Innovation Statement Law Reform: Safe Harbour and Ipso Facto

Treasury Laws Amendment (2017 Enterprise Incentives No.2 Bill)

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1. Introduction

1.1 Who we are

SV Partners Pty Ltd (SV Partners) provides professional corporate and personal insolvency advice to accountants, financial institutions, corporations, financial and legal advisors, and individuals. With a team of over 100 insolvency specialists across the eastern seaboard, our expert advisors focus on recovery, reconstruction advice and formal insolvency appointments. We also operate one of the largest private bankruptcy practices in Australia.

1.2 Our experience

Our executive team has extensive experience in the insolvency and turnaround industry and hold memberships with Australian Restructuring, Insolvency and Turnaround Association (ARITA), Chartered Accountants Australia and New Zealand (CAANZ), Certified Practicing Accountants Australia (CPA), Institute of Public Accountants (IPA), Australian Institute of Credit Management (AICM), Turnaround Management Association (TMA), Australian Institute of Company Directors (AICD) and the QLD Master Builders Association (QMBA).

We also hold positions on the Australian Securities and Investments Commission (ASIC) Liquidator panel, the Australian Taxation Office (ATO) Liquidator panel and Department of Employment Fair Entitlements Guarantee (DoE FEG) panel.

1.3 Executive summary

The proposed Bill goes too far in carving out insolvent trading provisions. Main concerns involve 'pre-insolvency advisors' potential abuse of the provisions, increased obligations on the Liquidator to prove that safe harbour protection is not available when pursuing an insolvent trading action and that the proposed bill does not achieve the objective of balancing creditors rights with responsible business risk taking.

2. Safe harbour provisions

Australian insolvent trading laws have been debated often.

In January 2010, a discussion paper[1] assessed if Australia's insolvent trading laws were stifling entrepreneurial activity and provided three options to resolve any concern. An additional defence for directors or allow for flexible reorganising the company outside of external administration were considered, but resulted in no change.

In October 2014, the Australian Restructuring, Insolvency and Turnaround Association (ARITA) released a discussion paper[2] which championed the removal of the insolvent trading provisions to allow directors to have a safe harbour to make decisions on potential restructuring in conjunction with a formal restructuring adviser.

[1] Insolvent Trading: A safe harbour for reorganising attempts outside of external administration
[2] A Platform for Recovery 2014: Dealing with Corporate Financial Distress in Australia

In December 2015, the Productivity Commission's report (No. 75[3]) recommended a 'safe harbour defence' to allow directors to obtain independent advice without the threat of insolvent trading penalties.

Based on the Productivity Commission's recommendation, a proposal paper[4] for safe harbour provisions was released for comment in April 2016. Model A provided for an additional defence to insolvent trading and model B carved out insolvent trading provisions, focusing on the director retaining control without the requirement to seek assistance from a restructuring advisor. Following that consultation, the proposed Bill was released in March 2017.

The Bill proposes a modified version of model B through the creation of new sections to the *Corporations Act 2001 (Cth)* (the Act) which will create a safe harbour for directors' from personal liability for contravention of the civil penalty provisions of section 588G(2), through the:

- development and application of a recovery plan that is *reasonably likely* to lead to a *better outcome for the company and its creditors* than the alternative (being voluntary administration or liquidation);
- ensuring employee entitlements (including Superannuation) pursuant to section 596AA(2) of the Act are provided for;
- company continues to meet reporting obligations in the *Income Tax Assessment Act 1997*; and
- maintenance of company records that are adequate (and must be provided to an administrator or liquidator on appointment).

2.1 Determining what is 'reasonably likely' to lead to a 'better outcome'

In the initial proposal, model B required the director to '*take reasonable steps to maintain or return a company to solvency within a reasonable period of time*[5]', however, this has been removed in the proposed Bill. Further, initial indications that legislation would flesh out what 'reasonable steps' and what 'a reasonable period of time' would entail have also been overlooked.

Reasonableness is determined on an objective standard and whilst the proposed Bill attempts to provide guidance at 588GA(2) by listing five *general factors* to be considered; the explanatory memorandum[6] renders them ineffective by stating it is not necessary for all five factors to apply for reasonableness to be demonstrated, however, in the alternative, if they did, one cannot ensure that the course of action can be deemed reasonable.[7]

2.2 Our concerns

The productivity commission's recommendation for a safe harbour for directors was made on the basis that the '*restructuring advisers be registered, that the company be solvent at the time of the adviser's appointment and that the adviser is presented with complete books and records on their appointment*'[8]. The report goes onto discuss implementation, disclosure concerns, timing and coverage and the overall operation of potential safe harbour provisions.

