Briefing note April 2017

Australia's insolvency law reforms

On 28 March 2017, as part of the National Innovation and Science Agenda, the Minister for Revenue and Financial Services, the Hon Kelly O'Dwyer MP released draft legislation designed to reform Australia's insolvency laws. The proposed reforms are significant and are aimed at encouraging Australians to be more innovative and ambitious. Public submissions on the draft legislation close on Monday, 24 April 2017.

Overview

In this client briefing note, we look at the history leading to the draft legislation, the content of the draft legislation as it applies to corporate insolvency and areas of focus for affected parties.

History

The proposed amendments to Australia's insolvency framework were first announced on 7 December 2015. (The last attempt at law reform of Australia's insolvency framework, specifically to promote risk-taking, was in 2010-2011.[1])

These proposals primarily included:

- the creation of a "safe harbour" from insolvent trading liability for directors;
- amendments to the law to make "ipso facto" clauses (which permit contract variation or termination upon insolvency of a counterparty) unenforceable if a company is restructuring; and
- a reduction of the default personal bankruptcy period from three years to one year.

In April 2016, as part of the Turnbull Government's National Innovation & Science Agenda, the Australian Treasury Department released a proposals paper which provided further detail around the proposed changes ("**Proposals Paper**"). Public consultation on the proposals occurred between 29 April and 27 May 2016. Our briefing note regarding the Proposals Paper, and practical considerations for financiers, suppliers and investors, can be accessed here.

The drivers behind this push for reform is the longstanding perception of Australia's insolvency laws being some of the most stringent globally, hindering risk-taking and the ability to save financially foundering companies. In the words of the Productivity Commission Report of 2015 (which was released on the same day as the Government's first announcement on reform; 7 December 2015):

"...the Australian system is generally regarded as too creditor focused. While the insolvency system supports the financial system and the availability of credit by prioritising creditors' rights and returns, it sometimes does so at the expense of genuine restructuring, or as an impediment to expedient liquidation."[2]

Safe Harbour

Under sections 588G and 588M of the *Corporations Act 2001* (Cth) ("**Act**"), a director can be made personally liable for unsecured debts incurred by the company if the company is, or if by incurring the debt becomes, insolvent and there are reasonable grounds for suspecting that the company is or would become insolvent at the time.

The draft legislation appears to lean in favour of "Safe Harbour Model A" in the Proposals Paper. Under the proposed new section 588GA of the Act, directors may have a defence against liability if, after they start to suspect that the company may become or be insolvent, they start to take a course of action that is reasonably likely to lead to a better outcome for the company and its creditors, including by:

[1] Treasury Discussion paper, January 2010, *Insolvent Trading: A Safe Harbour for Reorganisation Attempts Outside of External Administration,* available at: <http://archive.treasury.gov.au/documents/1713/PDF/Insolvent_Trading_Safe_Harbour_DP.pdf>

[2] Productivity Commission 2015, *Business Set-up, Transfer and Closure,* Final Report 75, Canberra, available at: <http://www.pc.gov.au/inquiries/completed/business/report/business.pdf>

"obtaining appropriate advice from an appropriately qualified entity who was given sufficient information to given appropriate advice"

A debt incurred after the commencement of that above-mentioned course of action, and before that course of action ceases to be reasonably likely to lead to a better outcome for the company, will not be subject to the liability imposed by s588G of the Act. It is framed as a defence, and not a carve-out (see below); a person who wishes to rely upon the proposed section 588GA bears the evidentiary burden of proof in relation to that matter.

This model, generally foreshadowed in the Productivity Commission Report of 2015, therefore brings in the much-discussed restructuring adviser. To our knowledge, there is no indication yet as to whether that maybe a solicitor, registered liquidator or whether both may qualify.

Relevant links

1. Explanatory Document - Regulations - National Innovation and Science Agenda - Improving corporate insolvency law
2. Explanatory Memorandum - National Innovation and Science Agenda - Improving corporate insolvency law
3. Exposure Draft - National Innovation and Science Agenda - Improving corporate insolvency law
4. Media Release - Government releases insolvency law reforms for consultation - The Hon Kelly O'Dwyer MP

"Safe Harbour Model B", which was essentially a carve-out from section 588G of the Act (i.e. where the director incurred the debt as part of reasonable steps to maintain or return the company to solvency, held the honest and reasonable belief that incurring the debt was in the best interests of company and its creditors as a whole and the incurring of the debt did not materially increase the risk to creditors) appears not to have been favoured by legislators.

