HERBERT SMITH FREEHILLS

REVISED AND IMPROVED: NEW INSOLVENT TRADING SAFE HARBOUR AND IPSO FACTO LEGISLATION PASSES THROUGH THE SENATE

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Legal Briefings – By **Paul Apáthy, Sarah Spencer and Leyton Cronk**

On 11 September 2017, two major reforms to Australia's insolvency laws – an insolvent trading safe harbour and a restriction on the enforcement of *ipso facto* rights in certain circumstances – passed through the Senate with certain amendments being made at the final hour. The Bill now awaits royal assent.

In this article we summarise the final amendments made to the Bill and the key improvements compared to the earlier draft legislation.

EXECUTIVE SUMMARY

- On 11 September 2017, the *Treasury Laws Amendment (2017 Enterprise Incentives No. 2) Bill 2017* (**the Bill**) passed through the Senate with certain amendments being made at the final hour.
- The safe harbour provisions will commence the day after the Bill receives royal assent. However, the *ipso facto* reforms will commence on the later of 1 July 2018 or 6 months after the Bill receives royal assent.
- Following industry consultation, the proposed insolvent trading safe harbour has been

improved from the draft legislation introduced on 28 March 2017.

- Under the Bill as passed, the insolvent trading safe harbour applies where the directors start *developing one or more* courses of action that are reasonably likely to provide a better outcome for *the company* than an immediate *liquidation or administration*. The safe harbour protects directors from insolvent trading liability arising from debts incurred *directly or indirectly* in connection with any such course of action.

- Whilst amendments were proposed in the Senate to re-instate the safe harbour as a defence rather than a carve out and a requirement that a registered liquidator be appointed as the 'harbour master', these were not approved. The Senate did approve an independent review of the safe harbour provisions after 2 years of operation.

- The *ipso facto* regime has also been developed, although aspects remain uncertain. Importantly, the ipso facto regime will now apply to schemes of arrangement, administration and *receivership*. It will also now prevent a counterparty using the *company's financial position* at the time of the scheme, administration or receivership as the triggering event. The regime in the Bill removes the counterparty's ability to exercise rights based solely on those trigger events *indefinitely*.

- The Senate amended the legislation to extend the operation of the *ipso facto* regime to include a stay on rights prescribed by regulation, rights which are in substance contrary to the provision introducing the stay and self-executing provisions (being provisions in an agreement which automatically come into operation). These amendments further broaden the *ipso facto* regime but potentially create some uncertainty as to the extent of their application.

REFRESHER ON THE BACKGROUND TO THE REFORMS

The passing of the reforms on 11 September 2017 in the Senate comes as the latest instalment in relation to the insolvent trading safe harbour and *ipso facto* reforms. A fuller account of the history that led to the Bill being introduced is set out in our previous update.

Previously, we reported on the draft legislation released by the Australian Federal Government (**Government**) on 28 March 2017 in relation to these reforms, and also made submissions to Treasury addressing a number of concerns.

Following the consultation process, the Government introduced a revised version of the legislation to Parliament on 1 June 2017 in the form of the *Treasury Laws Amendment (2017 Enterprise Incentives No. 2) Bill 2017* (**the Bill**). The revised Bill took into account a great number of concerns that were raised during the consultation process and we were pleased to see that the Government adopted a number of our recommendations.

On 22 June 2017, the Bill was introduced into the Senate and referred to the Senate Economics Legislation Committee (**the Senate Committee**), to which we made further submissions. Following a report being released by the Senate Committee, further changes were proposed at the final hour in the Senate on 11 September 2017, some of which were passed.

INSOLVENT TRADING SAFE HARBOUR

The safe harbour provisions provide directors with an exception from insolvent trading liability where they are developing courses of action which are reasonably likely to lead to a better outcome for the company than administration or liquidation. Our previous update contains an overview of the effect and operation of the provisions as contained in the earlier draft legislation.

KEY CHANGES

A number of key issues that we raised in our earlier articles and submissions have been addressed by the revised Bill. Briefly, the key changes are as follows:

- **Review of legislation:** the safe harbour provisions must be independently reviewed within 2 years after coming into effect;
- **Exception to insolvent trading, not a defence:** following various changes to the drafting of the Bill, the safe harbour provisions will operate as an *exception* to the insolvent trading regime, rather than a defence;
- **Developing one or more courses of action:** the Bill now proposes that a director will enter safe harbour once the director *starts developing one or more* courses of action reasonably likely to lead to a better outcome, rather than only being available once a director has *taken a course of action,* as was the case under the draft legislation. This is a significant improvement which makes it clear that directors would have the benefit of safe harbour while exploring and developing a range of turnaround strategies, rather than needing to immediately select and pursue one particular strategy;
- **Direct and indirect debts included:** the Bill now proposes that the safe harbour be available in respect of all debts *incurred directly or indirectly in connection with any such course of action*, rather than only those incurred in connection with the course of action. Again, this is a significant improvement which makes it clear that safe harbour would be available if multiple strategies are being pursued, and in respect of debts that are not directly related to the turnaround strategy itself (e.g. debts incurred in the ordinary course of ongoing trading);
- **A better outcome for 'the company' only:** the draft legislation would have required the course of action being taken by directors to be reasonably likely to lead to a better outcome for the company *and* its creditors. The Bill now proposes that the focus be

solely on the outcome for the company. Whilst this removes the uncertainty of referring to both creditors and the company in the earlier draft legislation, it may create some further uncertainty as to what 'the company' means in this context and how a 'better outcome' is to be assessed if stakeholders other than creditors need to be considered;

