any other action under the contract detrimental to the distressed company.

Response to query 3.2b - Should any legislation introduced which makes ipso facto clauses void have retrospective operation? Are there any other circumstances to which a moratorium on the operation of ipso facto clauses should also be extended?

37. Retrospective legislation is a contentious issue and rightly so. A suggested approach is to make any retrospective operation effective only after a statutorily mandated grace period. This should permit the market to adjust without undue harshness provided the grace period is reasonable. There will need to be wide consultation with industry bodies before such a change is implemented.

38. The moratorium should also extend to circumstances where:

- The company has entered into the so called twilight period of insolvency in circumstances where the company has sought restructuring advice and/or is implementing a restructuring plan

- the company is in fact insolvent but there is not yet a formal insolvency process in place

- the company has admitted insolvency

- the company has been served with formal demands for the payment of debt such as statutory demands

- there is a judgment debt that has been entered against the company.

Response to query 3.2.1 - Does this constitute an adequate anti-avoidance mechanism?

39. Yes.

Response to query 3.2.2 - What contracts or classes of contracts should be specifically excluded from the operation of the provision?

40. Guidance should be taken from the US position which allows ipso facto clauses to be enforced in respect of, inter alia:

    - certain personal services contracts, for example personal services by a person with special knowledge, judgment taste or skill (s 356(e)(2) US Bankruptcy Code);

    - contracts to extend credit or issue securities (s 356(e)(2)(B) US Bankruptcy Code);

    - forward contracts such as commodity contracts, swap agreements or master netting agreements (s 556 US Bankruptcy Code)

    - certain transportation leases such as aircraft equipment and vessels (s 1110 US Bankruptcy Code)

Response to query 3.2.3 - Do you consider this safeguard necessary and appropriate? If not, what mechanism, if any, would be appropriate?

41. A safeguard is necessary to ameliorate or eliminate the hardship to contracting counter-parties. That said, the proposed safeguard is likely to be too broad and may undermine attempts by companies to restructure. A more nuanced approach is preferred.

42. For example, in relation to secured creditors, consideration should be given to the US approach of ensuring “adequate protection” within the meaning of s 362(g) of the US Bankruptcy Code. Typically, adequate protection in the US takes the form of periodic cash payments to cover depreciation and interest or replacement collateral. Australia would benefit from the significant amount of jurisprudence that has developed in the formulation of this concept.

43. Difficulties arise in respect of unsecured creditors. Under Chapter 11 there is little scope for unsecured creditors to be permitted to exercise ipso facto clauses. This is understandable as the primacy of Chapter 11 is promoting restructuring. Any provision allowing a creditor to be exempted from the prohibition on ipso facto clauses will need to be carefully framed so as not to undermine the objectives of the provision (i.e. promoting restructuring). One option available to unsecured creditors in the context of Chapter 11 is a right of reclamation under s 546(c) of the US Bankruptcy Code. Reclamation is the right of a seller to take back certain goods sold on credit terms to an insolvent buyer. This should be considered.

44. Even if a right of reclamation were to be implemented, this would not prevent the harshness of effectively forcing creditors to continue to supply goods or services to a company which may be insolvent. One solution to the conundrum is for Parliament to clearly emphasise its intention in enacting any legislation which would render ipso facto clauses void. This way it would be left to the courts to determine when a creditor was suffering hardship. Criteria however should be provided to assess hardship in context and in particular requiring the court to consider the countervailing interests of the company and creditors as a whole.

45. I would be pleased to discuss any of the above matters and provide further input if requested.

Yours faithfully

Farid Assaf