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AUSTRALIAN GOVERNMENT RELEASES DRAFT INSOLVENT TRADING AND IPSO FACTO LEGISLATION

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Legal Briefings – By **Paul Apáthy**, **Sarah Spencer** and **Lisa Filippin**

On 28 March 2017, the Australian Federal Government (**Government**) released draft legislation in relation to two major reforms intended to encourage turnaround, restructuring and business rescue.

The draft legislation introduces a safe harbour for directors from liability for insolvent trading, and stays the operation of *ipso facto* clauses where a company enters into administration or proposes a scheme of arrangement.

EXECUTIVE SUMMARY

- The Government has released draft legislation for public consultation in relation to two major reforms in Australia's insolvency laws: introducing an insolvent trading 'safe harbour' and restricting the operation of *ipso facto* clauses in certain circumstances.
- Insolvent trading safe harbour – under the draft reforms, directors will be protected from (civil) insolvent trading liability where they take a course of action that is reasonably likely to lead to a better outcome for the company and the company's creditors as a whole.
- *Ipso facto* clauses – the draft reforms will stay the operation of *ipso facto* clauses when a

company enters into administration or proposes a scheme of arrangement. There are a number of types of transaction that are exempt from this restriction.

- Whilst the draft legislation has significantly improved on previous proposals, there remain some issues with the legislation that require further consideration and refinement.
- The closing date for submissions on the draft legislation is Monday 24 April 2017.
- In this article we summarise the key aspects of the draft legislation, and outline a number of the remaining issues to be resolved.

BACKGROUND

There has been general sentiment that Australia's insolvency laws require reform to encourage restructuring and turnaround, which typically results in better outcomes for stakeholders than formal insolvency.

Under Australia's strict insolvent trading laws, directors risk personal liability for debts incurred when a company is unable to pay its debts. This has acted as a disincentive for directors to seek to restructure outside formal insolvency.

Furthermore, there is currently no restriction in Australia on the operation of *ipso facto* clauses upon the occurrence of an insolvency-related event. Such clauses are common in commercial contracts and allow counterparties to terminate their dealings with the company upon the occurrence of such events, which can have a devastating impact on the business.

On 29 April 2016 the Government released its Improving Bankruptcy and Insolvency Laws Proposal Paper, (**Proposal Paper**) and launched a public consultation process with respect to the proposals therein. The Proposal Paper contained proposals for law changes to introduce a 'safe harbour' for insolvent trading, to restrict the operation of *ipso facto* clauses and to reduce the default bankruptcy period for individuals from three years to one year.

We published several articles describing and considering the implications of these earlier insolvent trading safe harbour and *ipso facto* proposals, and also (along with many other participants in Australia's restructuring and insolvency community) made submissions on those proposals.

Following on from last year's consultation, the Government has now released draft legislation to introduce the insolvent trading safe harbour and restrictions on *ipso facto* clauses (the status of the bankruptcy reform is unclear). The draft legislation is a significant improvement on the initial Government proposals in the Proposal Paper, and we are pleased to see that the reforms address many of the issues raised in our submissions.

In this article we summarise the key aspects of the draft legislation, and outline a number of the remaining issues to be resolved.

INSOLVENT TRADING SAFE HARBOUR

The draft legislation introduces section 588GA into the Corporations Act 2001 (Cth) (**Corporations Act**). This section provides directors with a defence to a civil action for insolvent trading under section 588G(2).

For the safe harbour to apply, the debt that the liquidator alleges has been incurred whilst the company was insolvent must have been incurred in connection with a course of action that is reasonably likely to lead to a better outcome for the company and the company's creditors. The 'defence' will cease to be available to the director upon the earliest of the following:

- the director stops taking that course of action;
- when the course of action is no longer reasonably likely to lead to a better outcome; or
- when the company becomes a 'Chapter 5 body corporate'.

The draft legislation defines 'better outcome' as an outcome which is better for both the company and the company's creditors *as a whole* than the outcome of the company becoming a Chapter 5 body corporate.

A 'Chapter 5 body corporate' is defined in the Corporations Act as a company which is being wound up, to which a receiver has been appointed, that is under administration, that has executed a deed of company arrangement (that has not terminated) or entered into a compromise or arrangement the administration of which has not been concluded.

The section sets out a non-exhaustive list of factors that may be taken into account in determining whether a course of action is reasonably likely to lead to a better outcome. These include whether the directors:

- take appropriate steps to prevent any misconduct by officers or employees of the company that could adversely affect the ability of the company to pay all its debts;
- ensure the company is keeping appropriate financial records consistent with the size and nature of the company;

- obtain appropriate advice from an appropriately qualified entity who was given sufficient information to give such advice;
- properly inform themselves as to the financial position of the company; and
- are developing or implementing a plan for the restructuring of the company to improve its financial position.

