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24 April 2017

Mr James Mason

Financial System Division

The Treasury

Langton Crescent

PARKES ACT 2600

Email: insolvency@treasury.gov.au

Dear Mr Mason

Submission

National Innovation and Science Agenda – Improving Corporate Insolvency Law

Exposure Draft of the *Treasury Laws Amendment (2017 Enterprise Incentives No.2) Bill 2017*

PPB Advisory welcomes the opportunity to comment on the draft legislation and the accompanying draft explanatory memorandum that reforms Australia’s insolvency laws. We are of the view that the proposed amendments, with limited further amendment, will help promote a culture of entrepreneurship and innovation and also help to reduce the stigma associated with business failure. Our submission comments on what further amendments should be considered to ensure the success of the reforms.

**About PPB Advisory**

PPB Advisory is a leading advisory firm that delivers impactful advice and strategic outcomes to help clients navigate critical and complex issues, improve their performance and realise their strategic goals.

Litmus Group is a division of PPB Advisory and a management consulting firm focussed on strategy execution to improve the enterprise value of its clients. Litmus partners with clients to translate their strategic intent into the outcomes they had envisaged.

Collectively we have a team of around 350 people across Australia and Singapore working with clients around the world. We:

* provide insolvency services to companies and individuals
* advise on complex business restructures and turnarounds
* undertake forensic investigations
* provide strategic, operational and financial advice
* optimise workforce asset and enterprise value
* manage enterprise risk
* lead major transactions involving changes of ownership or capital structures

PPB Advisory has been promoting safe harbour, ipso facto and related insolvency law reforms since at least 2011. We commenced the process with a paper that Mr Stephen Parbery, our then Chairman, presented at the annual Supreme Court of New South Wales Conference on Corporate Law in Sydney in 2011. This followed many other presentations on the same theme. Mr Parbery also provided a copy of his 2011 paper to the Australian Securities and Investments Commission (ASIC) and, more recently, PPB Advisory has run a number of lunchtime presentations addressing law reform with business leaders including Mr David Gonski.

**Safe Harbour**

As discussed above, PPB Advisory supports the proposed Safe Harbour reform. However, that support is subject to due consideration being given to the following comments, concerns and amendments:

1. Reasonably likely to lead to a better outcome

The proposed new section 588GA introduces a carve out to section 588G(2) of the Corporations Act, such that directors will not be liable for certain debts incurred whilst insolvent if after suspecting insolvency, the director takes a course of action reasonably likely to lead to a better outcome for both the company and its creditors as a whole than becoming a Chapter 5 body corporate i.e. being wound up, having a receiver appointed to it, being under administration, having executed a deed of company arrangement or having entered into a compromise or arrangement.

The new subsection 588GA(2) provides an indicative and non-exhaustive list of factors to be considered in determining whether a course of action is reasonably likely to lead to a better outcome for a company and its creditors, including obtaining appropriate advice, developing or implementing a plan to restructure the company to improve its financial position, and maintaining appropriate financial records. Taking each of these factors in turn:

* 1. Obtaining appropriate advice

ASIC, the Australian Restructuring Insolvency and Turnaround Association (ARITA), the media and the business community at large have all expressed significant concern about the practices of what are commonly known as ‘pre-insolvency advisors’. They are unregulated, operate with relative impunity and have been found to engage in activities such as illegal phoenixing, asset and business sales for less than commercial value and charging extortionate fees. Accordingly, we strongly advocate that advice be obtained by directors from professionals who are both regulated and experienced in business insolvency, restructuring and turnaround.

* 1. Plan to restructure the company

Fortunately, insolvency and devising plans to return a company to solvency are relatively rare business events. Further, they often involve complexity, significant resource constraints and short timeframes. If they are done poorly the harm done to stakeholders including directors, creditors, employees and the community at large can be considerable. Consequently, it is regarded as a specialist business area much like tax, audit and financial planning are deemed specialisations warranting expertise, experience and regulation. Accordingly, we strongly recommend that plans to restructure a company be drafted by a director guided by a professional who is both regulated and experienced in business insolvency, restructuring and turnaround.

* 1. Maintaining appropriate records

A key document that is produced by a director in Chapter 5 body corporate administrations is a Report as to Affairs (RATA) form detailing the financial status of the company. The document is attested to by the director as being accurate and there are serious repercussions for the director if it is found to be incomplete or inaccurate. Consequently, the RATA is very helpful in determining the true financial state of the company, assessing its prospects for restructuring and turnaround and the reasonableness of any course of action that may then arise. Accordingly, in our opinion, subsection 588GA(2) should include the requirement for a director to produce an accurate and complete RATA. If in the event such a RATA is not produced serious consideration should be given to depriving the director the protection of the safe harbour provisions.

* 1. Possible retrospective application

Given the wording of subsection 588H(4)(a), which refers to *‘actions taken before...commencement’* we are concerned that safe harbour may operate retrospectively. If that is the case then directors who trade a company whilst it is insolvent, and at that time have no intention of drafting a suitable plan to restructure the company, may at a substantially later time change their mind and claim safe harbour backdated to commencement of the insolvent trading. We do not support this outcome. Accordingly, we recommend that the issue be clarified.

