



Improving bankruptcy and insolvency laws

Proposals Paper

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Consultation Process

The Australian Government (the Government) welcomes feedback from all interested stakeholders on the issues outlined in this proposal paper.

The proposal paper contains several focus questions. Stakeholders are invited to address any issue raised in this paper and should not feel obliged to address every question. The information obtained through this process will inform the Government's approach on the way forward.

Closing date for submissions: Friday 27 May 2016

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Note to participants

The proposals outlined in this paper have not received Government approval and are obviously not yet law. As a consequence, this paper is merely seeking feedback to inform further policy development.

Executive summary

The Innovation and Science Agenda (Agenda) drives prosperity by putting innovation and science at the centre of the Government's economic narrative. Innovation and entrepreneurship is central to economic growth, job creation and future prosperity. We are asking Australians to be more agile in reaching out to the global marketplace, while also creating an environment that attracts the world's best.

The Agenda focuses on measures in four areas: culture and capital; collaboration; talent and skills; and Government as an exemplar. Under the culture and capital area there are three measures to improve bankruptcy and insolvency laws:

1. reducing the current default bankruptcy period from three years to one year
2. introducing a 'safe harbour' for directors from personal liability for insolvent trading if they appoint a restructuring adviser to develop a turnaround plan for the company, and
3. making 'ipso facto' clauses, which have the purpose of allowing contracts to be terminated solely due to an insolvency event, unenforceable if a company is undertaking a restructure.

More often than not, entrepreneurs will fail several times before they achieve success. To create an ecosystem that enables these entrepreneurs to succeed will require a cultural shift. Our current insolvency laws put too much focus on penalising and stigmatising the failures. With these measures in place, bankruptcy and insolvency laws will strike a better balance between encouraging entrepreneurship and protecting creditors. Over time, these changes will help reduce the stigma associated with business failure.

This proposals paper seeks views from the public on how best to implement these measures in order to encourage Australians to embrace risk, learn from mistakes, be ambitious and experiment to find solutions.

This paper purposely asks broad questions, and in each instance, the public is invited to comment generally on the Government's proposals, and need not confine themselves to commenting in response to specific queries.

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1 Reducing the default bankruptcy period

This section sets out some issues in bankruptcy and personal insolvency that will need to be considered in reducing the default bankruptcy period from three years to one year. A preliminary proposal is set out for each issue and the Government seeks the views of the public on these proposals.

Background

The current default period for a bankruptcy is three years. Ordinarily, the three-year period starts from the date on which the bankrupt filed his or her statement of affairs¹.

However, where a trustee objects to the discharge of a bankrupt, the period of bankruptcy may be extended to five or eight years, depending on the grounds for that objection. Notice of the objection is provided to the bankrupt who can appeal the objection.

The default bankruptcy period of three years may discourage innovation and business start-ups. During the bankruptcy period restrictions are placed on a bankrupt in respect of overseas travel and incurring further debts. A bankrupt may also be subject to licencing and employment restrictions (including prohibition from being a company director).

Reducing the default period and related restrictions to one year will encourage entrepreneurial endeavour and reduce associated stigma. The measure acknowledges that bankruptcy can be a result of necessary risk-taking or misfortune rather than misdeed, and encourages former bankrupts to continue entrepreneurial activity.

¹ Section 149 of the *Bankruptcy Act 1996* (Bankruptcy Act)

1.1 Misconduct

Ordinarily, a person will be discharged from their bankruptcy three years after they file their statement of affairs, or earlier if their bankruptcy is annulled (where a bankruptcy is cancelled). A bankruptcy may be extended to five years or eight years in cases where an objection is lodged.² In circumstances of misconduct, a trustee may lodge an objection to discharge before a bankrupt is discharged.

A trustee may lodge an objection on a number of grounds, such as a bankrupt's failure to:

- provide information about their income to their trustee
- explain how money was spent
- pay assessed income contributions, or
- report all assets and creditors.

An objection can be removed before the end of bankruptcy if the basis for the objection is resolved.