The Explanatory Memorandum makes clear that it is not necessary for all of these factors to apply for directors to be able to rely on the safe harbour 'defence', and it is possible for that defence to apply even where none of those factors are present. Equally, the Explanatory Memorandum states that all of those factors may be present, but a court may still find that the course of action was not reasonable.

There are a number of restrictions on the availability of the safe harbour:

- it will not apply to a company that fails to meet its employee entitlement and tax reporting obligations; and
- company books or information will not be admissible as evidence in support of a director taking a reasonable course of action where that director failed to provide such books or information to a liquidator or administrator when requested. The Explanatory Memorandum explains that this will prevent directors from impeding any investigation into the company by a liquidator or administrator.

The legislation refers to the safe harbour provision contained in s 588GA(1) as a 'defence' and one in which an evidential burden is placed on the director seeking to rely on it. However, the evidential burden only requires that the director present evidence which shows a 'reasonable possibility' that a reasonable course of action was taken. The draft Explanatory Memorandum explains once such evidence is provided, the liquidator then bears the onus of establishing that the course of action taken by the director was in fact not reasonable.

PRELIMINARY COMMENTS

The new section 588GA differs significantly from both the Model A and Model B safe harbour options contained in last year's Proposal Paper. The requirement to appoint an 'appropriately experienced, qualified and informed restructuring adviser' (or 'harbour master'), which was the hallmark of Model A and which we submitted ought not to be a necessary requirement, has been dropped. However, the provision also does not include any of the key requirements of Model B either (that the directors attempt to return the company to solvency within a reasonable period of time, that the person considers incurring the debt in the best interests of the company and its creditors as a whole and that incurring the debt does not materially increase the risk of serious loss to creditors).

The draft provision gives rise to a number of issues for consideration:

- **A better outcome for 'the company' and the company's creditors** The key test for the applicability of the safe harbour defence is that the course of action must lead to a better outcome for the company and the company's creditors (as a whole). What does the reference to 'the company' mean in this scenario and, given that the safe harbour only has operation where a company is unable to pay its debts, does it mean something different from the company's creditors (e.g. does it require, for example, the survival of the corporate entity)? We think it would be clearer to simply refer to the 'company's creditors as a whole'.

- **Better than what?** The better outcome test requires that the course of action adopted be reasonably likely to lead to an outcome better than the outcome of the company becoming a Chapter 5 body corporate. This term is broadly defined (see above), and includes steps that may actually be required as part of implementing the restructuring (e.g. a scheme of arrangement or deed of company arrangement (**DOCA**)). The test therefore sets the bar too high (it appears to require pursuit of a restructuring without using any of the Chapter 5 tools) and is difficult to evaluate (does a director need to consider all of the possible outcomes under any of the Chapter 5 processes?). We think it would be simpler and clearer to simply require that the course of action is reasonably likely to lead to a better outcome than the *immediate* (or prompt) appointment of an administrator or liquidator.

- **When does the safe harbour end?** The draft legislation provides that the safe harbour comes to an end when the company becomes a Chapter 5 body corporate. This term includes, among other things, where a company has entered into a compromise or arrangement (the administration of which has not been concluded). It also includes appointment of a receiver (but not necessarily a receiver over the entire company). These are situations where a restructuring may still be pursued, but without the benefit of the safe harbour defence, directors could be at risk of insolvent trading liability. We therefore do not think these are appropriate triggers for the safe harbour to terminate.

- **Incurring new debts** The new section 588GA does not provide explicit guidance on the extent to which directors are required to turn their minds to the appropriateness of

incurring new debts. In this regard we note that 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.'* The Explanatory Memorandum also indicates that the phrase 'the company's creditors as a whole' is intended to cover both existing creditors and new creditors (as a result of incurring new debt). However, there is a natural tension between the two groups – existing creditors might be better served by trading on, but generally new creditors will not (unless they are paid in full).

IPSO FACTO CLAUSES

The draft legislation introduces two new provisions (sections 415D and 451E) that relate to *ipso facto* clauses triggered by schemes of arrangement and administration, respectively. This is a narrower approach than the previous Government proposal, which also applied to receiverships.

SCHEMES OF ARRANGEMENT

Under the new section 415D, any contractual right which is triggered merely because the company enters into a scheme of arrangement is unenforceable whilst the company is the subject of the scheme proposal, provided that the scheme application states that it is made for the purpose of avoiding being wound up in insolvency.

The stay on enforcing the *ipso facto* right starts when the company makes an application to hold a meeting of creditors and ends:

- if the application for the scheme is withdrawn or dismissed; or
- at the end of the scheme (unless the scheme ends because of an order or resolution that the company be wound up, in which case, when the company is wound up).