1. Incurring new debts

Generally, for an insolvent business to continue to trade whilst a restructuring or workout plan is being drafted and considered, it will have to incur new debt (e.g. for ongoing wages, rent and utilities). The explanatory memorandum states ‘*Where a director takes on debt from new creditors and they do not believe they can repay the debt in accordance with its terms this would be ostensibly a breach of the general director’s duties as well as being dishonest. As such, a director would not be protected in relation to incurring debts of this nature*.’ At commencement of the safe harbour and before a workable plan is finalised, a director probably will not reasonably know whether new debt can be repaid in accordance with its terms. Consequently, this restriction may prove to be a significant inhibitor to a director considering trading a company to give effect to a developing workout or restructure plan. Further, the interests of existing creditors and new creditors are widely different. Existing creditors may benefit from continued trading at the cost of new creditors (unless the new creditors are paid in full). Given these issues, we recommend that serious consideration be given to granting new debt a priority over old debt.

1. Better outcome for the company

The proposed new section 588GA states that a better outcome ‘*means an outcome that is better for both the company; and the company’s creditors as a whole’*. We are concerned about the utility of requiring a better outcome for the company being a constraint. Often there is little or no utility in preserving an insolvent corporate vehicle as it has no value to shareholders or other stakeholders, including employees and creditors.  Why prejudice a better outcome for the company’s creditors as a whole if this outcome also results in the demise of the corporate entity?  Accordingly, we recommend deleting the reference to a ‘*better outcome for the company’*.

1. The end of safe harbour

Restructuring or workout may still be pursued when a company is in Receivership, Compromise or Arrangement (all Chapter 5 body corporate administrations). However, the draft legislation provides that the safe harbour comes to an end when the company becomes a Chapter 5 body corporate. Without the benefit of a safe harbour defence directors may be loathed to pursue restructuring. Accordingly, these may not be appropriate events for termination of safe harbour.

1. Employee entitlements

Subsection 588GA(4) provides that safe harbour does not apply if a company fails to provide for the entitlements of its employees (including superannuation). An issue is whether the provision includes all prospective employee entitlements (e.g. including accrued long service and sick leave, redundancy entitlements and pay in lieu of notice) or whether the provision is restricted to employee entitlements when they fall due in the ordinary course of business. If prospective employee entitlements have to be fully provided for, this could prove to be a significant financial impediment to qualifying for safe harbour. Accordingly, we recommend that this issue be resolved and that the term “*provide for*” be precisely defined.

1. Holding companies

Section 588V provides that holding companies have a separate liability for the insolvent trading of their subsidiaries. Often a trading entity to which safe harbour may apply is a subsidiary of a holding company. In our opinion, for safe harbour to be effective that protection should also be afforded to holding companies.

1. Independence and subsequent external administration

A complying plan to restructure a company may require the appointment of an external administrator at some point in the plan. In some circumstances the *Corporations Act* or ARITA’s Code of Professional Practice act to prevent the company’s pre-appointment restructuring advisor from subsequently acting as the company’s external administrator. Additional costs, complexity and/or delay then arise which may inhibit the success of the restructuring plan. Subject to the advisory being appropriately qualified and obtaining Court approval, we recommend that the pre-appointment restructuring advisor not be prevented from subsequently acting as the company’s external administrator.

1. Insolvent trading before and after safe harbour

Safe harbour protection only applies when a director is taking the reasonable steps required to formulate or implement a complying plan to restructure the company. A director may trade a company and incur debts whilst it is insolvent for some time before contemplating formulating a complying restructuring plan, thereby commencing the safe harbour period. Alternatively, a director may trade whilst the company is insolvent after the safe harbour period in the event that the restructuring plan no longer complies, otherwise fails or is not implemented. Accordingly, it appears that it is open to a liquidator, if subsequently appointed to a company, to mount an action against a director for the damage suffered by creditors during the period of insolvent trading before safe harbour commenced and/or after safe harbour ceased. Consequently, in these circumstances safe harbour only provides partial protection to a director.

**Ipso Facto Protection**

As discussed above, PPB Advisory supports the proposed Ipso Facto reform. However, that support is subject to due consideration being given to the following comments, concerns and amendments:

1. Narrow focus

The draft legislation focusses solely on providing ipso facto protection to administration and schemes of arrangement. However, we have seen a number of papers from law firms who make out good arguments for the extension of ipso facto protection to receiverships, deeds of company arrangement and liquidation (in certain circumstances). Whilst we don’t intend to summarise those arguments in our submission (given that they will be well ventilated in other submissions), we recommend that further consideration be given to expanding the breadth of external administrations to which ipso facto protection applies.

1. Provision of additional credit

Under the draft legislation, counterparties are not obliged to provide additional credit when restricted from exercising their ipso facto rights. Does the provision of additional credit just refer to the advancing of actual funds to the company, or does it also include the continuation of any contractual arrangement where the company pays in arrears? If the latter, then the ipso facto protection is quite limited and affords little relief. Similarly, would a company be permitted to continue to trade within existing credit limits with trade creditors? We recommend that these questions be answered.

1. ‘Ejection clauses’ in corporate trading trusts

‘Ejection clauses’ in trust instruments operate to automatically remove a corporate trustee in the event of a winding up or other external administration appointment. The right of the ejected corporate trustee (which is subject to external administration) to assert a lien over the trust assets to secure its right of indemnity for debts incurred in the proper administration of the trust are often significantly diminished by the new trustee’s claim to the trust assets. In these circumstances, we are of the opinion that there should be limits on the power to remove the company as trustee. Therefore, we recommend that ‘replacement of trustees’ be removed from the proposed list of excluded contract types.

**Conclusion**

In summary, we are very pleased to see encouragement of business rescue and turnaround and the adoption of some of the world’s ‘best practice’ restructuring concepts that have been the subject of many submissions to Government over a number of years. If you have any questions, please call me on 02 8116 3020.

Yours faithfully



**Mark Robinson**

Partner