Interestingly though, the "Safe Harbour Model A" mandated the appointment of a restructuring adviser. Under the draft legislation the appointment of a restructuring adviser is not mandatory to qualify for the defence from liability under s588G of the Act – it is simply one of five considerations to be had in determining whether a course of action is reasonably likely to lead to a better outcome. Other considerations include whether directors are taking appropriate steps to prevent any misconduct by officers or employees of the company that could adversely affect its solvency and whether they are properly informing themselves as to the company's financial position.

Separately, the draft legislation includes a proposed section 588GB, which provides that books are not available to support the defence as a matter of evidence where they have previously not been permitted to be inspected under the coercive means provided for under the Act. For example, section 530B of the Act (i.e. a person is not entitled, as against a liquidator, to retain possession of the books of a company).

Ipso facto clauses

"Ipso facto" clauses generally permit a contracting party to vary or terminate a contact (among other actions) where an "insolvency event" occurs in relation to the counterparty. Such clauses are boilerplate in contracts in many industries such as banking and construction, where "insolvency event" is typically defined far more broadly than simply an external appointment (e.g. a receiver).

The draft legislation (also to be housed in the Act) provides that a right under a contract, agreement or arrangement against a body under Part 5.1 of the Act (which means a company or registrable body under Part 5B.2 of the Act) is not enforceable merely because that body is the subject of an application under section 411 of the Act or a compromise or arrangement as result of an application under that section.

Section 411 of the Act covers schemes of arrangement; court-sanctioned agreements that permit the restructuring or the rights and liabilities of the creditors and shareholders of a company. Under the draft legislation, such private rights will not be enforceable during the period when the application under section 411 of the Act is made and when it ends, whether through Court dismissal or otherwise. (A stay on a Part 5.1 body's right to additional credit during this period is also incorporated into the draft legislation.)

This protection will only apply if the application under section 411 of the Act states that it is being made for the purpose of the Part 5.1 body avoiding insolvency. Under the proposed sections 415E and 415F of the Act, the Court would be able to lift the stay on enforcement, including in the interest of justice, and give leave for a third party to exercise its private rights against a Part 5.1 body notwithstanding that it is subject to an application under section 411 of the Act. In doing so, the Court will need to be satisfied that the rights are not being exercised, or likely to be exercised or there is a threat to exercise the rights, merely as the Part 5.1 body is subject to an application under section 411 of the Act.

The draft legislation provides that certain rights will not be affected, including those proscribed by regulation. The Government has helpfully given a list of type of contracts and contractual rights excluded from the stay on ipso facto clauses, including rights of set-off, securities underwriting agreements, arrangements under ISDA Master Agreements and structured financings that include so-called "flip clauses".

Mirror provisions are included in the draft legislation for companies which are under administration (proposed sections 451E to 451G).

Interestingly, the Proposals Paper included as insolvency events which would trigger the operation of the ipso facto safety features, a Receiver or Controller being appointed to a company or the company entering into a Deed of Company Arrangement. These proposals did not find their way into the draft legislation, which is perhaps a relief to financial institutions concerned with how far the rebalancing reforms would go.

Considerations

As we stated in our previous briefing, while the proposed legislation is undoubtedly a boon for turnarounds, the impact on third parties remains to be seen. Particularly in circumstances where the draft legislation is arguably quite broad, and contains several areas which no doubt will generate an appreciable body of case law as the legislation is tested and applied.

Organisations should now consider:

- Whether their major contracts will be affected by the proposed legislation as it currently stands;
- Using flexible payment terms for supply contracts rather than fixed payment terms, noting many such contracts are not stipulated exclusions;
- Angel investors and other early debt providers as well as those dealing with stressed and distressed counterparties should be aware that whichever "safe harbour" is adopted, risk taking is likely to increase in the start-up and restructuring space. It may be appropriate to consider incorporating specialised reporting covenants and other monitoring rights.

Next steps

The Government is currently seeking feedback on the draft legislation. Feedback received by the Government will inform any changes that are made to the draft legislation.

Submissions will close on Monday, 24 April 2017.

Please reach out to our key contacts if you would like assistance with making a submission or if you would like to discuss any related issues.

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