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26 May 2016

Dear Sir or Madam,

**Submission in response to the Treasury ‘National Innovation and Science Agenda – Improving bankruptcy and insolvency laws’**

This is a joint submission by the Insolvency and Reconstruction Committee and the Corporations Committee of the Business Law Section of the Law Council of Australia (‘the Committees’) in response to the release of the Treasury Discussion Paper ‘National Innovation and Science Agenda – Improving bankruptcy and insolvency laws’ on 29 April 2016 (the ‘Discussion Paper’).

**Summary**

While we would prefer to see a more significant modification of insolvent trading laws, the Committees strongly support Model B.

We prefer Model B over Model A, due to the need to increase the confidence of boards and to encourage them to take good faith steps to restructure companies. We think the proposed “carve out” will be a simpler way to address the issue and will instill more confidence than a defence, because it minimises the likelihood of litigation and calls upon insurance policies.

We recommend that some aspects of Model A be incorporated into either regulations or regulatory guidance relating to Model B to clarify the meaning of “reasonable steps” and to require the appointment of a registered restructuring advisor.

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## **Introduction**

We welcome the opportunity to comment on the proposals set out in the Discussion Paper issued on 29 April 2016. The consideration of amendments to encourage and facilitate restructuring and to reduce the stigma attached to business financial distress and failure are measures that our Committees have been advocating for several years through Senate Economics References Committees, the Financial System Inquiry and in response to the Treasury Discussion Paper 'Insolvent Trading: A Safe Harbour for Reorganisation Attempts Outside of External Administration' in 2010.

In our view, the need for these reforms is long overdue and we welcome the opportunity to contribute our views for consideration on the final form of the amendments through this submission.

### ***Comments on the insolvency regime***

#### ***Support for the cultural shift***

The Discussion Paper raises three topics for potential reform arising from the 'culture and capital' part of the Innovation and Science Agenda released on 7 December 2015. They aim to drive a 'cultural shift' from penalising and stigmatising failure to providing a 'better balance between encouraging entrepreneurship and protecting creditors. We fully support this change in emphasis.

The public discourse concerning Australian insolvency law is frequently one of blame and punishment, emphasising widespread dissatisfaction from creditors and other key stakeholders. One factor contributing to this feeling of frustration is that the vast majority of businesses enter external administration with few or no assets.

A widely held belief among insolvency practitioners and business advisors is that businesses enter external administration too late when little can be done to save the business. If business people could be encouraged to be pro-active and to seek and act on advice earlier this would provide more flexible options for saving the business. However, business people are reluctant to seek help in part due to the stigma of insolvency and failure. The Innovation Statement and the reforms proposed in this Discussion Paper will go a considerable way to reframing the dialogue to focus on positive efforts to restructure and rescue distressed businesses.

Directors should not face personal liability

The current liability framework imposed on company directors by federal, state and territory laws is too harsh in imposing personal liability for good faith business decisions. This stifles entrepreneurial risk taking and causes boards to focus too much on compliance and legal risk management instead of strategic oversight of operational decision-making.

It is the experience of many members of the committees that business people are reluctant to take on board positions because of the risks of personal liability, including for insolvent trading.

In our view, insolvent trading imposes liability on directors which is much too strict in the instance where directors try to avoid the company's insolvency by engaging in good faith restructuring efforts. In doing so, these directors may face potentially significant personal liability for all unsecured debts incurred by the company during the restructuring. If the restructuring efforts fail and the company eventually enters liquidation, a liquidator or a creditor may seek to take action against the directors, not because of any culpable or reckless behaviour, but because they were directors who allowed the company to continue trading during a time when it was insolvent.<sup>1</sup> Accordingly, the directors may be inclined to put the company into voluntary administration as a precautionary measure to avoid that personal liability or to resign from their position rather than participate in restructuring efforts.