There may be practical challenges for trustees in gathering sufficient evidence to support lodgement of an objection within the reduced bankruptcy period.

Courts currently do not have a direct role in extending the period of bankruptcy. However, there is a general avenue of appeal for an act, omission or decision of a trustee.³ This, for example, would allow a bankrupt, creditor or another affected person to apply to the Court where a trustee objects or fails to object to discharge.

Proposal 1.1

The Government proposes to retain the trustee's ability to object to discharge and to extend the period of bankruptcy to up to eight years.

Query 1.1

The Government seeks views from the public on whether the criteria for lodging an objection and the standard of evidence to support an objection should be changed to facilitate a trustee's ability to object to discharge.

1.2 Ongoing obligations for bankrupts

1.2.1 Requirement to assist trustee

Even after a person is discharged from their bankruptcy they may have ongoing obligations under the Bankruptcy Act to assist their trustee to realise and distribute property⁴, and pay any outstanding income contributions⁵.

² The grounds for an objection are set out in section 149D of the Bankruptcy Act.

³ Section 178 of the Bankruptcy Act.

⁴ Section 152 of the Bankruptcy Act.

Reducing the default bankruptcy period

These obligations ensure a trustee can complete the work required in the administration of a bankruptcy, such as finalising any investigations or completing the sale of assets, even after discharge.

Proposal 1.2.1

The Government proposes to change the Bankruptcy Act to ensure the obligations on a bankrupt to assist in the administration of their bankruptcy remain even after they have been discharged to allow for the proper administration of bankruptcy.

Query 1.2.1a

The Government seeks views from the public on which particular obligations on a bankrupt should continue even after a bankrupt is discharged.

Query 1.2.1b

The Government seeks views from the public on what incentives and mechanisms should be in place to ensure compliance with obligations after discharge.

1.2.2 Income contributions

Generally, a bankrupt can continue their employment and continue earning income during their bankruptcy (subject to certain licensing and industry restrictions, as discussed in section 1.3.3 below). However, where a bankrupt's after-tax income exceeds a certain amount⁶ they have to pay half of any excess income to their trustee (for distribution to their creditors) for the duration of their bankruptcy.

The income threshold can be increased where there are exceptional circumstances⁷ and where a bankrupt has any dependants⁸.

Proposal 1.2.2

The Government proposes to separate the obligation to pay income contributions from the default bankruptcy period. Instead, individuals will continue to pay income contributions for three years even with the reduction in the default bankruptcy period. Further to proposal 1.1 above, where the period of bankruptcy is extended to five or eight years, income contributions will also be payable for that extended period.

⁵ Note: Proposal 1.2.2 suggests income contribution obligations will continue for three years even with a reduction in the default bankruptcy period.

⁶ Prescribed amount calculated by the formula in section 139K of the Bankruptcy Act.

⁷ Section 139T of the Bankruptcy Act.

⁸ As defined in section 139K of the Bankruptcy Act.

1.3 Restrictions

1.3.1 Access to credit

Restrictions are placed on a bankrupt's ability to obtain credit during their bankruptcy. If a bankrupt obtains credit above a certain amount⁹ they must tell the supplier that they are bankrupt.

After a bankrupt is discharged from bankruptcy, a record of their bankruptcy will remain on their commercial credit record for the later of five years from the date of bankruptcy or two years after discharge. As such, discharged bankrupts may still have practical difficulties in obtaining credit.

The National Personal Insolvency Index contains a permanent record of bankruptcy. This ensures credit providers have the ability to confirm the previous bankruptcy status of any potential debtors.

Proposal 1.3.1a

The Government proposes to reduce credit restrictions under the Bankruptcy Act to one year, subject to any extension for misconduct.

Proposal 1.3.1b

The Government proposes to retain the permanent record of bankruptcy in the National Personal Insolvency Index.

Query 1.3.1

The Government seeks views from the public on whether it is appropriate to reduce the retention period for personal insolvency information in credit reports.

