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Dear Manager

**Improving Bankruptcy and Insolvency Laws, Proposals Paper: Public Submission  
due 27 May 2016**

This submission comments on government's Improving bankruptcy and insolvency laws, proposals paper, released on 29 April 2016, and in particular those aspects concerned with safe harbour and ipso facto clauses.

The observations in this submission are based on my experience in the restructuring and insolvency industry since 1995. I have worked in Australia, the UK and the Middle East. In my dealings in the UK and the Middle East, I worked on restructurings alongside persons recognised globally as preeminent practitioners, and involving parties from the UK, the Middle East, USA, Europe and Asia. I joined Australian law firm DibbsBarker as a Restructuring Partner in May 2014.

## **1. Executive Summary**

- Government is to be commended for its proposed approach to safe harbour law reform. Significantly, this government is willing to consider making real change to the insolvent trading framework itself (and not solely contemplate a new defence), signalling a real cultural shift.
- In the author's view, safe harbour model B is the preferred outcome, albeit further consideration of the proposed text is warranted. It is simpler than model A. It shifts the burden of proof and expressly makes it permissible for a director to honestly and reasonably pursue restructuring efforts. In doing so, model B should encourage entrepreneurship and go some way to reversing the conservatism in director behaviour that the current law has led to.
- Safe harbour model A also represents a strong stance. If this model is preferred, it is well craft and will provide clear guidance to directors of companies as to what is expected of them during times of financial turbulence, with minor comments on matters of detail.
- The government should give serious thought to whether section 588FA of the *Corporations Act* voidable preferences should be inoperable during the safe harbour. Only preferences with intent to prefer should be voidable.
- In the author's view, the government's proposed ipso facto reform is appropriate and for specific guidance on the proposed breadth and exclusions, the author submits that the Canadian regime is well balanced and helpful.

## 2. Safe Harbour Model B

### 2.1 Summary views

It is submitted that safe harbour model B is the simpler and preferable approach. The transfer of the burden of proof should facilitate entrepreneurship and lessen conservatism. It should have the effect of enabling a broader range of companies to attract and retain good quality directors. For these reasons, model B is better suited to and will appeal more to the start-up market and directors.

However, it does not contain the additional guidance to directors around the appointment of a restructuring adviser and the need for appropriate books and records set out in model A. These matters are important and should be addressed in explanatory memoranda (as government suggests) and/or ASIC regulatory guidance, to more fully assist parties in construing model B and to describe what is expected of directors who seek to benefit from model B.

Moreover, the text proposed requires thought. In summary, I submit variations to the text as follows:

“Section 588G does not apply:

- (a) if the debt was incurred as part of or during reasonable steps taken with a view to returning the company to solvency within a reasonable period of time, which view was honestly and reasonably held; and
- (b) if 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.”

I expand below.

### 2.2 The UK wrongful trading framework

In light of the government’s willingness to consider model B, I encourage government to consider whether adoption (in whole or part) of the UK wrongful trading framework in section 214 of the *Insolvency Act, 1986* (UK) would meet its policy considerations.

A director in the UK contravenes the *Insolvency Act*, if that person continues to trade an insolvent company notwithstanding they “knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation” (section 214(1) and (2)).

In the UK, the law goes further, and provides that if it is clear that liquidation cannot be avoided, but the director “took every step with a view to minimising the potential loss to the company’s creditors”, that person will not be liable for wrongful trading (section 214(3)).

In lay terms, the practical effect of the UK wrongful trading framework is that directors cannot blindly without care, trade a company whilst it is insolvent. The directors must be trading a company for a proper purpose, that is to attempt to turn it around and avoid insolvent liquidation or, if that is not possible, taking every step with a view to minimising loss to creditors. The significant benefit of adopting the UK framework is that the drafting has been undertaken and tested, with case law available to Australia for construction purposes. Moreover, in my experience working in the UK, there is no fear of personal liability which interferes with and is a distraction from restructuring efforts. Rather, companies, their key stakeholders and advisers focus on attempting to deliver value accretive outcomes. This differs to my experience, including recent and current experience, in Australia.

### 2.3 The government’s proposed framework

The government’s proposed framework already incorporates aspects which, in practical terms, mirror the UK framework, namely to avoid insolvent liquidation (or in government’s terms, to return the company to solvency). The author supports this approach.

However some of the language in the proposed framework is, in the author’s submission, confusing and in practice, will present an impediment from an advisory and reliance perspective. I comment below.