We note our fundamental objection to the current insolvent trading liability framework, which overly penalises directors for not shutting down the business at the first suspicion of insolvency. We support the repeal of Pt 5.7B, Divisions 3 and 4 of the *Corporations Act 2001* (Cth) (the **Act**).

The insolvent trading regime was introduced in the 1960s at a time when the liability framework for company directors was much different, and expectations much lower, than today. In our view, the exponential rise in personal liability risks for company directors, together with the more comprehensive disclosure framework in place for companies, renders insolvent trading unnecessary and fundamentally unhelpful. Insolvent trading sets the wrong incentives for directors of companies entering financial distress, which is the incentive to either close the business or resign. This is counter-productive to the principles underpinning the Innovation Statement.

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<sup>1</sup> See, for example, *McLellan, in the matter of The Stake Man Pty Ltd v Carroll* [2009] FCA 1415.

Australia's insolvent trading laws are widely recognised as being some of the harshest in the world. Amendments to recognise the value of good faith restructuring efforts by providing protection to directors, within reasonable limits, to encourage them to participate in good faith efforts to rescue the business will help bring Australian laws into line with other developed economies. While we wish to state that our preferred approach is to repeal insolvent trading, we accept that this was not raised by the Discussion Paper and we respond to the Paper below.

#### *Defence of good faith restructuring*

Attempting a restructure (or 'workout') in good faith is currently not recognised as a defence to insolvent trading under section 588H of the Act. Indeed, courts recognise that directors can act honestly and reasonably in trying to save the company but nonetheless breach insolvent trading laws.<sup>2</sup>

#### *Preference for Model B*

The Treasury Discussion Paper has raised two potential models (Model A and Model B). Model A represents a safe harbour defence for directors who engage in good faith restructuring efforts while Model B represents a carve out for good faith restructuring. **The Committees strongly support Model B**, but recommend that some aspects of Model A be incorporated into either regulations or regulatory guidance to clarify what reasonable steps may involve and to require the appointment of a registered restructuring advisor.

We favour the Model B instead of the proposed defence to increase directors' confidence that if their restructuring efforts fail, and they act in good faith and seek out and act upon appropriate professional advice, then they will be protected from insolvent trading. Accordingly, the directors will be more inclined to endeavour to undertake the restructure.

#### *Model A*

The introduction of Model A would add to the existing defences in s 588H.

Providing a defence will involve the directors needing to establish the elements after a claim under s 588G has already been proven against them. In our view, adding a defence will not provide sufficient confidence to encourage directors to participate in good faith restructuring efforts because the risk of litigation under s 588G remains.

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<sup>2</sup> Ibid.

As one respondent to the Treasury's survey of directors in 2008 noted: "I don't feel as if my actions will put me at ultimate risk but I may lose 5 years of my life proving it."

Furthermore, Model A (in our view) involves too many elements for directors to prove.

### Model B

We favour Model B because it offers a simpler and more streamlined approach that will provide clarity for directors when participating in good faith restructuring. We recommend that some (but not all) elements of Model A be incorporated into Model B to ensure that the provision provides clear guidance to directors during restructuring efforts.

The introduction of a defence to address director concerns about challenges to good faith business decisions in the form of the statutory business judgment rule in section 180(2) of the Act has been roundly criticised for failing to fulfill its purpose. In our view, the introduction of a safe harbour defence will produce a similar outcome.

Directors who are concerned about the risk of litigation for insolvent trading will be reluctant to engage in good faith restructuring efforts. This may cause more companies to be put into voluntary administration earlier than necessary (to take advantage of the existing defence to insolvent trading in s 588H(5)) or more directors simply resigning from their boards to eliminate the risk altogether.

Neither outcome supports effective restructuring efforts and in our view Model B should be the preferred approach because it will provide an effective presumption against liability, which a liquidator (or creditor) will need to overcome in order to pursue insolvent trading claims. Those who act consistently within the carve out can be confident that they are far less likely to be sued and hence may be more likely to continue to assist with good faith restructuring.