[3] Productivity Commission Inquiry Report No. 75: Business Set Ups, transfers and Closures, 30 September 2015 (the PC report)
[4] Improving bankruptcy and insolvency laws
[5] Improving bankruptcy and insolvency laws Proposals Paper April 2016 (National Innovation and Science Agenda)
[6] Treasury Laws Amendment (2017 Enterprise Incentives No. 2) Explanatory Memorandum (EM)
[7] Points 1.32 – 1.35 of EM
[8] Page 373 of the PC report

Our responses to the questions in the proposal paper (submitted on 26 May 2016) are included at attachment A and in our 2016 submission we favoured model A as it:

- dealt with concerns surrounding the conduct of 'pre-insolvency advisors', who do not have obligations to be registered with a regulatory body, do not hold a minimum standard of education and are not bound by any professional and ethical standards;
- could be codified to ensure directors have a clear obligation to act when a company is in financial distress, accessing professional assistance and working with the company's stakeholders in an informal capacity to return the Company to a solvent position; and
- required the involvement of a qualified professional – termed a 'restructuring advisor', who could potentially assist with access to additional funding.

Model B shifted the responsibility from a director to act when a company is in financial distress to the Liquidator (after the Company has failed) to prove that a director committed an offence.

The proposed Bill fails to achieve the objective of balancing creditors' rights with responsible business risk taking by failing to address the negative implications on existing and new creditors, relevant timeframes and the basic obligation to ensure the Company becomes viable within a reasonable period of time.

Liquidators pursing insolvent trading claims are currently required to undertake substantial investigations, incur legal expenses and their own expenses with the anticipation that recoveries from a successful judgment will provide reimbursement of these expenses as well as a return to creditors. Providing such a flexible carve out of the provisions without obligations imposed on directors to achieve a result will increase the burden on liquidators to bring recalcitrant directors to account, and when they do, the higher costs are likely to be borne by creditors.

2.3 Potential impact of the Bill on voidable transactions

The implications of directors seeking relief from insolvent trading actions may have an adverse impact on the recovery of voidable transactions (in the event the company is liquidated) as the proposed Bill fails to address any of the following:

- the *Insolvency Law Reform Act 2016* introduced in March 2017 clarifies relation back date in specific circumstances, a scenario involving a failed attempt to claim safe harbour should also be addressed to coincide with the commencement of the safe harbour period;
- presumptions of insolvency specified in section 286 of the Act should be extended to include a failed attempt at safe harbour;
- clarification that safe harbour protection only extends to a director for offences pertaining to insolvent trading; and
- there does not appear to be any protection for new creditors incurred during the 'safe harbour period' in terms of voidable preference recoveries.

3. Ipso facto clauses

Part 2 of the proposed Bill codifying a stay on enforcing rights merely because of arrangements or restructures appears reasonable with the types of contracts proposed to be excluded logical.

Attachment A: Our response to Improving bankruptcy and insolvency laws proposal paper

Proposal	Query No	Query	Response
Defence to section 588G of the CA (Model A)	2.2	Will model A provide an appropriate safe harbour for directors?	Yes, with the following changes/additions. It is insufficient for the requirement of relevant company records and the restructuring advisor's opinion to be the only determinants of the company's future viability. Directors must take reasonable steps to comply with the Advisor's recommendations to enable the company to be restructured in an informal capacity. If a director can evidence that the events that proceeded the insolvency of the company were unlikely to be predicted and outside of the director's control then the defence would be satisfactory.
	2.2.1a	What qualifications and experience should directors take into account when appointing a restructuring officer, & should this be set out in ASIC RG?	The recommended qualifications should be an external administrator or accountant and a member of ARITA and either the Institute of Charters Accountants Australia (ICCA) or CPA Australia. Yes, a regulatory guide specifying what qualifications are required should be produced by ASIC.
	2.2.1b	Which organisations, if any, should be approved to provide accreditation to restructuring advisors, if such approval is incorporated in the measure?	We recommended that the appropriate organisations should be the Australian Securities and Investments Commission (ASIC) and the Australian Restructuring Insolvency and Turnaround Association (ARITA).
	2.2.1c	Is the method of determining viability appropriate?	No. Currently the method is too broad. The method suggested is that the company can avoid insolvent liquidation and be returned to solvency within a reasonable period of time. This method very broad for the following reasons: 1. proving the insolvency or solvency of a company is a specialist's process which incorporates a large body of case law. The key principles are: insolvency as a cash flow test, use of balance sheet to supplement information, use of indicators of insolvency, how secured creditors and set off affects the assumptions, and access to debt/equity funding. These should be the bases of what is considered when assessing the company's current position. 2. providing an opinion that a company can avoid an insolvency event takes into consideration many forward looking statements that are affected by unknown factors occurring in the future. The Advisor would seek reliance on the statements of the directors (with their specific industry knowledge) and/or historical relationships.