1.3.2 Overseas travel

A bankrupt is restricted from overseas travel during their bankruptcy. The Bankruptcy Act requires a bankrupt to give their passport to their trustee upon request and specifies that it is an offence for a bankrupt to travel without their trustee's written consent. A trustee can also place conditions on the bankrupt's travel, for example they can ask a bankrupt to return by a specific date.

Once a bankrupt is discharged from their bankruptcy, this restriction from overseas travel no longer applies and their passport is returned to them.

Proposal 1.3.2

The Government proposes to reduce the overseas travel restriction to one year, subject to any extension for misconduct.

⁹ Section 269 of the Bankruptcy Act and allowing for indexation under section 304A.

1.3.3 Licences and industry associations

While the Bankruptcy Act does not restrict a bankrupt from employment, there are some industry associations and licensing authorities that impose restrictions or conditions if a member or licensee becomes bankrupt. The consequences can range from requirements to notify the industry association to outright exclusion from a profession upon bankruptcy.

Existing State and Territory licencing and industry restrictions on undischarged bankrupts may automatically be reduced as a consequence of the reduction. Other licencing and industry restrictions will not be automatically reduced. The Government will work with these associations to determine the implications of the reduced default period of bankruptcy.

For the restrictions that are governed by Commonwealth law, such as exclusion from being a company director or a Member of Parliament, the Government proposes to reduce these restrictions to a one-year default period.

Proposal 1.3.3

The Government proposes to consult with relevant industry and licensing associations with a view to aligning restrictions with the reduced period of bankruptcy, where appropriate.

2 Safe harbour

This section sets out the Government's proposed models to implement a safe harbour for directors from the insolvency provisions of the *Corporations Act 2001* (Corporations Act). Two preliminary proposals are set out and the Government seeks the views of the public on this proposal.

2.1 Background

Currently, a company director may be liable under Australia's insolvent trading provisions if:

- they are a director of a company at the time when the company incurs a debt;
- the company is insolvent at that time, or becomes insolvent by incurring that debt; and
- at that time, there are reasonable grounds for suspecting that the company is insolvent, or would become insolvent.¹⁰

The threat of Australia's insolvent trading laws, combined with uncertainty over the precise moment a company becomes insolvent have long been identified as a driver behind companies entering voluntary administration, even in circumstances where the company may be viable in the long term.¹¹

Concerns over inadvertent breaches of insolvent trading laws are frequently cited as a reason early stage (angel) investors and professional directors are reluctant to become involved in a startup.

Introducing a safe harbour to the insolvent trading offences facilitates the restructure of businesses, striking a better balance between encouraging entrepreneurship and protecting creditors.

2.2 Safe Harbour Model A

A safe harbour is designed to preserve enterprise value and offer a cost effective and flexible mechanism to work through liquidity issues outside of formal administration.

¹⁰ Section 588G of the *Corporations Act 2001*.

¹¹ Productivity Commission Report on *Business Set-up, Transfer and Closure*, 2015, p. 378.

Safe Harbour and Ipso Facto Clauses

The Productivity Commission, in its 2015 report on *Business Set-up, Transfer and Closure* (PC Report) recommended that a safe harbour, framed around the appointment by the directors of a professional restructuring adviser will allow directors to make decisions relating to the possible restructuring of the company, free from fear of liability.

A safe harbour will provide directors with a restructuring option that allows them to retain control of the company while receiving formal advice rather than necessarily surrendering control to an external administrator. The Government acknowledges that it is important that this occurs in a framework which still provides for the interests of creditors.

The Corporations Act places emphasis on the importance of companies keeping and maintaining adequate financial records.¹² It is thus an important precondition of the appointment of an adviser that the company maintain adequate, up-to-date financial records which explain the company's transactions and financial position.

Significantly, to be valid, a restructuring adviser's opinion that the company can avoid insolvent liquidation and be returned to solvency must be properly informed.