### Bankruptcy period

Reducing the default period of bankruptcy and addressing some of the punitive aspects of bankruptcy will also assist in helping to reduce the stigma of business failure. However, we recommend that the measure be targeted to business-related bankruptcy and not to the vast majority of personal bankruptcies being consumer bankruptcies.

There are different policy considerations between business and consumer bankruptcy that may justify a more nuanced approach to reducing the term of bankruptcy to a default of one year. Although the Committees have some concerns about the practical operation of this measure, which are outlined below, we are supportive of trying to reduce bankruptcy

stigma provided the operation of the new provisions can be practically managed in a way that will ensure bankrupts and former bankrupts will comply with their legal obligations so as to protect creditor interests and discourage reckless credit behaviour.

### *Ipsa facto clauses*

The third element of the Discussion Paper is to address the significant adverse commercial effects of contractual clauses that allow for termination or variation of the contract due to insolvency or external administration of a party to the contract. These clauses are referred to as 'ipso facto clauses' because they operate automatically and this can have the effect of severely limiting restructuring options.

Ipsa facto clauses can effectively destroy the value of an otherwise viable business and thereby result in lower returns to creditors and increasing dissatisfaction with the insolvency process.

We have long advocated for reform of ipso facto clauses and strongly support this initiative, although we have some suggestions for consideration regarding the operation of the provision, discussed below. Introducing this reform will significantly assist the use of external administration procedures (such as voluntary administration) to restructure and rescue companies entering financial difficulties.

### **Specific comments**

In this section we provide our comments on the specific questions asked in the Discussion Paper.

### **Reducing personal bankruptcy**

#### Query 1.1

The overall objective of the proposals is to encourage innovation and entrepreneurship. The vast majority of bankruptcies arise from consumer debt and non-business related reasons. Approximately 20% of bankruptcies for the year ended 30 June 2015 were business related (19% for year ended 30 June 2014).<sup>3</sup> These statistics rely upon the reasons for bankruptcy given by a bankrupt in their statement of affairs. It is reasonable to assume the actual proportion of business bankruptcies would be smaller than reported because of the reluctance to admit personal circumstances as the reason for the bankruptcy.

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<sup>3</sup> Source: [www.afsa.gov.au/resources/statistics](http://www.afsa.gov.au/resources/statistics).

Having regard to the above objective to encourage innovation and entrepreneurship the discharge from bankruptcy after one year should only apply to bankruptcies that were directly resulted from or substantially resulted from the failure of a business that commenced within the previous 5 years of the date of bankruptcy. This is a reasonable period for the business to test its viability.

Many overseas jurisdictions distinguish between consumer bankruptcies and bankruptcies that are the result of business activity.<sup>4</sup>

It will be the responsibility of the bankrupt to provide evidence to the trustee that these circumstances permitting early discharge would apply to them. The trustee will be required to make a decision in respect of the early discharge of bankrupt within a certain period of time. If a bankrupt is not satisfied with the decision of the trustee the decision will be subject to review by the Inspector General in Bankruptcy as is currently in case with objections to discharge. The bankrupt may then appeal to the AAT or the Federal Court as is currently the case with objections to discharge.

The trustee must also be satisfied there are satisfactory arrangements in place to satisfy the obligations of compulsory income contributions for the following two years.

There is also the issue of the treatment of after acquired property. There will need to be a carve out for inheritances and winnings derived within the two years after the early discharge.

There will also have to be obligations on the former bankrupt to provide information to the trustee in bankruptcy as required to assist in the administration of the bankrupt estate during the subsequent 2 years. (See Query 1.2 below). We note the comments made in the ARITA submission to this Discussion Paper and add our support to those recommendations on this matter.

#### Query 1.2.1a

The Committees question whether, if obligations still continue after the one -year period, would that mean that a former bankrupt is an “insolvent under administration”?

