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Briefing note May 2016

Australia's shifting insolvency regime

In April 2016, the Australian Treasury Department released a Proposals Paper setting out proposals directed at improving the Australian insolvency framework consistent with the goals flagged in the Commonwealth Government's National Innovation and Science Agenda.

The proposals are said to be aimed at promoting entrepreneurship and business turnaround by ameliorating the impact of financial distress and include:

- the creation of a "safe harbour" from insolvent trading liability for directors;
- amendments to the law to make "ipso facto" clauses (which permit contract variation or termination upon insolvency of a counterparty) unenforceable if a company is restructuring; and
- a reduction of the default personal bankruptcy period from three years to one year.

> ***"If I owe you a pound, I have a problem; but if I owe you a million, the problem is yours"***
>
> John Maynard Keynes

Financiers, suppliers and investors need to consider the impact of the proposals.

Overview

In this briefing note we look at two of the main proposals for law reform to Australia's insolvency regime, the "safe harbour" and "ipso facto" proposals, and list a few practical considerations.

Safe harbour protection

Under sections 588G and 588M of the *Corporations Act* 2001 (the Act), a director can be made personally liable for unsecured debts incurred by the company if the company is, or if by incurring the debt becomes, insolvent and there are reasonable grounds for suspecting that the company is or would become insolvent at the time.

The Government is considering two options for a "safe harbour" to promote business rehabilitation and encourage entrepreneurship.

The first proposal is a defence to liability under section 588G of the Act that would apply if at the time the debt was incurred a reasonable director would have an expectation, based on advice from an appropriately experienced, qualified and informed "restructuring advisor" that the company could be returned to solvency within a reasonable time period and the director takes reasonable steps to ensure it does so.

The defence would apply where a "restructuring advisor" is appointed, provided with the appropriate books and records of the company and is and remains of the opinion that the company can avoid insolvent liquidation and be returned to solvency within a reasonable period of time. The Proposals Paper states that companies would not need to disclose they are operating in a "safe harbour", but would still be subject to existing disclosure obligations.

The second proposed model of a "safe harbour" is an exception to section 588G of the Act that would apply where the debt was incurred as part of reasonable steps to maintain or return the company to solvency within a reasonable period of time and the director 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 incurring the debt did not materially increase the risk of serious loss to creditors. Early engagement with stakeholders and appointment of restructuring advisors are examples of "reasonable steps" that would be taken into consideration in this regard.

Ipso facto clauses

"Ipso facto" clauses generally permit a contracting party to vary or terminate a contact (among other actions) where an "insolvency event" occurs in relation to the counterparty. Such clauses are boilerplate in contracts in many industries such as banking and construction, where "insolvency event" is typically defined far more broadly than simply an external appointment (e.g. a receiver).

The Proposals Paper records the Government's intention to make these clauses void as it is considered that such clauses diminish the value of a business entering insolvency and may reduce the scope for restructuring. It also records an intention to include an anti-avoidance mechanism so that any clause which would have a similar effect would likewise be void. An "insolvency event" is not fully defined in the Proposals Paper - however, it is clear that it will include the appointment of an external controller. Other grounds for amendment or termination, including non-payment or non-performance of an obligation, will not be affected.

The Government has invited comments from the public as to whether other specific instances of the operation of "ipso facto" clauses should be void, including the acceleration of payments or imposition of new arrangements for payment and, importantly, whether any legislation should have a retrospective effect.

Finally, the Proposals Paper states that some 'prescribed financial contracts', for example swaps and certain derivatives, will be carved out from the proposed changes and seeks feedback on classes of contract that should be excluded in this regard. The Government is also considering including provisions to enable affected parties to apply to court to vary contractual terms if they can show that they have suffered hardship.

Practical considerations

Whilst the outcome of the Federal Election on 2 July 2016 may impact the detail and progress of the proposals, the business community nevertheless has been given an outline of the current Government's intentions. There has been long-time support for these changes from insolvency experts favouring a shift to a more US-style regime with its greater emphasis on preserving business value rather than individual rights. "Ipso facto" clauses are already outlawed or curtailed in other jurisdictions, including the US, France, Germany and Sweden. With limited exceptions mainly related to suppliers, the UK still permits such clauses.

Whilst beneficial for turnarounds, the impact of the proposed changes on third parties remains to be seen. For example, financiers will question the cost of lending in circumstances where their rights as secured creditors are diminished. Organisations should now consider:

- Ensuring major contracts contain a broad range of robust rights permitting variation or termination for key events that may continue to provide protection and operate if "ipso facto" clauses are made void. While the foreshadowed anti-avoidance provisions may prohibit reliance on some of these clauses, this will depend upon the scope of the new laws and judicial interpretation - careful drafting of robust alternative rights may survive.
- Using flexible payment terms for supply contracts rather than fixed payment terms, although whether shortening of payment periods and other credit tightening strategies will remain enforceable will depend on the terms of the individual contract and the proposed new laws.
- Angel investors and other early debt providers as well as those dealing with stressed and distressed counterparties should be aware that whichever "safe harbour" model is implemented, risk taking is likely to increase in the start-up and restructuring space. It may be appropriate to consider incorporating specialised reporting covenants and other monitoring rights in finance documentation.

Key Issues

- Australia is considering amendments to legislation to create a "safe harbour" for directors from insolvent trading liability and to void "ipso facto" clauses allowing for contract termination or variation where a counterparty suffers an "insolvency event".
- The proposal is to introduce the changes to the law in mid-2017.
- Affected parties should have regard to these changes when negotiating contracts now.

Public consultation

The Government is currently seeking feedback on the Proposals Paper (accessible here). Feedback received will inform further policy development.

Please reach out to our key contacts if you wish to discuss any issues.

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