Proposal	Query No	Query	Response
Defence to section 588G of the CA (Model A)	2.2.1d	What factors should a restructuring advisor take into account when determining viability? Should these be set out in regulation or left to the discretion of the advisor?	The factors we recommend are: • there should be a base level requirement to perform specific tests based on the above points in 2.2.1c, but the overall opinion should be left to the discretion of the Advisor. • the Advisor could assist the company in obtaining further funding if required to return the company to solvency within a reasonable period of time.
	2.2.1e	Are the protections and obligations for the restructuring advisor appropriate, and what other protections and obligations should the law provide for?	The proposed protections and obligations for the restructuring advisor are logical. Two of these protections that should remain are that the restructuring advisor: • is not a shadow or de facto director; and • is not able to be appointed to any subsequent insolvency without leave of the Court, which is in line with Corporations and Bankruptcy statute and section 6 of ARITA Professional Code of Conduct. Obligations of the director have not been addressed. The director should take all reasonable sets to implement the recommendations of the Advisor, provide all reasonable assistance as requested and act in good faith. All obligations of the restructuring advisor and the director should be set out in the regulations.
Other features of safe harbour	2.2.2a	Do you agree that safe harbour would not prevent voidable director related transactions or personal liability for specific employee liabilities incurred during the safe harbour period (if company is subsequently liquidated)?	Voidable antecedent transactions predicated on determining a date of insolvency prior to or as a result of entering into the transaction are likely to be affected by the opinion of the restructuring advisor stating the company's ability to be solvent within a reasonable period of time. The impact of this depends on the timing of when the restructuring advisor's opinion was provided, and if the informal workout occurred. The current provisions of section 588 of the Act should all remain in the event of an insolvent liquidation, provided that all elements of voiding the transaction can be met. Yes, safe harbour provisions should not prevent voidable recoveries or absolve the director from personal liability associated with employee liabilities, if the company is liquidated due to a failure of the informal workout.
	2.2.2b	Company continuous disclosure requirements would remain during the safe harbour period, which may impact privacy. Do you agree?	Yes, continuous disclosure should occur, together with a defined timeframe for the process of "informal restructuring" to ensure that a company does not stay in the "safe harbour period" indefinitely. It is also recommended that key stakeholders be involved in this process as they should have the right to withdraw their support.
Where safe harbour is not available	2.2.3	In what other circumstances should the safe harbour defence not be available?	If the director does not take all reasonable steps to implement the Advisor's recommendations, they should not be afforded the defence.
Section 588G of the CA does not apply (Model B)	2.3	What are the merits and drawbacks of this model?	The drawback of this model is that is shifts the responsibility of the director to ensure the company not trading insolvently or will return to solvency within a reasonable timeframe to the Liquidator, in their obligation to pursue the director with creditors' funds. We are of the view that this is unlikely to have a positive effect in director dealings.

Proposal	Query No	Query	Response
Any term of a contract or agreement which terminates or amends any contract or agreement by reason only that an 'insolvency event' has occurred would be void. Any provision that has the effect of providing for, or permitting, anything that in substance is contrary to the above provision would be of no force or effect	3.2a	Are there other specific instances where the operation of ipso facto clauses should be void?	We agree that counterparties to a contract with an insolvent party should not be allowed to amend, accelerate or vary an agreement for the sole purpose of insolvency.
	3.2b	Should any legislation introduced which makes ipso facto clauses void have retrospective operation?	No
	3.2.b	Are there any other circumstances to which a moratorium on the operation of ipso facto clauses should also be extended?	Yes. Liquidators that are converting a business sale or who have a genuine reason should also have the capacity to void an ipso facto clause. It is agreed that any other type of ipso facto clause that varies the terms or terminates a contract that would be detrimental to a company undertaking restructuring should be void.
	3.2.1	Does the mechanism of any provision in an agreement that has the effect of providing for, or permitting, any that in substance is contrary would be of no force or effect constitute adequate anti-avoidance?	Yes
	3.2.2	What contracts or classes of contracts should be specifically excluded from the operation of the provision?	We agree with prescribed financial contracts.
	3.2.3	Do you consider appeal on the grounds of hardship to be a necessary and appropriate safeguard? If no, what mechanism would be?	Yes