This will be less of an issue if early discharge only applies to less than 20% of bankruptcies. Information required will be in respect of compulsory income contributions and certain after acquired property, namely winnings and inheritances. There will also

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<sup>4</sup> INSOL International, *Consumer Debt Report II, Report of Findings and Recommendations* (2011), 3.

need to be a general obligation to provide information to a trustee in respect of the administration of the bankrupt estate.

It is necessary to have these post early discharge obligations because otherwise there would be fewer funds available in the estate for distribution to creditors and to meet the costs of the administration of the estate. Without these on-going obligations there would be less funds available from the Estate Interest Charge and Asset Realisation Charge, which is paid from the bankrupt estates to the Commonwealth to meet the costs of AFSA.

Query 1.2.1b

The Committees express concern about the practical logistics of how this will work. Currently, the main way to require bankrupts to comply is the "threat" of an objection to discharge and an extension of the bankruptcy. This would not apply to bankrupts where there has been an early discharge. The Committees are concerned about the apparent contradiction of the label of bankrupt ending after one year, but the obligations of bankruptcy extend beyond one year. The Committees are also concerned about how far the obligations will extend: is this just for income contributions or other obligations of bankrupts as well?

Failure to comply with the post early discharge obligations would be an offence subject to the existing Infringement Notice system in the Bankruptcy Act. The process of issuing warnings, infringement notices and follow up enforcement will require additional resources in the Enforcement area of AFSA.

Another incentive could be to extend automatic disqualification from managing a corporation (section 206B of the Act) to people who have outstanding notices to provide information to a trustee in bankruptcy where those outstanding notices have been outstanding for more than one month. ASIC could add those persons to the disqualified persons register on receipt of evidence from the trustee of the outstanding notice. The trustee could have an obligation to advise ASIC that the notice has been satisfied and ASIC will remove the person from the disqualified persons register. The person may refer the notice from the trustee to the Inspector General in Bankruptcy for review.

These proposed arrangements are consistent with the automatic disqualification that applies to a person subject to a composition under section 73 of the Bankruptcy Act, whereby the bankruptcy is annulled but the debtor has ongoing obligations.



Failure to comply with the post-bankruptcy obligations can mean that the “obligation period” is extended for a further three or five years in a similar way to the current extension of the period of bankruptcy. The period could be automatically extended as long as there are outstanding obligations that have been outstanding for more than a month. A trustee could be expressly empowered to require a security bond to assist with compliance with post-bankruptcy obligations. The security bond would be automatically released to the estate for distribution in the normal course if there are outstanding obligations after service of the requirements on the discharged bankrupt or their nominee for service if they are overseas. The requirement for and size of the bond can be subject to review by the Inspector General.

We note the comments made in the ARITA submission to this Discussion Paper and add our support to those recommendations on this matter.

Proposal 1.2.2

Retaining a longer period of income contributions may result in greater returns to creditors if bankrupts are able to earn increased income following the termination of their bankruptcy. We repeat our concerns about enforcement of this obligation once formal bankruptcy has ended.

Query 1.3.1a

This seems to flow as a natural consequence of the proposed reduction of bankruptcy to one year.

Query 1.3.1b

The Committees have no comment in response to this query.

Query 1.3.1

The Committees are of the view that it would not be appropriate to reduce the retention period for personal insolvency information in credit reports. The debtor should be entitled to make submissions of a certain length providing explanations and they should be available as part of credit reporting.

Query 1.3.2

The restriction on overseas travel will not be necessary in the case of a debtor subject to early discharge because it will be a requirement for early discharge that suitable arrangements are in place to ensure they comply with their ongoing obligations. One of

the ongoing obligations will be the requirement to provide current contact details to the trustee including an address and contact person in Australia who will accept service of notices.

A trustee could also be expressly empowered to require a security bond to assist with compliance with post-bankruptcy obligations. The security bond would be automatically be released to the estate for distribution in the normal course if there are outstanding obligations after service of the requirements on the discharged bankrupt or their nominee for service if they are overseas. The requirement for and size of the bond can be subject to review by the Inspector General.