ADMINISTRATION

Under the new section 451E, any contractual right which is triggered merely because the company is under administration is unenforceable whilst the company is in administration (subject to any court extension to the stay).

The stay on enforcing the *ipso facto* right starts when the company enters into administration and ends when:

- the administration ends (unless it ends because of a resolution or order that the company be wound up, in which case it ends when the company is wound up); or
- if an application for an extension order is made within 7 days after the administration ends, the application for that order is withdrawn or the extension order ceases to be in force.

EXCLUSIONS

For both restrictions, there are a number of types of contracts and agreements which are excluded from the stay on enforcement of the *ipso facto* clauses. The categories of exclusions are:

- types of contracts prescribed by the regulations;
- contracts subject to a ministerial determination;
- contracts entered into after a scheme commences or the company enters into administration; and
- contracts which manage financial risk associated with a financial product (but only in respect of rights which are commercially necessary for that contract).

The draft Explanatory Document provides a list of the types of contracts which the Government propose to include in the regulations that will be excluded from the stay of enforcement of *ipso facto* clauses. The contracts have been prescribed in the regulations to allow the Government to update and expand the list as necessary to take into account the development of financial products. Presently, the excluded contracts to be prescribed by the regulations include:

- agreements under the *Payment Systems and Netting Act 1998*, including contracts dealt with under the *Banking Act 1959* and *Insurance Act 1973*;
- rights of set off;
- flexible priority arrangements;
- flawed asset arrangements;

- replacement of trustees;
- securities underwriting agreements;
- arrangements entered into under an ISDA master agreement;
- repurchase agreements, forward contracts, commodity contracts, swaps, rated securitisations and structured financings that include ‘flip clauses’;
- master netting agreements;
- lease contracts for aircraft objects in aviation transactions;
- securitisation arrangements which involve special purpose vehicles;
- securities settlement facilities;
- covered bond transactions;
- debt factoring agreements;
- real time gross settlement arrangements; and
- contracts for personal services.

STAY ON RIGHT TO ADDITIONAL CREDIT

The draft legislation also provides that where an entity is prevented from enforcing a contractual right due to the operation of these *ipso facto* provisions, any contractual right that the company has against that entity for the provision of additional credit is also unenforceable. The term ‘provision of additional credit’ is not defined.

COURT ORDERS

Importantly, the legislation provides that the Court may lift the stay on application by the affected party if it is satisfied that it is in the interests of justice to do so.

The Court also has the power to order that certain rights may only be enforced with the leave of the Court and in accordance with such terms as the Court imposes. This has the potential to allow the Court to prohibit counterparties exercising contractual rights on other grounds (e.g. termination for convenience clauses, or other insolvency related triggers).

PRELIMINARY COMMENTS

Again, these new *ipso facto* provisions differ markedly from those contained in the Proposal Paper. In particular, the scope of the provisions has been narrowed to focus on administration and schemes of arrangement, and there is no longer an ‘anti-avoidance’ concept.

However, we think that the following issues merit further consideration:

- **Factual insolvency** As we noted in our article and submissions last year, an *ipso facto* rule that only relates to the company's formal entry into administration may not be effective in isolation, given that many contracts also contain termination rights for factual insolvency (i.e. inability to pay debts). For the *ipso facto* restriction to be effective in practice where a company has entered administration, the proposed section 451E would also need to prevent counterparties exercising rights due to the insolvency or financial condition of the company at any time before or during the company's administration. Consideration could also be given (although probably less critical) to whether a similar approach is warranted in respect of schemes of arrangement.

- **Receiverships** The draft legislation does not contain *ipso facto* restrictions in respect of receivership. As discussed in our article last year, it could be argued that there is potential policy justification for excluding receivership from the *ipso facto* regime given that technically it is a security enforcement mechanic rather than a corporate rescue regime for the benefit of all creditors. However, in practice, receivership is a common regime in Australia pursuant to which practitioners often try to sell the business on a going concern basis. It is common for companies in receivership to be subject to a parallel administration, either because the directors appoint an administrator following the receiver's appointment, or because a secured creditor holding all assets security chooses to appoint a receiver 'over the top' of an administrator following the administrator's appointment. We assume it is still intended that a secured creditor with security over all or substantially all of the assets of the company will be entitled to appoint a receiver in response to a voluntary administrator appointment (notwithstanding the administration moratorium). If it is still intended that secured creditors are to have this right, then there will need to be a specific carve out from the *ipso facto* restrictions allowing such secured creditors to enforce security in response to a voluntary administration appointment. Typically in a scenario where a receiver is appointed in response to a voluntary administrator, the receiver will take primary control of the company for the benefit of the secured creditor and the administrator will take a 'back seat'. In this case the receiver effectively obtains the benefit of the voluntary administration moratorium and it may therefore also be consistent in these cases for the same *ipso facto* restrictions to apply as would be the case for any company in administration in order to best facilitate value preservation (coupled with appropriate protections for counterparties that continue dealing with the company in receivership). Consistent with the position outlined above, consideration should also be given to whether secured creditors should have a similar right in respect of schemes.

