WILL THE SAFE HARBOUR *IPSO FACTO* ASSIST WITH RESTRUCTURING IN AUSTRALIA? - PROPOSED REFORM TO AUSTRALIAN INSOLVENCY LAWS

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The Productivity Commission has handed down its long-awaited report on Business Set-Up, Transfer and Closure (**Report**) to the Australian Federal Government. Key recommendations from the Report have been embraced by the Australian Government including a *'safe harbour'* from personal liability for insolvent trading for directors and making *'ipso facto'* clauses unenforceable whilst a company is undertaking a restructure.

The Australian Government has included these reforms to Australia's insolvency laws with a desire to build a stronger entrepreneurial culture with these measures considered to support calculated risk taking and encourage innovation.

It is anticipated that the key recommendations will be introduced as part of a National Innovation and Science Agenda (**NISA**) by the middle of 2017.

WHY CHANGE? WHY NOW?

It is no secret that market drivers in Australian business, and indeed globally, are undergoing immense change. In recent years, the Australian economy has seen a shift from the mineral and resources sector with the Australian Government looking ahead to create a dynamic, 21st Century economy through an *'ideas boom'*.

In November 2014, the Australian Government announced a Productivity Commission enquiry into barriers to business entries and exits. The purpose? To identify appropriate options to reduce barriers and drive efficiency and growth in the Australian economy.

Fast-forward to December 2015, the Australian Government launched NISA geared at creating a culture of entrepreneurship, innovation and risk taking. NISA includes a package with incentives to ensure that Australians with new ideas are able to get started and are supported if they fail.

The Report found that Australia's insolvency regime was operating well overall. The Report suggests, however, that reforms are necessary to address flaws in restructuring processes due to (amongst other things) negative perceptions and risk aversion.

The recommendations in the Report to encourage a shift in culture toward restructuring over formal insolvency processes clearly support the Australian Government's current agenda. Hence the Productivity Commission's recommended changes to insolvency law in Australia, aimed at encouraging viable companies facing financial difficulty to restructure, have been adopted by the Australian Government.

CURRENT RISK AVERSE CULTURE

Currently the *Corporations Act 2001* (Cth) (**Act**) includes provisions which attract personal liability for directors for insolvent trading. Given the difficulties in pinpointing the exact time that a company becomes insolvent, the serious consequences of insolvent trading have been linked with discouraging directors from taking steps to restructure a company that is experiencing financial difficulty. The Report notes that these factors have "long been identified as a driver behind companies entering voluntary administration, sometimes prematurely."

Although it has been shown that actions for insolvent trading brought against directors are relatively scarce (due to difficulty in proving intent and cost), the risk of personal liability may discourage a director from taking what would otherwise be considered a calculated risk. This in turn may stifle innovation and growth of the company.

NOT A 'SAFE HARBOUR' FOR THE INSOLVENT BUT A SLIP WAY FOR THE VIABLE

The recommendation of the Productivity Commission to amend the Act to include a *'safe harbour'* defence is based on the premise of providing protection against insolvent trading laws for directors who genuinely take the opportunity to restructure a wounded, but salvageable, company.

The *'safe harbour'* defence is not to be applied carte blanche. To ensure that the *'safe harbour'* defence is implemented for its proper purpose (being to encourage good corporate governance whilst improving genuine opportunities to restructure) the Report considers various aspects of its availability and coverage.

Crucially, it is only available where an adviser (who is registered with at least 5 years' experience as an insolvency and turnaround practitioner) has been appointed with the "explicit purpose of providing restructuring advice". This advice is to be triggered by a specific instance of financial difficulty and is to be directed at the continued solvency and ongoing viability of the business.

There will be some debate, no doubt, about who will fit the bill to be an adviser in order for directors to rely on the *'safe harbour'* defence. The debate will also centre on whether the appointed adviser is able to take on a formal appointment should one arise. In any event, the position of a Chief Restructuring Officer may, on a formal basis, become more prevalent in Australia once this defence is implemented.

The *'safe harbour'* defence should <u>not</u> be available to directors where the company is already insolvent. On this basis, the Report recommends that amendments to the Act include that, "if the adviser forms the opinion that restructure into any form of viable business or businesses is not possible, they are under a duty to terminate the safe harbour period and advise the directors that a formal insolvency process should commence."