**The text proposed in “(a) if the debt was incurred as part of reasonable steps...”**

In the author’s submission, this would be better framed as:

“(a) if the debt was incurred as part of *or during* reasonable steps to ~~maintain or~~ return the company to solvency within a reasonable period of time”

**Rationale:**

- To include “or during”: The incurrance of the debt might not be one of or part of the reasonable steps to turn the company around. The reasonable step might be to sell an asset (eg a non-core business or non-core land) or cut certain costs, on the assumption that if the asset is sold or the costs are cut, then the company will return to solvency. As a result, it is rational (and should be permissible) for the director to continue to trade the company as a going concern ie, incur trading debts, while it takes those steps.
- To delete “maintain”: The text is unnecessary. If a debt is incurred at a time the company is solvent or it becomes solvent by incurring that debt, then section 588G does not apply.

**The text proposed in “(b) the person held the honest and reasonable belief ...”**

In the author’s submission, the text in (b) is appropriate. It turns the directors’ mind to the debts that are being incurred during the restructuring efforts. This is necessary and helpful. In my experience, directors will readily take steps such as attempt to raise new capital or refinance debt. However, in addition, the director needs to turn their mind to the ongoing trading debts that are incurred while the restructuring efforts are devised and implemented, and ensure that the continuing incurrance of those debts is in the best interests of the company and its creditors taken as a whole. In essence, this test should ensure that the director asks him or herself, am I doing all that I reasonably can and should do, not just in the capital structure but also at an operational level, to create efficiencies and improve profitability.

**The text proposed in “(c) incurring the debt does not materially increase the risk of serious loss...”**

In the author’s submission, the text in (c) is flawed, confusing and not required in light of (b). It should be removed. Accordingly, see the framework proposed by the author in paragraph 2.1 above.

In the alternative, if that position is not accepted, then the text in (c) would be better framed as part of a revised (a) as follows:

“(a) if the debt was incurred as part of *or during* reasonable steps *taken with a view:*

(i) to ~~maintain or~~ return the company to solvency within a reasonable period of time; and

(ii) to minimise the potential loss to the company’s creditors<sup>1</sup>,

*which view was honestly and reasonably held”*

**Rationale:**

In the author’s submission, the proposed text regarding loss to creditors does not need to be mentioned in the law at all. Creditors are protected by the proposed text in (b). Moreover, creditors have the protection under (a), which requires steps to return the company to solvency. A return to solvency by definition means that creditors are paid in full when due. Steps to return the company to solvency equate to steps to increase value and decrease loss.

While I am not opposed to language which directs directors’ minds to what they need to focus on, the language needs to be considered carefully, and it should not unduly complicate the regime or be repetitive (ie do the work that another provision is already doing).

<sup>1</sup> See section 214(3) *Insolvency Act, 1986* (UK), being the source of this text. In the UK, the text arises as an additional carve out where insolvency cannot be avoided but nonetheless, the director takes every step to minimise loss to creditors.

Notwithstanding this submission, if an additional test which expressly turns directors' minds to the risk of loss to creditors is considered necessary by government, then the test needs to be reconsidered, for example along the lines of the UK text as set out above. That is, are the turnaround steps likely to be value accretive, thereby minimising loss to creditors and enhancing the prospect of a full return? This test looks at what the directors are doing, and allows the Court to consider whether in all of the circumstances what they are doing is reasonable.

Reasons in support of the submission to change the focus away from "increasing the risk of material loss", to "minimising potential loss" are provided below.

- The text as proposed is confused, too narrow and will unintentionally make it very difficult for directors to fall within the carve out.
- In a turnaround context, there is always the *risk* of loss and in insolvency, the loss will almost always be material. At the very least, the Court should be looking at actual loss occasioned not mere risk in hindsight.
- A focus on the risk of increased material loss to creditors is unduly complicated. In bringing proceedings, it will involve a technical and expensive debate, focussed on quantifying the risk of loss, the materiality of loss, the increase in loss, all in hindsight, at the time the debt was incurred.
- The focus is also flawed. Honest and reasonable decisions can be made which carry a risk of increased material loss to creditors if the turnaround efforts fail. It is incorrect to suggest that all such decisions are somehow improper and directors should be personally liable for making them. This is the difficult environment of severe financial distress. It is an important reason why restructuring experts ought to be involved.
- Most obviously, in a turnaround context, it is often necessary for material new debt to be incurred to provide short-term liquidity. For example, a bridging loan is a common feature of a turnaround and will be one of the reasonable steps that a director will often be advised to take in pursuit of solvency. The bridging loan may not itself provide solvency, rather it may provide liquidity relief to keep creditors at bay, and buy time to deliver the more substantial turnaround plan. It is often granted on a high yield unsecured (perhaps convertible) basis where there is no available security (or nothing of value) for the company to give.

