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24 April 2017

Financial System Division
The Treasury
Langton Crescent
PARKES ACT 2600

by email: insolvency@treasury.gov.au

Att: Mr James Mason

Dear Sir

National Innovation and Science Agenda - Improving Corporate Insolvency Law

We respectfully make this submission in response to the draft legislation and accompanying draft explanatory memorandum which will amend the Corporations Act 2001 to promote a culture of entrepreneurship and innovation and help reduce the stigma associated with business failure.

Our submission is in two parts:

1. the first part provides our commentary and observations regarding the proposed safe harbour for insolvent trading
2. the second part provides our commentary and observations regarding the proposed stay on ipso facto clauses.

Ferrier Hodgson supports the Government's stated intention of driving 'cultural change amongst company directors' through these reforms.

Consistent with our previous submission on 27 May 2016, we remain of the view that there needs to be an appropriate balance between the importance of creditors' rights and incentivising directors to explore options for the turnaround of a financially distressed company or its business. We also remain of the view that the current Voluntary Administration regime is working successfully to achieve its intended purpose as set out in s. 435A of the Act, and believe the safe harbour and ipso facto law reform will complement that regime.

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We are therefore generally supportive of the proposed changes to the draft legislation, but in this submission make some observations about how we believe the draft legislation could be improved or made clearer.

About Ferrier Hodgson

Ferrier Hodgson is one of Asia-Pacific's leading providers of restructuring and business advisory services. Since 1976 we have developed a reputation for solving complex financial and operational problems with commercial solutions that deliver value and results to all levels of stakeholders.

Our key service lines are:

- Restructuring, turnaround and insolvency
- Forensic accounting
- Forensic IT
- Management consulting
- Corporate and transaction advisory

1. Safe harbour for insolvent trading

The safe harbour reforms are aimed at protecting directors from insolvent trading claims while they are engaged in legitimate restructuring efforts outside a formal insolvency process.

Without repeating the proposed detailed changes to the legislation, there are a number of areas we believe require change or clarity:

- there should be a minimum standard for an 'appropriately qualified' adviser, namely that the adviser holds professional indemnity insurance that covers the adviser for the provision of relevant advice. This would ensure that the adviser:

  - is a member of a recognised professional body and/or is required by law to hold insurance (e.g. registered liquidator, lawyer, member of professional accounting body)

  - has independently applied for and obtained insurance against the risk of liability for acts or omissions in providing advisory services

- the parties at most risk from a company continuing to trade during a safe harbour period are new creditors whose debts are incurred while the restructuring is being attempted. If the company is trading whilst insolvent under safe harbour, these new debts are, by definition, at risk. While we acknowledge the risk to new creditors may

be an unavoidable element of safe harbour, a number of options designed to protect new creditors are worthy of consideration:

  - requiring the payment of new creditors in full as a pre-condition to the safe harbour defence

  - providing new creditor claims incurred during the safe harbour period with a priority in any subsequent liquidation over claims of unsecured creditors existing at the time the safe harbour commences

  - limiting the period during which the company can operate under safe harbour in order to minimise any damage to new creditors

  - another option would be to protect ‘new money’ rather than ‘new creditors’ in the points above

- we agree with the approach that there is no requirement for directors to disclose that they are operating in safe harbour as this would be counter-productive to the aims of the reforms. We note, however, the potential injustice to new suppliers which we provide our comments on in the points above. We also note that continuous disclosure requirements for publicly listed companies may require disclosure of the appointment of a restructuring adviser, which may alert stakeholders to the fact the company is operating in safe harbour, and therefore in financial difficulty. We do not believe such disclosure requirements should be changed

- as currently drafted, the safe harbour only applies to debts incurred ‘in connection with the course of action’. Whilst that is likely to include ongoing trading debts incurred during the safe harbour period, we believe this should be clarified – i.e. that safe harbour applies to all debts incurred in good faith during that period

- we believe the reference to ‘providing for the entitlements of its employees’ requires clarification. For example, it is not clear to us whether a company needs to have cash available at all times to meet entitlements? Does it mean if a company could have paid all notice and redundancy liabilities at the start of safe harbour but could not at the point of administration, that the safe harbour defence will not apply?

- similarly we believe the tax reporting requirement also requires clarification as to what is actually intended. For example, does it mean that all lodgements need to be up to date, or does it mean that a company needs to have sufficient funds to meet all of its taxation liabilities, or both?