The Committees also query what is meant by “subject to any extension for misconduct”. Presumably that is referring to ‘subject to extension of the bankruptcy period’. The period of the travel restriction should be the same as the period of bankruptcy (that is, 1 year in the case of early discharge or three years unless extended). The proposal set out in the Committee's submission is that it will be one of the pre-conditions of early discharge that suitable arrangements are in place to ensure that the former bankrupt complies with their ongoing obligations, if any.

### **Safe harbour for insolvent trading**

#### Query 2.2

The Committees strongly favour Model B rather than Model A for reasons discussed above. If Model A were chosen as the preferred reform then we have a number of suggestions and comments outlined below under the specific queries.

#### Query 2.2.1a and 2.2.1b

While the Committees support the need to appoint a restructuring advisor, we suggest that there be an ability to appoint a restructuring advisor who can act in a number of capacities, and not solely as a restructuring advisor.

In our experience, companies will often appoint consultants to advise them on a range of strategic matters. It is possible to appoint a restructuring advisor who brings a variety of capabilities to the role, which can include restructuring advice.

If the role were restricted to restructuring advice only we believe this would send a negative signal to creditors and to the broader market and may trigger the need to publicly disclose this (for disclosing entities under the Act) which could reduce confidence in the future of the business and frustrate viable restructuring efforts.

In short, appointing a person designated 'restructuring advisor' would be likely to send a negative signal to the market that the company is insolvent or likely to become insolvent. Changing the public perception of good faith restructuring efforts will be enhanced if a restructuring advisor could be appointed for a full range of professional advice. This would also provide a more comprehensive response to the company's financial challenges.

The Committees support the need for restructuring advisors to have appropriate levels of experience, qualifications and to be members of a recognised professional association. The Committees recommend that a current membership (including a current practising certificate if applicable to that profession) be an essential and ongoing requirement. We support the comments made in the ARITA submission to this Discussion Paper on the need for restructuring advisors to have appropriate levels of experience and qualifications and to be members of professional associations with appropriate frameworks for ethics, professional conduct, discipline and education.

The three bullet points listed on page 12 are a minimum. The Committees note that some professional associations have membership and disciplinary procedures approved and administered by foreign bodies. Query whether members of those associations only should be included in the list of acceptable restructuring advisors.

The Committees do not support the limitation of restructuring advisors to registered company liquidators only as there are other professional backgrounds such as law, banking and finance that may provide appropriate skills and knowledge to fulfill the role of a registered restructuring advisor.

The Committees strongly advocate that ASIC should maintain a register of restructuring advisors and require inclusion on that register as an essential element of the defence.

We also recommend that ASIC should produce regulatory guidance as to what qualifications and experience are needed for inclusion in the register and what circumstances (such as prior offences or disqualification from professional associations) may warrant a person being prevented from registering as a restructuring advisor. ASIC registration should also require the maintenance of professional indemnity insurance and risk management systems, similar to requirements for AFSL holders.

Requiring ASIC registration and current membership of a recognised professional association assist in addressing community and business concerns about pre-insolvency advisors and their potential adverse influence on restructuring efforts.

Query 2.2.1c

The proposal refers to whether the company is viable. The Committees have concerns about allowing directors to trade plainly insolvent companies where there is little chance of returning the company to solvency. Therefore, we do not recommend a test of viability that allows for a de facto liquidation.

We recommend that the test of viability be referenced to this formulation:

*‘the director knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation’.*

This is the formulation used in the UK wrongful trading provision (Insolvency Act 1986 (UK) s 214(2)(b)). We believe that this provides sufficient flexibility to support good faith restructuring efforts but also makes it clear that directors should not be trading plainly insolvent businesses, with little or no prospect of restructuring them to a position of future solvency.

