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Dear Sir

Improving Bankruptcy and Insolvency Laws Proposals Paper – Submission

Thank you for the opportunity to make a submission on the Australian Government's 'Improving Bankruptcy and Insolvency Laws Proposals Paper' (**Proposals Paper**).

Background

1. We note the bankruptcy and insolvency reforms canvassed in the Proposals Paper are designed to effect a 'cultural shift' by creating 'an ecosystem that enables ... entrepreneurs to succeed'.[1] These aims were first expressed in the Government's 'National Innovation and Science Agenda' (**Agenda**) and the Productivity Commission's report, 'Business Set-Up, Transfer and Closure' (**Report**), both released on 7 December 2015.

2. In our experience, a 'fear of failure' has become an entrenched part of the business operating environment in Australia. There is a strong stigma associated with bankruptcy and insolvency that can be readily contrasted to the position in the United States, where new start-ups and business failures and exits are commonplace and even embraced as part of the psyche of the 'American dream.'[2]

3. In the corporate space, the fear of failure is particularly noticeable among directors. In an effort to avoid personal liability, directors have increasingly moved to place a company in voluntary administration at the first sign of financial trouble. Significantly, the appointment of a voluntary administrator is taken into account under sections 588H(5) and 588H(6) of the *Corporations Act 2001* (Cth) (**Act**) in assessing whether directors have breached their duty to prevent insolvent trading.

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[1] Proposals Paper, 3.

[2] This has been reinforced in various empirical studies: see, for example, Nicola Howell and Rosalind Mason, 'Reinforcing Stigma or Delivering a Fresh Start: Bankruptcy and Future Engagement in the Workforce' (2015) 38(4) *University of New South Wales Law Journal* 1529.

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4. Voluntary administration has in turn tended to destroy the enterprise value of companies as key creditors and suppliers, aided by 'ipso facto' contractual clauses authorising termination upon insolvency, have acted to protect their own interests, leaving little scope for a work out attempt. While secured creditors and major suppliers often recover most of their funds in full, corporate failure has a devastating impact on more vulnerable claimants such as employees and small trade creditors.

5. Apart from the appointment of a voluntary administrator that can precipitate the break-up of a company's business, the potential for personal liability, including civil and criminal penalties for insolvent trading and automatic disqualification from managing companies during a period of personal bankruptcy,[3] may cause directors to resign from office as soon as a company's solvency is in question.[4]

6. The risk-averse behaviour of directors, which is directly encouraged by the existing state of the law in Australia, can therefore have a paralytic effect on business, to the detriment of long-term economic growth. We support the reforms in the Proposals Paper because they have the potential to overcome these limitations and to promote a stronger corporate and business rescue culture in Australia.

7. In this submission, we have concentrated on the proposed 'safe harbour' and 'ipso facto' reforms.

Safe harbour reforms

8. The Proposals Paper outlines two options for implementing a safe harbour from insolvent trading liability for directors.

9. 'Model A' closely follows the Productivity Commission's recommendation in the Report that, to limit the prospect of abuse to the detriment of a company's creditors, directors should only be able to invoke a safe harbour defence from insolvent trading if they are diligently implementing a restructuring plan created by an insolvency and turnaround adviser appointed by the company.

10. Under Model A, directors will not face liability for insolvent trading if they have a reasonable expectation, based on advice provided by an experienced, qualified and informed restructuring adviser, that the company can be returned to solvency within a reasonable period of time and they are taking reasonable steps to ensure it does so (by implementing the adviser's restructuring plan).

11. So that a restructuring adviser can make an informed assessment of a company's future viability, Model A requires directors to provide the adviser with up-to-date books and records reflecting the company's transactions and financial position.

12. The operation of Model A in a complex restructure where there is a need to obtain agreement from multiple stakeholders will be challenging. It is likely to require almost constantly-updated advice from the restructuring adviser. Further, given the consequences if the restructure fails, it is likely that the advice will be conservative.

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[3] Act, ss 206A(1), 206B(3).

[4] Law Council of Australia, Insolvency Practitioners' Association of Australia and Turnaround Management Association, 'Joint Submission in Relation to Insolvent Trading Safe Harbour Options Paper', 2 March 2010, 8.

13. In contrast to Model A, 'Model B' adopts a far more flexible approach to director liability. It does not require directors to appoint a restructuring adviser to avoid liability for insolvent trading but rather excludes liability upon the satisfaction of three broad conditions:

    (a) a debt is incurred as part of reasonable steps taken by directors to maintain or return a company to solvency within a reasonable period of time;

    (b) directors hold the honest and reasonable belief that the incursion of the debt is in the best interests of the company and its creditors as a whole; and

    (c) the incursion of the debt does not materially increase the risk of serious loss to creditors.