- **DOCAs** The draft legislation does not contain explicit *ipso facto* restrictions in respect of DOCAs. A DOCA is essentially a restructuring plan between a company in administration and its creditors. It is the means by which a company can successfully restructure and exit administration. Consideration should be given to whether it would be consistent with the approach otherwise taken in the draft legislation (and as contemplated by the

Proposal Paper last year) for an *ipso facto* restriction to also apply if a company enters into a DOCA.

- **Liquidation** The draft legislation does not directly contain *ipso facto* restrictions in respect of liquidation. However, there are provisions suggesting that where liquidation follows a scheme or administration the period of protection can extend until the company is wound up. It is not entirely clear what this extension is seeking to achieve. However, in any event, we think it is justifiable for the *ipso facto* restrictions not to apply in a liquidation, as a liquidation is not a business rescue procedure (and generally creditors and counterparties are not restricted from exercising self-help remedies in a liquidation).

- **Temporary stay?** In the case of both schemes and administration, the *ipso facto* protection only lasts until the scheme is approved or the administration completes. This could result in the somewhat perverse outcome that as soon as a company has been successfully restructured counterparties could exercise their contractual rights to terminate (if their contractual rights did not require a *subsisting* insolvency event for their exercise). Consideration should be given to whether the stay on enforcement in respect of administration and schemes of arrangement should be permanent.

- **Schemes avoiding winding up** The draft provisions require that for a scheme to have the benefit of *ipso facto* protection, the scheme application must state that it is being made for the purpose of avoiding being wound up in insolvency. It is unclear why this has been required.

- **Acceleration and set-off rights** The draft Explanatory Document indicates that set-off rights, and a number of other similar arrangements are excluded from operation of the ipso facto restrictions. However, acceleration rights under loans and financial instruments (depending on their nature) are not necessarily excluded. This may limit the ability of counterparties to exercise set-off rights in question, if not all of the debt sought to be set off is actually due. This can be a particular issue for banks in an administration where it has been held that amounts accruing under the administrator's lien take priority to such set-off rights.

- **Contractual rights vs contractual effects** The draft provisions now focus on contractual rights that trigger upon insolvency events (as opposed to the Proposal Paper that referred to termination or amendment). It is therefore unclear whether things that simply occur automatically under the terms of the contract upon the insolvency event are restricted or not. If not, counterparties could potentially draft around these provisions, for example, by stating that a contract automatically terminates upon either party entering administration.

- **Provision of additional credit** Under the draft legislation counterparties are not obliged to provide additional credit when restricted from excising their *ipso facto* rights. While we think it is important to include appropriate safeguards in this regard, any such exceptions need to be carefully considered and clearly delineated. 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 may be less substantial than first appears. Consideration should be given to whether a priority payment regime could help to address this issue. How would fluctuating balances be treated – for example would this permit a lender to refuse a 'rollover' of an existing loan (where it technically involved a repayment and readvance) or refuse to operate an overdraft within the balance on the date of the relevant insolvency event? Would a company be permitted to continue operating within existing credit limits with trade creditors?

CONCLUSION

The Government has made significant progress in refining the insolvent trading safe harbour and *ipso facto* provisions since launching the Proposal Paper last year. Generally we welcome the move to encourage business rescue and turnaround, and are glad to see that a significant number of our submissions have been incorporated into the draft legislation.

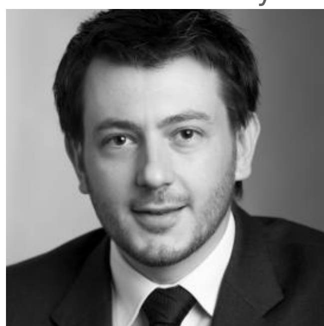
However, there remains further work to be done to ensure that these provisions work as intended, and that relevant stakeholders are adequately protected. Accordingly, we intend to make submissions to the Government reflecting, among other things, the points set out in this article. Submissions are due by 24 April 2017. We encourage other stakeholders to participate in this process by making a submission.

MORE INFORMATION

For more information about this decision or its possible implications to your business contact Paul Apáthy, Peter Smith, Mark Clifton, Sarah Spencer or Lisa Filippin.

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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