Proposal 2.2

It would be a defence to s588G if, at the time when the debt was incurred, a reasonable director would have an expectation, based on advice provided by an appropriately experienced, qualified and informed restructuring adviser, that the company can be returned to solvency within a reasonable period of time, and the director is taking reasonable steps to ensure it does so.

The defence would apply where the company appoints a restructuring adviser who:

- (a) is provided with appropriate books and records within a reasonable period of their appointment to enable them to form a view as to the viability of the business; and*
- (b) is and remains of the opinion that the company can avoid insolvent liquidation and is likely to be able to be returned to solvency within a reasonable period of time.*

The restructuring adviser would be required to exercise their powers and discharge their duties in good faith in the best interests of the company and to inform ASIC of any misconduct they identify.

Query 2.2

Subject to the further information on the proposal set out in the sections below, the Government seeks views from the public on whether this proposal provides an appropriate safe harbour for directors.

¹² For example, sections 286 and 588E of the *Corporations Act 2001*

2.2.1 The restructuring adviser

The adviser would need to be an appropriately experienced and qualified individual, appointed by the Company. The onus would be on the directors of the company to ensure that the experience and qualifications of the restructuring adviser were appropriate for the nature and circumstances of the company.

Restructuring advisers can play a crucial gatekeeping role in a safe harbour. As such, the Government intends that in order to be appointed as a restructuring adviser an individual should be an accredited member of an organisation, approved by the Minister, with its own:

- disciplinary framework;
- educational framework; and
- ethical standards.

Such organisations are likely to include (but not be limited to) the Law Society, CPA Australia, Chartered Accountants Australia and New Zealand, the Australian Restructuring, Insolvency and Turnaround Association and the Turnaround Management Association.

Government intends that any further factors which the directors should consider when appointing a restructuring advisers be set out in guidance.

Query 2.2.1a

The Government seeks views from the public on what qualifications and experience directors should take into account when appointing a restructuring adviser and whether those factors should be set out in regulatory guidance by the Australian Securities and Investments Commission, or in the regulations.

Query 2.2.1b

The Government seeks views from the public on which organisations, if any, should be approved to provide accreditation to restructuring advisers if such approval is incorporated in the measure.

The role of the restructuring adviser would be to form an opinion as to whether the company is “viable”. The Government considers that the test of viability is whether the company can:

- avoid insolvent liquidation, and
- be returned to solvency within a reasonable period of time.

Query 2.2.1c

Is this an appropriate method of determining viability?

Query 2.2.1d

What factors should the restructuring adviser take into account in determining viability? Should these be set out in regulation, or left to the discretion of the adviser?

Safe Harbour and Ipso Facto Clauses

In order to carry out their role, the restructuring adviser would have a number of obligations and protections.

The restructuring adviser would be:

- appointed by the company, not the directors, and thus owe any duties to the company;
- required to exercise their powers and discharge their duties in good faith in the best interests of the company and to inform ASIC of any misconduct they identify;
- not be civilly liable to third parties for an erroneous opinion provided that it was honestly and reasonably held;
- unable to be appointed in any subsequent insolvency without the leave of the Court; and
- specifically carved out of the expanded definition of director contained in the Act (i.e. would not be a shadow or de facto director);

Query 2.2.1e

The Government seeks views from the public on whether these are appropriate protections and obligations for the restructuring adviser, and what other protections and obligations the law should provide for.

2.2.2 Other features of safe harbour

The safe harbour proposed operates as only a defence to the insolvent trading provisions contained in s588G of the Corporations Act. Directors remain subject to all the other obligations that the law provides, including the existing unreasonable directors related transaction provisions.

Safe harbour would not prevent, upon a subsequent liquidation of the company, any civil claim against a director in relation to any outstanding employee entitlements which accrued during the safe harbour period.

Similarly, the period during which the safe harbour defence applies should be disregarded for the purposes of calculating any reach-back period for director related party transactions.

Query 2.2.2a

Do you agree with this approach?