- the draft legislation provides that the safe harbour comes to an end when the company becomes a Chapter 5 body corporate, which includes where a company has entered into a compromise or arrangement and that arrangement has not

concluded, and also includes the appointment of a receiver, but not necessarily over all of the assets of the company. These are situations where a restructuring may still be pursued, and it seems unfair to remove the safe harbour defence for directors in those circumstances. We do not believe the company becoming a Chapter 5 body corporate is an appropriate trigger to end the safe harbour.

2. Stay on ipso facto clauses

One of the greatest inhibitors of successful restructuring under the current insolvency regime is the existence and impact of ipso facto clauses. We therefore support the notion of a stay on the enforcement of ipso facto clauses upon a company's entry into formal insolvency proceedings.

In our view, the rationale of preserving business and enterprise value extends and applies to any insolvency process where an external administrator has the power to manage, trade and/or sell a business. As such, we do not believe the stay on ipso facto clauses should be limited to instances of voluntary administration or schemes of arrangement, but should also apply where a company enters liquidation or a managing controller is appointed to all or substantially all of a company's assets and undertakings.

Further to our general view that the stay should be extended beyond schemes or arrangement and voluntary administrations, there are a number of other specific areas which we believe require change or clarity:

- where a company is wound up, the liquidator has the power to trade the company's business 'so far as is necessary for the beneficial disposal or winding up of that business' (s. 477(1)(a)). While a rare occurrence, a liquidator also has the option of appointing a voluntary administrator under s. 436B of the Act – such an occurrence would result in a stay of ipso facto clauses. Further, we note the draft legislation contemplates the extension of an ipso facto stay in voluntary administration to any subsequent winding up. Accordingly, in our view, the extension of a stay from voluntary administration into liquidation is appropriate, but the stay in liquidation should be available in all liquidations, regardless of how the liquidation is commenced

- whilst it may be argued that a stay on ipso facto clauses should be excluded from receiverships on the basis they are technically a security enforcement mechanism rather than a corporate rescue regime for the benefit of all creditors, in practice, receiverships often involve the insolvency practitioner trying to sell the business on a going concern basis. Our view, therefore, is that a stay on ipso facto clauses should also be implemented where a managing controller is appointed to the whole or substantially the whole of the company's assets and undertakings, but not in cases where a controller is appointed over a specific asset/s of the company only

- the draft legislation includes a list of 'excluded contracts' which will not be subject to the stay of ipso facto clauses. That list contains the replacement of trustees – i.e. trustees are still able to be replaced following an insolvency event. One key issue facing insolvency practitioners is the effect of 'ejection clauses' in trust instruments which automatically remove a corporate trustee in the event of a winding up or other external administration appointment. The operation of such clauses casts doubt upon the power of sale of a liquidator appointed to a company which has been removed as trustee[1]. The cost-effectiveness and efficiency of external administrations will be served if the new stay on ipso facto clauses prevents the removal of a company as trustee in the event of the appointment of an external administrator. As such, we believe that 'replacement of trustee' should be removed from the proposed list of excluded contract types

- the draft legislation does not contain explicit ipso facto restrictions in relation to DOCAs. Given the importance of DOCAs as a restructuring tool, we believe a stay on ipso facto clauses should also apply if a company enters into a DOCA

- acceleration rights under loan agreements are not specifically excluded by the draft legislation, which may limit the ability of counterparties to exercise set-off rights in question, if not all of the debt sought to be set off is actually due. This can be a particular issue for banks in an administration where it has been held that amounts accruing under the administrator's lien take priority to such set-off rights.[2] We believe consideration should be given to this issue

- the legislation should be applied retrospectively such that ipso facto clauses contained in contracts entered into prior to the introduction of the new laws are considered void in the event of an insolvency appointment after the introduction of the new laws. If the legislation is not applied retrospectively, we believe it will result in an unnecessary amount of cost and confusion in the critical initial stages of an administration – e.g. on appointment, administrators may feel the need to make urgent court applications to determine whether a stay on ipso facto clauses apply.

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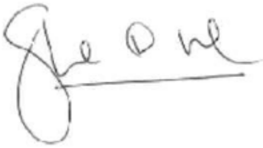
[1] D'Angelo N, 'Trustee "ejection clauses": consequences for liquidators, receivers and creditors', (2016) 17(6) *Insolvency Law Bulletin* 96.
[2] See Apathy P, Spencer S and Filippin L, 'Herbert Smith Freehills Legal Briefing: Australian Government releases draft insolvent trading and ipso facto legislation', 5 April 2017

Thank you for the opportunity to present our submission in relation to these critical changes to the law.

Please do not hesitate to contact Stewart McCallum, a Partner in our Melbourne office, on 03 9604 5660 if you have any queries or would like us to expand on any of the points contained in this submission.

Yours faithfully
Ferrier Hodgson



Stewart McCallum
Partner