If the company fails, it is highly probable that the material new unsecured indebtedness incurred to support the company through its turnaround efforts, will materially dilute other unsecured creditors upon a liquidation. Assuming that occurs, the dilutive effect will materially increase material loss to unsecured creditors.

- This exemplifies that the very short-term finance that is needed by a company in a turnaround context, cannot be incurred under the current proposed framework (c). If it is, advice must be given that in incurring that debt, which is material, the directors risk losing the protections afforded by the amendment and are at risk of section 588G liability. As such, in practice, the cultural reform which is proposed by the amendment will be stifled.

I provide other examples below, which further exemplify the flaw in the proposed text:

- A company must continue the services of its key contractor and incur certain operational costs before it can produce revenue. The debt incurred in continuing the services of the key contractor is material and unsecured, as are the operational costs. If the key contractor is not continued, the company will fail, but no further debt will be incurred. Creditors proportionate positions will be fixed as at today. The directors believe that the revenue derived in the near future by continuing the services of the key contractor and incurring the operational costs, will position the company to deliver a new capital raising, and that new capital raising will be sufficient to return the company to solvency. The directors honestly and reasonably believe that these steps are viable, including based on advice given by an experienced restructuring adviser. The directors decide to continue the services of the key supplier and incur material debt, and incur the operational costs which are also material, all of which materially dilutes the comparative position of all unsecured creditors. A significant unanticipated market event occurs in the months that follow and parties who routinely provide

capital solutions to companies in the industry make a strategic decision to make no further investment in the industry. The company cannot raise the capital and liquidation follows a voluntary administration appointment by the directors. The directors are liable for insolvent trading. While the steps that they pursued were reasonable, the Court finds that incurring the debts materially increased the risk of material loss to creditors by virtue of the (potential) material dilutive impact. (This identifies the additional issue with the drafting, in that the text does not require the loss to be realised, just a risk.)

The above example is relevant to any company which needs to spend funds upfront to secure revenue down the track – this is common in many industries, and relevant to many established companies, but directly impacts if not all, then most, start-ups (the focus of the government's policy).

- A small family owned company owns a non-core profitable business which it has decided to sell as a key step to return the company to solvency. It will use the proceeds to pay down unsecured debt. The other key steps involve managing creditors including the banking relationship. The director has not dealt with a company in financial difficulties before and engages a restructuring expert to assist her with the process, and in particular managing difficult creditor conversations and re-financing the bank. Advisers must also be engaged to sell the business. The costs of the restructuring expert, the advisers and sales process are not small, and in the context of her business, material. However, if those costs are not incurred, the director is concerned that she will not be able to turn the company around and will need to appoint a voluntary administrator. Some months later and before the non-core business is sold, a key customer of that business is unexpectedly placed into liquidation. In a low confidence market and with that revenue source gone, the sales process is adversely impacted and the likely purchase price will now fall far short of the price required to return the company to solvency. Reluctantly, the director places the company into voluntary administration and then liquidators are appointed. The director is liable for insolvent trading. While the steps that she pursued were reasonable and she followed ASIC guidance by appointing an expert to assist her, her decision to incur the material new costs materially increased the risk of material loss to creditors. It was clear at the time those costs were incurred that they were material, and if the efforts failed, there was a risk existing creditors would be materially diluted. (Again, there is a drafting issue, in that actual loss occasioned is not a consideration).

### 3. Safe Harbour Model A

Model A as proposed is well craft and well considered. Model A has the significant advantage over model B, in that it provides more specific guidance to directors about what is expected of them when the company is in financial difficulty. In doing so, it has the potential to bring about positive cultural reform, earlier intervention and an improved prospect of avoiding liquidation.

However, from a directors' perspective, it is more complicated than model B and carries the burden of proof.

If model B is preferred over model A, then the model A considerations around the steps that a director should take, including the appointment of a restructuring adviser, the qualifications of that adviser and the adviser's access to appropriate books and records, should form part of explanatory memoranda and/or ASIC regulatory guidelines for model B.

My submissions regarding model A are as follows:

- 2.2: The proposal provides an appropriate safe harbour for directors.
- 2.2.1a: The factors with respect to appropriate qualifications and experience of a restructuring adviser should be set out in regulatory guidance by ASIC. Critically, a restructuring adviser *must* have experience in assisting companies to *avoid* insolvent liquidation *and* return to solvency. Liquidators will not necessarily have such experience (liquidators are appointed to liquidate a company), although some will have. I have read and generally endorse the submissions of the TMAA with respect to appropriate qualifications and experience of a restructuring adviser.