CLAUSES THAT SINK AN OTHERWISE SALVAGEABLE SHIP

As part of the Australian Government's innovation revolution, it has embraced the Productivity Commission's recommendation for a moratorium on the operation of *'ipso facto'* clauses that are triggered by an insolvency event during the restructuring of a company. The Report suggests that its recommendation is directed at removing obstacles from the restructuring process, as the prevalence of *'ipso facto'* clauses in commercial contracts particularly supplier contracts) has been known to destroy any hope of reviving struggling companies once they enter administration.

The catastrophic effect of *'ipso facto'* clauses is particularly demonstrated by the demise of publicly listed telecommunications company One.Tel on its administration in 2001. One.Tel's access to essential telecommunications infrastructure effectively dried up within hours when its major suppliers exercised the *'ipso facto'* clauses in their supply contracts. This left One.Tel with no hope of revival to restructure or sale as a going concern.

The moratorium on *'ipso facto'* clauses will assist the restructuring process by maintaining the status quo of the business and its contracts. Some may argue that this is the true intention of the voluntary administration process.

The Report refers to recent changes made by the United Kingdom (UK) to prevent providers of essential services from exercising *'ipso facto'* clauses to facilitate restructuring. Particularly the Report considers the safeguards[1] implemented by the UK to instil confidence in suppliers that they will be paid.

The Productivity Commission is of the view that there is "merit in adopting safeguards to ensure that changes made to improve restructuring do not have unduly harsh impacts on suppliers." Such safeguards may include the ability for both external administrators and suppliers being entitled to apply to the Court, as follows:

1. External Administrators – apply to the Court for performance where the supplier is attempting to avoid the moratorium and continuation of the contract is in the best interests of the creditors; and
2. Suppliers – apply to the Court for termination of the contract where the moratorium could lead to undue hardship.

Essential to the Productivity Commission's recommendation is that any amendments to the Act are to be clear that the moratorium on *'ipso facto'* clauses does not absolve the company from any other obligation under the contract. As a result, any other breach (for example failure to make payments due) may be relied on by a supplier to terminate the contract.

US MODEL NOT FOR AUS

There has been for some time in Australia a call for us to simply adopt the regime in Chapter 11 of the United States Bankruptcy Code (**Chapter 11**) which provides for the reorganisation of debt by companies and may also be used by partnerships and individuals. A company that invokes the provisions of Chapter 11 becomes a *'debtor in possession'* and it retains control of its own affairs, whilst all creditors' rights are immediately frozen. In addition, the company owes a fiduciary duty to its creditors, who are represented by a committee.

The Chapter 11 process requires close supervision by the Bankruptcy Court and any proposed reorganisation plans cannot proceed without the Court's approval.

The Report suggests that the operation of the Chapter 11 initially seems appealing due to its focus on business restructure whilst the company retains control of its operations. There is, however, strong criticism of the *'debtor in possession'* concept under Chapter 11 as the very same directors, who steered the company into financial difficulty, are tasked with returning the company to a profitable path.

As Chapter 11 has seen little change since it was first enacted in 1978, the Report notes that a recent major review[2] of the process found it to be unsuitable for modern large companies in a complex corporate environment. In addition, it was found that Chapter 11 has become too expensive for small to medium-sized enterprises to restructure under the US federal bankruptcy laws.

The Report considers that the high dependency on Court supervision required under Chapter 11 is unjustified as it is unlikely to improve the speed or cost of what is, effectively, an administration process. Also, the judicial infrastructure is simply not currently available in Australia.

Overall, the Productivity Commission found that a "wholesale switch toward an insolvency regime akin to that of the United States is unnecessary, unjustified and was not supported by the participants of the inquiry."

A BALANCING ACT

Some other aspects of the Report, whilst not yet embraced by the Australian Government could have an impact on insolvency practitioners in Australia. One such area is the role of secured creditors and receivers. What the Report recommends is that the Australian Government conduct an independent review to ensure that receivers operate in a manner that protects the value of the secured property while minimising the opportunity for strategic manipulation. In addition, the review should ensure that receivers consider any impact their actions may have on the overall wellbeing of the company, particularly in circumstances where there are substantial unsecured creditors.