This standard would be the reference point for the restructuring advisor’s advice on the restructuring proposal. That is, the restructuring advisor’s report must allow the directors to believe that the company has reasonable prospects of avoiding insolvent liquidation. The Committees suggest that this should be included in the legislation and further emphasised in any regulatory guidance on what would be in the best interests of creditors and what would not materially increase the risk of serious loss to creditors under Model B.

Query 2.2.1d

The members of the Committees have not reached clear consensus on whether there should be a specific set of factors enshrined in legislation or in regulatory guidance or whether this should be left to the discretion of the advisor (framed by the two dot points listed on page 12).

The Committees support the benchmark of serious loss to creditors, although note that this needs to be assessed at the time of the decision to enter into the restructuring and not established merely by the fact that a restructuring has failed and creditor losses have increased.

Disputes are likely to arise concerning whether advice given by a person is restructuring advice for the purposes of the safe harbour. This has occurred in relation to cases where the existing defence against insolvent trading under s 588H(3) (reliance on advice about solvency) has occurred. Courts have been reluctant to find that a professional providing

advice on solvency as part of a diverse range of services qualified as advice under s 588H(3).<sup>5</sup> This is one reason why the Committees advocate Model B as the preferred option.

Query 2.2.1e

The Committees generally support the measures outlined on page 13. However, we note that the proposed carve out of the definition of director seems to assume that the restructuring advisor could be acting other than in the capacity as a professional advisor. We assume that restructuring advisors will not take on operational roles and would only give advice as professionals and so would come within the existing carve out in s9.

The retention of the prospect of the advisor being characterised as a shadow director is a means of incentivising the advisor not to stray beyond the boundaries of appropriate activity (i.e. providing advice that enables the directors to decide how to steer the company, not taking the tiller personally).

We support the requirement that restructuring advisors act according to high ethical and legal standards. We do however query the need for restructuring advisors to report to ASIC given they are not to be officers of the company and will owe duties to the company. Reporting of potential offences and contraventions will be undertaken by an insolvency practitioner if one is appointed. Of course, restructuring advisors will be bound by their professional codes of ethics and professional conduct rules to not advise on conduct that would contravene the law. Requiring restructuring advisors to be registered with ASIC will also provide an additional layer of regulatory supervision.

Query 2.2.2a

The Committees generally support this approach but we strongly recommend expanding the defence to cover ss 181-183, but only to the extent that the duties could be contravened by conduct that would constitute insolvent trading.

The potential for directors to be found to be in breach of their fiduciary duties to consider creditor interests by undertaking a restructuring, as occurred in the long-running Bell litigation, looms large over restructuring efforts. If the Government wishes to encourage and support restructuring by introducing a safe harbour defence to insolvent trading then this needs to extend to any existing duty to consider creditors, otherwise the threat of

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<sup>5</sup> See for example, *McLellan, in the matter of The Stake Man Pty Ltd v Carroll* [2009] FCA 1415.

personal liability for advisors and other third parties will continue to hinder restructuring efforts.

Query 2.2.2b

The Treasury paper presents a “non-position” with which the Committees agree. The Committees agree that issues of disclosure for public entities is best left to the companies and their management to determine rather than requiring public disclosure of the appointment of a restructuring adviser.

It will be important that any defence does not require a specific action that would require disclosure such as lodging a notice with ASIC. As noted above, it will be important to allow flexibility in the appointment so that a strategic advisor (if registered as a restructuring advisor) could also provide restructuring advice sufficient to satisfy the defence. It is possible that appointing a strategic advisor may not trigger continuous disclosure obligations due to the operation of the carve out provisions in the ASX Listing Rules, but it is best left to companies to determine whether the restructuring advice requires disclosure to the market on a case-by-case basis in accordance with the existing rules.

If the intention is to give directors confidence to attempt to restructure, then it would be useful for the legislation (or regulatory guidance) to note explicitly that the mere appointment of a restructuring advisor does not of itself necessarily require disclosure to the market under continuous disclosure laws (although in the circumstances of a particular company, disclosure of that fact may well be required).