- **A better outcome than immediate liquidation or administration only:** the draft legislation required that the test of a 'better outcome' involve a comparison with the outcomes from a Chapter 5 process at an undefined time. The Bill now only proposes that the comparison be to the immediate appointment of a liquidator or administrator;

- **Safe harbour not to end on receivership or entry into a scheme:** contrary to the draft legislation, the Bill provides that the safe harbour only end on the company entering into administration or liquidation (from which point the directors will no longer be responsible for the control of the company). This allows greater latitude for turnaround strategies to continue notwithstanding (or perhaps with the assistance of) a receivership or scheme of arrangement; and

- **Holding companies to be covered:** the Bill now also proposes protection for holding companies provided that they take reasonable steps to ensure that safe harbour is available to the directors of the subsidiary.

In response to the release of the revised Bill in June this year, the Turnaround Management Association has released best practice guidelines in relation to the practical steps companies and advisors can take when seeking to utilise the insolvent trading safe harbour.

The insolvent trading safe harbour provisions are due to commence one day after the Bill receives royal assent.

IPSO FACTO CLAUSES

The *ipso facto* provisions are intended to restrict counterparties from exercising contractual rights solely as a consequence of the company entering into administration, a scheme of arrangement or receivership (or is subject to the appointment of another form of managing controller).

KEY CHANGES

The key changes made in the Senate are as follows:

- **Regulations:** the stay will extend to contractual rights prescribed by regulation in relation to the company, or the company's financial position, triggered by the company entering into a scheme of arrangement, administration or receivership;

- **Rights contrary to the regime:** the stay will extend to contractual rights which, in substance, are contrary to the new provisions and which would otherwise be triggered by the schemes of arrangement, administration or receivership; and

- **Self-executing provisions:** the stay will apply to self-executing contractual provisions which apply automatically (i.e. without one party electing to enforce a right) on the appointment of an administrator, receiver or the company entering into a scheme of arrangement.

The introduction of these latter two points may create some uncertainty as to the extent of the *ipso facto* regime. Both were introduced very late in the process, and therefore unfortunately have not had the benefit of refinement and comment through the public consultation process.

In addition to the Senate amendments, a number of key issues with the draft legislation have been addressed in the drafting of the Bill following the consultation process. These include the following:

- **Application to receivership:** whilst the draft legislation proposed that a stay would only arise where a company enters into administration or a scheme of arrangement, the Bill now expands on that and makes a stay available when a company has a receiver and manager or other form of managing controller appointed to the whole or substantially the whole of the company's property (**Substantial Receivership**);

- **Extension to surrounding financial position:** under the draft legislation, the stay only applied to rights triggered by the administration or scheme of arrangement. However, it did not prevent the exercise of rights based on, for example, the factual insolvency that accompanies administration. Under the Bill, the stay is expanded to also apply to rights arising from the company's financial position where it enters administration, a scheme of arrangement or a Substantial Receivership. This will assist in restricting counterparties from relying on collateral defaults to circumvent the stay provisions;

- **Extension beyond the immediate event:** the Bill provides that the relevant contractual rights will be unenforceable indefinitely after the stay has lifted to the extent that the reason for enforcing the right relates to a company's financial position before the end of the stay period or the company's commencement of a scheme of arrangement, administration or Substantial Receivership;

- **Carve out for the 'decision period' in administration:** the Bill amends existing provisions to make it clear that the stay on exercising contractual rights which applies when a company enters into administration does not apply to a secured creditor's right to take enforcement action under its securities during the 'decision period'; and

- **Grandfathering provision:** the Bill provides that the *ipso facto* regime does not apply to contracts entered into before the commencement of the regime. This creates different regimes in relation to contracts entered into before or after this date, and may encourage parties to amend rather than replace existing contracts so as to continue to have the benefit of existing *ipso facto* rights.

The *ipso facto* reforms will commence on the later of 1 July 2018 or 6 months after the Bill receives royal assent.

CONCLUSION

We welcome these reforms which will further improve Australia's restructuring law regime. However we note that there are some areas of uncertainty in regards to the practical application of the new law. We will provide an update in the coming weeks further detailing these areas of difficulty or uncertainty.

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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