MAY 2016

COMMENTARY

Corporate and Business Rescue in Australia: Insolvency Law Reform Process Continues as Government Releases Proposals Paper

Background

On 7 December 2015, the Australian Government released its "National Innovation and Science Agenda" ("Agenda"). In the Agenda, the Government outlined its intention to make three significant reforms to Australia's insolvency laws, adopting the recommendations of the Productivity Commission ("Commission") in its report, "Business Set-Up, Transfer and Closure" ("Report"), released on the same day as the Agenda:

- Reducing the default bankruptcy period for individuals from three years to one year;
- Introducing a "safe harbour" providing directors with immunity from personal liability for insolvent trading under section 588G of the *Corporations Act 2001* (Cth) ("Act") during the implementation of a restructuring plan; and
- Preventing the enforcement of "ipso facto" contractual clauses during a restructuring attempt.

Insolvency reforms of the kind proposed in the Agenda have long been welcomed in the industry. Indeed, there has been a widespread view that directors have increasingly appointed voluntary administrators to companies at the first sign of financial trouble to take advantage of the defence to insolvent trading in sections 588H(5) and 588H(6) of the Act. Voluntary administration has in turn triggered the destruction of companies' enterprise value as core creditors and suppliers have terminated their contracts in reliance on ipso facto clauses that apply when companies experience an "insolvency event". All too often, those companies have eventually ended up being liquidated, and employees and other unsecured creditors have faced significant losses.

In progressing the reforms, the Government released a proposals paper, "Improving Bankruptcy and Insolvency Laws" ("Proposals Paper"), on 29 April 2016 for public consultation.

Reduced Bankruptcy Period

According to the Proposals Paper, reducing the default bankruptcy period (along with relevant restrictions that apply during bankruptcy such as credit and travel restrictions) to one year is designed to "encourage entrepreneurial endeavour and reduce associated stigma".

The reduced default bankruptcy period, which brings Australia into line with the default period in the United Kingdom, is a welcome reform which recognises that bankruptcy is not always the consequence of any "misconduct" by an individual and that genuine business failure is an ordinary part of a well-functioning economy. The pecuniary association given to bankruptcy in Australia has regrettably entrenched a "fear of failure" that has inhibited the development of an entrepreneurial culture of the kind seen in the United States.

However, in accordance with the Commission's recommendation in the Report, it is proposed that the default bankruptcy period may be extended for an individual bankrupt (as is currently the case) if the bankrupt has engaged in misconduct, for example by failing to pay assessed income contributions. The retention of the extension period is designed to prevent abuse of the bankruptcy process by individuals seeking to avoid liability for their debts.

The Proposals Paper also adopts the Commission's recommendation for a bankrupt's obligation to pay income contributions to be separated from the default bankruptcy period, so that income contributions will be payable for three years (if the bankruptcy period is not extended due to misconduct) even with a reduced default bankruptcy period.

Safe Harbour from Insolvent Trading Liability

The Proposals Paper outlines two options for implementing a safe harbour.

"Model A" closely follows the Commission's recommendation in the Report that, to limit the prospect of abuse to the detriment of a company's creditors, directors should be able to invoke a safe harbour defence from insolvent trading only if they are diligently implementing a restructuring plan created by an insolvency and turnaround adviser appointed by the company.

Under Model A, directors will not face liability for insolvent trading if they have a reasonable expectation, based on advice provided by an experienced, qualified and informed restructuring adviser, that the company can be returned to solvency within a reasonable period of time and they are taking reasonable steps to ensure it does so (for example, by putting in place the steps recommended by the adviser in a restructuring plan).

So that the restructuring adviser can make an informed assessment of the company's future viability, Model A requires directors to provide the adviser with up-to-date books and records reflecting the company's transactions and financial position.

To enable it to refine Model A in greater detail, the Government is seeking public views on matters including:

- The qualifications and experience expected of a restructuring adviser, including the level of professional accreditation required;
- The factors that should be taken into account by a restructuring adviser in determining whether a company is viable;
- The nature of a restructuring adviser's role and the protections from personal liability that should be available to an adviser; and
- The circumstances where the safe harbour defence should not be available—for example, in cases where a director has previously breached his or her duties to the detriment of creditors or where a company has not complied with its obligations to pay taxes or employee entitlements.

In contrast to Model A, "Model B" adopts a far more flexible approach to director liability. It does not require directors to appoint a restructuring adviser to avoid liability for insolvent trading, and it implements the safe harbour as a "carve out" from the primary definition of insolvent trading in section 588G of the Act rather than as a defence to insolvent trading.

Specifically, under Model B, section 588G of the Act will be taken not to apply where:

- A debt is incurred as part of reasonable steps taken by directors to maintain or return a company to solvency within a reasonable period of time;
- Directors hold the honest and reasonable belief that the incursion of the debt is in the best interests of the company and its creditors as a whole; and
- The incursion of the debt does not materially increase the risk of serious loss to creditors.

Model B has the benefit of encouraging greater collaboration between directors and the full range of a company's creditors in circumstances of financial difficulty, with the Government noting in the Proposals Paper that early engagement with creditors and other corporate stakeholders would form part of the Court's consideration of whether directors have taken "reasonable steps" to maintain or return a company to solvency. While it is indicated in the Proposals Paper that the appointment of a restructuring adviser will also be a relevant factor for the Court to consider in that regard, Model B avoids the development of a formulaic "one size fits all" approach that requires the appointment of a restructuring adviser in all cases for the safe harbour to be validly invoked.