Query 2.2.3

The Committees do not support the proposals contained in [2.2.3]. We strongly urge that ASIC should not have power to determine when a person cannot rely on the defence. This would add a cloud of uncertainty to the application of the defence that limits its value. Courts and not regulatory agencies must address compliance with the law.

Allowing the discretion to selectively apply the defence ex-post would fundamentally undermine the reason for including the defence – that is, to give directors more confidence to restructure and save the company and its business. Issues such as this are another reason that the Committees favour Model B over Model A. As for disqualified persons, taking part in the management of corporations while disqualified from doing so is already a criminal offence under s 206A of the Act.

As to the implications of failing to comply with certain reporting obligations, the Committees are concerned that adding too many requirements to the safe harbour will mean that it is rarely used. There may be viable companies that are appropriate restructuring candidates, but which have poor internal information and accounting processes that can be fixed by obtaining and implementing good professional advice. Such companies should be eligible for the safe harbour.

Query 2.3

The Committees strongly recommend the implementation of Model B over Model A. We believe that Proposal 2.3 provides a sufficiently flexible mechanism that will greatly assist with restructuring efforts and remove the current disincentive for directors to participate and support business restructuring.

We also support the value of clarifying further the elements of the carve out (Proposal 2.3), including what may constitute reasonable steps (para (a)) and what evidence can be used to support an honest and reasonable belief (para (b)). This could be done by including relevant factors in the Corporations Regulations or by the formulation of a Regulatory Guide by ASIC.

We strongly support Proposal 2.3 being a true presumption against liability/carve out, with the liquidator or creditor applicant having the onus of disproving the elements. This will give directors the confidence that their good faith and reasonable restructuring efforts are unlikely to attract insolvent trading liability.

One of the problems with Model A is that it is a defence that must be established by the directors after having been found liable for insolvent trading. This exposes them to protracted litigation risk even if they can establish the defence.

As to the wording of the proposed Model B reform we make the following comments.

*Paragraph (a)*

We are concerned that the proposed wording (if the debt was incurred) will require a time consuming analysis of each specific debt to determine if the carve out applies. This formulation could also allow a liquidator or creditor to focus on a 'debt by debt' analysis to overcome the carve out. This is unproductive and will not encourage good faith restructuring but will shift the focus to individual debt assessments that will distract management from the important task of saving the business. As noted above, we

recommend a formulation that is focused on reasonable steps to return the company to solvency. Perhaps the provision could be:

*‘if the debt was incurred at a time when the director had reasonable grounds to believe that there was a realistic prospect that the company would avoid going into insolvent liquidation within a reasonable period of time.*

*Paragraph (b)*

Our concern regarding the individual debt focus also applies here. We recommend changing the phrase ‘incurring the debt’ to ‘incurring debts’.

*Paragraph (c)*

We strongly recommend that the formulation include ‘creditors as a whole’ instead of the current focus on individual creditors. It will also be helpful to emphasise that directors who participate in good faith and viable restructuring efforts should not be penalised by identifying the mere increase of losses suffered by creditors if the restructuring deal fails. The focus should be on conduct that unreasonably increases the risk of serious loss. This is another reason that we believe that the appointment of a registered restructuring advisor is an essential element of the Model B defence because they will have the necessary skills and knowledge to help directors maintain an appropriate balance in their decision making between the prospects of a viable restructuring and the increased risk to creditors in continuing to trade the business at a time when it may be insolvent.

**Ipsa facto clauses**

Query 3.2a

The Committees strongly support the introduction of amendments to address what has been described by insolvency practitioners as the biggest issue holding back voluntary administration as a restructuring tool - the *ipsa facto* clause.

This reform is long overdue. The Committees recommend that the wording of the provision include not only termination and amendment but also variation of the operation of the contract. This would capture the imposition of higher rates of interest upon an insolvency event. The provision should also cover conditions precedent.

