HERBERT SMITH FREEHILLS

AUSTRALIAN GOVERNMENT FORGES AHEAD WITH MAJOR INSOLVENCY LAW REFORM

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Legal Briefings – By **Paul Apáthy** and **Siba Diqer**

On 29 April 2016, the Australian Federal Government (**Government**) announced three major insolvency law reform proposals in its Improving Bankruptcy and Insolvency Laws Proposal Paper[1] (**Proposal**). The Government has invited submissions from stakeholders and given this is a rare opportunity to undertake substantial reform, we strongly encourage involvement.

IN BRIEF

Stakeholders should study the Proposal carefully as the changes will have far reaching consequences, but be aware of the short timeframe, with submissions due by Friday, 27 May 2016. A summary of the proposed changes is set out below.

SUMMARY

The Proposal focuses on three areas for improvement of bankruptcy and insolvency laws:

- **safe harbour** - introducing a 'safe harbour' for directors from personal liability for insolvent trading if they satisfy certain requirements;
- ***ipso facto* clauses** - making ipso facto clauses, which allow contracts to be terminated solely due to an insolvency event, unenforceable if a company is undertaking a restructure; and
- **bankruptcy period** - reducing the current default period for personal bankruptcy from

three years to one year.

The Proposal was released following the Productivity Commission's Business Set-up, Transfer and Closure Productivity Commission Inquiry Report[2] (**Report**) released on 7 December 2015 and in response to key stakeholder concerns that reform in this area was long overdue.

INSOLVENT TRADING SAFE HARBOUR

The Report identified that the threat of directors' liability under Australia's insolvent trading laws, combined with uncertainty over the precise moment of insolvency, is a driver behind companies entering voluntary administration, sometimes prematurely. Based on ASIC administrative data, the Report found that the current insolvency system in Australia does not promote effective restructuring and failure rates after a company enters voluntary administration are high.

The Government has formulated two alternative proposals for the introduction of a 'safe harbour' either as a defence (model A) or a carve-out (model B) for directors in respect of the insolvent trading provision in section 588G of the Corporations Act 2001 (Cth) (Corporations Act). The Government has requested feedback on both alternatives.

Model A

Under the model A option, it would be a defence to section 588G of the Corporations Act 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:

1. 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

2. 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 time.

The restructuring adviser would:

- be appropriately experienced and qualified;
- owe duties to the company;
- 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 identified;
- not be civilly liable to third parties for an erroneous opinion if it was honestly and reasonably held;
- be unable to be appointed in any subsequent insolvency without leave of the Court; and
- be carved out of the definition of 'director' contained in the Corporations Act.

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. However, the Government has indicated that in order to be appointed as a restructuring adviser that individual would need to be an accredited member of an organisation such as the Law Society, CPA Australia, Chartered Accountants Australia and New Zealand, the Australian Restructuring, Insolvency and Turnaround Association or the Turnaround Management Association.

Directors would remain subject to all other legal obligations as the 'safe harbour' defence would only operate in respect of insolvent trading liability under section 588G.

The company's continuous disclosure obligations would also continue to operate, but the Government does not propose to require companies to disclose whether they are operating in safe harbour.

In certain circumstances, the model A option safe harbour defence would not be available to a director, for example where the director was disqualified from managing a corporation at the time the debt was accrued, or ASIC or the Court determine the director is ineligible to rely on the defence due to prior conduct.

Model B

Model B is a less prescriptive alternative, which aims 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.

The model B option provides that section 588G would not apply:

1. 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

2. 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

3. incurring the debt does not materially increase the risk of serious loss to creditors.

As model B, unlike model A, operates as a carve out rather than a defence, the onus would instead be on the liquidator to show that a director has breached any one of the three limbs of the proposed provision.

***Ipso facto* clauses**

An *ipso facto* clause is a contractual provision that allows one party to terminate or modify the operation of an agreement upon the occurrence of an insolvency event e.g. when a voluntary administrator is appointed. These clauses are very common in all types of commercial contracts. However, the ability of commercial counterparties to terminate in these circumstances is often irreparably damaging to the value of a business which may require key contracts to continue to operate, and can undermine the ability to restructure or turnaround a business within a formal insolvency process.

The Report recommended that the Corporations Act be amended such that ipso facto clauses which allow termination solely on the basis of an insolvency event be unenforceable if the company is in voluntary administration or in the process of forming a scheme of arrangement.

In the Proposal, the Government has taken the view that this protection ought to be extended even further. It has proposed that any term of an agreement which terminates or amends any agreement (or any term thereof), by reason only that an 'insolvency event' has occurred would be void. Furthermore, any provision in an agreement that has the effect of providing for anything that in substance is contrary to this prohibition would also be void.

The Government has proposed that 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 into a deed of company arrangement.

The Proposal would not extend the operation of the provision beyond ipso facto clauses, for example, a party will maintain a right to terminate for other breaches of contract such as non-payment or non-performance.

The Government intends to carve out certain prescribed financial contracts and has asked stakeholders for their feedback on which contracts should be specifically excluded from the operation of the provision.

The Government intends to include a provision that a counterparty which has suffered hardship may apply to the Court to vary contractual terms.

BANKRUPTCY PERIOD

The Government proposes to reduce the default (i.e. normal) bankruptcy period to one year (a reduction from the current three year period). This would result in the related restrictions imposed on bankrupts, such as the prohibitions on being a company director, incurring further debts and travelling overseas, also being reduced to one year. The Government believes that this reduced period will encourage entrepreneurial endeavour and reduce the stigma associated with personal bankruptcy. The Government proposes to retain a trustee's ability to object to the discharge of a bankrupt and extend the period of bankruptcy to up to eight years.

The proposed reduction excludes income contributions such that where a bankrupt's after-tax income exceeds the prescribed amount, half of any excess income will continue to be paid to the bankrupt's trustee for distribution to the bankrupt's creditors for three years (or the extended period of up to eight years), even if this extends beyond the formal bankruptcy period.

The Government proposes to amend the *Bankruptcy Act 1996* (Cth) to ensure the obligations on a bankrupt to assist in the administration of his or her bankruptcy remain even after discharge.

THE SIGNIFICANCE OF THE PROPOSAL

The Proposal is a significant and encouraging development for Australian bankruptcy, insolvency and restructuring law, introducing substantial changes to encourage business rescue and entrepreneurship and to modernise the legislative framework.

The Government's request for submissions presents an opportunity for business to provide further input and participate in developing the Proposal further. The period for making submissions is very short – the Government has set a deadline of Friday, 27 May 2016 (less than a month away). Stakeholders should review the Proposal without delay.

Herbert Smith Freehills is studying the Proposal carefully and will provide further detailed comments in the coming weeks.

ENDNOTES

1. Improving Bankruptcy and Insolvency Laws Proposal Paper

2. Business Set-up, Transfer and Closure Productivity Commission Inquiry Report

This article is one of a series that Herbert Smith Freehills is publishing on the Government's insolvency and bankruptcy law reform proposals.

KEY CONTACTS

If you have any questions, or would like to know how this might affect your business, phone, or email these key contacts.

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