Traditionally the receiver is a medium between the company and the secured creditor of the assets over which the receiver is appointed. There are currently few lines of communication between a receiver and the broader base of creditors. With a view to greater transparency, the Report recommends that the Act be amended to allow:

3. for a committee of inspection to be formed by stakeholders in a receivership, namely unsecured creditors including employees and government authorities like the Australian Taxation Office; and
4. that where a committee of inspection is formed, it shall have:

> (a) a basic right to information regarding the receivership process including a description of the proposed process, the results of sale and costs; and
> (b) standing to apply to the Court for relief in relation to the costs of the receivership, but not any actions of the receiver.

Reforms in the UK in 2003 with the intention of encouraging restructuring saw the removal of receiverships from its insolvency toolkit as a result of the introduction of the *Enterprise Act 2002* (UK). Instead, secured creditors were left with an ability to appoint an administrator, who has a statutory obligation to achieve a *'value maximising rescue'*[3].

The Report refers to an empirical evaluation[4] of the UK's reforms under the *Enterprise Act 2002* which found that the abolition of receiverships has only been partially successful as 'increased recoveries in administrations were consumed by higher costs and sophisticated secured lenders found ways to work around the legislated changes.' On this basis, the Productivity Commission does not consider it necessary to abolish receiverships in Australia, however, its recommendations are made with the intention of striking a balance between the rights of secured creditors against the risk to the overall value of the company if a receiver is appointed.

A 'PRE-PACK' BY ANY OTHER NAME?

The Report has suggested that amendments also be made to the Act to provide for 'pre-positioned' sales under which directors may negotiate for the sale of the company (or parts of it) to be finalised directly prior to or during formal insolvency. The Report admits that the process may be analogous to the unintentional *'pre-pack'* feature of the UK insolvency landscape.

The UK *'pre-pack'* has been criticised for its lack of transparency, high failure rate and low benefit to unsecured creditors. Taking this into account, the Productivity Commission recommends a two-tiered approach to *'pre-positioned'* sales with differing presumptions as to whether the sale should proceed as follows:

5. *Related party not involved* - the presumption is that the sale should proceed unless the administrator can prove that the sale price is not within reasonable range of market value or the sale may encroach on the administrator's duties; or
6. *Related party involved* - there is no presumption favouring the sale with administrator's examination to continue as normal.

To ensure transparency, the Report recommends that the Act be amended to require disclosure of information regarding the sale to the company's creditors in all cases. Although the recommendation to include the *'pre-positioned'* sale into the insolvency scene has not been taken up by the Australian Government, it may be on the horizon. This is because the Report suggests that any resulting sale from *'safe harbour'* advice should also attract the defence as against voidable transactions from administrators and liquidators.

CONCLUSION

The announcement by the Australian Government to include key recommendations of the *'safe harbour'* defence and the moratorium on *'ipso facto'* clauses has been greeted with a great deal of approval. There are some who will say that these two initiatives in particular should have been in place some time ago. Whether these initiatives could have allowed more successful restructures is only speculation. The issue now is for the Australian Government to act as quickly as possible to get relevant legislation passed – for some companies it will already be too late. For others, it may be the *'life raft'* they have been waiting for.

[1] The supplier will be able to seek a personal guarantee from the insolvency practitioner at any time to given them more certainty that the supplies will be paid for; 2. The supplier will be able to apply to Court to terminate their contract on the grounds of 'hardship'; 3. Guidance will be issued to insolvency practitioners to urge them to make contact with essential suppliers at the earliest possible time following their appointment to discuss their needs in relation to supply, to ensure that undue costs are not incurred. (Swinson, J. Continuity of Supply of Essential Services to Insolvent Businesses, 9 February 2015, HCWS265, UK).

[2] American Bankruptcy Institute, 2014, Commission to Study the Reform of Chapter 11: Final Report and Recommendations.

[3] Armour, J, Hsu, A and Walters, A 2008, 'Corporate Insolvency in the United Kingdom: The Impact of the Enterprise Act 2002', European Company and Financial Law Review, vol.2/2008.

[4] ibid.