The Committees suggest that s 301 of the Bankruptcy Act 1966 (Cth) or the essential services provisions in section 600F of the Act could be used as a base to draft the provision.



Query 3.2b (first reference on p18)

The Committees argue that the provision should not automatically apply to existing contracts, but that a sunset/transition period could be included to give contractual parties time to adjust their contracting processes.

Query 3.2b (second reference on p18)

The Committees support the proposed insolvency events. The Committees note that, while some may question whether private receivership (as the only non-collective process on the list) should be included, we consider that including it is useful because it may remove an incentive to appoint receivers to overcome the protection if not included.

The Committees note that there are similar policy arguments supporting the extension of the protection to liquidation (as the Bankruptcy Act provision does) and notes that voluntary liquidation is now the most common form of external administration.

A voluntary liquidation can be used to restructure a business, and generally offers a lower cost for SMEs than voluntary administration, receivership or a scheme of arrangement. Furthermore, how will overlapping appointments with liquidation work if liquidation is excluded from the protection? For instance, a company enters receivership (and gains protection) but then also enters liquidation. Would the protection remain? Would it remain only if the receiver were managing the company's business? In our view, consistency and simplicity favour extending the protection to voluntary liquidation. We note the comments made in the ARITA submission to this Discussion Paper and add our support to those recommendations on this matter.

The Committees also note that scheme administrators and deed administrators do not have personal liability for debts incurred during the administration, unlike receivers and voluntary administrators. This presents an arguably unfair advantage to the deed and scheme administrators, unless a provision was included to require them to perform the company's obligations where they take advantage of the ipso facto protection.

The Committees also question whether 'insolvency event' should be confined to specific appointments, or whether it be expanded to cover terms in the contract that refer to the state of insolvency (such as not being able to pay debts as and when they become due and payable). Otherwise, a creditor could rely on the failure to pay other creditors' debts when due and payable to terminate even where an administrator is appointed. Where contractual counterparties retain insolvency linked clauses which are not based on formal

external administration appointments, then this may lead to companies being less frank with their counterparties to avoid detection of information that could trigger the default clauses.

Query 3.2.1

The Committees are of the view that this is too broad and too vague to be used as an effective anti-avoidance mechanism. The Committees support maintaining the right of a contractual counterparty to terminate or vary the contract due to performance measures not tied to an insolvency event. The policy underpinning the protection against ipso facto clauses is to not give an advantage simply based on insolvency, but if performance of the contract unrelated to an insolvency event is not fulfilled then rights to terminate or change a contract should remain.

Query 3.2.2

The Committees strongly support the need for several exceptions to the ipso facto protections. Foreign laws protecting against ipso facto clauses commonly carve out certain financial contracts (such as derivatives and other contracts that involve close out netting). The carve outs listed seem appropriate and justifiable.

The Committees query how the exclusion for 'extending further credit' will operate in practice. For instance, if a contractor is obliged to perform work under credit terms under the contractual provisions as they exist, must it continue to do so until there is some other right to terminate or can it refuse to perform further work on credit terms?

Query 3.2.3

The Committees do not support the introduction of a general court power to vary contract terms. This would strike against long held common law principles that the courts do not remake commercial bargains. Such a provision exists in Canadian legislation dealing with 'critical suppliers', but it appears to be rarely used.<sup>6</sup> The Committees support allowing a party to seek leave of the court to terminate or vary the contract as an exception to the ipso facto protection, but not to have the court vary the terms of the contract.

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<sup>6</sup> Companies' Creditors Arrangements Act 1985 (RSC) s 11.4.

If you have any questions in relation to this submission, in the first instance please contact the Chair of the Insolvency and Reconstruction Law Committee, Victoria Butler, on  
or via email:

Yours sincerely,

**Rebecca Maslen-Stannage, Acting Chair**  
Business Law Section