- 2.2.1b: The organisations listed are appropriate and should be approved to provide accreditation to restructuring advisers. I have read and generally endorse the submissions of the TMAA with respect to appropriate organisations and accreditation.
- 2.2.1c: An appropriate method of determining viability is proposed.
- 2.2.1d: ASIC might provide guidance including by way of examples on factors to be taken into account in determining viability, and advisers should also exercise discretion that is, act with the benefit of their experience. The Productivity Commission provides a helpful summary of submissions and guidance on the topic of viability in its business set-up, transfer and closure final report at page 375-376.
- 2.2.1e: Appropriate protections and obligations for the restructuring adviser are proposed.
- 2.2.2a: The approach proposed is appropriate. Additionally (and this submission applies to model A *and* model B), **the government should give serious thought to whether section 588FA of the Corporations Act voidable preferences should be inoperable during the safe harbour**, to avoid creditors demanding 'cash on delivery' or other arrangements which protect them eg funds in trust, which have the potential to frustrate the restructuring efforts. It is of importance to note that companies in financial distress are ordinarily cash poor and need support from creditors which alleviates the cash crisis and does not heighten it. Without amendment to section 588FA, as soon as a restructuring adviser is appointed, creditors will be concerned to protect their own positions in respect of any payments that they receive, to avoid having to repay them to a liquidator in the event the company fails. They do so by demanding cash up front for new indebtedness. While the proposed ipso facto regime could be directed to prevent changes to contracts upon the appointment of a restructuring adviser (see paragraph 3 below), that will not go far enough. Usually, creditors will be unpaid and will be able to stop work based on non-payment.

Importantly, this submission considers the safe harbour framework from the creditors' perspective. Creditors will be asked as part of a restructuring plan to agree to deferred payment terms. The appointment of the restructuring adviser, who is probably at the deal table negotiating the deferral with the company (particularly with respect to all key creditors), clearly flags insolvency concerns to the creditor making the defence impossible to rely upon (see text in section 588FG(1) – the creditor cannot have grounds for suspecting insolvency if it wishes to rely on the defence). Creditors should be free to support the company, by agreeing to the deferral plan and agreeing to continue supply, without being in the firing line if the efforts fail and a liquidator is appointed.

There is no doubt that the appointment of a restructuring adviser will embolden liquidators of companies which failed in their restructuring efforts – for the appointment of the adviser (alerting parties to insolvency concerns) renders the only available defence to voidable preferences, useless. The government needs to be aware of this and must consider what amendment ought to be made to compensate for that factor, and ensure that the safe harbour framework is as effective as possible.

In the author's submission, an amendment to the law could provide that only preferences with intent to prefer would be voidable during the safe harbour. Section 239(5) of the *Insolvency Act 1986, UK* provides sample text for consideration (tweaked to align it to the Australian position): "*The court shall not make an order [under section 588FF] in respect of [an unfair preference given by the company to a creditor of the company] unless the company which gave the preference was influenced in deciding to give it by a desire to produce in relation to that creditor the effect [mentioned in section 588FA(1)(b)].*"

- 2.2.2b: The approach to disclosure is appropriate. Listed companies undertaking restructuring efforts are currently obliged to make disclosure regarding those efforts and financial position. Putting aside the question of what is disclosable information, if companies are concerned that the appointment of a restructuring adviser may 'spook the market' (ie by suggesting insolvency even if that is not the case), then companies should be encouraged to appoint restructuring advisers early and at a time when the company is solvent or the cash flow issues are considered to be short-term, and those facts can be set out in a market announcement as is advised. This should encourage early intervention. This would not

obviate the need to make a subsequent announcement about the financial position of the company if it deteriorates. If the company is already insolvent, then that should be apparent on the basis of existing announced material and the appointment of the restructuring adviser tells the market that the company is attempting to do something about it.

#### 4. **Ipsa Facto**

The author supports the government's proposed ipso facto model. Generally, the author is supportive of a framework which broadly adopts the breadth and exclusions set out in the Canadian provisions which prohibit the enforcement of ipso facto clauses in insolvency. Specifically:

- 3.2b: insolvency event should extend to the appointment of a restructuring adviser (under either safe harbour model).

I am happy to discuss any aspect of this submission with you.

Yours sincerely



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