Ipso Facto Clauses

In their most basic form, "ipso facto" contractual clauses enable a party, such as a supplier or a financier, to terminate a contract with a company if the company experiences an "insolvency event", which is usually defined in the relevant contract to include the appointment of a liquidator, receiver or voluntary administrator; a company's negotiation of a scheme of arrangement; and/or a company's technical insolvency under section 95A of the Act.

To maximise the potential for a company or its business to be revived, the Commission recommended in the Report that ipso facto clauses should be unenforceable during voluntary administration or the negotiation of a scheme of arrangement.

The Proposals Paper adopts this recommendation, while also including the appointment of a receiver and a company's entry into a deed of company arrangement within the circumstances where an ipso facto clause allowing termination of a contract will be void. However, the Government intends to exclude "prescribed financial contracts" (which may potentially cover swaps, derivatives and closeout netting contracts) from the restriction on the enforcement of ipso facto clauses. It is also proposed to allow individual suppliers and creditors to apply to the Court for permission to terminate a contract if they have suffered particular hardship.

Notably, the Proposals Paper does not contemplate that the ipso facto enforcement restriction will apply where a company is pursuing an *informal* restructuring attempt outside the control of an external administrator—that is, in the circumstances contemplated in Model A and Model B of the proposed safe harbour provisions. That is a significant omission because, while a safe harbour is likely to increase the willingness of directors to pursue a workout attempt in the interests of creditors instead of prematurely appointing a voluntary administrator, it cannot be assumed that all creditors will wish to cooperate in an informal restructuring attempt. If a key creditor or supplier seeks to withdraw its support for a company by terminating its contract with the company, the prospect of the restructuring attempt being successful will be compromised.

In the Proposals Paper, the Government seeks input on the appropriateness of the ipso facto reforms, including whether contractual clauses allowing a party to enforce rights *other than termination* upon the occurrence of an insolvency event, such as payment acceleration or the requirement for additional security, should also be void.

In that regard, more extensive enforcement restrictions are currently included in the United States reorganisation process in Chapter 11 of the *Bankruptcy Code* ("Code"). For example, section 363(l) of the Code prevents a counterparty from forfeiting, modifying or terminating a company's interest in a contract for the use, sale or lease of property based on the company's insolvency or financial condition (including the commencement of a Chapter 11 case), while sections 365(e) and 365(f) of the Code prevent counterparties from restricting the assignment of, terminating or modifying executory contracts or unexpired leases in those circumstances. Even more broadly, the Code provides for a suspension of the enforcement rights of secured creditors during the pendency of a Chapter 11 case as long as such creditors are provided with "adequate protection" of their interests. It is also possible for a Chapter 11 reorganisation plan to override the enforcement rights of secured creditors (the so-called "cramdown" mechanism) as long as, among other things, the treatment of such creditors' claims under the plan is "fair and equitable".

While broader enforcement restrictions, outside the exercise of termination rights, would increase the incidence of corporate and business rescue in Australia, the Government would need to ensure that any such restrictions still leave creditors with sufficient avenues to protect their interests in the event of insolvency—for example, by employing "adequate protection" and "fair and equitable" concepts similar to those adopted in the United States. Failure to do so may significantly increase the cost and/or reduce the supply of credit for companies, to the detriment of employees, other corporate stakeholders and the economy more broadly.

A Broader Move to a Chapter 11 Process in Australia?

In the Report, the Commission recommended against the wholesale adoption of a Chapter 11 restructuring framework in Australia, indicating that the excessive costs and delays, as well as cultural differences between Australia and the United States, would make that option unpalatable to the Australian public. Nevertheless, the Commission recognised the merit in further investigating the use of "certain components" of the Chapter 11 process to advance corporate and business rescue in Australia. The Commission's recommendations in that regard are consistent with previous recommendations made by the Government's Financial System Inquiry and the Senate Economics References Committee's ASIC Inquiry in 2014.

While the Proposals Paper does not specifically refer to Chapter 11 and, apart from the possible extension of the proposed ipso facto moratorium, does not indicate any movement toward features coextensive with the Chapter 11 process, it is hoped that the Government will explore the Commission's recommendations in further detail in future years.

Next Steps in the Reform Process

While the intended insolvency law reforms are long overdue, it is suggested that Model B of the proposed safe harbour provisions may be more preferable than Model A because of Model B's flexibility and the likelihood that it will encourage greater involvement of creditors in a collective informal workout attempt. The appointment of a restructuring adviser as a precondition to the operation of a safe harbour for directors may not be appropriate every time a restructuring attempt is contemplated and risks a nonconsultative process that excludes or limits creditor involvement.

Further, to enhance the likelihood of a collective creditor process and an ultimately successful restructuring attempt, the Government should consider extending the ipso facto enforcement restriction to circumstances where directors are pursuing a workout in the manner contemplated by the proposed safe harbour provisions. Broader enforcement restrictions similar to those which apply under the Chapter 11 process in the United States also warrant further investigation.

Public submissions on the Proposals Paper close on 27 May 2016. With the Federal election due on 2 July 2016, it is hoped that the new Government continues diligently to progress the insolvency reforms by preparing draft legislation and actively engaging with stakeholders in what would appear to be the most significant adjustment to Australia's insolvency landscape in the last decade.

Lawyer Contacts

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