14. It is noted in the Proposals Paper that early engagement with creditors and other corporate stakeholders would form part of the Court's consideration of whether directors have taken 'reasonable steps' to maintain or return a company to solvency. The only comment we make here is that in a complex restructuring involving offshore bondholders or other creditors, or where debt is trading, getting proper engagement with creditors can be challenging. It also cannot be assumed that all creditors are aligned to any proposed restructure. It is conceivable that there could be creditors who are more interested in the company failing or being restructured through an insolvency process. An example would be creditors holding credit default swaps as protection against an insolvency.

15. While it is indicated in the Proposals Paper that the appointment of a restructuring adviser will also be a relevant factor for the Court to consider in that regard, unlike Model A it is only *a* factor and not the determinative factor.

16. Model B would therefore go a considerable way towards addressing industry concerns that a self-interested, individualist culture, fed by the fear of failure noted at paragraphs 2 to 3 above, permeates insolvency decisions rather than a collaborative and consultative process in which stakeholders work together to harness enterprise value and revive a distressed company, or at least its business, wherever possible.

17. While the automatic appointment of a restructuring adviser under Model A may increase the likelihood of corporate and business rescue in Australia, it is unlikely to effect the 'cultural shift' the Government desires insofar as directors may be encouraged to view the appointment in a 'one size fits all' manner which fundamentally reflects the pursuit of self-interest rather than the collective pursuit of a maximally beneficial outcome for all stakeholders. Indeed, if creditors are not consulted before the appointment of a restructuring adviser, they will continue to feel isolated from the insolvency process and they will accordingly maintain an exit-focused, 'enforcement assessment' of their rights rather than concentrating on the maximisation of enterprise value for the collective benefit of all corporate stakeholders. Further, there is no guarantee that a restructuring adviser, once appointed under Model A, will devise and help to implement a restructuring plan in consultation with creditors and other corporate stakeholders.

18. Despite our preference for Model B over Model A, we query whether it is appropriate to structure Model B as a *carve out* to the operation of section 588G of the Act rather than a *defence* to liability. Indeed, while a carve out is likely to promote restructuring attempts in Australia by reducing risk-averse behaviour on the part of directors, it is not appropriate for a liquidator to be expected to *disprove* directors' compliance with the safe harbour conditions. Leaving the onus of proof on directors by structuring Model B as a defence to

liability is likely to encourage them to take greater precautions in ensuring that a workout attempt is in the best interests of creditors and other stakeholders before proceeding.

Do the safe habour proposals go far enough to support innovation and start-up companies?

19. Part of the Australian Government's agenda is to encourage innovation. Innovation necessarily involves higher degrees of risk and so if the aim is to encourage more start-up companies to engage in innovation, whether in technology, science or elsewhere, we query whether the safe harbour proposals go far enough. Perhaps there is a case to be made for a different regime to apply to directors of start-up companies, at least during the initial start-up phase. The risk of such companies failing must be far greater than in the case of other companies. If so, the application of s.588G, even with a safe harbour along the lines contemplated in the Proposals Paper, may discourage people from being prepared to act as a director of such companies.

Ipso facto reforms

20. In our experience, the exercise of ipso facto contractual termination rights by key suppliers and financiers has compromised the salvage of otherwise viable companies and businesses as core operating resources and financial support are withdrawn in circumstances of financial distress.

21. To maximise the potential for a company or its business to be revived, the Productivity Commission recommended in the Report that ipso facto clauses should be unenforceable during voluntary administration or the negotiation of a scheme of arrangement.

22. In the Proposals Paper, the Government has extended the ipso facto enforcement moratorium to also include circumstances where a receiver is appointed or a company enters into a deed of company arrangement.

23. The Government's proposal to allow creditors and suppliers to apply for a court order terminating a contract if the ipso facto enforcement moratorium would cause undue hardship is a welcome part of the reforms because it provides a safety net for particularly vulnerable corporate stakeholders that have a limited capacity to self-protect against the risk of insolvency loss, such as small trade creditors lacking the bargaining power to insist on security.

24. Notably, however, the Proposals Paper does not contemplate that the ipso facto enforcement restriction will apply where a company is pursuing an informal restructuring attempt outside the control of an external administrator – that is, in the circumstances contemplated in Model A and Model B of the proposed safe harbour provisions. That is a significant omission because, while a safe harbour is likely to increase the willingness of directors to pursue a workout attempt in the interests of creditors instead of prematurely appointing a voluntary administrator, it cannot be assumed that all creditors will wish to cooperate in an informal restructuring attempt. If a key creditor or supplier seeks to withdraw its support for a company by terminating its contract with the company, the prospect of the restructuring attempt being successful will be compromised.

