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Restructuring the Nation: Australia's Proposed Restructuring & Insolvency Law Reforms

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Australia's need for long overdue insolvency reform

As part of the Australian Government's National Innovation and Science Agenda, it committed to releasing proposals to improve Australia's bankruptcy and insolvency laws. The announcement of this commitment in the Productivity Commission's report "Business Set-Up, Transfer and Closure" (Commission Report) was much anticipated and positively received following several years of calls for reform.

The last substantive reforms to Australia's insolvency system arose out of the Harmer Inquiry conducted in the 1980's. Since that time, the corporate world has become more complicated and financial transactions increasingly complex. The renewed reform debate, seeking a change towards a more restructuring and rescue culture, has been long advocated by Australia's peak industry body, the Australian Restructuring Insolvency and Turnaround Association (ARITA).

It is well recognised that Australia's current insolvency laws put too much focus on penalising and stigmatising failure. In putting bankruptcy and insolvency law reform on the agenda, the Australian Government has recognised that 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 and law reform to support it.

The proposals paper was released on 29 April 2016 (Proposals Paper) and sought views from industry and the public on how best to implement the proposed measures in order to encourage Australians to embrace risk, learn from mistakes, be ambitious and experiment to find solutions.

Three key measures

There are three key measures identified in the Proposals Paper aimed at improving Australia's 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; and
3. making '*ipso facto*' clauses unenforceable.

Exclusion period for bankrupts

Currently, a bankrupt in Australia is precluded from acting as a company director and is restricted in terms of access to finance, employment opportunities and travel for three years. The Government has proposed that if no malfeasance has occurred, that exclusion period should be reduced to one year, although the Bankruptcy Trustee and courts will retain the power to extend this period. However, the bankrupt individual must continue to make excess income contributions to the Trustee for a period of three years.

Reducing the exclusion period is intended to lessen the stigma attached to bankruptcy and encourage entrepreneurs to start new business, while still preserving regulatory oversight to prevent abuse of the bankruptcy process.

Safe harbour

Currently, a company director may be liable under Australia's insolvent trading provisions (Corporations Act 2001 (Cth) s588G) if:

(a) they are a director of a company at the time when the company incurs a debt;

(b) the company is insolvent at that time or becomes insolvent by incurring that debt; and

(c) at that time, there are reasonable grounds for suspecting that the company is insolvent or would become insolvent.

Following ARITA's thought leadership on the issue, it was acknowledged in both the Commission Report and the Proposal Paper that 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. Concerns over inadvertent breaches of insolvent trading laws are also frequently cited as a reason early stage investors and professional directors are reluctant to become involved in a startup.

Introducing a safe harbour to the insolvent trading offence is proposed to strike a better balance between encouraging entrepreneurship and protecting customers. It is designed to preserve enterprise value and offer a cost effective and flexible mechanism to work through liquidity issues outside of formal administration. The Proposals Paper has provided two models of safe harbour reform for submission and consideration.

Safe Habour Model A proposes that 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 (Adviser) who:

- 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
- 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 Proposals Paper recognises that an Adviser play a crucial gatekeeping role in a safe harbour.

Safe Harbour Model B contemplates safe harbour as a carve out, rather than a defence. It proposes that s588G will not apply:

- if the debt was incurred as part of reasonable steps to maintain or return the company to solvency within a reasonable period of time;
- 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
- incurring the debt does not materially increase the risk of serious loss to creditors.

In this model, the burden of proof is reversed so that a liquidator bringing a claim will need to show that a director has breached any one of the three limbs. Importantly, while the appointment of as Adviser is not required, it may form part of the 'reasonable steps' taken by directors to address the financial distress in a timely manner.

Finally, it is noted in the Proposals Paper that as the safe harbour is for the benefit of directors of companies with good corporate governance who are acting in accordance with their directors' duties, it will not be available:

- to a person who is disqualified from managing a corporation at the time the debt was accrued;
- to a person who was determined by ASIC or the Court to be ineligible to rely on the defence because of prior conduct;
- when a company has failed to lodge multiple Business Activity Statements; or
- where there has been significant failure to pay employee claims, PAYG or employee superannuation.

Ipso facto

Ipso facto clauses are contractual clauses which allow one party to terminate an agreement by reason *only of the fact* (*"ipso facto"*) of the insolvency of the other party. These clauses are found in many critical supplier contracts, franchise and licence agreements and leases for land and equipment.

Under the existing corporate insolvency regime in Australia, there is no prohibition or moratorium on enforcement of *ipso facto* clauses. Where such clauses exist, the appointment of a voluntary administrator to a financially distressed company can result in the company's main trading partners invoking their right to automatically terminate contracts, despite there being no outstanding payments or other contract default. The ultimate result is that there is then no business to restructure, the value of the company's goodwill plummets and there is no longer any going concern for creditors.

The Commission Report noted that the operation of *ipso facto* clauses severely reduces the scope for a successful restructure of a business and recommended that they be unenforceable if a company is undertaking a restructure. The Proposals Paper highlighted that the lack of protection from the operation of *ipso facto* clauses has been a key criticism of Australia's voluntary administration regime.

The Government's proposal in respect of *ipso facto* clauses provides 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.

An insolvency event is defined to include the appointment of an administrator, receiver or controller, the company entering into a deed of company arrangement or undertaking a scheme of arrangement.

The Proposals Paper recognises that there are certain classes of contracts, such as swaps, certain derivatives and close-out netting arrangements which require types of *ipso facto* clauses remain operational. As such, the Government intends to carve out certain prescribed financial contracts.

Legislated reforms

Once legislated, these reforms will facilitate a transformation of the Australian economy by allowing companies and directors to take necessary risks to innovate while continuing to support creditor protection.

The deadline for submissions has now passed. Amended legislation is expected by mid-2017 subject to the legislative reform timetable after the Australian election in 2016 (which is underway at the time of writing).