Safe harbour is intended to encourage directors to acknowledge financial difficulty early and to attempt informal workouts where appropriate. Experience of informal workouts in the Australian and overseas markets has shown that privacy is an important factor in their success. While the Government thus does not propose to require that companies disclose whether they are operating in safe harbour, no relaxation of a company's continuous disclosure obligations is proposed.

Query 2.2.2b

Do you agree with our approach to disclosure?

2.2.3 Where safe harbour is not available

It is intended that safe harbour is extended to directors of companies with good corporate governance who are acting in accordance with their directors' duties.

Accordingly, safe harbour would not be available:

- to a person who was:
 - disqualified from managing a corporation at the time the debt was accrued; or
 - determined by ASIC or the Court to be ineligible to rely on the defence because of prior conduct.

ASIC or the Court may determine that a person is ineligible to rely upon the defence for a specified future period if satisfied that previously the person has breached their director's duties and :

- as a result of the breach property that would have been available to meet the claims of a creditor was not available; and
- the creditor (including the Commonwealth Government through the Fair Entitlements Guarantee) has consequentially suffered loss.

Additionally, safe harbour would not be available:

- when a company has failed to lodge multiple Business Activity Statements; or
- when there has been significant failure to pay:
 - employee claims;
 - PAYG;
 - employee superannuation;
 - Employee claims which accrue during the safe harbour period.

Query 2.2.3

The Government seeks views from the public on in what other circumstances should the safe harbour defence not be available.

2.3 Safe Harbour Model B

Currently, a company director may be liable under Australia's insolvent trading provisions if:

- they are a director of a company at the time when the company incurs a debt;
- the company is insolvent at that time, or becomes insolvent by incurring that debt; and
- at that time, there are reasonable grounds for suspecting that the company is insolvent, or would become insolvent.¹³

The focus of s588G of the Corporations Act is on the solvency of the company, the knowledge of the company's directors as to its solvency, and the timing of incurring a debt, rather than conduct of the directors in incurring the debt.

This focus ignores the reality that, in times when a company is facing financial difficulty, it is possible for directors to properly take the view that it may be in the best interests of both the company and its creditors as a whole to trade out of its difficulties or to undertake a restructure outside formal insolvency to return the company to long term viability, even if there is some risk of loss in the short term.

Accordingly, this model seeks to provide directors who are acting in the best interests of the company and its creditors as a whole with a safe harbour within which they may attempt to return the company to profitability. It does so by modifying the current operation of s588G of the Corporations Act.

Proposal 2.3

Section 588 does not apply:

(a) if the debt was incurred as part of reasonable steps to maintain or return the company to solvency within a reasonable period of time; and

(b) 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; and

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

Query 2.3

The Government seeks your feedback on the merits and drawbacks of this model of safe harbour.

This model contemplates safe harbour as a carve out, rather than a defence, and thus the burden of proof would lie on any liquidator bringing a claim to show that a director had breached any one of the three limbs of the provision.

¹³ Section 588G of the *Corporations Act 2001*.

Safe Harbour and Ipso Facto Clauses

While this model is not formally predicated on the appointment of a restructuring adviser by the company, the Government acknowledges that it is an important policy objective to ensure that directors seek to engage with financial distress in a timely and professional manner.

The requirement that directors take “reasonable steps to maintain or return a company to solvency within a reasonable period of time” would be considered by the court in circumstances where the defence is raised, and the formal appointment of an appropriately qualified and experienced restructuring adviser would be included in that consideration.

The Government also considers that the early engagement with shareholders, creditors (including employees) and other stakeholders would form part of the “reasonable steps” considered in this defence.

The Government intends that the Explanatory memorandum which accompanies any legislation would discuss more fully the indicia of both “reasonable steps” and “reasonable time”.

3 Ipso facto clauses

In the NISA, the Government announced that it would make ipso facto clauses, which allow contracts to be terminated solely due to an insolvency event, unenforceable if a company is undertaking a restructure.

This section sets out the Government's proposed model for constraining the operation of ipso facto clauses.