25. We therefore submit that the Government should extend the ipso facto enforcement moratorium to the circumstances contemplated by Model B of the proposed safe harbour (which, as noted at paragraphs 13 to 18 above, is our preferred safe harbour model).

26. In the Proposals Paper, the Government asks for views from stakeholders as to whether contractual clauses allowing a party to enforce rights other than termination upon the occurrence of an insolvency event, such as payment acceleration or the requirement for additional security, should also be void.

27. In that regard, more extensive enforcement restrictions are currently included in the United States reorganisation process in Chapter 11 of the Bankruptcy Code (Code). For example, section 363(l) of the Code prevents a counterparty from forfeiting, modifying or terminating a company's interest in a contract for the use, sale or lease of property based on the company's insolvency or financial condition (including the commencement of a Chapter 11 case), while sections 365(e) and 365(f) of the Code prevent counterparties from restricting the assignment of, terminating or modifying executory contracts or unexpired leases in those circumstances.

    Even more broadly, the Code provides for a suspension of the enforcement rights of secured creditors during the pendency of a Chapter 11 case as long as such creditors are provided with 'adequate protection' of their interests. It is also possible for a Chapter 11 reorganisation plan to override the enforcement rights of secured creditors (the so-called 'cramdown' mechanism) as long as, among other things, the treatment of such creditors' claims under the plan is 'fair and equitable'.

28. We submit that the Government should consider adopting similar enforcement restrictions in Australia. However, it would be important for the Government to ensure that any such restrictions still leave creditors with sufficient avenues to protect their interests in the event of insolvency, for example by employing 'adequate protection' and 'fair and equitable' concepts similar to those adopted in the United States. Failure to do so may significantly increase the cost and/or reduce the supply of credit for companies, to the detriment of employees, other corporate stakeholders and the economy more broadly.

Examination of other reforms

29. In the Report, the Productivity Commission recommended against the wholesale adoption of a Chapter 11 restructuring framework in Australia, indicating the excessive costs and significant involvement of the courts under Chapter 11, as well as cultural differences between Australia and the United States, would mean that 'the overall costs are disproportionate to any likely gains.'[5] Nevertheless, the Productivity Commission argued that 'it may be possible to "cherry pick" certain components of the Chapter 11 system' to promote corporate and business rescue in Australia.[6] The Productivity Commission's recommendations in that regard are consistent with previous recommendations made by the Government's Financial System Inquiry and the Senate Economics References Committee's ASIC Inquiry in 2014.

[5] Report, 36.

[6] Report, 372.

30. The Proposals Paper does not specifically refer to Chapter 11. We submit that the Government should investigate adopting the specific features of Chapter 11 noted at paragraphs 26 to 27 above as part of the current ipso facto reforms. However, to ensure the implementation of the current reforms is not delayed, we submit that further consideration of the merit of adopting other features of the Chapter 11 process in Australia should be the subject of a separate discussion paper to be released in the next 12 to 18 months. We believe a detailed investigation of the inclusion of other Chapter 11 features in the Act would be beneficial to maximize the prospect of rehabilitating viable but distressed companies and businesses in Australia and cultivating a collectivist, rescue-friendly culture, which serves as the motivation for the current Proposals Paper.

31. We submit that the separate discussion paper should also investigate other possible reforms raised by the Productivity Commission in the Report, including:

    (a) allowing voluntary administration to continue only if, within one month of being appointed, the administrator certifies there are reasonable grounds to believe the company is capable of being a viable business;

    (b) preventing enforcement actions by creditors during the formation of a scheme of arrangement;

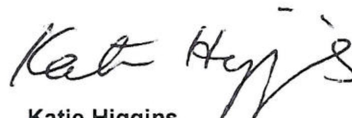
    (c) allowing directors to conduct 'pre-positioning' work to sell a company or parts of its business with the benefit of various independence and contractual review provisions absent from the United Kingdom's 'pre-pack' process; and

    (d) creating a streamlined 'small liquidation' process to minimise regulatory burdens where few assets are at stake.[7]

31. Stakeholders have generally supported these reforms on the basis that they will achieve greater efficiency in the insolvency process and increase the rate of corporate and business rescue.

Thank you again for the opportunity to make this submission.

Yours faithfully



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[7] Report, 377, 399, 388-392, 403-409.