3.1 Background

Ipso facto clauses allow one party to a contract or agreement to terminate or vary the contract in specific circumstances. A common form of ipso facto clause allows a party to terminate a contract solely due to the commencement of formal insolvency proceedings, regardless of continued performance. For example, the company's trade creditors may refuse to provide goods and services even though they are still being paid.

The operation of these clauses further diminishes the value of a business entering insolvency and may reduce the scope for a successful restructure or prevent the sale of the business as a going concern, with consequential impact on the returns to creditors in any subsequent liquidation.

The lack of protection from the operation of ipso facto clauses has been a key criticism of the voluntary administration regime contained in Part 5.3A of the Corporations Act.

The PC Report recommended that the Corporations Act be amended such that ipso facto clauses that have the purpose of allowing termination of contracts solely due to an insolvency event are unenforceable if the company is in voluntary administration or the process of forming a scheme of arrangement.

For reasons of practicality the Government considers that this approach should be extended to include other types of ipso facto clauses (such as clauses that vary terms of a contract) which may be disproportionately detrimental to companies undertaking a restructure.

3.2 The Ipso Facto model

Proposal 3.2

The Government proposes that any term of a contract or agreement which terminates or amends any contract or agreement (or any term of any contract or agreement), by reason only that an 'insolvency event' has occurred would be void.

Any provision in an agreement 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.

Query 3.2.a

Are there other specific instances where the operation of ipso facto clauses should be void. For example by prohibiting the acceleration of payments or the imposition of new arrangements for payment, or a requirement to provide additional security for credit.

Query 3.2b

Should any legislation introduced which makes ipso facto clauses void have retrospective operation?

In this model an insolvency event would include:

- an administrator having been appointed in respect of the company;
- the company undertaking a scheme of arrangement for the purpose of avoiding administration or insolvent liquidation;
- a receiver or controller being appointed;
- the company entering a Deed of Company Arrangement.

Query 3.2.b

Are there any other circumstances to which a moratorium on the operation of ipso facto clauses should also be extended?

3.2.1 Anti-avoidance

There will always be a temptation for counterparties to strengthen their contractual position by including terms designed to work around any prohibition on the operation of ipso facto clauses.

Safe Harbour and Ipso Facto Clauses

As an anti-avoidance mechanism, it is proposed that any provision in an agreement that has the effect of providing for, or permitting, anything that in substance is contrary would be of no force or effect.

Nothing in the proposal would extend the operation of the provision beyond ipso facto clauses; counterparties would maintain a right to terminate, amend, accelerate or vary an agreement with the debtor company for any other reason, such as for a breach involving non-payment or non-performance.

Nothing in the operation of the provision would require any creditor to provide a further advance of money or credit.

Query 3.2.1

Does this constitute an adequate anti-avoidance mechanism?

3.2.2 Exclusions

We recognise that there are a number of circumstances where preventing the operation of ipso facto clauses would be undesirable, impractical, or introduce unnecessary uncertainty into the market.

We also recognise that there are certain classes of contracts which, by their nature, require that types of ipso facto clauses remain operational. For example, the ability to terminate transactions under a close-out netting contract is fundamental to managing counterparty risk in international derivatives markets and a restriction on exercising close-out rights on administration or other insolvency proceeding would create a significant impact on industry.

Accordingly, the Government intend to carve out certain “prescribed financial contracts” (to be set in the regulation) where uncertainty around the ability to enforce that type of contract represent a material risk to the efficiency, stability and liquidity of the capital markets which depend on them. For example, Swaps, certain derivatives, close-out netting arrangements under close-out netting contracts as protected under the *Payment Systems and Netting Act 1998*, or its foreign equivalents.

Query 3.2.2

What contracts or classes of contracts should be specifically excluded from the operation of the provision?

3.2.3 Appeal

We intend to include a provision that affected counterparties may apply to the court to vary contract terms if they can show that they have suffered hardship.

Query 3.2.3

Do you consider this safeguard necessary and appropriate? If not, what mechanism, if any, would be appropriate?